

**THE MEANING OF EXPENDITURE ACTUALLY INCURRED IN THE CONTEXT OF  
SHARE-BASED PAYMENTS FOR TRADING STOCK OR SERVICES RENDERED**

A mini thesis submitted in partial fulfilment of  
the requirements for the degree of

**Masters in Commerce (Taxation)**

of

**RHODES UNIVERSITY**

by

**MBULELO NGUTA**

January 2015

## Abstract

Section 11(a) of the Income Tax Act 58 of 1962 entitles taxpayers to a deduction in respect of expenditure actually incurred, provided that all the other requirements of section 11 and section 23 of the Act have been met. A company may issue its own shares, credited as fully paid up, as a payment for trading stock or services rendered, as was the case in *C:SARS v Labat Africa* (2011) 74 SATC 1. The question that was raised by this decision is whether the issue of shares constitutes “expenditure” as contemplated in section 11(a) of the Act.

It is trite that a share in a company is a bundle of rights which entitle the holder to dividends when declared and to a vote in shareholders’ meetings and that a share does not come into the hands of a shareholder by way of transfer from the company, but is rather created as a bundle of rights for him in the company. In *C: SARS v Labat Africa*, the Supreme Court of Appeal decided that to issue shares as a payment for goods is not expenditure as contemplated in section 11(a) of the Act.

The Act does not define “expenditure”. It has been interpreted in certain cases as a payment of money or disbursement, while it has been interpreted as the undertaking of a legal obligation in other cases. The *Labat Africa* case has been criticised for its interpretation of expenditure on the grounds that it is contrary to the principle that “actually incurred” does not mean “actually paid”. This research has argued that, in the context of the *Labat Africa* case, which related to an issue of shares in payment for goods, Harms AP’s judgment was concerned with showing why a share issue is not expenditure. He could not have intended to deny a deduction to transactions such as credit purchases.

## **Key words**

*Expenditure actually incurred, C: SARS v Labat Africa, share-based payments and section 11(a) of the Income Tax Act.*

## **Acknowledgments**

I will always be grateful to Professor Stack for all the patient and expert guidance. The comments were always invaluable and enlightening. I will always be grateful for all the efficient and prompt responses, including over Christmas. I am also grateful to my friend, Johnnie Jacobs, for all the help with the printing and binding. And lastly, to my mother, Nocawe Nguta, I will miss you always.

## TABLE OF CONTENTS

1.	Chapter 1 Introduction	1
1.1	Context the research	1
1.2	Research goals	3
1.3	Research methods, procedures and techniques	4
1.4	Overview of chapters	5
2.	Chapter 2 The nature of shares and share capital	6
2.1	Introduction	6
2.2	The nature of shares	7
2.3	Shares in a 'sale'	9
2.4	Carrying out a share transaction	10
2.5	Redeemable preference shares and convertible instruments	12
2.6	Conclusions	14
3.	Chapter 3 Expenditure actually incurred	16
3.1	Introduction	16
3.2	A brief history of the concept of expenditure in income tax	17
3.3	The meaning of expenditure as interpreted by the courts	19
3.4	CSARS v Labat Africa (2011) 74 SATC 1	27
3.5	The year of assessment	29
3.6	Expenditure as contrasted with payment, settlement and a discharge of liability	30
3.7	A purposive interpretation of the term "expenditure"	36
3.8	Expenditure and the <i>actually incurred</i> requirement	41
3.9	ITC 1587 (1994) 57 SATC 97 and <i>Golden Dumps</i>	44
3.10	Barter and non-cash transactions	49
3.11	Accounting treatment of expenditure	52
3.12	Actual, future and contingent liabilities	54
3.13	Conclusions	55
4.	Chapter 4 Paying with shares	58

4.1.	Introduction	58
4.2.	Paying with the issue of shares	59
4.3.	Forfeiture of the right to demand cash for shares	63
4.4.	Hybrid debt instruments	69
4.5.	Accounting treatment of distributions to equity participants	70
4.6.	Tax asymmetry	70
4.7.	Conclusions	72
5.	Chapter 5 Conclusion	75
5.1	Introduction	75
5.2	The goals of the research	75
5.2.1	The legal nature of shares and share capital	76
5.2.2	Expenditure actually incurred	77
5.2.3	Expenditure <i>versus</i> payment, discharge or settlement	79
5.2.4	The issue of shares as payment for goods or services	80
5.2.5	Conclusion – the <i>Labat Africa</i> decision	82
6.	List of references	83

## CHAPTER 1 – INTRODUCTION

### 1.1 Context of the research

In terms of the Income Tax Act 58 of 1962 (“the Act”), a taxpayer, in the present case a company, is entitled to a deduction when it expends money, or its equivalent, for the acquisition of trading stock or in payment for services rendered to it in the course of its trade, provided that all the other requirements of section 11 and section 23 of the Act are met. The preamble to section 11 and section 11(a) of the Act state as follows:

#### **11 General deductions allowed in determination of taxable income**

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

- (a) Expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature . . .

Circumstances may arise where the taxpayer, faced with cash flow problems, pays a creditor for goods or services by issuing its own shares, credited as fully paid up in favour of the creditor. In such a case, no money is actually expended and no physical asset is transferred. The value of the shares constitutes payment for the goods or services. In the company’s accounting records the entry will be a credit to share capital, thus increasing the issued share capital, and a debit against the amount owing to the creditor. In these cases, the question is whether or not an issue of the taxpayer’s own shares as a consideration for trading stock or services constitutes *expenditure*.

In *C: SARS v Labat Africa Ltd* (2011) 74 SATC 1, the Supreme Court of Appeal decided that to issue shares as a consideration for goods is not *expenditure* as contemplated in section 11(a) of the Act. The *ratio* of the court was briefly that shares, by their legal nature, cannot constitute *expenditure* because the assets of a company are not diminished when it issues its own shares as a consideration.

While the case dealt with shares issued for goods, the reasoning applies to all claims for a deduction where shares were used as a consideration (Meyerowitz: 2004). The Act does not define *expenditure* and the meaning of the term has received relatively little attention. The courts have always tended to focus on the words “actually incurred”, because there would always be an expenditure or a loss, the question being whether or not it was actually incurred, and if so, when was it actually incurred (Emslie: 2011).

The *Labat Africa* case started in the Pretoria Tax Court as *ITC 1801* (2005) 68 SATC 57 in which the Commissioner’s assessment, denying a claim for a deduction of the value of shares issued as a consideration for the acquisition of a trademark was set aside. The court came to the conclusion that *expenditure actually incurred* means that there must be an unconditional legal obligation incurred and this does not require a discharge of the obligation. The court stated that shares do constitute a consideration and it relied on the decision in *Lace Proprietary Mines Ltd v CIR* (1938) 9 SATC 349 for this finding.

*ITC 1801* came a year after a decision of the Johannesburg Tax Court in *ITC 1783* (2004) 66 SATC 373 in which Goldblatt J decided that an issue of shares does not constitute *expenditure*. Goldblatt J stated that *expenditure* means the spending of money or its equivalent and that, in an allotment of shares, nothing is spent by the taxpayer. What happens is simply the dilution of the holdings of the current shareholders. The company does not reduce its assets.

*ITC 1801* was unsuccessfully appealed to the High Court by the Commissioner. The Commissioner appealed again to the Supreme Court of Appeal. Harms AP upheld the appeal and held that *expenditure* means an action of spending funds which requires a diminution of assets or at least movement of assets. Harms AP held that a liability or obligation must be discharged by means of *expenditure*. Since the 1930s, South African courts have always maintained that *expenditure actually incurred* does not require actual payment. If it is actually incurred, then it is deductible even if paid in a later year (*PE Electric Tramway Company Ltd v CIR* (1936) 8 SATC 13; *Caltex Oil SA v SIR* (1975) 37 SATC 1). It is submitted that, with the *Labat Africa* decision, the law on *expenditure actually incurred* seems to have been turned on its head (Emslie: 2011).

## 1.2 Research goals

The research seeks to address an area of law that has not, until recently, been considered by the courts, and to contribute to the conceptual understanding of terms such as *expenditure*, *payment*, *discharge of a liability*, *incurring of a liability* and the nature of shares. The research aims to investigate the meaning of *expenditure* and the nature of share-based payments and thus address the following goals:

- a) to consider the nature of shares and share capital;
- b) to explore the meaning of *expenditure actually incurred*;
- c) to consider whether *expenditure* is different to and independent from payment or settlement, or the discharge of a liability;
- d) to investigate whether an issue of shares for trading stock or services received constitutes *expenditure* as contemplated in the Act;
- e) to consider whether the *Labat Africa* judgment was correctly decided.

## 1.3 Research methods, procedures and techniques

An interpretative research approach will be adopted for the present research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology to be applied can be described as a doctrinal research methodology. This methodology provides a systematic exposition of the rules of a particular legal category (in the present case the legal rules relating to the deductibility of shares issued in satisfaction of a liability in terms of section 11(a) of the Act), analyses the relationship between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2008).

The research is purely based on documentary data and will systematically explore and discuss the applicable legal principles and rules relating to *expenditure* and the nature of shares. The documentary sources to be used for the research are the following:

- a) legislation (mainly the Income Tax Acts and the Companies Act 71 of 2008);
- b) relevant South African case law;
- c) regulations, Interpretation Notes and Notices where applicable;
- d) relevant foreign case law;
- e) articles in accredited journals; and
- f) textbooks.

The research will be conducted in the form of an extended argument, supported by the above documentary data and material. The validity and reliability of research conclusions will be ensured by:

- a) observing the hierarchy of the sources of law in relation to their authoritative and persuasive value;
- b) adhering to the rules of statutory interpretation, as established by statute and common law;
- c) placing evidential weight on authoritative sources of law such legislation and case law, and refer to the writings of experts in the field;
- d) discussing opposing viewpoints and conclude based on the balance of credible evidence and the weight of authorities; and
- e) ensuring the rigour of arguments.

All the research data is in the public domain and accordingly no ethical considerations relating to the use of data arise. No interviews were conducted and opinions are considered in their written form.

#### 1.4 Overview of chapters

This thesis has five chapters. Chapter one is an introductory chapter. It sets out all the preliminary issues, such as the context of the research, research goals, research methods and a general overview of the thesis.

Chapter two discusses the nature of shares and share capital in order to address one of the research goals: to examine the nature of shares in relation to expenditure in order to determine whether or not a share issue amounts to expenditure as contemplated in the Act.

Chapter three discusses the meaning of expenditure actually incurred in order to address another of the research goals, namely to explore the meaning of expenditure in order to establish whether or not it is different from payment, settlement, discharge of liability and the incurring of a liability.

Chapter four discusses the payment for goods or services in which a company issues its own shares, credited as fully paid up. Chapter four seeks to address the research goal of determining whether or not an issue of a company's own shares in payment for goods or services rendered is expenditure as contemplated in the Act.

Chapter five is the final chapter and it provides concluding remarks on all the matters discussed in the essay. Chapter five also presents comments on whether or not the *Labat Africa* judgment was correctly decided.

## CHAPTER 2 – THE NATURE OF SHARES AND SHARE CAPITAL

### 2.1 Introduction

This chapter discusses the nature of shares and share capital. The discussion is informed by one of the research goals, namely to explore the meaning of shares in relation to the meaning of expenditure as contemplated in the Act. The discussion is presented with a view to establishing whether or not, on a proper legal nature of shares, an issue of shares amounts to expenditure as contemplated in the Act. The nature of shares is considered in this chapter, the meaning of expenditure in the next chapter and thereafter the direct question is posed whether or not an issue of shares constitutes expenditure.

Meyerowitz (2004) argues that it is of “little or no relevance to analyse the nature of a share because it cannot be issued without payment to the company”. With the greatest respect, the nature of the taxpayer’s performance is relevant in answering the question whether or not there has been *expenditure* actually incurred. If a share has been offered as the taxpayer’s performance, it is relevant to analyse its nature. The fact that, by law, a share cannot be issued without payment to the company is equally relevant and must be considered.

It is trite that a company has its own separate existence. It is a juristic person that exists independently of its members and shareholders. A company has an artificial personality conferred on it by the law in order to enable its members to continue with trading activities despite changes in their membership and to limit their personal liability. It has its own rights and liabilities which are not necessarily those of its members. It may sue or be sued in its own name (Joubert: 2013; *CIR v Estate Kohler* (1953) 18 SATC 154).

Joubert (2013: 226) states that a company's share capital comes into existence by way of contribution by its own shareholders. The Companies Act 71 of 2008 ("the new Companies Act") makes no reference to "share capital" (Joubert: 227). Notwithstanding this omission, Joubert argues that, as a matter of company law, when share capital has been created, it is divided into any number of shares with a certain value and the shares are then issued and allotted to the members of the company, subject to the company's memorandum and articles of association. Section 35 of the new Companies Act has abolished the par and nominal value of shares.

A company has its own existence in law, and it is distinct and different from the people who own shares in it (*Ochberg v CIR* (1931) 5 SATC 93). When a company issues shares to an allottee, no property passes from the company to the allottee (*Estate Kohler*). The shares do not come to the allottee or shareholder by way of transfer from the company (*FCT v St Helens Farm Pty Ltd* (1981) 81 ATC 4040). Chapter four discusses these aspects of shares and these cases in more detail. There are two recognized ways by which one may become a shareholder in a company and they are explained by de Sward (2008: 483) as follows:

A shareholder can acquire shares in a company in one of two ways, namely, by acquiring shares from a current shareholder, or from the company itself.

## 2.2 The nature of shares

The new Companies Act defines a share as "one of the units into which the proprietary interest in a profit company is divided". The Companies Act 61 of 1973 ("the repealed Companies Act") defined it as a share in a company's share capital, including a debenture of a company. However, these definitions do not go far enough in explaining the nature of a share. The nature of a share has been considered in a number of cases in South Africa. It is submitted that the words of Joubert ACJ in *De Leef Family Trust and Others v CIR* 1993 (3) SA 345 (A) state the legal position correctly. The judge (at 356) explained the nature of a share as follows:

The nature of a share may be elaborated on by stating that it represents a complex of rights and duties of a shareholder, including the latter's right to participate in a distribution of the company's surplus assets on its liquidation.

Thus a shareholder in a company has a bundle of personal and incorporeal rights against the company (*Standard Bank of SA Ltd & Another v Ocean Commodities Inc & Others* 1980 (2) 175). The bundle of rights ordinarily granted to a shareholder was explained in the *De Leef Family Trust* case as a right to a dividend when declared, a right to vote in member's meetings and a right to the distribution of a dividend on winding up or reduction of capital. A share in a company is intangible and thus incapable of physical possession or transfer. It cannot be consumed like other properties (*Cooper v Boyes & Another* 1994 (4) SA 521).

The *Cooper* case dealt with a usufruct over shares. A usufruct is a right to use property belonging to another person by enjoying the fruits (dividends in this case) of such property, while the property keeps its substance (*Cooper v Boyes*). In the *Cooper* case, the usufructuary, being the person entitled to the use of the property, contended that when the shares were bequeathed to the heir, subject to her usufruct, the said usufruct was a quasi-usufruct. In the case of a quasi-usufruct, the usufructuary returns the equivalent of the property subject to the usufruct because such property will have been destroyed by consumption. In the case of livestock, the usufructuary would not be required to return the original livestock that was subject to her usufruct. The original livestock will have been destroyed by consumption (or death) because it is a consumable thing. The usufructuary will only be required to return the equivalent, or the same number, of the livestock that was bequeathed, subject to her usufruct. In the *Cooper* case, the court held that shares may not be subject to a quasi-usufruct because they are not consumable things capable of physical possession.

It is trite that a share may be acquired either from a current shareholder or from the company itself. In the case of an acquisition of shares from a current shareholder, a transfer of ownership takes place between the current and the new shareholder. There is no transfer between the company and any of the shareholders. In these

circumstances, the company will rectify or update its share register by replacing the current shareholder and seller of shares with the new shareholder. In effect, the new shareholder will take over the rights that were enjoyed by the previous shareholder.

In the case of an acquisition of shares from the company itself, rather than from a current shareholder, different considerations may apply. There is no transfer of ownership between two parties as one finds in the case of an acquisition from a current shareholder, yet there is still no transfer of the shares between the company and the prospective shareholder or allottee. It is correct that before a share has been issued and allotted by a company, it does not exist as a piece of property (*FCT v St Helens Farm*) and this leads one to the question of what actually happens when a company issues its own shares to an allottee.

What actually happens when a company issues its own shares to an allottee was explained in the *Estate Kohler* case. In that case, it was explained that when a company issues its own shares, there is no transfer and nothing passes between the company and the allottee. It was explained that what actually happens in law is that the company *creates* in itself a bundle of rights, and possibly obligations, for the allottee and that nothing passes from the company to the allottee. The effect of such an issue will, although not always, be a dilution of the holdings of the current shareholders of the company.

### 2.3 Shares in a 'sale'

A sale is described by Joubert (2010: 3) as an agreement in terms of which a vendor makes something available to the purchaser in return for the payment of a price. A transaction between a current and a prospective shareholder in terms of which the ownership of shares is transferred to the latter in return for an agreed consideration, would amount to a sale agreement between the parties. After such a transaction has been concluded, the parties will still have to approach the company in order to give effect to their sale agreement.

However, as it has been explained, shares may also be acquired directly from a company. When shares are acquired from a company, the word *purchase* is often used to suggest that the prospective shareholder buys from the company and the company sells the shares for an agreed amount. This is incorrect because the company is not a seller and the prospective shareholder is not a purchaser (van Rensburg: 2013). It is submitted that van Rensburg is correct. There is no sale agreement in terms of which something is sold and purchased between the parties. Van Rensburg is correct that the proper characterization of the transaction should be that it is a subscription agreement between the company and the prospective shareholder. The shareholder subscribes for – does not buy – shares in the company.

The idea of subscription negates transfer of ownership as between the company and the prospective shareholder. The idea of subscription implies membership of the entity to which subscription is made. In a transaction between two parties in which a share in a company is sold, what the purchaser effectively buys is membership of the company which entitles him or her to all the benefits of such membership such as dividends and a voting right in members' meetings. The purchaser does not buy any piece of property which he acquires by transfer from the company to his estate. However, the membership he acquires does increase his estate by the value of the shares he holds in the company because such membership, through his shareholding, has a monetary value. It is also correct that he owns the shares or units he has subscribed for in the company although they did not come to him by way of transfer from the company.

#### 2.4 Carrying out a share transaction

When a taxpayer acquires an asset, such as a vehicle, from a vendor in a sale agreement, the transaction is ordinarily completed by payment of the purchase price and delivery of the asset subject to the sale. However, different considerations apply when a transaction involves the acquisition of shares. Shares, like debts and claims, are incorporeal things and physical delivery of them is impossible. Thus the law recognises that transactions involving the acquisition of shares or debts cannot be completed by means of delivery of the share or debt to the purchaser.

In the case of incorporeal things like shares, transactions to acquire them are ordinarily completed by means of cession. Joubert (2003: 3) defines a cession as “a bilateral juristic act whereby a right is transferred by mere agreement between the transferor, termed a cedent, and a transferee, termed a cessionary”. This is significant because it assists in understanding the nature of shares and what actually happens when they are disposed of. In the *Standard Bank of SA* case, King J had to consider questions relating to the transfer or disposal of shares. The judge (at 180) dealt with the question of the transfer of shares in the following words:

As aforesaid, in the case of an incorporeal, delivery inter partes as between cedent and cessionary is not necessary and, on completion of the contract of cession coupled with the necessary intent for ownership to pass, it will pass whether or not there is an underlying valid causa.

It was stated in the *Standard Bank of SA* case that, in South African law, it was previously necessary in transactions involving the acquisition of shares that share certificates and transfer forms signed in blank be delivered in order for ownership to pass. However, this is no longer a requirement of the law. A contract of cession is sufficient for ownership to pass. It is clear that even with the requirements relating to share certificates and transfer forms, what was being delivered was not the actual shares subject to a sale, but documents proving their ownership and enabling the transfer of such ownership.

In a pledge involving shares as the underlying assets, similar considerations apply. Joubert (2008: 365) defines a pledge as a:

Limited real right of security in a movable asset, created by delivery of the asset to the pledgee pursuant to an agreement between himself and the owner of the asset, by which it is sought to secure the fulfilment of an obligation due to the pledgee by the pledgor, or some third person.

A pledge is a form of security for a debt just like a mortgage. An individual may sometimes pledge his shares in order to secure his indebtedness. Where an individual pledges an asset such as expensive jewellery, such an asset must be delivered to the pledgee in order to secure the pledgor's indebtedness. In the case of shares, delivery is neither possible nor required. In the case of *Oertel, NO v Brink* 1972 (3) SA 699 (W), the court dealt with a pledge of shares in order to secure the pledgor's indebtedness. In that case, Boshoff J (at 674) recognised that in the case of a corporeal thing, delivery is required in order to place the pledgee in possession of the pledged asset. However, in the case of incorporeal things like shares "delivery is by way of cession of the right and the possession which the cessionary then has is really a quasi-possession".

Ownership over all incorporeal things, such as shares and debts, is passed in a similar manner: by way of cession. However, what is passed on is not similar in respect of all incorporeal things. When a debt is ceded to a cessionary, what is passed on is a claim against a debtor which the cessionary may enforce in law. When a share is ceded to a cessionary, what is passed on is a bundle of rights against a company which, until then, entitled the cedent to vote in company meetings and receive dividends. When a share is transferred from one party to another, ownership does change as between the parties, from one party to another. However, when a company pledges or cedes its own shares to secure its indebtedness, there are no changes or transfers of ownership. It would seem that the true position is that rights are created in the company in favour of the pledgee or cessionary in order to secure the indebtedness of the company. These considerations assist in understanding the nature of shares in order to answer the question whether or not an issue of shares constitutes *expenditure*.

## 2.5 Redeemable preference shares and hybrid instruments

According to Joubert (2013), there are three main classes of shares in South African law. They are ordinary shares, deferred shares and preference shares, which may or may not be redeemable preference shares. Ordinary shares entitle their holders to repayment of capital and payment of dividends after preference shareholders have been paid. Deferred shares entitle their holders to payment of dividends only after a

prescribed minimum dividend has been paid to holders of ordinary shares. Holders of preference shares have a preferential right to dividends, when declared by the company. If there is no express provision in the company's memorandum of association, holders of preference shares will share in the company's capital on a *pro rata* basis. Redeemable preference shares entitle their holders to have the shares redeemed from them by the company. The treatment of preference shares does not appear to be different from that of ordinary shares where they are issued as payment for goods or services rendered. The rights attached to them do not seem to affect the position.

There are two hybrid instruments recognised in sections 8E and 8F of the Act. They are hybrid equity instruments and hybrid debt instruments. A hybrid equity instrument is a redeemable preference share which a company is obliged to redeem in whole or in part within three years or which the holder has an option to dispose of within three years from the date of its issue. A hybrid debt instrument is an instrument which, at the option of the issuing company, is convertible into any of its shares or those of a connected entity or which the issuing company is entitled to repay by issuing its own shares, or those of a connected entity, within a period of three years from the date of the instrument.

Sections 8E and 8F of the Act deal with the treatment of dividends and interest arising from the instruments. The sections do not deal with the questions of expenditure and deductibility that were raised by the *Labat Africa* case. Hybrid debt instruments fit squarely into the subject of this thesis. In some instances, it may be possible that the taxpayer (company) was granted a deduction during the year in which it incurred the debt represented by the debt instrument, which is later converted into shares in its share capital. Chapter 4 of the thesis discusses whether or not expenditure is actually incurred by a taxpayer when a hybrid debt instrument is issued, that is later converted into shares in its share capital.

## 2.6 Conclusions

A company is a juristic person with an existence of its own that is separate from that of its members. It has debts and claims of its own and it is a taxpayer in its own right. A company has share capital which comes by way of contribution by its own shareholders. The share capital is divided into any number of shares with a certain value, as authorised by the company's articles of association. A company's share capital is owned by its shareholders who all hold a relative proprietary interest in the company depending on their respective shareholding.

A share is an intangible asset. It is a bundle of rights held by a shareholder in the company which entitle him to dividends declared by the company and to vote in shareholders' meetings. When shares are issued to a shareholder, what actually happens is that a bundle of rights in the company is created for the shareholder. A share does not come into the hands of a shareholder by means of transfer from the company. It is rather created for the shareholder in the share capital of the company as a bundle of rights.

Transactions such as a sale and a pledge serve to explain the nature of shares. In a sale of shares between a current and a prospective shareholder, there is transfer of ownership between the parties, but there is no transfer between the company and the new shareholder. What the company does is to replace the current shareholder with the new shareholder in its share register. The manner in which a share transaction is carried out is different from other transactions. In a sale or pledge, the delivery of the thing being sold or pledged is ordinarily necessary in order to complete the transaction. However, in a share transaction no delivery is required or possible. The transaction is completed by means of a cession between the parties. Whether or not shares issued by a company in payment for goods or services constitute a deductible expense is the essential question in this thesis. In spite of the rights attached to them, the treatment of preference shares does not appear to be different from that of ordinary shares where they are issued as payment for goods or services rendered and therefore no separate discussion on this class of shares is presented. The next chapter discusses the

meaning of expenditure as contemplated in section 11(a) of the Act. This is essential in order to determine whether or not shares, as discussed in this chapter, constitute expenditure when they are issued by a company in payment for goods or services.

## CHAPTER 3 – EXPENDITURE ACTUALLY INCURRED

### 3.1 Introduction

This chapter discusses the meaning of expenditure actually incurred as contemplated in section 11(a) of the Act. There is a difference of opinion regarding the meaning of expenditure. On the one hand, it is interpreted as a contractual or legal obligation while, on the other hand, it is interpreted as the action of spending money or funds. In order to answer the question whether or not an issue of shares, whose legal nature is discussed in chapter 2, amounts to expenditure as contemplated in the Act, a discussion on the meaning of expenditure is necessary.

Section 11(a) of the Act entitles every taxpayer to a deduction for *expenditure* actually incurred in the production of income. The meaning of expenditure has seldom directly received the attention of the courts. Where it has been considered, it has usually been in relation to a loss or to whether or not it has been actually incurred, or when it was actually incurred. A review of case law relating to expenditure indicates that decisions are often contradictory and inconsistent. This could be due to the fact that the majority of cases in which expenditure was considered, and in which attempts were made to define it, never dealt with the direct question of what constitutes expenditure.

A discussion on the meaning of *expenditure actually incurred* always begins with the *PE Electric Tramway* case of 1936. There are ten or more other significant cases on this subject, decided by the Appellate Division or a Provincial Division that are worthy of review. In the *PE Electric Tramway* case, the taxpayer company successfully claimed a deduction for *compensation for injury* it had paid to an employee's spouse. It also claimed a deduction for the legal costs it incurred in resisting the claim for the compensation. Watermeyer AJP examined the meaning of *expenditure actually incurred* and, in so doing, the learned judge made a statement which has been repeated in various judgments since 1936. Watermeyer AJP (at 15) stated in the *PE Electric Tramway* case that "expenses actually incurred cannot mean actually paid".

### 3.2 A brief history of the concept of *expenditure* in income tax

South Africa started taxing income with the introduction of the Income Tax Act, 28 of 1914, one hundred years ago. The terms and concepts found in the current Income Tax Act can still be traced back to the 1914 Act. Allowable deductions were dealt with in section 14(a) of the 1914 Act. With a few differences in wording, the substance of section 14(a) is comparable to the provisions of section 11(a) of the Act. However, the 1914 Act used the term *outgoings* instead of the term *expenditure* that is used in the current Act.

The interpretation of the term *outgoings* is found as early as 1918 in *CIR v Delagoa Bay Cigarette Co*, (1918) 32 SATC 47 in which an example is adopted from the English case of *Knowles v McAdam* (3 Ex.D. 23) of a bale of cotton acquired for 20 shillings and sold for 25 shillings. In this example, the 20 shillings is an *outgoing* while the 5 shillings represents a profit. It seems that the manner in which the term *outgoings* was used and understood in the English case was that it meant *out-bound* or *leaving* the entity. The ordinary meaning of *outgoing* seems to support this.

In 1917, the 1914 Act was replaced with Income Tax Act, 41 of 1917 and allowable deductions were dealt with under section 17(1)(a) of the 1917 Act. The 1917 Act used the same term *outgoings* in subsection (a) of section 17(1). However, while the word *expenditure* appeared nowhere under section 14 of the 1914 Act, it appeared under section 17(1)(b) of the 1917 Act. The relevant parts of section 17(1) stated as follows:

**17.** The deductions so allowed shall be –

- (a) losses and outgoings actually incurred in the Union in the production of the income, provided such losses and outgoings are not of a capital nature;
- (b) such expenditure incurred outside the Union in the production of the income as the Commissioner may allow;

The 1917 Act used the terms *outgoings* and *expenditure* in the same section. There is possibly not much to be made of this, but it does seem to suggest that the drafters of the law attributed the same meaning to both terms or used them as synonyms. In 1925, the 1917 Act was replaced with Income Tax Act, 40 of 1925 and from this year, the term *outgoings* was abandoned in favour of the term *expenditure*. In 1941, the 1925 Act was itself replaced with Income Tax Act, 31 of 1941. The term *expenditure* has been in use since 1925 and it remains so today.

In *Ochberg* (1931), there is another indication of the meaning attached to the term *outgoings*. Wessels JA (at 112) stated that “*in other words that he pays his tax not out of his capital but out of his incomings*” (emphasis added). The term *incomings* is used in contrast to the term *outgoings*. It appears that *incomings* represent all that comes into the business of the taxpayer from its trading activities as compared to all that leaves the business, the latter being *outgoings*. The difference between the two is either a profit or a loss. The term *outgoings* may no longer be part of the Act, but it remains a part of South African case law many years after it was abandoned in the Income Tax Act and seems to enjoy regular use by the courts.

Two cases serve to illustrate the usage of the term *outgoings* in our case law. The first case is *CIR v General Motors SA (Pty) Ltd* (1982) 43 SATC 249. The facts and the findings are not relevant. The case is only used to illustrate the use of the term *outgoings*. McCreath J (at 256) stated as follows:

If, however, the main purpose of the delay in the payments was to provide working capital for the taxpayer, how does that delay make the payments outgoings of a capital nature? They were, nevertheless, though deferred, outgoings incurred in connection with the trading operations of the taxpayer. (Emphasis added)

In 1994, the term *outgoings* was again used by Corbett CJ in *CIR v Felix Schuh SA (Pty) Ltd* (1994) 56 SATC 57 (A) where the Chief Justice (at 69) stated:

The real question is whether, by reason of currency fluctuations, the respondent actually incurred during the year of assessment any outgoing or liability in respect of its foreign loan . . . (Emphasis added)

The above cases seem to support the view that the term *outgoings* is understood to mean the same thing as *expenditure* in section 11(a) of the present Act. It is submitted that *outgoings* is synonymous with *expenditure* and the above cases show that this is the way in which the courts have understood and used the two terms.

### 3.3 The meaning of expenditure as interpreted by the courts

The accepted interpretation of Watermeyer AJP's statement in the *PE Electric Tramway* case is that the meaning of expenditure does not entail payment. In this respect, examples are often made of credit purchases in which a transaction takes place in the current tax year but will only be paid in the following tax year. In such cases, it is accepted that the taxpayer is entitled to deduct the amount of the credit purchase in the year in which the transaction took place, notwithstanding that payment will only be made in the following year. Watermeyer AJP (at 15) explained his statement by stating that "so long as the liability to pay them actually has been incurred they may be deductible". This appears to mean that if it is certain that the expenses, though not yet paid, will be actually paid at some point in the future, one may be permitted a deduction.

In *Joffe & Co v CIR* (1946) 13 SATC 354, the same Judge Watermeyer, by that time a Chief Justice, who had written the judgment in the *PE Electric Tramway* case wrote the judgment in the *Joffe & Co* case about ten years later. The *Joffe & Co* case is similar in material respects to the *PE Electric Tramway* case. In *Joffe & Co*, the taxpayer was unsuccessful in its claim for a deduction of compensation paid to the dependents of a plumber who died when a building structure collapsed on him on the basis that the taxpayer could not prove that such a risk was inherent to its business and necessarily attached to it by its ordinary operations.

In the *Joffe & Co* case, Watermeyer CJ (at 360) sought to distinguish between a loss and expenditure in the following words:

In relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money. (Emphasis added)

It is submitted that Watermeyer CJ could never have intended to undo the principle that expenditure actually incurred does not mean actually paid. It is clear that the judge mainly sought to distinguish between a loss and expenditure in the *Joffe & Co* case. In any event, it does not appear that the judge sought to define the meaning of expenditure with the words he used in the *PE Electric Tramway* case, as will be discussed later in this thesis. However, the above remarks are not without significance because they suggest that expenditure entails a voluntary *payment of money*, without which one may not say there is expenditure. It could also be argued, as set out above, that in the *Joffe & Co* case, the judge was more concerned with distinguishing between a loss and expenditure rather than giving a definitive account of expenditure, but it is interesting that the same judge gave what appears to be a contradictory definition of expenditure, holding in one case that expenditure actually incurred does not mean actually paid while holding in a different case that it means the payment of money.

In *Stone v SIR* (1975) 36 SATC 117, there was yet another occasion to interpret the meaning of expenditure in a context in which it was distinguished from a loss. In the *Stone* case, the taxpayer had suffered losses on loans advanced to a trickster who was later convicted of fraud and whose estate was liquidated. In attempting to distinguish expenditure from a loss, Corbett AJA (at 128) quoted with approval, and thus adopted, words from an English judge in which expenditure was defined as “something or another which the trader pays out”. It was also stated that it is “something which comes out of his pocket”.

The *Caltex Oil* case also grappled with the expression *expenditure actually incurred* in section 11(a) of the Act. In the *Caltex Oil* case, the taxpayer had bought petroleum products priced in sterling from its sister company in the UK. Before the taxpayer could pay the invoiced amount, the British pound devalued against the South African rand, causing the taxpayer to pay less than the invoiced amount. However, the taxpayer sought to deduct the full invoiced amount that it had earlier recorded on its books and it failed in its attempt to do so. In its judgment, the court adopted the words of Watermeyer AJP in the *PE Electric Tramway* case. Botha J (at 12) explained that *expenditure actually incurred* does not mean actually paid during the year of assessment in question but refers to all expenditure for which there is incurred a liability to pay, whether or not discharged during the year of assessment in question.

It is worth noting that the *PE Electric Tramway* and *Caltex Oil* cases do not consider *expenditure* independently from the *actually incurred* requirement of section 11(a) of the Act, as if to suggest that the three words, *expenditure actually incurred*, cannot be separated and read apart from each other. Another challenge with these two decisions is that they do not seem to explain whether or not the Act envisages one or two requirements with the combination of three words. If the Act envisages two requirements, then it would seem that there must be *expenditure* which must be *actually incurred*. If not, then it would seem, according to the judgments, that a liability to make payment must be actually incurred, but the payment need not have been made at the time a deduction is claimed.

In *Edgars Stores Ltd v CIR* (1988) 50 SATC 81, the court dealt with two methods of rental payments. In terms of the lease agreement between the taxpayer and its landlord, the taxpayer was required to pay the greater of the “basic” rental and the “turnover” rental. The basic rental was payable monthly, while the turnover rental was paid as a percentage of the taxpayer’s turnover if turnover exceeded a certain amount. If the turnover was greater in one year, the landlord would be paid turnover rental by topping up the difference between the basic rental paid thus far and the amount of turnover rental payable in terms of an agreed-on formula, based on the taxpayer’s financial statements. The turnover rental could therefore only be calculated after the

taxpayer's financial statements became available.

The main question in the *Edgars Stores* case was whether or not the turnover rental was *actually incurred* and the taxpayer thus entitled to deduct such turnover rental despite the fact that it would only be determined later. The court held that the turnover rental was not actually incurred and the taxpayer was not entitled to deduct turnover rental in that year of assessment. It could only deduct the basic rental. In its judgment, the court sought to distinguish between *actually incurred* and *actually paid*. In his minority judgment in favour of the taxpayer, Nicholas AJA (at 95) confirmed the principle established in the *PE Electric Tramway* case when he repeated the words of Watermeyer AJP that *actually incurred* does not mean *actually paid*.

The case of *CIR v Golden Dumps* (1993) 55 SATC 198 (A) dealt with the transfer of shares to a former employee and the deductibility of the expenditure on such shares. The facts of this case were that the taxpayer had engaged the services of the employee as a financial director. He was given a mandate to raise R20 million in London that was required for a reorganization and amalgamation of two mining companies in which a new company would be formed. The taxpayer was part of the group of companies, but was not itself a mining company. It was a management company. In return for his services, and upon successful conclusion of the negotiations, the employee was offered 200 000 shares in the new company for a consideration of R85 000. He succeeded in his negotiations in London, but a short time after he had returned he was summarily dismissed from the company. Thereupon, he successfully sued the taxpayer for the delivery of the shares at the agreed consideration of R85 000.

The taxpayer was a management company and it is recorded that it never held shares in other companies. When it was ordered to deliver the shares, it had to buy the shares in order to deliver them to the former employee. By the time it acquired them, the shares were worth over R3 million. This is the sum, less the consideration of R85 000, that the taxpayer sought to deduct from its income. The taxpayer succeeded in claiming the deduction, the dispute being the year in which the expenditure for the shares was incurred. The Commissioner contended that the expenditure was only deductible in the

year in which the action against the taxpayer was instituted, which meant that the taxpayer had not claimed the deduction in that year and had therefore forgone the deduction. The taxpayer contended that the expenditure was actually incurred in the year the Appellate Division decided the appeal, which argument was upheld by the court.

This case goes back to what was stated in chapter 2, namely that there are two ways in which a shareholder may acquire shares in a company. It may do so directly from the company or it may acquire them from a current shareholder. In the *Golden Dumps* case, the shares were not acquired by the employee directly from the issuing company. Instead, *Golden Dumps* bought the shares in the newly formed company from its chairman and then delivered them to the employee, as required by the court. Another point is that the shares were not the taxpayer's shares, but were those of another company.

The taxpayer never issued its own shares, credited as fully paid up, in payment for the employee's services. This is different from what was considered in the *Labat Africa* case. There can be no doubt regarding the deductibility of the expenditure in cases such as *Golden Dumps*. In circumstances such as the *Labat Africa* case, the question is whether or not the value of shares issued in payment for goods or services constitutes expenditure as contemplated in the Act. However, in circumstances such as the *Golden Dumps* case, it seems that the question is whether the amount of money spent in acquiring the shares is a permissible deduction, which it obviously was. In grappling with the words *expenditure actually incurred*, Nicholas AJA (at 204) adopted the words of Watermeyer AJP in the *PE Electric Tramway* case that expenditure actually incurred does not mean actually paid as long as the liability to pay has been actually incurred.

*CIR v Felix Schuh (SA) Pty Ltd* (1994) 56 SATC 57 is another case in which there was an attempt to interpret the meaning of expenditure. In the *Felix Schuh* case, the taxpayer incurred foreign exchange losses on its loan repayments to a German company because the South African rand devalued against the lender's currency, causing the taxpayer to pay more in rand. In the course of his judgment, Corbett CJ (at

69) sought to distinguish between expenditure and a loss in the following words:

Broadly speaking, as these cases show, 'expenditure' refers to disbursements or expenses incurred or paid voluntarily, whereas 'losses' connote involuntary deprivations occurring fortuitously. (Emphasis added)

In the *Felix Schuh* case, Corbett CJ uses the conjunction 'or' which seems to suggest that the said expenses or disbursements do not necessarily have to have been paid. It appears that in Corbett CJ's view, there would still be expenditure where an item has been *actually incurred* without payment. It appears that the incurring of an expense or payment of it are similar considerations which qualify it as expenditure. It seems that the words *incurred* and *paid* are not treated as synonyms and that what the judge sought to convey was that there will be expenditure if an expense is *incurred* or paid and that it does not have to be both incurred and paid before there could be expenditure.

A very recent case is one of the interesting cases on the subject. The case is *Omnia Fertilizer v CSARS* (2003) 65 SATC 159. In the *Omnia Fertilizer* case, the taxpayer was a fertilizer manufacturer who received stock from suppliers on credit. The normal practice of the parties was that a supplier was paid later upon submitting an invoice. After the stock was delivered to the taxpayer, it allocated the expenditure, credited the suppliers' account in its books and claimed the deduction from its income when it submitted its tax returns. However, the suppliers failed to invoice the taxpayer, causing it to credit the unclaimed amounts to income after one or two years.

The Commissioner argued that the taxpayer had recouped the expenditure in terms of section 8 of the Act, while the taxpayer argued that it could not have recouped the amount because the liability for the expenditure had not been extinguished by prescription or agreement. The taxpayer argued that in terms of the definition of gross income, the above amounts could not be receipts or accruals. The taxpayer contended that what happened was a mere accounting treatment of the amounts. The taxpayer failed in its appeal and it was held that the meaning of recoup is wide and that it does not require an extinguishment of the liability. In the course of his judgment, Howie P (at

163) made significant remarks on the meaning of expenditure in the following words:

The question here is whether expenditure, which by reason of taxation provisions constitutes that which is legally owing but has not yet been paid out can, on those facts, be recouped within the meaning of the section. (Emphasis added)

Howie P appeared to distinguish expenditure from payment. If a taxpayer owes an amount of money for services rendered then there is, in terms of the provisions of the Act, expenditure because *expenditure* is that which is legally owing but has not yet been paid out. It appears that this definition fits that of a liability in accounting terms and ordinary business language. This raises the question of whether or not the judge thought *expenditure actually incurred* envisages one or two separate requirements.

Another relevant case is *Ackermans Ltd v CSARS* (2010) 73 SATC 1, which dealt with the sale of a business as a going concern. In the *Ackermans* case, a business was sold together with its contingent liabilities. In order to compensate the purchaser for the contingent liabilities, the parties agreed that the taxpayer would reduce the purchase price by the amount of the contingent liabilities instead of getting the full purchase price and immediately paying the purchaser the amount of the contingent liabilities. The taxpayer failed in its appeal and the court held that there was no expenditure actually incurred. The contingent liabilities were the liability for post-retirement medical benefits for employees, a long-term bonus scheme and repair obligations undertaken by the taxpayer.

The taxpayer argued in the *Ackermans* case that if it had continued with its trading activities, the expenses would have become deductible in its hands after they became unconditional. This argument was accepted by the Commissioner and the court. The taxpayer argued that it would have received the sum of the liabilities from the purchaser and immediately paid it back, if it had not been agreed that it would reduce the purchase price, in which event the liabilities would have been deductible in its hands having become unconditional. The taxpayer argued that it made no difference that it chose to reduce its purchase price rather than receive the amount of the contingent

liabilities and immediately pay it back to the purchaser. The taxpayer claimed the deduction on the basis that it sold assets worth over R1 billion for a sum of R800 million and that the portion of the purchase price it forfeited meant that the liabilities became unconditional and were therefore deductible. The taxpayer argued that if the deduction was denied, it created an anomaly in that it would never be deductible while it would have been permitted as a deduction if it had continued with its trading activities. It was also argued by the taxpayer that *expenditure* did not have to have its source in a legal liability.

It appears that the taxpayer failed in the *Ackermans* case because the liabilities were contingent and would only become unconditional in the future, in which case the liability would not be in the hands of the taxpayer but those of the purchaser. It is submitted that the taxpayer's appeal was not rejected on the basis that it chose to reduce its purchase price. It is submitted that if the liabilities were unconditional at the time of the sale agreement, the taxpayer would have been permitted a deduction. The transaction in the *Ackermans* case is not similar to a share-based payment transaction. Nevertheless, on the meaning of *expenditure incurred*, Cloete JA (at 5) stated that it "means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability". These remarks seem to confirm what was stated in the *Omnia Fertilizer* case by Howie P.

From this discussion it appears that the meaning attributed by the courts to the expression *expenditure actually incurred* has always varied between the undertaking of a legal liability and the payment of money. The facts of each case discussed differ, but the relevant aspect in all the cases is the interpretation given by the court to *expenditure* or the phrase "expenditure actually incurred". The *Labat Africa* case, discussed below, dealt with an issue of a company's own shares for the acquisition of an asset and in that case it was held that expenditure means the payment of money.

### 3.4 CSARS v Labat Africa (2011) 74 SATC 1

The *Labat Africa* decision was briefly discussed in chapter 1. The case started in the Pretoria Tax Court as *ITC 1801* and the relevant facts are simple. In *Labat Africa*, the taxpayer entered into a written agreement in terms of which it took over the business operations of the seller which included all its intangible assets and a trade mark. The consideration given by the taxpayer for acquiring the business was an issue of shares worth over R133 million, credited as fully paid up in favour of the vendor. It was agreed between the parties that the sum attributable to the trade mark was an amount of over R44 million. This is the amount, satisfied by an issue of shares, that the taxpayer sought to deduct in terms of section 11(gA) of the Act.

The taxpayer was successful in the Pretoria Tax Court and the High Court, but failed when the Commissioner's appeal was upheld at the Supreme Court of Appeal. Section 11(gA), which applied at the time and has now been replaced by section 11(gC), entitled a taxpayer to a deduction in respect of any expenditure actually incurred in acquiring a trade mark by assignment. It is trite that *expenditure* in section 11(gA) (and now section 11(gC)) bears the same meaning as *expenditure* in section 11(a) of the Act and this seems to have been accepted by the parties and the court.

In the *Labat Africa* case, expenditure was defined by Harms AP in words that appear to contradict what was stated in the *Omnia Fertilizer* case (decided eight years before the *Labat Africa* judgment), where Howie, P (at 163) used the words: "The question here is whether expenditure, which by reason of taxation provisions constitutes that which is legally owing but has not yet been paid out". In *Labat Africa*, Harms AP (at 6) stated the following about the meaning of expenditure:

Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent.

This statement appears to envisage the actual payment of an amount (or consumption of an asset) and not the incurring thereof prior to payment. On a plain reading, the

*Labat Africa* decision appears to disturb a settled principle that expenditure actually incurred does not mean expenditure actually paid and appears to suggest that a taxpayer may not be permitted a deduction without the actual payment of money.

The *Labat Africa* case appears to suggest that transactions such as credit purchases should be denied a deduction. In a credit purchase, there is ordinarily no action of spending funds in a current year of assessment. The spending of funds typically falls outside of the current tax year. On a reading of the *Labat Africa* case, it seems that such a credit purchase must be denied a deduction in the year in which the transaction took place and the liability *actually incurred*. It may still be denied a deduction in a later year because the expenditure would have been actually incurred in a previous year. The *Labat Africa* case would also seem to deny a deduction for transactions such as the one in the *Ackermans* case on the basis that there was no spending of funds. In the *Ackermans* case, it was accepted that the liabilities would have been deductible in the hands of the taxpayer if they were unconditional at the time of the sale. However, the *Labat Africa* case would seem to deny a deduction in circumstances where the taxpayer agrees to reduce its purchase price notwithstanding that the liabilities may be unconditional. The *Labat Africa* case does not account for why credit purchases are permitted as deductions although that there is no actual spending of money.

When the *Omnia Fertilizer* and the *Labat Africa* cases are taken together, it would seem that the same court spoke in conflicting terms, saying one thing on the one hand and the opposite on the other hand. In the former case, it was stated that expenditure is that “which is legally owing but has not yet been paid out” and in the latter case it was stated that it is “the action of spending funds”. It seems that expenditure cannot logically be the two things at the same time. It is important to note the context in which expenditure was defined in the *Labat Africa* case. A reasonable interpretative process must not ignore the colour given to the language by the context (*Thoroughbred Breeders Association v Price Waterhouse* 2001 (4) SA 554 (SCA)). The context in the *Labat Africa* case was that of a share-based payment for an asset, which is different from all the other major cases reviewed in the previous sections. The *Labat Africa* case is analysed again in chapter 4, and its conclusions are considered there.

### 3.5 The year of assessment

The definition of gross income in section 1 of the Act makes reference to a year or period of assessment. Section 11(a) of the Act makes no reference to a year or period of assessment. One could argue that it appears that what comes into the taxpayer's pocket as income or an accrual must be determined in relation to a certain year or period of assessment, but that it is not the case in respect of deductions permitted to the taxpayer. The relevant parts of section 1 of the Act define a year of assessment as follows:

**'year of assessment'** means any year or other period in respect of which any tax or duty leviable under this Act is chargeable . . .

The definition of a year of assessment does not appear to be contentious. It does not appear that there has been any litigation in respect of the definition of a year of assessment as contemplated in the definition of gross income. However, an authoritative statement regarding expenditure and the year of assessment was made by the Appellate Division in *Sub-Nigel Ltd v CIR* (1948) 15 SATC 381. The case dealt with a deduction for premiums paid in order to insure against loss of income by a mining company. In the course of his judgment, Centlivres JA (at 390) stated the following about expenditure and a year of assessment:

For the whole scheme of the Act shows that, as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular year can be deducted.

The above statement was adopted in the *Caltex Oil* case by Botha JA (at 11), who relied on the *Sub-Nigel* case in stating the following:

It is clear from these provisions that income tax is assessed on an annual basis in respect of the taxable income received by or accrued to any person during the period of assessment, and determined in accordance with the provisions of the Act.

The reasoning in the *Sub-Nigel* and *Caltex Oil* cases was adopted in the *Golden Dumps* case. It is clear from the *Golden Dumps* case that had it not been for the finding that the expenditure was actually incurred in the year the Supreme Court of Appeal decided the matter, the deduction would have been denied on the grounds that the expenditure was actually incurred in a previous year of assessment. These cases support the view that if a taxpayer incurs expenditure in year one, but fails to claim the deduction in that year, it will be denied the deduction in year two or other subsequent years of assessment.

### 3.6 Expenditure as contrasted with payment, settlement and a discharge of liability

The review of a number of cases presented in the previous section indicates that there has never been any consistent statement of law on the meaning of expenditure. It appears that since 1936 the pendulum has always swung between two contradictory positions on the meaning of expenditure. On the one hand, it has been held that it means the undertaking of a legal liability but that it does not necessarily require payment. On the other hand, it has been held that expenditure means the payment of money or the action of spending funds.

It must be noted that, unlike the *Labat Africa* case, the majority of the cases in which the meaning of expenditure was explored never dealt with the direct question of what constitutes expenditure. In *Labat Africa*, the question for decision as framed by Harms AP was whether the issuing of shares by a company amounts to expenditure. In the majority of the other cases, the question outlined for decision was whether or not there was expenditure actually incurred by the taxpayer, which seems to be broader than the question outlined in the *Labat Africa* case.

All the decisions reviewed above, except the *PE Electric Tramway* case, are decisions of the Appellate Division and have equal authoritative force. It may be argued that the fact that the *Labat Africa* case dealt with the direct question of whether an issue of shares constitutes expenditure strengthens it as a legal precedent on the meaning of expenditure, but this appears to be the case only in the context of share-based

payments. The other cases that have expressed judgments that are contrary to the *Labat Africa* decision are, however, not weakened as legal precedents. These cases dealt with relevant questions, although the questions were broader than the question which had to be answered in the *Labat Africa* case. It may be argued that the principles established in those cases are of general application.

Ger (2004) criticises the notion that expenditure is the spending of money, which requires a diminution of assets, on the grounds that it seems to confuse the incurring of expenditure with the settlement of it. Van Zyl (2012) criticises the *Labat Africa* decision on similar grounds. He expresses the opinion that it confused expenditure with the actual discharge of an obligation and interpreted it to mean actual payment, which it is not. In the cases of *PE Electric Tramway*, *Caltex Oil* and *Edgars Stores*, a principle was established that *actually incurred* does not mean *actually paid*. It does not appear that the courts sought to explain the meaning of expenditure with these words. It seems that the courts sought to deal with the *actually incurred* requirement in section 11(a) of the Act, rather than providing an account of what constitutes expenditure.

Writers such as Ger (2004), Emslie (2011), Silke (2005), van Zyl (2012) and a number of judgments on the meaning of *expenditure actually incurred* seem to suggest that there is a difference between *expenditure* on the one hand, and payment, settlement or discharge of liability on the other hand. A reading of the above writers and the judgments they rely on suggests that what is meant by payment, settlement or discharge of a liability is the giving of, or parting with money or assets of monetary value or some kind of reciprocal performance in order to extinguish one's indebtedness. The writers suggest that *expenditure* exists before the acts of giving, parting with or performance and that it is itself not the action of spending money as suggested by Harms AP in the *Labat Africa* case.

If expenditure is not payment, settlement or discharge of liability then it must be something other than these things. An attempt to explain the meaning of expenditure in a way that distinguishes it from payment, settlement or discharge of liability is made by Emslie. Emslie (2011: 186) explains the meaning of expenditure as follows:

... 'expenditure' is not the actual spending of money or the actual disbursement of an asset with a monetary value which results in a diminution or movement of assets of the person who expends, but the contractual (or other legal) obligation to spend money which will result in a future diminution or movement of assets of the person who expends.

Emslie's (2011) definition of expenditure is worthy of examination in that in the *Ackermans* case, Cloete JA rejected an argument by the taxpayer's counsel that if a loss can exist independently from a legal liability, there is accordingly no reason why expenditure must have its source in a legal liability owed by the taxpayer. The judge (at 5) stated that, to his mind, "expenditure incurred means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability". However, one wonders whether there could not be circumstances where spending by the taxpayer takes place without any prior legal or contractual obligation to pay, but would still be deductible from the taxpayer's income as expenditure.

Consider the case of bonuses paid by a company to its employees. The payment of bonuses (or the quantum of the bonuses) is often discretionary and a company is not obliged to pay any bonuses to its employees, unless required to do so in terms of an employment contract, or other contractual obligation. When the company decides in one year, without any prior obligation to do so, to pay bonuses to its employees, it would seem that, according to Emslie and the *Ackermans* case, such spending by the company would not be deductible. In this example, there would certainly be no contractual or legal obligation on the company to pay bonuses, but such spending would ordinarily be deductible.

Certain companies, in terms of company policy, pay bonuses that are discretionary and only paid when the company management takes a decision to pay them. It could be argued in this case that the decision by the company to pay bonuses constitutes a legal obligation on the basis of which the spending could qualify as expenditure in terms of the *Ackermans* and Emslie definition. However, contractual and other legal obligations such as paying for services rendered, paying levies and tariffs are ordinarily enforceable in law against a taxpayer. A bonus on the other hand remains discretionary. A company's management that takes decisions about the affairs of the company ordinarily has the power to reverse its own decisions. It is submitted that a company resolution to pay bonuses is unlikely to create a legal obligation that is enforceable by the employees of the company. If this argument is correct, then the challenge to Emslie's definition will be that it has limited application. The court in the *Ackermans* case did not explain why expenditure should have its source in a legal liability owed by the taxpayer.

Emslie (2011) provides a useful analogy which serves to explain his meaning of expenditure. Emslie's analogy is briefly explained in the following words: on 15 February, a taxpayer with a February year-end concludes a contract to purchase stock at the price of R10 000, which is payable 30 days after delivery. The goods are delivered on 25 February and payment is only made on 25 March. This example may be of assistance in understanding the reasoning of Harms AP in the *Labat Africa* case. In terms of this analogy, the judges in *Joffe & Co*, *Stone*, *Felix Schuh* and *Labat Africa*, on a plain reading of these cases, would no doubt conclude that expenditure took place on 25 March when payment for the stock was made. There are challenges with this line of reasoning because it suggests that the taxpayer should not be allowed a deduction for the spending in the tax year ended February.

Emslie (2011) argues that, logically, expenditure must first exist before it is actually incurred. In the phrase "expenditure actually incurred", the word *expenditure* is the subject and the words "actually incurred" are the predicate (Jarvie: 2007). In the short sentence "the car was purchased voetstoots", the *car* is the subject while the words "was purchased voetstoots" are the predicate. The car must exist before it can be purchased voetstoots. The same reasoning applies to *expenditure actually incurred*.

A predicate always refers to the subject by, for example, either affirming or denying it (Jarvie: 2007). It submitted that Emslie is correct that, logically, expenditure must exist before it is actually incurred. The order of words in the phrase “expenditure actually incurred” seems to support this reasoning. In the *Labat Africa* case, Harms AP stated that expenditure is the spending of money. Accordingly, in Emslie’s analogy in which a taxpayer concludes a contract for the purchase of goods on 15 February, with the goods delivered on 25 February while payment is made on 25 March, Harms AP suggests that expenditure occurred on 25 March, because that is when there was an action of spending funds.

However, it is clear in Emslie (2011)’s analogy that something was *actually incurred* on 25 February when the goods were delivered because that is when the taxpayer became unconditionally liable to pay. What was *actually incurred* on 25 February can only be the expenditure. On Harms AP’s reasoning, it would seem that expenditure was *actually incurred* on 25 February, but the expenditure only came into existence on 25 March when payment was made because payment is what constitutes expenditure in Harms AP’s reasoning. It seems that there would be a logical problem with the *Labat Africa* reasoning where it is applied to the analogies set out earlier. In the analogy of a car, Harms AP would seem to suggest that the car was *purchased voetstoots* before it even existed, a situation which seems illogical and untenable.

The reasoning of Emslie (2011) is that there is first expenditure, secondly the actual incurring of the expenditure on fulfilment of certain conditions and thirdly the discharge of the expenditure by means of payment. It appears that according to Emslie, before it is discharged by payment, expenditure must exist and be actually incurred. Payment in these circumstances may only be a discharge of expenditure actually incurred. However, it is submitted that there could be circumstances where the order of things is not as set out above, in which case the meaning of certain concepts may be questionable to the extent that they depend on the occurrence of another event before they could be said to exist.

On Emslie's (2011) reasoning, a discharge or payment presupposes that there is expenditure actually incurred. Consider a case where a taxpayer visits a supplier of goods which are generally in high demand. In order to ensure a supply the taxpayer pays the full purchase price and receives the goods at a later date. This practice occurs on a daily basis, either by individuals or businesses. Consider the example of a small bookstore that buys books from a supplier. On 10 February, a contract is concluded for the purchase of the books. On 11 February, the bookstore pays R10 000 to the supplier in order to ensure its supply and the books are delivered to the bookstore on 1 March. This may not be the best analogy, but in Emslie's reasoning, it would seem that, in this case, there was expenditure on 10 February when the contract was concluded between the parties. There was a discharge on 11 February when the bookstore paid R10 000 to the supplier, but the expenditure would seem to have only been *actually incurred* on 1 March because that is when the bookstore would have become absolutely and unconditionally liable, notwithstanding that it paid R10 000 before that date. If Emslie suggests in his reasoning that for a discharge, there must be expenditure actually incurred then it seems in the above case that the payment made by the bookstore on 11 February would be something other than a discharge. However, if a discharge is possible without the actual incurring of expenditure then in this analogy the bookstore may be denied a deduction because, although it paid R10 000 on 11 February, there was only expenditure but it was not *actually incurred*.

In the *Labat Africa* case, Harms AP (at 5) stated that "the liability or obligation must be discharged by means of expenditure". In Harms AP's reasoning, therefore, when contracts are concluded and goods delivered (as in the above analogy), there is a liability that is actually incurred and the taxpayer's payment of the liability is expenditure. There is no doubt that Emslie (2011), van Zyl (2012) and Ger (2012) would object to this reasoning. They argue that first there is expenditure, secondly the incurring of such expenditure and thirdly a discharge of the expenditure by payment or other means.

The Act does not use words such as *discharge*, *payment* or *settlement*. The Act uses the words *expenditure actually incurred* and it is submitted that, from these words, it is necessarily implied that the taxpayer pays or sacrifices something of monetary value. If

not, then there would be no reason for the deduction. It seems that if *expenditure* does not necessarily imply payment or sacrifice, then the drafters of the Act would have incorporated the words *payment* or *discharge* into section 11(a) of the Act.

### 3.7 A purposive interpretation of the term “expenditure”

In order to understand the *Ackermans* and Emslie (2011) reasoning, one must try to read the words they use in their definition of expenditure into the relevant parts of section 11(a) of the Act. If this is done, the relevant parts of section 11(a) would state that there is deductible from a taxpayer’s income the *undertaking of an obligation to pay that is actually incurred* during the year of assessment. It is doubtful whether this interpretation of expenditure would have been intended by the drafters of the law. It may be that this reading does not do justice to the *Ackermans* and Emslie reasoning, but it does reasonably present the essence of it.

In order to understand the reasoning of the *Joffe & Co*, *Stone*, *Felix Schuh* and the *Labat Africa* cases, it is obvious one must do the same reading into the relevant parts of section 11(a) of the Act. In terms of these cases, expenditure is *payment*, the spending of funds or a *disbursement*. If the same exercise is carried out in respect of the *Joffe & Co*, *Stone*, *Felix Schuh* and *Labat Africa* meaning of expenditure, then the relevant parts of section 11(a) of the Act would state that there is deductible from a taxpayer’s income *payments, funds spent and disbursements actually incurred* during the year of assessment. This does not seem to be an unreasonable construction that is at odds with the words of section 11(a) and the general scheme of the Act. On the other hand, the *Ackermans* and Emslie (2011) interpretation suggests that it is the undertaking to pay or contractual obligation that is deductible from the taxpayer’s income.

When a taxpayer makes an undertaking to pay something, no economic sacrifice has yet been made. It appears that such an undertaking is a step towards the actual economic sacrifice. However, it is not suggested that the *Joffe & Co*, *Stone*, *Felix Schuh* and *Labat Africa* meaning of expenditure is the correct one. There are obvious

challenges with the *Labat Africa* interpretation of expenditure as argued by Emslie (2011) and other writers. The *Labat Africa* interpretation means that a taxpayer who concludes a contract for delivery of goods on 15 February, with the goods delivered on 25 February but only paid for on 10 March must be denied a deduction in that year. It is not conceivable that such a situation could have been intended by the drafters of the Act, yet this appears to be a fair and reasonable interpretation to attribute to the *Joffe & Co*, *Stone*, *Felix Schuh* and *Labat Africa* cases.

In the *Labat Africa* case, Harms AP (at 6) attempted to give meaning to the concept of expenditure when he stated that “expenditure ... requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends”. Van Zyl (2012) found gaps in this interpretation of expenditure. This aspect is dealt with fully in other sections of this thesis. The *Ackermans* and Emslie (2011) interpretation of expenditure states that it is the undertaking of a liability to pay, while the *Labat Africa* interpretation states that it is a payment of funds or a disbursement. If expenditure requires payment, then many transactions, such as credit purchases, may be precluded from deduction. In view of the definition of gross income that includes amounts received or (unconditionally) accrued to the taxpayer, it could be argued that it is unlikely that the legislature could have intended to deny a deduction of an amount that is actually incurred, but not yet paid. However, it must always be borne in mind that “gross income is not limited to the converse of expenditure” as stated by Harms AP (at 8) in *Labat Africa*. This appears to mean that what is received by one taxpayer may not be automatically deductible in the hands of the taxpayer who is the payer.

Cilliers (2011) appears to have considered all the interpretations and anomalies discussed in this section. He introduces another interpretation that seeks to make sense of all the contradictions. Cilliers’ interpretation, together with that of van Rensburg (2013), is worthy of examination as it seeks to move the discussion on expenditure beyond the “payment - liability to pay” debate flowing from the *Joffe & Co*, *Stone*, *Felix Schuh* and *Labat* cases on the one hand and in *PE Electric Tramway*, *Ackermans* and *Edgars Stores* on the other hand. Cilliers states that when the Act uses the words *expenditure actually incurred*, it does not necessarily require that there must *already*

have been *expenditure* in the sense of payment or disbursement when it is considered whether or not it has been actually incurred or when a deduction is claimed. Cilliers (2011: 227) explains the role of expenditure in the relevant parts of section 11(a) of the Act as follows:

In this context the role played by the word 'expenditure' . . . is merely to emphasise that an unconditional obligation on its own is not enough.

This argument can be explained by making use of Emslie's (2011) analogy. In Emslie's analogy, the taxpayer concludes a contract for the delivery of goods on 15 February, the goods are delivered on 25 February and payment is only made on 25 March. The criticism against the *Labat Africa* decision is that it means that the expenditure took place on 25 March and accordingly the taxpayer must be denied a deduction for the year ended February. Cilliers states that Harms AP is correct in his interpretation of the meaning of expenditure, but the judge's interpretation ought not necessarily to lead to the consequences to which it seems to lead.

In the case of Emslie's (2011) analogy, Cilliers (2011) argues that although expenditure in the *Labat Africa* sense may literally be said to have occurred on 25 March, it was not necessarily required that by 25 February there should already have *been* expenditure as understood in the judgment and accordingly the taxpayer ought not to be denied a deduction. The presence of expenditure in the phrase *expenditure actually incurred* emphasises that an unconditional liability alone will not be enough. Cilliers explains that it is not necessarily required that there should already have been expenditure by the time the liability is incurred, notwithstanding that the language of section 11(a) seems to plainly require it. He (2011: 227) explains as follows:

The subject-matter or object of the obligation must correspond to something that would constitute 'expenditure' in the sense envisaged in paragraph [12] of *Labat*, i.e. it must involve the diminution of the taxpayer's assets.

In the *PE Electric Tramway* case, the court stated that expenditure does not necessarily have to be *actually paid* in order to qualify for a deduction. Watermeyer AJP (at 15) stated that “so long as the liability to pay them actually has been incurred they may be deductible”. The judge also gave an example of a trader who owes money at the end of the tax year for goods or services which he has not yet paid. The judge states that notwithstanding that the said liabilities have not yet been paid, they are deductible. The judge’s words in the *PE Electric Tramway* case may be reasonably construed to mean that although no payment has been made by the taxpayer by the end of the tax year in respect of certain liabilities, if it is certain that such a payment will be made at a future date falling outside the current tax year, it may be unreasonable to deny the taxpayer a deduction in those circumstances. The taxpayer may risk losing the deduction in that the incurring of the liability, and the payment of it, will take place in two different tax years. Accordingly, if it is certain that such an economic sacrifice will be made at a future date falling outside the current tax year, to deny the taxpayer a deduction in both the current and a future year of assessment and would be to cause unnecessary hardship.

Taxing statutes are subject to the same rules of statutory interpretation as any other legislation. The golden rule is that where the language of the statute is clear, it must be adhered to in order to ascertain the intention of the legislature. However, it is recognised that tax law imposes a burden on its subjects and in cases where the language of the statute is ambiguous or open to more than one interpretation, an interpretation that favours the taxpayer must be adopted (*Glen Anil Development Corporation v SIR* (1975) 37 SATC 319). This principle is commonly known as the *contra fiscum* rule. The reasoning of Watermeyer AJP in the *PE Electric Tramway* case seems to be consistent with the *contra fiscum* rule.

Cilliers (2011) argues that one need not ‘yet’ have expenditure before it could be said that there is *expenditure actually incurred*, but in the same vein, argues that in a certain way there needs to be expenditure. He (2011: 228) explains as follows:

On the other hand, there must, however, indeed from the outset be 'expenditure' in the sense that the subject-matter of the relevant obligation must be such that, on the hypothesis that it will eventually be settled (like all obligations are, in the absence of simulation, intended to be), it would meet the test laid down in paragraph [12] of *Labat*.

Cilliers (2011) argues that one must *hypothetically* examine the position at the time of discharge of the taxpayer's liability as provided for in the parties' contract and ascertain whether there will be *expenditure* as contemplated in the Act. This means that one puts his mind forward to the time when the taxpayer will discharge its obligations as set out in the contract and considers whether or not the means of discharge will constitute expenditure as contemplated in the *Labat Africa* case. In the *PE Electric Tramway* case, the court stated that the expense is deductible *so long as the liability to pay actually has been incurred*, which would appear to mean that it must be certain from the outset that, although no economic sacrifice has yet been made, it will eventually be made. To deny the taxpayer a deduction in the current and future year of assessment would possibly offend against the *contra fiscum* rule. It appears that an overly literal interpretation would be unreasonable and may possibly fail to reflect the true intention of the legislature. The intention of the legislature could not have been to deny taxpayers a deduction because the payment of a liability falls outside the tax year in which the liability was actually incurred.

Van Rensburg (2013) offers an interpretation of the *Labat Africa* case that is similar to that of Cilliers (2011). She also argues that there need not yet have been expenditure at the time a deduction is claimed by the taxpayer. She argues that *expenditure* looks at the "content of the performance" and in order for the performance to constitute expenditure, it must meet the requirement set out by Harms AP in the *Labat Africa* case, this being a *diminution or movement* of the taxpayer's assets. Van Rensburg (2013: 63) gives the following explanation of expenditure in terms of *Labat Africa*:

Instead, once an unconditional obligation to perform exists, the taxpayer must claim the deduction, provided that the performance that he is obliged to perform (in future), will constitute a diminution or movement of his assets.

The Cilliers (2011) interpretation is sound and reasonable. It does not entail any unnecessary hardship for taxpayers. It seems to incorporate the Emslie and the *Labat Africa* interpretations of expenditure in a way that is consistent with statutory rules of interpreting legislation in general and tax statutes in particular. However, it may be said that the Cilliers interpretation opens up tax laws to interpretation by *divination*, a practice in terms of which a judge applies the law not by interpreting the plain language of the statute but by guessing what the drafters meant.

The undesirable outcomes of *divination* are that there will be no uniformity in the application of the law. Each judge interprets and applies the law according to their sense of fairness and the accuracy of guessing what the drafters meant or ought to have meant when they drafted the law. It may be an untenable situation which potentially means that the judges make and apply the law. This would violate the separation of powers doctrine in the Constitution of the Republic of South Africa, 1996. However, it may be safely said that the Cilliers interpretation does not necessarily amount to *divination*. It is a purposive interpretation of the law and it is supported by principles of statutory interpretation and the scheme of the Act. In any event, superior courts do create binding precedents on the interpretation of the provisions of the Act which may lessen the possibility of *divination* in the interpretation and application of the law.

### 3.8 Expenditure and the *actually incurred* requirement

The review of case law set out in the previous section indicates that there are two interpretations of expenditure, one holding that it is a payment or disbursement and the other one holding that it is a contractual or legal liability to pay. In the *Edgars Stores* case, Corbett JA (at 90) stated that “only expenditure in respect of which a taxpayer has incurred an unconditional legal obligation may be deducted”. The judge’s words can only mean that there must first be expenditure and that an unconditional legal liability must be incurred in respect of the said expenditure in order to qualify for a deduction.

In the *Omnia Fertilizer* case, it was stated that expenditure is *that which is legally owing but has not yet been paid out*. In the *Ackermans* case, Cloete JA (at 5) stated that expenditure “is the undertaking of an obligation to pay”. In the *Labat Africa* case, Harms AP (at 5) stated that “obligation or liability and expenditure are not synonymous”. The interpretation of “expenditure” in the *Omnia Fertilizer* case deserves attention as it seems to fit the ordinary meaning of a debt. No one would dispute the statement that a debt is *that which is legally owing but not yet paid out*. This begs the question whether or not *expenditure* is the same thing as a debt or a liability owed by the taxpayer. It can be asked whether or not Howie P conceived *expenditure* as *that which is legally owing but has not yet been paid out*, without any qualification.

There is evidence that the judge conceived it thus. This is supported by the use of the term *unpaid expenditure* in Howie P’s judgment. The judge makes interesting observations which may seem to come close to the proposition by Cilliers (2011) that *expenditure actually incurred* does not necessarily require that there must have been payment at the time a deduction is claimed. Howie P (at 164) states that where *unpaid expenditure* has been allowed as a deduction, there is not just an expenditure entry on the taxpayer’s books showing the debt. There is something more than that. After explaining what happens when *unpaid expenditure* is allowed as a deduction, the judge (at 164) stated the following:

There is, in addition, an assertion by the taxpayer, accepted and acted upon by the Commissioner, recognising the likelihood, if not the inevitability, that the debt will be paid.  
(Emphasis added)

Cilliers (2011) argues that there need not yet be *expenditure* at the time a deduction is claimed or when the expenditure is said to have been actually incurred as long as the taxpayer’s performance at a future date will be a payment, a diminution or movement of assets as set out in the *Labat Africa* case. On the other hand, Howie P states in the *Omnia Fertilizer* case that at the time the deduction is claimed there need only be a legal liability owed by the taxpayer but no payment as yet, which is expenditure, as long as there is a likelihood or inevitability that the liability will be paid at a future date. The

only difference between Howie P's interpretation and that of Emslie (2011) is that the latter calls expenditure a contractual or legal obligation to pay, while in Howie P's case it is *that which is legally owing but not yet paid*. Practically, it seems that this means the same thing. If a taxpayer owes someone, it has a contractual or legal obligation to pay.

According to Emslie (2011), payment is a different question altogether and there is no question of payment at the time the expenditure comes into existence. In Howie P's case, there are questions about payment at the time the expenditure comes into existence in that there must be a likelihood or an inevitability that the liability or debt will eventually be paid. This brings Howie P's understanding of expenditure closer to that of Cilliers (2011) on the basis that in both cases it is contemplated at the time a deduction is claimed that something will eventually be paid (in the case of Howie P) or the performance will be a payment, diminution or movement of assets (in the case of Cilliers).

This section of the chapter examines the *actually incurred* requirement and its relationship with expenditure in the phrase *expenditure actually incurred*. It is clear that in the expression *expenditure actually incurred*, the words *actually incurred* qualify the word *expenditure*. This means that a taxpayer is entitled to deduct its expenditure, provided the expenditure has been actually incurred. In the *Ackermans* case, Cloete JA (at 5) interpreted the words *expenditure incurred*, which he stated that they meant the undertaking of an obligation to pay or the incurring of a liability. There is an obvious problem with the judge's words and it is that the Act has no such a word combination. Incurring expenditure and *actually incurred* do not seem to mean the same thing. Cases such as *Labat Africa* and writers such as Emslie (2011) seem to support the view that *incurring expenditure* and "actually incurred" do not mean the same thing. In terms of writers such as Emslie (2011), it appears that to incur expenditure is to take on an obligation to spend money while *actually incurred* means to be unconditionally liable. It is not clear whether Cloete JA meant incurring expenditure or expenditure actually incurred with his word combination. However, the omission of the word *actually* and the definition he provides suggests that he sought to explain the meaning of expenditure.

The challenge in grappling with the meaning of the “actually incurred” requirement is that the courts have always considered the phrase *expenditure actually incurred* in a way that seems to suggest that these three words must always be read together. This is clear from the statement of de Swardt (2008), in which he relies on the *Edgars Stores* case, that “it seems clear that the actual discharge of a liability is not necessary for such a liability to constitute *expenditure actually incurred*”.

Discharge relates to payment, although it is not necessarily payment as a debtor may discharge a liability by offering some other performance of value. It seems that questions of discharge are always related to expenditure as in all its definitions expenditure seems to necessarily contemplate payment or performance. Emslie (2011) states it is a contractual or legal obligation to *pay* while Harms AP states that it is an action of payment or disbursement, requiring a diminution or movement of assets. The *actually incurred* requirement is explained by Emslie as an *unconditional legal liability to pay*. In Emslie’s analogy, the taxpayer had an unconditional legal liability upon the delivery of the goods because there was no condition he could advance as a reason not to pay.

### 3.9 ITC 1587 (1994) 57 SATC 97 and *Golden Dumps*

Emslie (2011) states that “actually incurred” refers to an unconditional legal liability to pay. However, consider the case *ITC 1587 (1994) 57 SATC 97* in which an attempt was made to explain the meaning of *actually incurred*. The case dealt with a deduction of charges on discounted promissory notes. In explaining the meaning of *incurred*, van Dijkhorst J (at 103), relying on foreign cases, stated the following:

Incurred is not limited to defrayed, discharged or borne, but does not include a loss or expenditure which is no more that impending, threatened or expected.

Van Dijkhorst J states that *actually incurred* means already defrayed, borne, suffered or laid out by the taxpayer, although it is not limited to those things. Considering Emslie’s

(2011) analogy once more in order to understand the difference between these two interpretations, the contract is concluded by the taxpayer on 15 February, the goods are delivered on 25 February and payment is made on 25 March. Emslie argues that the *actually incurred* requirement was met on 25 February because that is when the taxpayer became unconditionally liable to pay the purchase price. However, in van Dijkhorst J's reasoning, nothing is defrayed, borne or laid out by the taxpayer on 25 February. This only occurs on 25 March, at the time when Emslie states that there is a discharge. To van Dijkhorst J, Emslie's discharge plainly means *incurred*.

The judge's reasoning may seem rather confusing. In the same paragraph in which he defines *incurred* as meaning defrayed, borne or laid out, he also states that *expenditure actually incurred* does not mean actually paid, as was set out in the *PE Electric Tramway* case. When the judge says "not impending, threatened or expected", he can only mean that which has happened or taken place as a matter of fact, but when he says in the same paragraph that it does not mean *actually paid* despite defining *incurred* to mean defrayed or discharged, he seems to be contradicting himself. It may be noted that van Dijkhorst J omits the word *actually* in the above definition, but it does not appear that this omission would change the meaning he attributes to *incurred*.

An attempt to attribute a meaning of the word "actually" was made in the *PE Electric Tramway* case when Watermeyer AJP sought to distinguish between expenses *necessarily incurred* and those *actually incurred*. Necessarily incurred expenses are those that are incurred by a prudent taxpayer and are necessary for the operation of his business. Expenses actually incurred may not be necessary for the conduct of a business and may be extravagant and wasteful by a profligate taxpayer. Watermeyer AJP nevertheless concluded that these expenses are actually incurred, although they may not be necessary for the conduct of the business and that a prudent taxpayer would not have incurred them. By this he meant that they have been borne as a matter of fact, they have been borne in reality and they have been borne in truth despite that they were strictly not necessary and that a prudent taxpayer would not have incurred them. This submission is supported by Nicholas AJA (at 205) in the *Golden Dumps* case in which the judge states that "according to the Short Oxford English Dictionary,

the adverb *actually* means ‘in act or fact; really’”.

Van Dijkhorst J’s words suggest that the *actually incurred* requirement in section 11(a) requires actual payment, which would seem to be inconsistent with an established principle that *actually incurred* does not mean *actually paid*. Burt (2004) poses the question whether or not the term *expenditure actually incurred* envisages anything other than the incurring of an unconditional legal obligation requiring some performance of a monetary value. He may be justified in asking this question on the basis, as set out earlier, that the courts seem to use the words *expenditure actually incurred* to suggest that they must always be read together. This can be seen in *ITC 1801*, discussed in chapter 1, in which it was stated that the expression *expenditure actually incurred* means that the taxpayer should have incurred an unconditional legal obligation.

The question posed by Burt (2004) goes back to the question of whether or not section 11(a) envisages one or two requirements with the words *expenditure actually incurred*. The majority of writers seem to accept that section 11(a) envisages two requirements with the above words. Emslie (2011) accepts that expenditure must first exist before it can be actually incurred. Cilliers (2011) also accepts that there must be expenditure before it can be said to be *actually incurred*. The suggestion by Burt (2004) may be attributed to the fact that the courts have never grappled with the meaning of “expenditure” in section 11(a) of the Act. The meaning of expenditure has always seemed settled and as such the courts always had to answer the question whether or not the expenditure was actually incurred and, if so, when was it actually incurred. When the courts grappled with questions regarding the *actually incurred* requirement, the meaning would be attributed to the complete expression *expenditure actually incurred*.

There still remains van Dijkhorst J and Nicholas AJA’s reasoning, which seems to suggest, against an established principle, that the *actually incurred* requirement in section 11(a) of the Act requires actual payment or discharge. Van Dijkhorst J states that *incurred* is not limited to defrayed, discharged or borne but does not include impending or threatened, by which he necessarily means that *incurred* means defrayed,

borne or discharged as a matter of fact rather than impending, threatened or expected. Van Dijkhorst J's interpretation of *incurred* does not seem to be implausible.

The accepted meaning of *actually incurred* as being an unconditional legal liability owed by the taxpayer seems to have its parallel in the meaning of *accrued to*. In *WH Lategan v CIR* (1926) 2 SATC 16, the term *accrued to* in the definition of gross income in section 1 of the Act was defined by Watermeyer J (at 20) as meaning "that to which he has become entitled". In the *Ochberg v CIR* (1932) 6 SATC 1, it was explained that an amount or right *accrues to* a taxpayer when he becomes *unconditionally entitled* to it. This principle has been adopted in a number of recent cases in which the meaning of *accrued to* has been considered. The opposite of *accrued to* or *received by* is ordinarily expenditure. What is expended by one taxpayer is ordinarily *received by* or *accrues to*, another taxpayer. It has been explained in a number of cases, including the *Edgars Stores* case, that *expenditure actually incurred* envisages an unconditional legal obligation upon the taxpayer. The principle established in *WH Lategan* and *Ochberg* (1932) seems to naturally apply in the opposite to *incurred*. If a taxpayer must be *unconditionally entitled* to an amount in order for it to accrue to him, then it seems to follow that the counterparty must be *unconditionally liable* for such an amount in order to qualify for a deduction.

In his attempt to explain the meaning of *incurred*, it may be noted that van Dijkhorst J does not contrast its meaning with *conditional* as he does with *impending*, *threatened* or *expected*. If the judge had stated that *incurred* does not include *conditional* losses, expenditure or obligations, it would be easy to understand that the meaning of *incurred* requires an unconditional obligation or liability. It is unclear whether or not, where a liability that is not *impending*, *threatened* or *expected* it is also unconditional.

It may be legitimate to state that van Dijkhorst J's definition of *incurred* suggests that it requires payment or discharge, as against the *PE Electric Tramway* principle that *actually incurred* does not mean *actually paid*. It is clear in Emslie's (2011) analogy that van Dijkhorst J's account of *incurred* would lead to hardship for taxpayers where a

deduction is denied in both the current and the future year of assessment. If van Dijkhorst J and Nicholas AJA's interpretation is a better account of the meaning of *actually incurred*, but that it suggests *actual payment* in contrast to established principles, then it seems that Cilliers (2011) may have a better way of explaining it.

Cilliers (2011) offers an interesting interpretation that is similar to the one he offers on *expenditure* to explain why it may not be necessarily inconsistent with the scheme of the Act that the *actually incurred* requirement in section 11(a) is interpreted in a manner that seems to suggest that it requires actual payment. Cilliers (2011: 227) states the following:

. . . the answer is precisely that the 'actually incurred' requirement itself shows that what section 11(a) contemplates at an overall level is not that there must actually (already) 'be' expenditure in the sense contemplated in paragraphs [8] and [12] of Labat.

Van Dijkhorst J's interpretation of the *actually incurred* requirement is clearly inconsistent with Cilliers' explanation as set out above. In van Dijkhorst J and Nicholas AJA's interpretation, *actually incurred* means "defrayed, borne or laid as a matter of fact or in reality". In this case, section 11(a) would have to be read to mean *expenditure defrayed or borne as a matter of fact or in reality*. It seems contradictory to say there must be expenditure borne as a matter of fact or in reality but at the same time hold that there need not yet already 'be' expenditure as explained by Cilliers. It appears that the propositions are mutually exclusive. Even if one accepted van Dijkhorst J and Nicholas AJA's interpretation of *actually incurred*, a purposive interpretation of section 11(a) is possible in light of the *contra fiscum* rule in order to avoid circumstances in which a deduction is denied in both the current and the future year of assessment. It is clear that Watermeyer AJP adopted this kind of interpretation when he stated that *actually incurred* does not mean *actually paid* in the *PE Electric Tramway* case.

### 3.10 Barter and non-cash transactions

In order to examine the correctness of the decision in the *Labat Africa* case, and the reasoning of Cilliers (2011) and van Rensburg (2013), it is necessary to examine day-to-day transactions such as credit purchases or non-cash transactions to see whether their deduction would be barred on an application of the conclusions in *Labat Africa*. In terms of the *Labat Africa* case and other decisions before it, expenditure is the spending of money, diminution or movement of the spender's assets.

Cilliers (2011) states that section 11(a) does not necessarily require that there should already be expenditure in the sense contemplated in *Labat Africa* at the time a deduction is claimed. He argues that the words *expenditure actually incurred* show what is required at an overall level, which is that a legal obligation alone is not sufficient. He argues that, at the time that it is due, the performance must be such that it would amount to expenditure as contemplated in the *Labat Africa* case. Ger (2012) and van Zyl (2012) provide points of criticism about the consequences of the *Labat Africa* decision on credit purchases and non-cash transactions in that these transactions would seem to be denied a deduction on the application of the *Labat Africa* case.

Ger (2012) states that on Harms AP's reasoning, if goods are bought on credit in year one and payment is made in year two, it would seem that there was no expenditure because there was no payment, diminution or movement of assets. However, as Ger himself seems to acknowledge, in practice the taxpayer would be allowed a deduction in year one under these circumstances. The *Labat Africa* case must still be examined as to whether or not, on a plain reading, it would to deny a deduction for such transactions. The analogy of a bookstore would assist in explaining the *Labat Africa* reasoning in the case of credit purchases. If the bookstore concludes a contract to buy books on credit from a supplier on 30 January and the books are delivered on 28 February, it appears that, on the *Labat Africa* reasoning, that the bookstore would be denied a deduction for the expense in the year ended February because there was no payment, diminution or movement of the taxpayer's assets. This could not have been intended by the drafters of the law and may cause hardship for taxpayers. One could,

nonetheless, argue that no hardship would result because the assets of the purchaser have not been diminished. However, the hardship lies in the fact that in the following year, the deduction may be disallowed on the basis that it was incurred in the previous year, as shown by the *Sub-Nigel* case, while in the previous year it could not be claimed because there was no payment of money as yet.

It seems that an explanation for the above anomaly may be found in the *Omnia Fertilizer* case. The explanation is found in the words of Howie P that were partially quoted earlier in which he dealt with the meaning of expenditure. The full statement by the judge (at 164) on the point is as follows:

There is, in addition, an assertion by the taxpayer, accepted and acted upon by the Commissioner, recognising the likelihood, if not the inevitability, that the debt will be paid. That is the basis for regarding the unpaid debts as actual expenditure. (Emphasis added)

On a plain and literal reading of section 11(a), aided by the decision in the *Labat Africa* case, it appears that unpaid debts would not be permitted a deduction from the taxpayer's income. It is submitted that the reason why unpaid debts would be permitted as a deduction in terms of section 11(a) of the Act is the result of a purposive interpretation of the provisions of the Act and the *contra fiscum* rule. The *Omnia Fertilizer* case supports this submission. In that case, the taxpayer was a fertilizer manufacturer who received stock from suppliers. The practice of the parties was that suppliers were paid upon submitting an invoice, but no suppliers submitted an invoice during the year in question and it appears that no invoice had been submitted at the time the matter was decided by the Supreme Court of Appeal.

What is pertinent in the *Omnia Fertilizer* case is that the taxpayer had only recorded a liability in its books. It had not paid out anything to any supplier and arguably it had not diminished its assets in any way or experienced any movement of its assets. The taxpayer was, nevertheless, allowed a deduction of the recorded liability as actual expenditure notwithstanding non-payment. The question before the court was whether or not there was a recoupment, as the suppliers had failed to invoice the taxpayer for

payment by the following tax year. It is submitted that it was sound to allow the taxpayer a deduction and this was in line with a purposive reading of the law in light of relevant principles of statutory interpretation.

Van Zyl (2012) sets out an interesting analogy in an attempt to show the limits of the *Labat Africa* decision, which requires that a taxpayer parts with something or is impoverished, even if temporarily, or engages in a movement of its assets in order to qualify for a deduction. Van Zyl takes the case of X, a physiotherapist, who, in return for services rendered to him by Y, who is an electrician, performs physiotherapy on Y in full and final payment of what he owes Y for his services. An ordinary patient would have paid X an amount R500 for the session. Van Zyl argues that because X could have charged an ordinary patient R500, he must have incurred expenditure as contemplated in the *Labat Africa* case. This argument will also be dealt with fully in the next chapter where it is considered in the context of share-based payment transactions.

The barter scenario described by van Zyl (2012) would seem to be akin to a set-off, a situation in which parties are mutually indebted to each other under similar obligations, usually to pay money (van Rensburg: 2012). In *Labat Africa*, Harms AP stated that expenditure is payment, diminution or movement of the assets of the spender. In van Zyl's barter scenario, it seems that there is neither of these things, yet there is a legitimate transaction without simulation. The question is whether or not X should be denied a deduction. The only other way the parties could have carried out their transaction would have been by X paying Y for his services to him and thereafter Y immediately paying X the same amount of money for the physiotherapy session.

In *Stanton v Drayton Commercial Investment Co Ltd* (1982) 2 All ER 942, Lord Roskill (at 949) stated that such a "circuitous process is not essential". It appears that such an exercise would constitute an unnecessary meandering with the same result. It is submitted that Harms AP could not have intended to deny a deduction to transactions such as this. The context in which he defined expenditure was that of a share-based payment in which a company creates a bundle of rights in itself. Van Zyl's analogy is not exactly the same as a share-based payment transaction as will be seen later.

### 3.11 Accounting treatment of expenditure

Faul, Pistorius, van Vuuren, Vorster and Myburgh (2004) published an introductory textbook in accounting in which relevant accounting concepts are explained in a manner that even non-accountants could understand. The relevant accounting concepts for the purposes of this thesis are a liability, current or non-current, an expense, expenditure and the concept of accrual. Taxpayers' books are prepared in accordance with certain accounting principles and the Commissioner may take these accounting principles into account in assessing a taxpayer, but, ultimately, as will be shown later, the Commissioner may disregard them.

Faul *et al* (2004: 388) state that a current liability "represents a current obligation of an entity resulting from preceding events whose payment is expected to lead to an outflow of resources from the entity". According to the authors, in order for a current liability to be regarded as such, the obligation must be payable within a year from the date of the entity's balance sheet. Non-current liabilities are similarly defined, with the exception that the date on which an obligation is payable is longer than one year from the date of an entity's balance sheet.

Faul *et al* (2004: 66) state that expenses "are decreases in economic benefits during a financial period in the form of outflows or depletions in assets or the incurring of liabilities which decrease equity". An exception regarding a decrease in equity is where the decrease is due to disbursements made to equity participants, which appears to mean shareholders. The taxpayer in the *Omnia Fertilizer* case claimed a deduction of a liability from its income when, in accounting terms, there was no outflow of economic benefits or resources as yet. This may be due to the recognition principle or the concept of accrual in accounting. Faul *et al* (2004: 29) state that in terms of the concept of accrual, "transactions and other events having an influence on the financial position of the entity must be recognised when they occur and not when cash resulting from the transaction or event is received or paid". The authors explain that if the above principle were not applied, debt transactions would not be recognised.

It appears that deductions are allowed for transactions which, in accounting terms, may only be described as liabilities for which there is not yet any outflow of economic benefits. The question of accounting principles and the provisions of the Act has been considered in some cases. The case of *Pyott Ltd v CIR* (1944) 13 SATC 121 dealt with provisions made in the balance sheet in order to meet refunds for deposits paid on containers by the taxpayer's customers. In the *Pyott* case, the taxpayer carried on business as a manufacturer of biscuits and it also manufactured the tins in which the biscuits were sold. The cost of the tins was included in the price of the biscuits in that the biscuits were sold for a little more than they would have been sold without the tins. A portion of the purchase price attributable to the tins was refundable to the taxpayer's customers upon the return of a container. In order to ensure that it met the demand for refunds when customers returned the containers, the taxpayer raised a provision of £9 000 in its balance sheet. The court tacitly acknowledged that the raising of a provision was a sound accounting practice, but it held that the £9 000 was not a permissible deduction in terms of the Act. In the relevant parts of his judgment, after dealing with the question of sound accounting principles, Davis AJA (at 126) stated that "the answer is that our Income Tax Act has laid down what is to be taxed, even if in so doing it may be said to disregard those principles".

The other cases in which questions similar to the *Pyott* case were considered are *Brookes Lemos Ltd v CIR* (1947) 14 SATC 295 and *Greases (SA) Ltd v CIR* (1951) 17 SATC 358. The *Brookes Lemos* case dealt with deposits on the return of containers, which deposits the taxpayer held loosely in trust for its customers. It was held that the taxpayer was not a trustee and that the deposits formed part of its gross income. The *Greases SA* case also dealt with deposits on containers which the taxpayer held loosely in trust. In this case, the taxpayer had even created a *drums suspense account* in its books but utilized the deposits in its business operations. The *drums suspense account* was surely a sound accounting practice, but the court held that the deposits had to be included in the taxpayer's gross income, in effect denying a deduction in respect of the amount transferred to the drums suspense account to provide for future liabilities to repay the deposits.

### 3.12 Actual, future and contingent liabilities

It appears that there is a difference between actual, future and contingent liabilities. Actual liabilities do not present a problem. It can be deduced from the cases *ITC 1587* and *Golden Dumps* that actual liabilities are those liabilities that have been borne as 'a matter of fact' or 'in reality'. It appears that this would be the case where expenses have been incurred and settled in the same tax year. There is no doubt that such liabilities should be deductible from the taxpayer's income.

It appears that one may deduce from the *PE Electric Tramway* and *Omnia Fertilizer* cases that future liabilities are liabilities in which a liability is incurred, but which will only be settled at a date falling outside a current year of assessment. It cannot be a future liability if the taxpayer only foresees or envisages that it will incur it at some point in the future. It appears that a future liability envisages a present legal obligation which will only be settled at some point in the future. It appears that it would be incorrect to speak of a liability without any form of a present legal obligation. In the *PE Electric* and *Omnia Fertilizer* cases, there was a present legal obligation actually incurred by the taxpayer, but which would only be settled at a date falling outside a current year of assessment. Future liabilities are deductible from a taxpayer's income if they are actually incurred and this seems to envisage that it must be certain that they will be settled at some future date falling outside of a current year of assessment.

The case *Nasionale Pers Bpk v KBI* (1986) 48 SATC 55 dealt with a provision made in the taxpayer's books of account for the future payment of bonuses. The case summary shows that the claim for the deduction was refused on the grounds that it was not actually incurred. The judgment is written in Afrikaans, but in his translation, Williams (2009: 424) indicates that the following was stated by Hoexter JA:

The requirement that the expenditure must be 'actually incurred' has however the result that possible future outgoings that are regarded as merely probable are not deductible in terms of section 11(a).

The *Edgars Stores* and the *Ackermans* cases show that contingent liabilities are conditional. A contingent liability is one in which the liability is dependent upon certain events before it could be said to be actually incurred by the taxpayer. It appears that only upon the fulfilment of certain conditions may the liability be said to have fallen upon the taxpayer. In the *Edgars Stores* case, the taxpayer's liability in respect of the turnover rental was contingent in that it depended upon its determination in terms of an agreed formula after the taxpayer's financial statements became available at the end of the financial year. Contingent liabilities are not deductible because case law shows that there must be an unconditional legal obligation during the year of assessment in respect of the expenditure in order for it to qualify for a deduction.

### 3.13 Conclusions

There has never been a consistent statement of the law regarding the meaning of expenditure. On the one hand, it has been said to be a contractual or legal obligation to pay, and on the other hand, it has been said to be a payment or disbursement. A number of major cases such as *Stone, Joffe & Co* and *Labat Africa* have held that expenditure envisages payment of money or a disbursement. This has the implication that by the time a deduction is claimed by the taxpayer, payment must have been made in order to successfully claim the deduction. This interpretation of expenditure has the consequence of denying a deduction to transactions such as credit purchases, which are permitted a deduction in practice.

A number of other cases such as *PE Electric Tramway*, *Caltex Oil* and *Edgars Stores* have held that expenditure envisages the undertaking of a legal obligation and does not require actual payment. This interpretation of expenditure would seem to permit a deduction in circumstances where the taxpayer suffered no diminution of its assets. This could occur where a taxpayer is paid for services rendered by being admitted as a member of the organization to which the services were rendered. In circumstances such as this, there would certainly be an undertaking of a legal obligation, but it appears that it would be incorrect to refer to the offer of membership as expenditure.

Writers such as Emslie (2011) and Ger (2012) argue that payment, discharge or settlement of a liability are events that occur only after expenditure has come into existence and been actually incurred. They argue that these events are themselves not expenditure, but a means to meet the expenditure. Section 11(a) of the Act does not use words such as discharge, payment or settlement. It only uses the phrase *expenditure actually incurred*. It is clear that some form of payment or economic sacrifice must have been envisaged in the phrase *expenditure actually incurred*. It appears that if no form of payment was envisaged in the phrase, then the drafters of the law would have incorporated the words payment, discharge or settlement into section 11(a) of the Act. Cilliers (2011) states that the *Labat Africa* meaning of expenditure considers the position hypothetically at the time of discharge and does not necessarily require that there should be *expenditure* as contemplated at the time a deduction is claimed. The *Labat Africa* meaning of expenditure is preferable if the interpretation of Cilliers (2011) is adopted in that it is consistent with a purposive interpretation of the law and the *contra fiscum* principle.

The *actually incurred* requirement appears to envisage an *unconditional liability* as interpreted by Emslie (2011) and by the courts in cases such as *Ackermans* and *Edgars Stores*. On the other hand, *actually incurred* appears to mean *defrayed* or *borne* in fact or in reality. The latter meaning is suggested in cases such as *ITC 1587* and *Golden Dumps*. It seems to suggest that for expenditure to be *actually incurred*, it requires actual payment, as against an established principle that *actually incurred* does not mean *actually paid*. This may lead to unnecessary hardship for taxpayers where a deduction is denied in both the year it was actually incurred and the year it was paid because these events took place in different years of assessment. Cilliers (2011) states that the *actually incurred* requirement in section 11(a) of the Act indicates what the law requires at an overall level. This purposive interpretation of the law must be supported in order to avoid hardship to taxpayer.

Van Zyl (2012) and Ger (2012) point to the consequences of the *Labat Africa* decision on non-cash and credit transactions. It would cause unnecessary hardship to taxpayers if the above transactions were denied a deduction on the basis that there is no

payment, diminution or movement of assets as contemplated in the *Labat Africa* case. However, it does not seem that Harms AP could have intended that these transactions be denied a deduction. The context in which he defined expenditure was that of a share-based payment. The transactions are not necessarily similar to share-based payments. The *Omnia Fertilizer* case appears to provide evidence of a purposive interpretation and application of section 11(a) on credit purchases and similar transactions.

A proper interpretation of expenditure is that it does envisage or require payment as stated in *Labat Africa*, but that a taxpayer ought not to be denied a deduction where payment is not made in the same year in which the liability was actually incurred as long as it is certain that the performance at a future date will amount to a payment or diminution of assets as contemplated in the *Labat Africa* judgment. It appears that this is the manner in which the courts interpret and apply the provisions of section 11(a) in practice. The *Omnia Fertilizer* case seems to support this submission. This understanding is relevant in answering the question in the next chapter whether or not an issue of the taxpayer's own shares is expenditure as contemplated in section 11(a) of the Act and therefore qualifies for a deduction. The next chapter discusses the issue of the taxpayer's own shares as a consideration for goods or services rendered. A correct meaning of expenditure, as discussed in chapter 3, is relevant in considering whether or not there is expenditure when a taxpayer issues its own shares as a consideration for goods or services rendered.

## CHAPTER 4 – PAYING WITH SHARES

### 4.1. Introduction

The previous chapter discussed the meaning of expenditure as contemplated in section 11(a) of the Act. This chapter discusses the issuing of shares as payment for goods or services rendered to a taxpayer in order to address one of the research goals, namely to consider whether or not an issue of shares for trading stock or services rendered constitutes *expenditure* as contemplated in section 11(a) of the Act. The *Labat Africa* case was not the first case heard by the Supreme Court of Appeal in which expenditure was defined as the action of spending funds or money, but appears to be the first one in which the direct question was decided on whether or not an issue of shares constitutes expenditure as contemplated in the Act.

The second section of this chapter discusses various court decisions in which shares were issued as a consideration for goods or services. This is done with a view to examining how the courts have always treated transactions involving shares as either a receipt or as a form of payment for goods or services. Some of the cases discussed in this section are the *Lace Proprietary Mines*, *Niko* and *Labat Africa*. The third section of the chapter discusses the forfeiture of a right by the company to receive cash for the subscription of its shares and considers whether or not there is expenditure in such circumstances. The English cases in which the argument regarding the forfeiture of a right to demand cash was first made are also considered in this section.

The fourth section of the chapter discusses hybrid debt instrument with a view to consider whether or not there is expenditure when a taxpayer's creditor converts a debt against the company into its shares. The rest of the other sections briefly discuss the accounting treatment of share issues and the notion of tax asymmetry in which the receipt of shares is included in the taxpayer's gross income while the issue of shares as a consideration for goods or services rendered is not allowed a deduction. The last section offers concluding remarks and summarises the discussion in this chapter.

There are circumstances where a taxpayer, in this case a company, pays for goods or services by issuing its own shares, credited as fully paid up. This could be done for many reasons. One of the reasons a taxpayer would issue its own shares for goods or services rendered is where it is experiencing cash flow problems in which it does not have enough cash on hand to pay for the goods or services. These transactions are generally known as share-based payments. However, Pretorius, Venter, von Well and Wingard (2009) distinguish between two types of share-based payment transactions. It is significant to identify the types of share-based transactions that are the subject of discussion in this thesis.

Pretorius *et al* (2009) explain that there are cash-settled share-based payment transactions and equity-settled share-based payment transactions. Cash-settled share-based payments are transactions in which a taxpayer has a liability to transfer cash or assets to a supplier of goods or services in which the amount of such cash or assets is based on the price or value of the taxpayer's shares. Equity-settled share-based payments are transactions in which the taxpayer receives goods or services in return for the issue of its own shares to the supplier of the goods or services. This thesis is not concerned with cash-settled share-based payment transactions. It is concerned with the second type of transactions, namely equity-settled share-based payment transactions.

#### 4.2. Paying with the issue of shares

There are two court decisions that should be mentioned at the outset in a discussion about share-based payments, because one has been relied upon in recent cases on share-based payments and the other was a decision directly on the subject of share-based payments, although the question of their deductibility does not appear to have been argued before the court. The two decisions are the *Lace Proprietary Mines* case, which has already been mentioned in the previous chapters and *ITC 703 (1950) 17 SATC 208 (N)* which, as it appears, was a tax court decision.

In the *Lace Proprietary Mines* case, the taxpayer sold its mining claims to a newly formed mining company and the consideration was one million shares in the purchasing company. The question before the court was whether the sale of the claims was a change of investment, in which event the consideration would be of a capital nature or a realisation in a scheme of profit making, in which case the consideration would be of a revenue nature and taxable. It was found that the sale was a realisation in the nature of a profit-making scheme, the proceeds of which were taxable in the hands of the taxpayer. There was no question as to whether or not the consideration should have been taxable at all on the basis that it was shares, not cash or another asset. It appears that there was an unexpressed understanding that shares constitute a receipt as contemplated in the definition of “gross income” in section 1 of the Act.

In *ITC 703*, the taxpayer paid service providers by issuing to them 12 500 shares of £1 each in its share capital. The services rendered to the taxpayer related to the establishment of its business and certain services for a period of ten years after the establishment of the business. The deduction was allowed in respect of the period after the business had been established in proportion to the years in which services would be rendered to the taxpayer. The portion of the consideration relating to the establishment of the business was denied as being of a capital nature. There were no questions on whether or not the consideration, being shares, constituted expenditure at all. It appears that it was accepted that shares constitute expenditure.

In the *Ochberg* (1931) case, the taxpayer was a sole shareholder in a company which he caused to issue additional shares to himself. The transaction never increased or decreased the value of his shareholding in the company, he being the sole shareholder for all practical purposes. The shares were said to be issued to him for certain services he had rendered to the company. The question was whether or not the shares constituted gross income in the hands of the taxpayer. The majority of the court held that they constituted gross income because they were issued for services rendered by the taxpayer to the company. The minority held that the shares did not constitute a receipt if one considered the substance of the transaction on the basis that although the taxpayer was issued with additional shares, his wealth remained the same. The shares

never increased his wealth because the effect of the transaction was that his shareholding decreased by the same value of additional shares issued to him on the basis that he was the sole shareholder in the company and may be said to have taken from one pocket and put into the other, which left him in the same position as he was before the issue of additional shares. It may also be noted in this case that there was no question as to whether or not the shares should constitute gross income at all on the basis that they were shares, not cash or other assets.

In *CIR v Niko* (1940) 11SATC 124, the court dealt with the sale of a business as a going concern. The consideration received by the taxpayer for the sale of his business was an amount of cash and shares in a newly formed company. The dispute with the Commissioner related to the value at which the taxpayer's stock-in-trade should have been entered in his books when he submitted his tax return. The parties had accepted that the profit realised by the taxpayer on the sale of his business was of a capital nature. Notwithstanding that this point was not argued before it, the Appellate Division held that the proceeds of the sale were of a revenue nature on the grounds that the taxpayer's trading stock was his floating capital. It was held that the taxpayer was entitled to deduct the cost of his stock-in-trade from the proceeds of the sale and the difference was taxable. It may be noted again in this case that there was no debate as to whether or not shares constitute a receipt.

In *ITC 1783*, the taxpayer bought a business with valuable business licences by issuing to the seller shares worth over R5.2 million in its share capital, credited as fully paid up. Goldblatt J (at 376) adopted a dictionary meaning of expenditure and held that it meant the spending of money or its equivalent, resulting in the diminution of the assets of the person incurring the expenditure. Goldblatt J (at 376) held that a share is a bundle of rights in a company, that its issue does not involve a diminution of the company's assets but may diminish the holdings of the company's current shareholders. It appears that this case was never appealed by the taxpayer notwithstanding criticism of the decision by many writers such as Ger (2004) and Burt (2004).

*ITC 1801* was decided a year after *ITC 1783*. *ITC 1801* was the forerunner of the *Labat Africa* case, which was discussed in chapter 3, in which the taxpayer acquired a business together with its trademark by issuing to the counterparty shares worth over R133 million (R44 million being apportionable to the trade mark) in its share capital, credited as fully paid up. Jooste AJ considered *ITC 1783* in his judgment and concluded that it misstated the legal position on the subject of expenditure actually incurred. Jooste AJ (at 61) held that *expenditure actually incurred* meant an unconditional legal obligation and that it is not required that the obligation should have been discharged. The judge (at 64) relied on the *Lace Proprietary Mines* case in holding that an undertaking by a company to issue its own shares constituted a real consideration by the company, otherwise it would not have to be included in its income as it was done in *Lace Proprietary Mines*. He held that the shares constituted a real consideration.

On appeal to the High Court, the Commissioner lost the appeal and Jooste AJ's judgment was confirmed. The High Court judgment is less than three pages and it is thin on reasoning and the exposition of the law. There is not much that can be extracted from it regarding the legal principles raised by the transaction between the parties in *ITC 1801*. On further appeal by the Commissioner, the Supreme Court of Appeal accepted the reasoning of Goldblatt J in *ITC 1783* and upheld the Commissioner's appeal. Harms AP (at 5) held that expenditure is an action of spending funds, resulting in the diminution or movement of the assets of the person incurring the expenditure.

*ITC 703* is a tax court judgment and the question of whether or not an issue of shares constitutes expenditure was never argued before the court. The case may nonetheless appear to suggest that the courts have always regarded an issue of shares as expenditure. However, it does not appear that there are other cases in which the above suggestion could find support. On the contrary, authoritative cases such as *Estate Kohler* and *Estate Furman*, decided during the period *ITC 703* was decided, seem to suggest the opposite. *ITC 703* has no authoritative value. If it has any persuasive value, it is only negligible on the grounds that it is a tax court decision and the question of whether a share issue amounts to expenditure was never decided by the court.

The challenge against the reasoning of the court in *ITC 1801* is that the court seems to have considered the meaning of *expenditure actually incurred* when it should only have considered the meaning of *expenditure* as the proper question to be decided in that case. The court's approach in this case was that the expression as found in section 11(a) of the Act envisages one requirement, not two. The suggestion by Burt (2004) that *expenditure actually incurred* may envisage nothing more than an unconditional legal obligation is not tenable. The court in *ITC 1801*, as also found by Harms AP, seems to have conflated expenditure with a consideration. The court seems to have erred in doing so. Van Zyl (2012) correctly states that consideration has a wider application than expenditure.

The problem with cases such as *ITC 1783* and *Labat Africa* is that they appear to cause confusion and disturb what appears to be settled principles, while at the same time not purporting to overrule the cases in which the principles were established. When expenditure is defined as the spending of funds without any qualification, such a statement disturbs the principle that *actually incurred* does not mean *actually paid*. However, it has been shown in the previous chapters that there has never been a consistent statement of the law on the meaning of expenditure. On the one hand, it has been interpreted as meaning the undertaking of a legal liability while on the other hand it has been interpreted as meaning the payment of money. The decisions in *Lace Proprietary Mines*, *Ochberg*, *Niko* and *Labat Africa* show that a receipt of shares as a consideration is taxable in the hands of the taxpayer, while in terms of the decisions in *ITC 1783* and *Labat Africa*, the issue of shares as an outlay is not deductible. This is discussed in the section below on tax asymmetry.

#### 4.3 Forfeiture of the right to demand cash for shares

Critics of the *Labat Africa* judgment such as Ger (2012), Meyerowitz (2004) and van Zyl (2012) argue that as long as the taxpayer has incurred an unconditional legal liability, it should be entitled to a deduction and that it does not matter how it later chooses to settle the liability, be it by cash or an issue of shares. There are authoritative cases in South Africa in which the nature of shares has been considered. These cases are

directly relevant because they aid in answering the question whether or not an issue of shares is expenditure.

The *Estate Kohler* case dealt with a situation in which the deceased had caused shares in a company he controlled to be issued to a beneficiary. The minority judgment in the case found that, due to the legal nature of shares, there was no property passing from the company to the donee which would trigger estate duty. The majority judgment found that, although, on the pure legal nature of shares, there would be no property passing from the company to the donee, the Act specifically deemed that there was a donation in the circumstances of that case. Centlivres CJ (at 364) stated that “when a company issues shares to an allottee, no property passes from the company to the allottee”.

In the *Estate Kohler* case and *Estate Furman and Others v CIR* (1962) 25 SATC 4, the allotment of shares by the company controlled by the deceased to the donees was artificially dealt with as a donation by the provisions of the law. This is recognised by Steyn CJ (at 17) in his judgment in the *Estate Furman* case whose facts are similar to the *Estate Kohler* case. These cases seem to mean that unless there is a clear provision in the law deeming an issue or allotment of shares to be property passing from the company to the donee, the correct position is that such an issue or allotment does not constitute property passing from the company to the donee. The reason for this view is the legal nature of shares as discussed in chapter 2. It was explained in that chapter that when a company issues its own shares to an allottee, what happens is that the company creates a bundle of rights in itself for the allottee. It gives nothing out and it passes nothing to the allottee.

The critics of the *Labat Africa* case argue that by forfeiting the cash it is entitled to demand in terms of the law, a company is incurring expenditure. The basis in law for this argument is section 40 of the new Companies Act (and previously section 92 of the repealed Companies Act). Section 40 of the new Companies Act states that the board of a company may issue authorised shares only for adequate consideration to the company, as determined by the board. Section 92 of the repealed Companies Act stated that no company shall allot or issue any shares unless the full issue price of, or

other consideration for such shares has been paid to and received by the company.

It follows that no shares may, by law, be issued without the full subscription price being paid by the allottee unless it is expressly permitted by the law. De Swardt (2008: 484) argues that “on surrendering its personal right, a company is consequently parting with an asset, with an ensuing diminution of the company’s patrimony”. He argues that in giving up its “primary right” to receive the subscription price, the company is incurring an expense. Ger (2004) also states that when a company exchanges its own shares for services, it is giving up a right to claim payment in cash for the shares. The right it gives up is an economic sacrifice and accordingly constitutes expenditure. Burt (2004) presents similar arguments.

All these writers adopt this reasoning from English cases in which similar questions were considered. The most significant of these cases is *Osborne v Steel Barrel Co., Ltd* 1942 1 All ER 634. This was a decision of the Court of Appeal. The taxpayer was formed after acquiring stock and contracts for its benefit for a total sum of £10 000 in cash and 30 000 shares, credited as fully paid up. The Commissioners argued that the stock cost the company £10 000 only and that the shares it issued cost it nothing, hence no deduction should be permitted in respect of the shares. Lord Greene, MR rejected the Commissioner’s arguments as being based on a misconception of what happens when a company issues its own shares, credited as fully paid up.

The basis of taxation in the United Kingdom and South Africa is different. In South Africa, it is gross income while it appears to be profits and gains in the United Kingdom. However, the principles relating to share-based transactions would seem to have general application, despite a difference in legislation. If this is incorrect, then it still seems that English decisions could be of assistance in understanding the nature of share-based transactions. In *Osborne*, Lord Greene, MR (at 637) stated this:

The primary liability of an allottee is to pay for shares in cash; but, when shares are allotted credited as fully paid this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when, in pursuance of such a

transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash.

In *Craddock v Zevo Finance Co., Ltd* 1944 1 All ER, the principle established in the *Osborne* case was confirmed. The *Craddock* case dealt with a dispute regarding the value at which investments should have been entered in the taxpayer's books of account in order to determine its profits and losses. Lord Greene, MR also delivered judgment in this case and he stated that where a company acquires property for its own fully-paid up shares, the price paid by the company is the nominal value of the shares.

This principle was also confirmed in the *Stanton* case, which was referred to in chapter 3. The *Stanton* case dealt with the valuation to be placed on shares issued as a consideration for the acquisition of an investment portfolio. The *Stanton* case was decided in 1982 and it appears that by that time it was accepted in the English courts that where shares are issued as a consideration for goods or services, the price paid is the value of the shares. The question raised in the *Stanton* case was whether the purchase price should be the value of the shares as quoted on the exchange or the agreed price in the contract between the parties. This is the case in which Lord Roskill (at 949) stated that the “circuitous process” of paying out cash and later subscribing for shares is not essential.

Ger (2004) explains that in most cases of share-based payment transactions, companies are forced to issue shares because they do not have the ready liquidity to buy the assets or services they need. It appears that two situations can be distinguished in share-based payment transactions. The first is where a member of the public, seeking to subscribe for shares in a company, but who does not have the cash to do so, offers some consideration other than cash. The second situation is where the company has purchased goods or received services, but does not have the cash to pay for the goods or services, offers to settle the indebtedness by issuing shares in itself, credited as fully paid up to the supplier of goods or provider of services. The second situation is what Ger considers to be commonplace.

It must now be considered whether or not a company has a right to demand cash for the issue of its own shares, and if it does, under what circumstances. Van Rensburg (2012) has considered this question and she (2013: 70) submits as follows:

If the parties agreed that the consideration is in kind, the company's only right is the right to that in-kind consideration; it has no right (enforceable or otherwise) to a cash amount.

It is submitted that this view is correct and there is case law to support it. It is submitted that under the circumstances set out in situation one, the company may be entitled to demand payment in cash for the subscription of its shares. Even so, it does not seem that there has ever been a *primary right to demand cash* in South African law. The repealed Companies Act required the *full purchase price or other consideration* while the new Companies Act requires *adequate consideration*. It appears that the use of the conjunction 'or' never implied any primary right. It appears to have suggested an alternative. Parties could agree to *other consideration* notwithstanding that the purchase price could be settled in cash.

It is submitted that, in terms of the new Companies Act, when a company issues its own shares to a subscriber, it is entitled to demand adequate consideration and this may or may not be cash. However, when a company issues its own shares in settlement of an obligation to a supplier for services, then it may not demand any other consideration, be it cash or otherwise, since it has already been rendered with services which it chooses to settle by issuing its own shares. It would be incorrect to suggest that a company could demand cash for issuing its shares in settlement of its debt because this would amount to a situation in which the company seems to demand cash for the debt it owes to a creditor, which would be untenable. It is clear that, under these circumstances, there can be no primary right to demand cash. The support for this submission is to be found in the words of Stratford CJ (at 361) in the *Lace Proprietary Mines* case in which the learned judge stated as follows:

*No cash consideration could be demanded from the purchaser who was entitled and obliged to deliver these shares in fulfilment of its obligation to pay for the assets bought.*

In Australia, the position seems to be different from that in the English courts. The position seems comparable to the one set out in the *Estate Kohler* and *Estate Furman* cases. The relevant cases are *Ord Forrest (Pty) Ltd v FCT* (1973) 73 ATC 4022 and the *St Helens Farm* case which has been referred to in chapter 2. These cases dealt with gift duty under the Gift Duty Assessment Act of Australia, which appears to be the equivalent of donations tax in South Africa. The provision of the legislation considered in these cases was the meaning of *disposition* in the context of share allotments.

In *Ord Forrest*, the taxpayer issued shares to certain beneficiaries at less than their market value. The allotment was found to be a disposition of property in terms of the Gift Duty Assessment Act and it was accordingly held that the company had made a gift to the allottees which triggered gift duty. Stephen J (at 4024) considered the meaning of *disposition* and *gift* in the context of the allotments. It is significant to note that the Gift Duty Assessment Act considered by judge had a defined meaning of *disposition of property* which was an all-encompassing definition expressly including the *allotment of shares in a company*. In the circumstances of that case, the allotment by the company was expressly deemed to be a disposition of property by the law. Stephen J found that the words of the Gift Duty Assessment Act were clearly applicable to the case he considered. The judge also found that the words *disposition of property*, as defined in the law he considered, could not be confined to a situation where a third party causes a company to allot shares to an allottee, as in the case of a sale. The *St Helens Farm* case also considered questions similar to the ones considered in *Ord Forrest*. The case dealt with five appeals concerning the issue of shares at less than their fair value, which constituted a gift in terms of the Gift Duty Assessment Act. The Commissioner succeeded in that the allotments were found to constitute gifts as contemplated in the Gift Duty Assessment Act. The Commissioner was not successful in relation to the valuations he placed on the shares and the taxpayer companies successfully challenged the valuations. The *Ord Forrest* case was considered and it was held that due to the even division of opinion, it was not a binding precedent but was not overturned. Some of the judges followed the judgment of Stephen J in *Ord Forrest*.

It would not be advisable to adopt the conclusions of the courts in the Australian cases because they dealt with different questions and defined legislative terms in an Australian statute. In any event, van Rensburg (2013: 64) states that the Australian Tax Office does not regard share-based payments as either an “outgoing” or “expenditure” in terms of Australia’s Income Tax Assessment Acts of 1936 and 1997.

#### 4.4 Hybrid debt instruments

In a hybrid debt instrument, the taxpayer’s creditor has the option of converting the debt instrument into shares in the share capital of the taxpayer. One could conceive of two situations in respect of hybrid debt instruments. The first is a debenture, or an instrument akin to it, in terms of which the taxpayer acquires capital by creating in itself a long-term liability in favour of the holder of the instrument. The second situation could be where the taxpayer was provided with certain services, but the parties agree to enter into an acknowledgment of debt in which the taxpayer acknowledges its indebtedness. The parties could also provide in the acknowledgment of debt that the debt is payable within a period of two years, but should the taxpayer not be in a position to pay, the creditor will have an option to convert the debt into shares in the taxpayer’s share capital. This type of arrangement is possible and it does not appear that there would be anything in law to prevent parties from entering into such an arrangement.

The instrument described in the first situation clearly qualifies as a hybrid debt instrument in terms of section 8F of the Act. In the circumstances described in the first situation it would be incorrect to say there was any form of expenditure by the taxpayer. It appears that the first situation is akin to that of a loan in which the taxpayer pays interest on the loan amount. It appears that the question would be whether or not the interest paid by the taxpayer on the debenture or similar instrument is deductible. The conversion of the instrument at a later date does not render it a share issue for goods or services. The question relating to the deductibility of the interest on the debt instrument is dealt with in section 8F of the Act and it is not the subject of this thesis.

If the second situation is possible in law and could qualify as a hybrid debt instrument in terms of section 8F of the Act, then it seems that different considerations may have to apply. It appears that if a taxpayer company is unable to honour its acknowledgment of debt and issues shares in itself, the second situation would be akin to a share issue such as the one dealt with in the *Labat Africa* case, the difference being the passage of time between the provision of services or delivery of goods and the issue of shares. In *Labat Africa*, it appears that there was no passage of time between the two events while in the second situation it appears that two years may have passed.

#### 4.5 Accounting treatment of distributions to equity participants

It was stated in chapter 3 that, in accounting, expenses are understood as “decreases in economic benefits during a financial period in the form of outflows or depletions in assets or the incurring of liabilities which decrease equity”. However, Faul *et al* (2009: 69) state that there is an exception to this meaning of an expense where the decrease in equity is due to disbursements or distributions made to equity participants or shareholders. This seems to mean that, in accounting, a distribution to shareholders is not considered to be an expense. It appears that this exception regarding distributions to shareholders may be consistent with the legal nature of shares as discussed in chapter 2 of this thesis.

#### 4.6 Tax asymmetry

Tax asymmetry is a situation in which a receipt is taxable in the hands of one taxpayer, but the outlay is not deductible in the hands of the other taxpayer in the same transaction (Legwaila: 2013). Tax asymmetry is also possible in reverse. This is a situation in which the taxpayer who is a payer in the transaction gets a deduction while the taxpayer who is a receiver escapes tax on the receipt. The well-known case of *Erf 3183/1 Ladysmith (Pty) Ltd v CIR* (1996) 58 SATC 229 (A) is an example of the second type of tax asymmetry in which the transaction was nullified by the courts. In *Erf 3183/1 Ladysmith*, the taxpayers to the transaction sought to erect a factory in which one

claimed a deduction for the expenditure while the other did not pay tax on the leasehold improvements.

Paragraph (h) of the definition of gross income provides that the value of leasehold improvements must be included in the taxpayer's gross income where there was an obligation on the lessee to effect the improvements, while, effective after the *Erf 3138/1 Ladysmith* case, section 11(g) entitles a lessee to a deduction for effecting the improvements. In the *Erf 3183/1 Ladysmith* case, the parties conjured up a scheme in terms of which a tax-exempt entity was interposed in order to accept the right to have the lease improvements effected on the leased property without tax consequences. The interposed party had no obligation to effect the improvements on the leased property, but it imposed an obligation on the sub-lessee to effect the improvements so that the sub-lessee might claim a deduction in terms of section 11(f) at the time, while the landowner paid no tax because there was no positive obligation on the tax-exempt entity to effect leasehold improvements. In this case, the Commissioner was aggrieved by a situation in which a taxpayer might be entitled to a tax deduction while there was no other party liable to pay tax on the leasehold improvements.

In respect of share-based payments, the tax asymmetry is to be found in the fact that a share issue by a taxpayer is not permitted a deduction, while the receipt of the same shares by the counterparty is taxable in its hands. Van Zyl (2012) and Ger (2012) are among the writers who advance the tax asymmetry argument. The argument was also raised by the taxpayer in the *Labat Africa* case, but rejected by Harms AP. The judge (at 8) responded to the tax asymmetry argument by stating that "taxable income is not the difference between gross income and expenditure; and gross income is not limited to the converse of expenditure". It could be argued that a situation in which one taxpayer pays while the other is denied an equivalent deduction is inequitable.

However, one may refer to the often repeated statement that tax laws contain many anomalies (*Labat Africa*). One is also reminded by Hefer JA (at 48) in *Cactus Investments (Pty) Ltd v CIR* (1998) 61 SATC 43 that "there is also no equity in tax laws", "nor there is complete rationality".

#### 4.7 Conclusions

There are a number of cases decided before *ITC 1783* and *Labat Africa* in which the courts dealt with transactions involving shares as a consideration. These cases show that shares have always been regarded as a receipt for the purposes of a taxpayer's gross income. However, the cases are not a useful guide when it comes to questions regarding the deductibility of shares issued as payment for goods or services. Critics of the *Labat Africa* case argue that as long as the taxpayer has incurred an unconditional legal obligation it should be entitled to a deduction and that it does not matter how it later chooses to settle the obligation, be it by cash or an issue of shares.

In the *Labat Africa* case, Harms AP stated that there is no expenditure when a company issues its own shares as a payment for goods because there is no diminution or movement of its assets. The critics of the *Labat Africa* case argue that there is expenditure when a company sacrifices its primary right to demand cash for the subscription of its shares. They rely on English cases such *Osborne* and *Stanton* for this argument. However, writers such as van Rensburg (2013) correctly argue that where the parties have agreed on a consideration in kind for the issue of the company's shares, the company has no right to any other consideration.

The repealed Companies Act required a full *purchase price or other consideration* for the subscription of a company's shares while the new Companies Act requires *adequate consideration* for the subscription of a company's shares. It does not seem that any primary right was envisaged with these provisions. It appears that the parties could agree on another form of consideration despite the fact that the subscriber could pay for the subscription of shares in cash.

It appears that two situations may be distinguished regarding the issue of shares for goods or services. One is where a member of the public approaches a company with some consideration other than cash in order to subscribe for shares in the company and the other is where the company offers to pay a supplier of goods or services by

issuing its own shares (due to cash flow problems or other reasons). In the first situation, the company may demand the subscription price in the manner set out in its prospectus. In the second situation, the company has already been provided with services and it offers to settle the indebtedness by issuing its own shares to the service provider. Under these circumstances, it would be incorrect to suggest that the company could demand cash as this would amount to a situation in which the company demands cash for a debt it owes.

Even if it is assumed that there was or there is a primary right of the company to demand cash for the subscription of its shares, it appears that a company could only demand such cash in the first situation in which a member of the public approaches it to subscribe for shares with some consideration other than cash. Where the company has already been provided with services and later chooses to settle the indebtedness by issuing its own shares, it is clear that it would not be possible for the company to demand cash for the subscription of the shares because it would have already been provided with the service.

This discussion is relevant in the context of the argument by the critics of the *Labat Africa* case that a company forfeits its primary right to demand cash when it issues its shares for services rendered. It is clear that there can be no such right to demand cash for the subscription of its shares in circumstances where the company chooses to settle its indebtedness for services rendered by issuing its own shares. It appears that the correct position is that a company may demand cash for the subscription of its shares unless there was an agreement for a consideration in kind. It is clear that where a company issues its own shares in payment for goods or services rendered, there is an agreement for a consideration in kind for the subscription of its shares. It appears that it is incorrect to argue that a company forfeits a primary right to demand cash for the subscription of its shares under these circumstances.

In respect of different classes of shares, it appears that the different rights attached to preference shares do not affect the question regarding the deductibility of the shares issued as a payment for goods or services. The different rights attached to preference

shares relate to payment of dividends and voting rights in shareholders' meetings. It does not appear that there are any decided cases in which it is suggested that the rights attached to a class of shares may affect deductibility in terms of section 11(a) of the Act. The legal nature of shares, the meaning of expenditure actually incurred and the issuing of shares as payment for goods or services have all been discussed in the previous chapters. The next chapter is a conclusion and a last chapter of the thesis. The next chapter presents concluding remarks on all the matters discussed in this thesis.

## CHAPTER 5 – CONCLUSION

### 5.1 Introduction

The research sought to investigate an area of law that had not, until recently, been considered by the courts, and to contribute to the conceptual understanding of terms such as *expenditure*, *payment*, *discharge of a liability*, *incurring of a liability* and the nature of shares. The research sought to explore the meaning of *expenditure* and the nature of share-based payments. In order to address the purpose of the research, certain goals were articulated. The conclusions arising from the research that focussed on these goals are set out below.

### 5.2 The goals of the research

The research sought to investigate the meaning of expenditure and thus address the following goals:

- 5.2.1 to consider the nature of shares and share capital;
- 5.2.2 to explore the meaning of *expenditure actually incurred*;
- 5.2.3 to consider whether *expenditure* is different to and independent from payment or settlement, or the discharge of a liability;
- 5.2.4 to investigate whether an issue of shares for trading stock or services received constitutes *expenditure* as contemplated in the Act;
- 5.2.5 to consider whether the *Labat Africa* judgment was correctly decided.

### 5.2.1 The legal nature of shares and share capital

The first research goal of this thesis was to consider the legal nature shares and share capital, which subject is discussed in chapter 2 of the thesis. The discussion in chapter 2 establishes that in South African law, a company is recognised as a juristic person with perpetual succession. A company has debts and claims of its own. These debts and claims are not necessarily those of its shareholders or directors. A company's shareholders and directors enjoy limited liability for the company's debts. A company is a taxpayer in its own right.

A company has share capital which is contributed by its shareholders. After it has been contributed, the company's share capital is divided into any number of shares with a certain value as authorised by its articles of association. The shares are then issued and allotted to the company's shareholders. The discussion of case law and authorities in chapter 2 establishes that shares do not come into the hands of a shareholder by means of a transfer from the company. It is submitted that van Rensburg (2013) is correct in the assertion that the word "sale", which is often used in share transactions with a company, seems to be improper. It appears that the proper word should be "subscription agreement" where a shareholder is allotted shares by a company for a consideration.

The correct position regarding what happens when a company issues its own shares to a shareholder is stated in the *Estate Kohler* case. In that case it was stated that what actually happens when a company issues its own shares is that the company creates a bundle of rights in itself for the shareholder. It does not give out or pass anything to the shareholder. The correct position is that the shareholder subscribes for shares in the company. The idea of subscription implies membership. The shareholder becomes a member of the company in order to be entitled to rights such as dividends and voting in members' meetings.

### 5.2.2 Expenditure actually incurred

The second research goal of this thesis was to explore the meaning of expenditure actually incurred. In earlier Income Tax Acts (28 of 1914 & 41 of 1917), expenditure was referred to as an *outgoing* and, although this term has been abandoned from the Act, it still enjoys regular use by the courts. The *General Motors SA* and *Felix Schuh* cases support this submission. The original understanding of expenditure as that which is *outbound*, compared to that which is incoming, seems to have been retained in the Act.

In South African case law, the meaning of expenditure has always swung between the undertaking of a legal obligation and the spending or disbursement of funds. On the one hand, cases such as *PE Electric Tramway*, *Edgars Stores* and *Felix Schuh* hold that expenditure envisages the undertaking of a legal obligation. On the other hand, cases such as *Joffe & Co*, *Stone* and *Labat Africa* hold that expenditure envisages payment. The view that expenditure envisages the undertaking of a legal obligation is founded on the idea that there is a discharge, payment or settlement, all of which are independent of actual expenditure. The contrary view does not seem to recognise a discharge, payment or settlement as events apart and independent from expenditure. This view is supported by Harms AP's words in the *Labat Africa* case in which the judge (at 5) stated that "the liability or obligation must be discharged by means of expenditure". This can only mean that there is no such difference between expenditure and payment.

The view that expenditure envisages only a legal obligation draws its support from the statement made in the *PE Electric Tramway* case that has been repeated in many subsequent tax cases. In the *PE Electric Tramway* case, Watermeyer AJP (at 15) stated that *actually incurred* cannot mean *actually paid*. It is significant to note two things about the judge's statement in this case. The first is that the judge never differentiated between *expenditure* and payment, as the critics of the *Labat Africa* case seem to do. The second is that when the judge used the above words, he was not necessarily defining the meaning of expenditure as the critics of *Labat Africa* would seem to imply. It is clear that when the judge used the above words, he was concerned with the deductibility of an expense.

It is clear from the judgment that what the judge sought to establish was that if a taxpayer has taken upon itself an obligation or liability which for some reason has not yet been paid by the time the tax year closes, but will be paid later, it will be unreasonable to deny the taxpayer a deduction. This submission is strengthened by the judge's analogy of a trader who, by close of the tax year, owes money for stocks he purchased during the year but which he has not yet paid. The judge states that the trader has not yet paid such liabilities but they are deductible. The judge's approach seems to be consistent with the views expressed by Cilliers (2011) and van Rensburg (2011) that the taxpayer may deduct a liability if the performance at a future date will be such that it amounts to expenditure as contemplated in *Labat Africa*.

The major criticism against the *Labat Africa* case is that its definition of expenditure in which it is said to be the spending of money or disbursement of funds appears to exclude credit purchases and non-cash transactions from deductibility. This criticism is legitimate. However, it is doubtful whether Harms AP could have contemplated a situation in which credit purchases are not permissible deductions. Harms AP was concerned with an individual set of facts before him. The facts related to a claim for the deduction of the value of shares issued as a consideration for the purchase of assets. The primary question he had to answer was whether or not an issue of shares is expenditure as contemplated in the Act. It appears that his reasoning in grappling with the meaning of expenditure was meant to show why a share issue does not amount to expenditure, but, in so doing, he seems to have reversed certain principles by which transactions such as credit purchases are permissible deductions in South African law. The manner in which the provisions of section 11(a) are interpreted and applied in practice is such that it would satisfy the critics of the *Labat Africa* case. It appears that if, on the *Labat Africa* interpretation of expenditure, credit purchases, non-cash transactions and delayed payments are not denied a deduction by close of the tax year, the criticism against the *Labat Africa* interpretation of expenditure would fall away.

The view that expenditure envisages payment as contemplated in *Labat Africa*, but that a taxpayer ought not necessarily be denied a deduction where it has not yet paid at the time a deduction is claimed is convincing and must be adopted. Expenditure does envisage payment, but a taxpayer ought not to be denied a deduction because no payment has been made yet. One must look at the content of the performance as argued by van Rensburg to determine if there will be expenditure at the time the taxpayer renders his performance in terms of the parties' agreement. Cilliers (2011) argues that the *actually incurred* requirement in section 11(a) of the Act it establishes what the Act requires at an overall level, not that there must already have been expenditure.

### 5.2.3 Expenditure versus payment, discharge or settlement

The third research goal of this thesis was to consider whether or not there is a difference between expenditure on the one hand and payment, discharge or settlement on the other hand. Writers such as Emslie (2011) and Ger (2012) argue that expenditure exists before payment, discharge or settlement and that these are used to meet expenditure, but are themselves not expenditure. It was discussed in chapter 3 that the Act does not use words such as payment, discharge or settlement. The Act only uses the phrase "expenditure actually incurred".

It is submitted that the phrase "expenditure actually incurred" contemplates that the taxpayer pays or sacrifices something of economic value before it could be said that there is expenditure. If not, then it appears that the drafters of the law would have incorporated the words payment, discharge or settlement in section 11(a) of the Act. The assumed difference between expenditure on the one hand and payment, discharge or settlement on the other hand was never made in the *PE Electric Tramway* case. The view that expenditure is a contractual or legal obligation also seems to face challenges in circumstances where payment is made by the taxpayer without any prior legal or contractual obligation, such as in the case of discretionary bonuses. It appears that the difference made between expenditure on the one hand and payment, discharge or settlement on the other hand is not justified.

#### 5.2.4 The issue of shares as payment for goods or services

The fourth research goal of this thesis was to consider whether an issue of shares for trading stock or services constitutes expenditure as contemplated in section 11(a) of the Act. The law recognises a company as a juristic person with its own separate existence, apart from its shareholders. As set out earlier, a company is a taxpayer in its own right and its tax affairs and liabilities are not necessarily those of its members. A company has share capital which is contributed by its shareholders. After it has been contributed, the company's share capital is divided into any number of shares with a certain value as authorised by its articles of association. The shares are then issued and allotted to the company's shareholders. Shares do not come into the hands of a shareholder by means of transfer from the company. The correct position, as stated in the *Estate Kohler* case, is that the company creates a bundle of rights in itself, rather than giving out or passing anything to the shareholder.

The position of the South African courts, as set out in the *Labat Africa* case, that an issue of shares does not amount to expenditure by a company is more convincing than that of the English courts. The position of the South African courts is consistent with the general principles of company law regarding share capital and the nature of shares. It is trite that a share in a company is a bundle of rights which includes a right to share in the profits of the company when they are distributed and to a dividend upon reduction of capital or winding up of the company. It is argued by the critics of the *Labat Africa* case that the expenditure in a share issue lies in the forfeiture by the company of its right to demand cash for the subscription of its shares. The forfeiture argument is the basis upon which the English courts regard shares as a consideration or expenditure when issued by a company for the purchase of goods or services. However, there are shortcomings with this argument. A company cannot be said to sacrifice any right to demand cash for the subscription of its shares because the right it has is to demand the consideration agreed-on between the parties for the subscription of the shares. It would be incorrect to suggest that a company could demand cash for issuing its shares in settlement of its debt because this would amount to a situation in which the company seems to demand cash for the debt it owes to a creditor, which would be untenable.

The view that expenditure contemplates payment is more convincing than the view that it envisages nothing more than an obligation, usually to spend money on the basis that the latter view would seem to permit deductions where a taxpayer has suffered no diminution of its wealth. The view does not seem to cater for share issues and other transactions that are akin to share issues. The critics of the *Labat Africa* case contend that expenditure lies in the forfeiture by the company of its right to demand cash for the subscription of its shares. This view is partially correct. It has been discussed that only in limited circumstances may a company demand from a prospective shareholder that cash be paid for the subscription of its shares.

It does not appear that Harms AP could have intended to deny a deduction in circumstances where a taxpayer engages in some form of set off or barter transaction as set out by van Zyl (2012). It does not appear that Harms AP would have denied a deduction to the transaction in the *Golden Dumps* case on the basis that there was no parting with an asset because the taxpayer sacrificed part of the purchase price.

It is submitted that the original understanding of the meaning of expenditure as that which is *outbound*, compared to that which is incoming, has been retained in the Act. The contemporary use of the term “outgoings”, despite having been abandoned in the Act, seems to show that expenditure is still considered as that which is *outgoing*, against that which is *incoming*. Case law authoritatively shows that when a company issues its shares to a shareholder, nothing is passed or given out to the shareholder. What actually happens is that the company creates a bundle of rights in itself. If a share issue by a company does not pass or give out anything to the shareholder, then it means that there is nothing *outbound* in a share issue. It would be contrary to the original understanding of the meaning of expenditure, which has been retained in the Act, to argue that a share issue is an *outgoing* by a company.

### 5.3 Conclusion – the *Labat Africa* decision

The fifth research goal of this thesis was to consider whether or not the *Labat Africa* case was correctly decided. The *Labat Africa* judgment seems to deny a deduction to transactions such as credit purchases and the one in the *Golden Dumps* case, in which the taxpayer reduced its purchase price instead of getting the full purchase price and immediately paying back an equivalent amount of liabilities taken over by the purchaser. It would not be correct to deny a deduction on the basis that there was no payment and this could not have been intended by the drafters of the law. However, one must consider the context of the *Labat Africa* case, which was an issue of shares for goods.

Harms AP's reasoning was concerned with showing why a share issue is not expenditure. He could not have intended to deny a deduction to transactions such as credit purchases. On the interpretation of Cilliers (2011), the *Labat Africa* case does not necessarily deny a deduction to transactions such as credit purchases. Expenditure looks at the content of the performance to determine if there will be a diminution or movement of assets at the time the taxpayer renders its performance. The *Labat Africa* case could be criticised in certain respects, but it is submitted that it was correctly decided.

## LIST OF REFERENCES

### Books

1. Babbie, E. & Mouton, J. 2009. *The practice of social research*. Cape Town: Oxford University Press Southern Africa.
2. Faul, M.A et al. 2004. *Accounting: An Introduction*. LexisNexis Butterworths. Durban.
3. Jarvie, G. 2007. *Bloomsbury Grammar Guide*. A & C Black Publishers. London
4. Joubert, W.A. 2012. *The Law of South Africa*. LexisNexis. Durban.
5. Pretorius, D et al. 2009. *GAAP Handbook*. LexisNexis. Durban
6. Williams, R.C. 2009. *Income Tax in South Africa: cases and materials*. LexisNexis

### Legislation

7. Companies Act 71 of 2008
8. Companies Act 61 of 1973
9. Income Tax Act 58 of 1962
10. Income Tax Act 31 of 1941
11. Income Tax Act 40 of 1925
12. Income Tax Act 41 of 1917
13. Income Tax Act 28 of 1914

### Journal articles

14. Burt, K. 2004. *Issuing shares as consideration*. **Tax Planning**. 133
15. Cilliers, C. 2011. *The Labat decision and the interaction between 'expenditure' and the 'actually incurred' requirement*. **The Taxpayer**. 226
16. De Swardt, R. 2008. *Do share-based payments made for the procurement of services qualify as expenditure actually incurred?* **De Jure**. 475
17. Emslie, T. 2011. *Expenditure actually incurred*. **The Taxpayer**. 183

18. Ger, B. 2012. *The problem of paying with shares resurfaces*. **De Rebus**. 48
19. Ger, B. 2004. *The problem of paying with shares*. **De Rebus**. 61
20. McKerchar, M. *Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation*. eJournal of Tax Research. p5 – 22. [Online]. Available:  
[http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper1\\_v6n1.pdf](http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper1_v6n1.pdf) [accessed on 22 August 2014].
21. Legwaila, T. 2013. *The issue of shares is not expenditure for the purposes of the Income Tax Act: Commissioner, South African Revenue Services v Labat Africa Ltd*. **South African Law Journal**. 318
22. Meyerowitz, D. 2004. *Paying for goods or services by issuing shares*. **The Taxpayer**. 86
23. Silke, J. 2005. *Expenditure actually incurred*. **Tax Planning**. 12
24. Van Rensburg, JEC. 2013. *Some thoughts on the meaning of expenditure in the Income Tax Act*. **Tydskrif vir die Suid-Afrikaanse Reg**. 58
25. Van Zyl, SP. 2012. *The meaning of expenditure for the purposes of section 11(a) and 11 (GA) of the Income Tax Act 58 of 1962*. **Obiter**. 186

### Cases

26. Ackermans Ltd v CSARS (2010) 73 SATC 1
27. Brookes Lemos Ltd v CIR (1947) 14 SATC 295
28. Cactus Investments (Pty) Ltd v CIR (1998) 61 SATC 43
29. Caltex Oil (SA) Limited v SIR (1974) 37 SATC 1
30. CIR v Delagoa Bay Cigarette CO, Ltd (1918) 32 SATC 47
31. CIR v Estate Kohler (1953) 18 SATC 354
32. CIR v Felix Schuh SA (Pty) Ltd (1994) 56 SATC 57 (A)
33. CIR v General Motors SA (Pty) Ltd (1982) 43 SATC 249
34. CIR v Golden Dumps (Pty) Ltd (1993) 55 SATC 198 (A)

35. CIR v Niko (1940) 11SATC 124
36. CSARS v Labat Africa Ltd (2011) 74 SATC 1
37. Cooper v Boyes NO and Another 1994 (4) SA 521 (C)
38. De Leef Family Trust and Others v CIR 1993 (3) SA 345 (A)
39. Edgars Stores Ltd v CIR (1988) 50 SATC 81
40. Erf 3183/1 Ladysmith (Pty) Ltd v CIR (1996) 58 SATC 229 (A)
41. Estate Furman and Others v CIR (1962) 25 SATC 4
42. Glen Anil Development Corporation Ltd v SIR (1975) 37 SATC 319
43. Greases (SA) Ltd v CIR (1951) 17 SATC 358
44. ITC 703 (1950) 17 SATC 208 (N)
45. ITC 1587 (1994) 57 SATC 97
46. ITC 1783 (2004) 66 SATC 373
47. ITC 1801 (2005) 68 SATC 57
48. Joffe & Co (Pty) Ltd v CIR (1945) 13 SATC 354
49. Lace Proprietary Mines Ltd v CIR (1938) 9 SATC 349
50. Nasionale Pers Bpk v KBI (1986) 48 SATC 55
51. Ochberg v CIR (1931) 5 SATC 93 (AD)
52. Ochberg v CIR (1932) 6 SATC 1 (CPD)
53. Omnia Fertilizer Ltd v CSARS (2003) 65 SATC 159
54. Oertel, NO v Brink 1972 (3) SA 669 (W)
55. Port Elizabeth Electric Tramway Company Ltd v CIR (1935) 8 SATC 13
56. Pyott Ltd v CIR (1944) 13 SATC 121
57. Standard Bank of SA Ltd & Another v Ocean Commodities Inc & Others 1980 (2)  
SA 175 (T)
58. Stone v SIR (1974) 36 SATC 117

59. Sub-Nigel Ltd v CIR (1948) 15 SATC 381

60. Thoroughbred Breeders Association v Price Waterhouse 2001 (4) SA 554 (SCA)

61. WH Lategan v CIR (1926) 2 SATC 16

#### Foreign cases

##### UK

62. Craddock v Zevo Finance Co., Ltd 1944 1 All ER

63. Osborne v Steel Barrel Co., Ltd 1942 1 All ER

64. Stanton v Drayton Commercial Investment Co Ltd 1982 2 All ER

##### Australia

65. FCT v St Helens Farm Pty Ltd (1981) 81 ATC 4040

66. Ord Forest Pty. Limited v FCT (1973) 73 ATC 4022