

**THE TAX CONSEQUENCES OF A CONTINGENT LIABILITY
DISPOSED OF AS PART OF THE SALE OF A BUSINESS AS A GOING
CONCERN**

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

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Abstract

The sale of an entity as a going concern has a number of tax consequences for both the purchaser and the seller. The tax deductibility of a contingent liability upon its transfer from the seller to the purchaser, where the selling price has been reduced by the value of the contingent liabilities transferred, remains uncertain following the decision in *Ackermans Ltd v Commissioner for the South African Revenue Service*.

An expense is either deductible under a specific section of the Income Tax Act, 58 of 1962, or under the general expense provisions in terms of sections 11(a) and 23(g). The Act does not contain a specific section relating to contingent liabilities and therefore a contingent liability will need to be considered for deduction under these sections. The Act further disallows an expense as a deduction under section 23(e), where a reserve is created (for example a leave pay provision).

This study analyses the tax deductibility of a contingent liability, where the contingent liability has been transferred from the seller to the purchaser in a sale of an entity as a going concern and the purchase price has been reduced to compensate for the transfer of the contingent liability. The deductibility of the contingent liability was first assessed in terms of the provisions of the Act (sections 11(a), 23(g) and 23(e)) and associated case law. The decision in the *Ackermans* case and its preceding *Income Tax Case 1839* was then analysed in order to establish the principles arising from the decisions. Finally the proposals in the Draft Taxation Laws Amendment Bill, 2011, and the subsequent Discussion Document issued by the South African Revenue Service were discussed.

The analysis revealed the continuing confusion surrounding the *status quo*, thus demonstrating the importance of legislative intervention to provide guidelines for taxpayers.

Key words: Contingent liabilities; income tax; sale of a business

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Chapter 1: Introduction

1.1 The context of the research

The sale of a business as a going concern can result in a number of tax consequences, both for the buyer and the seller. When the owner of an entity decides to sell a business as a going concern, it is essential that the question of who will be responsible for the seller's previously incurred liabilities must be decided and provided for in the agreement of sale. When providing for the party who will be responsible for these liabilities, the purchaser and the seller must be aware of the tax implications that may arise as a result of the transfer or non-transfer of the liabilities.

Liabilities can take the form of fixed or contingent liabilities. The significant difference between a fixed and a contingent liability is that the obligation to pay a fixed liability is certain, whereas that of a contingent liability is uncertain. Examples of common contingent liabilities include leave pay provisions, bonus provisions, warranty provisions, etc. A contingent liability was defined in a paper by National Treasury, entitled "Provisions, contingent liabilities and contingent assets" (National Treasury, 2012:7) as:

- A possible obligation, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event(s) not wholly within the control of the entity, or
- A present obligation that is not recognised because the outflow of economic benefits or service potential is not probable, or
- A real present obligation, that cannot be recognised, either because the "when" (timing) or the "how much" (measurement) is not known.

It is clear from the definition that a contingent liability is uncertain and may, or may not result in an outflow of economic resources. Contingent liabilities are provided for, for financial accounting purposes, according to the accounting treatment prescribed in terms of International Financial Reporting Standards (IFRS). Keirby-Smith (1996:2), in a tax planning article, identified the challenges with regard to the tax deductibility of an expense and its accounting treatment:

The challenges facing the accountant in the form of provisions have extended to the offices of the Commissioner for Inland Revenue, with the result that numerous organisations have been on the receiving end of investigations by Inland Revenue, which have resulted in the add-back of provisions previously claimed and allowed for normal tax.

The uncertainty attached to a contingent liability is what makes its deductibility for income tax purposes difficult to determine. Sections 11(a) and 23(g) of the Income Tax Act, 58 of 1962 (hereafter referred to as the “Act”), provide a taxpayer with a deduction in respect of an expense. These sections, commonly referred to as the “general deduction formula” are summarised by Stiglingh, Koekemoer, van Schalkwyk, Wilcocks and de Swardt (2014:138) as “expenditure and losses actually incurred during the year of assessment, in the production of income, not of a capital nature, either in part, or in full, laid out or expended for the purpose of trade.”

The requirement that an expense must “actually [be] incurred” in the general deduction formula may present difficulties when the taxpayer applies the provisions of the Act in an attempt to deduct a contingent liability. In *Nasionale Pers Bpk v KBI*, 1986 (3) SA 549 (A) it was held that the expenses did not have to be physically paid by the year-end in order to be deductible. However, the expense had to be actually incurred. An expense is considered to have been actually incurred when the taxpayer becomes unconditionally obligated to make the payment. This principle was confirmed by the court in *Caltex Oil (SA) Pty Ltd v SIR*, 1975 (1) SA 665 (A), where it was held that expenditure does not refer only to expenditure actually paid, but also to expenditure where a liability has been incurred during the year.

Corbett JA, in delivering the judgment in *Edgars Stores Ltd v CIR*, 1988 (3) SA 876 (A), stated (at 90):

It is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred *an unconditional legal obligation during the year of assessment* in question may be deducted, in terms of s11(a), from the income return for the year... (own emphasis).

A contingent liability imposes only a possible obligation on the taxpayer, and therefore the contingent liability may not be deductible for tax purposes in accordance with the Act (the general deduction formula), as no unconditional legal obligation to make payment has been incurred. Furthermore, section 23(e) of the Act provides that no deductions may be made in respect of “income carried to any reserve fund, or capitalised in any way” (for example, a provision for accumulated leave not paid out). Section 23(e) of the Act therefore prohibits the deduction of an amount set aside out of income to make provision for a contingent liability in the form of a reserve fund.

The sale of a contingent liability as part of a business sales transaction is not uncommon. The purchaser takes over the contingent liability from the seller by means of a reduction of the selling price of the business. As such, it can be argued that as the contingent liability has become an unconditional liability for the seller, it would meet the requirements for deductibility under the “general deduction formula”. The purchaser of the business then has the problem of deducting any subsequent payments that arise in terms of the contingent liability. As these payments may not have been incurred “in the production of [the purchaser’s] income” a deduction may be denied.

The problems relating to the deductibility of a contingent liability have resulted in many different opinions of tax experts, and therefore it is surprising that more cases relating to the tax treatment have not previously come before the courts (Clegg, 2010: 19). In *Ackermans Ltd v Commissioner for South African Revenue Service, Pep Stores (SA) Ltd v Commissioner for South African Revenue Service*, 2011 1 SA 1 (SCA) (referred to as the *Ackermans* case), the court ruled on the deductibility of a contingent liability. The case presented by the seller (who had claimed a deduction of R23 017 959 against its taxable income relating to three contingent liabilities), was that it had not claimed the contingent liability as a deduction, but had rather paid the purchaser (indirectly, through a reduction in the selling price) to be relieved of its duty to fulfil the obligation of future payments of the contingent liabilities.

The Commissioner for the South African Revenue Service (referred to hereafter as the “Commissioner”) issued an additional assessment to the seller on the grounds that the expense claimed as a deduction was disallowed under the general deduction formula, because the expenditure did not constitute expenditure actually incurred, or incurred in the production of income. The seller argued that the deduction had been actually incurred as a transaction in

terms of which the purchaser agreed to relieve the seller of the duty to fulfil the liability which was certain and unconditional. The seller further argued that the deduction was incurred in the production of income, as the sale of the going concern would result in taxable income for the seller.

The court ruled in favour of the Commissioner and stated that the amount claimed as a deduction by the seller merely represented contingent liabilities and, as no obligation to effect payment existed, no amount had been actually incurred.

Haupt (2014:145), in summarising the *Ackermans* judgment, stated that the transfer of the liabilities to the purchaser did not mean that the seller had actually incurred the expenditure, and the deduction (in accordance with the general deduction formula) was not allowed. The argument in favour of the deduction in the *Ackermans* case was that the seller had paid the purchaser an amount equal to the contingent liability that the purchaser was taking over, in the form of a reduction in the selling price, and that the sum paid was actually incurred and therefore deductible (van Coller: 2011).

Following the decision in the *Ackermans* case, and possibly recognising that the tax position was uncertain, the Commissioner proposed amendments to the Act in the Draft Taxation Laws Amendment Bill, 19 of 2011 (hereafter referred to as the “Draft Bill”). The Draft Bill proposed an amendment to the definition of “gross income” in section 1 of the Act to include in gross income any relief received by the seller for a contingent liability that forms part of a sale of a business as a going concern. A new section 11F would be introduced into the Act to provide for the treatment of a contingent liability that is disposed of as part of the sale of a business as a going concern, and would deem the seller to have incurred expenditure in the production of income in respect of the contingent liability. The Draft Bill also proposed the introduction of a new section 24CA, which would effectively allow the purchaser to claim a deduction in respect of the purchased contingent liability. The proposed amendments were, however, not included in the Taxation Laws Amendment Bill, 19 of 2011, or the Taxation Laws Amendment Act, 2011, 24 of 2012, and the uncertainty remains. The Commissioner, subsequent to the proposed amendments in the Draft Bill, issued a draft discussion paper on the deductibility of a contingent liability upon its transfer from the seller to the purchaser as part of a sale of a going concern. The draft discussion paper issued by the South African Revenue Service (hereafter referred to as “SARS”) is entitled *Discussion Paper on the Tax*

Implications for the seller and purchaser in relation to the assumption of contingent liabilities in part settlement of the purchase price of assets acquired as part of a going concern (hereafter refer to as the “Discussion Paper”).

1.2 The goals of the research

It is clear, therefore, that uncertainty remains relating to the deductibility of contingent liabilities in the hands of the seller of the business, and the deductibility of payments by the purchaser in terms of the liability the purchaser has assumed.

The goal of the research is to investigate the deductibility of a contingent liability in the hands of the seller of a business, as part of a business sale as a going concern, or in the alternative, the deductibility in the hands of the purchaser of the payments made in respect of this contingent liability.

In achieving this goal the following sub-goals will be addressed:

- to describe the present treatment of contingent liabilities in the Act, and interpretations by the courts;
- to present and analyse the facts and the decision in the *Ackermans* case;
- to discuss the proposed amendment to the Act and its subsequent omission from the Taxation Laws Amendment Act;
- to discuss the proposals in the Discussion Paper; and
- to highlight the apparent continuing uncertainty and the need for legislative intervention.

1.3 Methods, procedures and techniques

An interpretative research approach was adopted, as this method seeks to both understand and describe the situation (Babbie & Mouton: 2009). The research methodology to be applied can be described as a doctrinal research methodology. The doctrinal research methodology provides a systematic exposition of the rules that govern a particular legal category (in the present case the legal rules relating to the deductibility of a contingent liability and the consequence of their transfer as a result of the sale of a business as a going concern), analyses

the relationships between rules, explains areas of difficulty and is based purely on documentary data (McKerchar: 2008).

The documentary data to be used for this research consists of:

- legislation (the Act and the Draft Taxation Laws Amendment Bill, 2011);
- relevant case law;
- South African Revenue Service Interpretation Notes, Notices and Regulations relating to the deduction of a contingent liability, the draft Discussion Paper; and
- textbooks and other writings.

The research will be conducted in the form of an extended argument that is supported by documentary evidence. The validity and reliability of the research and the conclusions will be ensured by:

- adhering to the rules of the statutory interpretation, as established in terms of statute and common law;
- placing greater evidential weight on legislation, case law which creates a precedent or which is of persuasive value (primary data), and the writings of acknowledged experts in the field;
- discussing opposing viewpoints and arriving at conclusions, based on a preponderance of credible evidence; and
- the rigour of the arguments.

All the data to be used for this research is available in the public domain, and therefore no ethical considerations arise. Interviews will not be conducted; opinions will be considered in their written form.

1.4 Overview of the thesis

The research will consist of five chapters. Each chapter discusses different aspects of the topic in order to formulate a conclusion to the research question. The first chapter will serve as an introduction and an overview of the research study. Chapter two will introduce the general principles for the deductibility of an expense and will define a contingent liability. Chapter three will form the main area of focus in the research and specifically in respect of

the *Ackermans* case, as well as other relevant cases (both local and international) which will be analysed and discussed. This chapter will provide a detailed discussion of whether a contingent liability, that has been transferred from the seller to the purchaser as part of the sale of a business as a going concern, is deductible. The deductibility of the contingent liability will be considered from the perspective of both the purchaser and the seller. Chapter four will discuss the proposed amendments to the Act by the Commissioner in the Draft Bill, and will discuss and evaluate the proposed method of treatment in the Draft Discussion Paper released by the Commissioner.

Chapter five will serve to conclude on the research. The chapter will summarise the findings of the research, indicating how the goals of the research were addressed and provide a final conclusion on the deductibility of a contingent liability transferred as part of the sale of a business as a going concern, from the perspectives of both the purchaser and the seller.

Chapter 2: Deductibility of an expense in accordance with the Act

2.1 Introduction

The first goal of the research is to describe the present treatment of contingent liabilities in terms of the Act, together with interpretations by the courts. This chapter will therefore first describe and define a contingent liability and thereafter discuss whether a contingent liability is eligible for deduction in terms of the general deduction formula, comprising the preamble to section 11 and section 11(a) and 23(g) of the Act. The deductibility of a contingent liability will be measured against the individual requirements of the general deduction formula and it will be concluded, in general terms, whether or not a contingent liability is deductible in terms of the Act.

The Act, through various provisions, provides for the deduction of an expense by a taxpayer. The expense is only deductible provided the requirements for deductibility, in terms of the Act, have been complied with. For a contingent liability to be deductible, the contingent liability must therefore comply with the provisions of the Act. This chapter will discuss the provisions of the Act, together with relevant case law, and then determines whether these provisions allow for the deduction of a contingent liability that has been transferred from the seller to the purchaser as part of a sale of an entity as a going concern.

A contingent liability arises as a result of an accounting provision and is recognised and measured in accordance with International Financial Reporting Standard (IFRS) ISA 37. It is common practice for provisions for contingent liabilities to form part of the sales transaction of a business sold as a going concern, and the purchaser takes over the obligation to make these payments, should they arise. The accounting transfer of a contingent liability from the seller to the purchaser remains uncomplicated. However, the tax treatment of the contingent liability for the purchaser and the seller is not clear.

2.2 Definition of contingent liabilities

The Act does not define a contingent liability. To fully understand the meaning and characteristics of a contingent liability, various definitions were referred to and compared, in order to identify commonalities in the definitions. International Financial Reporting Standard,

Part A, International Accounting Standards 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37, 2013:A1152), defines a contingent liability as:

- a) A possible obligation that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or
- b) A present obligation that arises from past events, but is not recognised because:
 - i) It is improbable that an outflow of resources embodying economic benefits will be required to settle the obligation;
 - ii) The amount of the obligation cannot be measured with sufficient reliability.

A contingent liability was defined in a paper issued by National Treasury entitled “Provisions, contingent liabilities and contingent assets” (National Treasury, 2012:7) as:

- A possible obligation, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event(s) not wholly within the control of the entity, or
- A present obligation that is not recognised because the outflow of economic benefits or service potential is not probable, or
- A real present obligation, that cannot be recognised, either because the “when” (timing) or the “how much” (measurement) is not known.

From these definitions, it is clear that the payment of a contingent liability is uncertain and that payment is dependent upon the happening of a future, unknown event. In discussing the transfer of a contingent liability on the sale of a business as a going concern, a distinction should be made between two types of contingent liabilities; those that are embedded in an asset and those that are not embedded in an asset (a free-standing contingent liability).

In a discussion paper issued by the South African Revenue Service (hereafter referred to as “SARS”) entitled *Discussion Paper on the Tax Implications for the seller and purchaser in relation to the assumption of contingent liabilities in part settlement of the purchase price of assets acquired as part of a going concern* (SARS, 2013:3) (hereafter referred to as “the Discussion Paper”) it is explained that the “embedded contingent liabilities” are inextricably

linked to the asset. Should the asset be transferred in the sale of an entity as a going concern, the contingent liability would also be transferred by the seller to the purchaser by law. An embedded contingent liability would clearly affect the market value of the asset and therefore the selling price. An example of an embedded contingent liability would be land owned and used by a mining company for mining. In terms of the National Environmental Management Laws Act, No 107 of 1998, the mining company is required to raise an environmental restoration provision to restore the mine dump once mining operations have ceased. The future obligation (restoration of the land) would be directly linked to (embedded in the value of) the assets (the mining site). An embedded contingent liability therefore cannot be separated from the asset that resulted in its creation.

A free-standing contingent liability differs from an embedded contingent liability. A free-standing contingent liability is not required to be transferred by law and can be contracted out of. It is a distinct obligation which is separately identifiable and is not embedded in an asset that is separately recognised for tax purposes (BDO: 2014). A free-standing contingent liability is not linked to a particular asset within an entity, and generally “stands alone”. The seller can retain (if it so wishes) the free-standing contingent liability and is not required to transfer it to the purchaser as part of the sale of the entity as a going concern. This type of contingent liability does not have an impact on the market value of an asset (SARS: 2013).

Only the tax deductibility of a free-standing contingent liability is addressed in this thesis. Examples of such free-standing contingent liabilities include:

- Leave pay: Employees earn “leave days” as part of their remuneration structure and accrue a certain number of days each month that they are employed. This leave can be taken by an employee, either by being absent from his/her duties, or by being paid out in cash. Irrespective of the manner in which the employee may choose to receive his/her leave entitlement, the company will create a provision for this future expense at the end of the company’s financial year. The payments relating to this provision may, however, be uncertain, as the company will not know whether employees will decide to be paid out in cash or to be absent from their duties. This meets the definition of “contingent liability” as the payment of the liability remains uncertain at the end of the financial year.

- **Warranties:** It is common practice for products to carry warranties. A company that has offered its customer a warranty for one of its products may, or may not, be required to repair or replace this item. The company will, however, through past practice, be able to predict the likelihood of the expected costs relating to warranty repairs and will raise an accounting provision to account for this future expenditure. The warranty provision provided for, however, may or may not be utilised in the future – the certainty of the company having to honour this provision is not determinable (payment is uncertain).
- **Bonuses:** Where a company has agreed to pay its staff a bonus on fulfilment of a future condition that is only determinable in the future (for example, employees being paid a bonus if the company achieves set profit targets in accordance with the finalised and audited financial statements), the company may wish to provide for this future bonus in the current year of assessment to which it relates. The payment of the bonus is, however, uncertain as it is unknown whether the condition (meeting a set profit target in terms of the audited financial statements) will be achieved.

A contingent liability is conditional upon the happening of a future and uncertain event. The future conditions can be suspensive or resolute conditions. The difference between a suspensive and a resolute condition is explained as follows (Norton Rose Fulbright South Africa: 2009):

A suspensive condition is a condition which (as the name suggests) suspends rights and obligations until the uncertain future event occurs. Upon the occurrence of the event, the suspended part of the contract is brought to life. If the suspended condition is never fulfilled, the suspended rights and obligations never come into existence. It is as if they never existed.

In the case of a resolute condition, there is no suspension or postponement of terms in a contract. Rights and obligations come into existence immediately upon agreement between the parties. If a resolute condition is fulfilled, the operation of the rights and obligations cease.

The question of whether a particular condition is resolute or suspensive in nature becomes critical when one has to examine whether, and when, certain rights vest in a party to a contract. The use of resolute conditions in a contract needs to be carefully

considered, A fulfilled resolutive condition terminates existing rights and obligations and requires the parties to restore their pre-contractual position. The parties may, alternatively, make use of suspensive conditions and avoid the duties of unbundling, restoring and the possible enforcing of the original position.

In *Design & Planning Service v Kruger*, 1974 (1) SA 689 (T) a suspensive condition was defined as follows:

In the case of a suspensive condition, the operation of the obligation flowing from the contract is suspended, in whole or in part, pending the occurrence or non-occurrence of a particular specified event. A term of contract, on the other hand, imposes a contractual obligation on a party to act or to refrain from acting, in a particular manner.

The fact that the payment of the contingent liability remains uncertain and will only become certain upon the happening of a future event is a suspensive condition (rather than a resolutive condition) and is present in all three examples above. As the nature of a contingent liability has been described and defined, its deductibility in terms of the Act will now be determined.

2.3 The general deduction formula

The Act does not contain a specific section providing for the deductibility of a contingent liability. The provisions for the deduction of expenses, other than those dealt with in specific sections of the Act, will therefore need to be considered. For an expense of a general nature to be deductible in terms of the Act, the expense needs to comply with the requirements laid down in the preamble to section 11 and section 11(a) of the Act and not prohibited under section 23. The combination of these sections of the Act is commonly known as the “general deduction formula” (Keirby-Smith, 1996:2). The preamble to section 11 and section 11(a) of the Act provides as follows:

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

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

Section 23 of the Act provides that:

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

- (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade

The preamble to section 11, section 11(a) and section 23(g) of the Act (the general deduction formula) can be broken down into the following elements that need to be satisfied before an expense is deductible:

- there must be an expenditure or a loss,
- the expenditure or the loss must actually be incurred,
- during the year of assessment,
- in the production of income,
- not of a capital nature, and
- either in part or in full, laid out or expended for the purposes of trade.

In *Port Elizabeth Electric Tramway Co Ltd v CIR*, 1936 CPD 241, 8 SATC 13, it was established that the two sections referred to above (sections 11(a) and 23(g)), must be read together when determining deductibility under the general deduction formula.

From the preamble to section 11 it is clear that before a taxpayer can claim the deduction of an expense in terms of the general deduction formula, the taxpayer must be carrying on a trade. The taxpayer must also derive income in carrying on a trade in order to deduct qualifying expenditure.

Section 1 of the Act defines “trade” as follows:

“trade” includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property, and the use of, or the grant of permission to use, any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design, as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark, as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any

copyright, as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any other property which is of a similar nature.

The definition of trade is wide. The Judge in *Burgess v CIR*, 1993 (4) SA 161 (A) (1993), 55 SATC 185, at 189, explained that the definition of trade should not only be given a wide interpretation, but, furthermore, that the definition itself was not exhaustive. Smalberger JA stated in *CIR v Pick 'n Pay Employee Share Purchase Trust*, 1992 (4) SA 39 (A), 54 SATC 271, that, when considering whether a trade was being carried on, ordinary common sense and business standards must be considered. Before a contingent liability can be considered for deductibility in accordance with the general deduction formula, the taxpayer (the purchaser and/or the seller in this case) must be carrying on a trade. The fact that the contingent liability, which arose as part of normal business operations, is transferred on the sale of a business as a going concern would indicate that a trade is being carried on.

As the taxpayer (seller or purchaser of the business) would be carrying on a trade, the deductibility of a contingent liability would need to meet the additional requirements of the general deduction formula. Important case decisions will be discussed in order to clarify the requirements for the deduction of an expense under the general deduction formula.

2.3.1 Expenditure and losses

An amount must be classified as expenditure or a loss before it can be deducted in terms of the general deduction formula. The Act does not define expenditure or a loss. *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157, 13 SATC 354, defined a loss as an involuntary deprivation, and an expense as a voluntary payment of money. These definitions were further confirmed in *CIR v Felix Schuh (SA) (Pty) Ltd*, 1994 (2) SA 801 (A), where expenses were referred to as disbursements or expenses paid voluntarily, while losses implied involuntary deprivations.

Findlay J, in the English case of *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co*, 17 TC 59 (at 64), explained the word “disbursements” to mean:

. . . something or other which the trader pays out; I think some sort of volition is indicated. If he chooses to pay out some disbursement, it is an expense, it is something

which comes out of his pocket. A loss is something different. That is not a thing which he expends or disburses. That is a thing which, so to speak, comes upon him *ab extra*.

In *ITC 1783* 2004, 66 SATC 373 (G), the taxpayer purchased a business. The agreement provided that the purchase price must be settled through the issue of its own shares. The court was required to consider whether one of the assets purchased (a licence agreement) would be considered expenditure under section 11(a) or section 11(gA) of the Act. Goldblatt J (at 376) stated the following:

Expenditure in its ordinary dictionary meaning is the spending of money or its equivalent e.g. time or labour, and a resulting diminution of the assets of the person incurring such expenditure. An allotment is the issuing of shares by a company and it does not in any way reduce the assets of the company, although it may reduce the value of the shares held by its shareholders. In these circumstances such issue or allotment of shares does not, in our view, constitute expenditure by the company.

In *ITC 1801* (2005), 68 SATC 57, the facts were not dissimilar to those of *ITC 1783* (where it was held that the allotment of shares does not constitute expenditure). In *ITC 1801*, it was reported that the Commissioner had disallowed a deduction claimed in terms of section 11(gA) of the Act on the grounds that the expenditure was not “actually incurred”, against which the respondent appealed to the Pretoria Tax Court (*ITC 1801*) which upheld the appeal. The Commissioner then appealed to the Supreme Court. The Supreme Court of Appeal held in *C:SARS v Labat Africa Ltd*, 2013 (2) SA 33 (SCA), 74 SATC 1, that the payment for a trademark by the issue of shares was not considered expenditure. Harms AP noted the following (at 5 and 6):

The question the court should have posed was whether the issuing of shares by a company amounts to ‘expenditure’, and not whether the issuing of shares amounts to an obligation, which it obviously does. The term ‘obligation’ or ‘liability’ and ‘expenditure’ are not synonyms. This is apparent from what was said by Botha JA in *Caltex Oil (SA) Ltd*, namely, that the expression ‘any expenditure actually incurred’ means ‘all expenditure for which a liability has been incurred during the year, whether or not the liability has been discharged during the year. (own emphasis)

These cases present similar characteristics – a taxpayer must have paid out cash (or transferred an asset) in respect of a liability, or must have incurred an unconditional legal liability to pay the amount for it to be considered expenditure.

In the transfer of a contingent liability from the seller to the purchaser in the sale of an entity as a going concern, the purchaser takes responsibility for the contingent liability. At the date of transfer the contingent liability is not unconditional and it is not known whether the contingent liability will become unconditional. As at the date of sale the contingent liability remains conditional. No expenditure has yet been incurred by the seller in respect of the contingent liability and therefore, as no expenditure has been incurred, the seller may not deduct the contingent liability as an expense under the general deduction formula. In terms of the general deduction formula no expense has actually been incurred. In the *Ackermans* case, the taxpayer argued in the Supreme Court of Appeal that an expense had been incurred, not directly in respect of the contingent liability, but as a result of the seller having to compensate the purchaser (indirectly through a reduction in the selling price) to take responsibility for the future fulfilment of the contingent liabilities.

Similarly, at the date of sale the purchaser has not incurred any expenditure relating to the contingent liability, as the liability remains conditional. The purchaser may therefore not deduct the contingent liability, as no expense (or loss) has been incurred.

The *Ackermans* case and the arguments of both the taxpayer and the Commissioner, as well as the final decision of the court, will be discussed in chapter 3.

2.3.2 Actually incurred

In *Nasionale Pers Bpk v KBI* it was held that the expenses did not have to be physically paid by the year-end in order to be deductible. However, the expense had to be actually incurred. An expense is considered to be actually incurred when the taxpayer becomes unconditionally obligated to make the payment. In this case, the taxpayer attempted to deduct a provision for bonuses raised at year-end. The bonus provision raised was only payable after year-end, if the employee was still in the company's employment at the time that the bonuses were paid.

It was held that at the end of the tax year (31 March) it was uncertain whether the taxpayer was under an obligation to pay the leave pay in respect of any given employee. The taxpayer's obligation was subject to a condition that the employee did not leave the taxpayer's service voluntarily or was not dismissed for misconduct before 31 October, and this obligation would only become unconditional after the end of the tax year. Hence, the expenditure in relation to leave pay was not "actually incurred during the tax year" (Williams, 2009:424)

This principle was confirmed by the court in *Caltex Oil (SA) Pty Ltd v CIR* where it was held that expenditure does not refer only to expenditure actually paid, but also to expenditure for which a liability has been incurred during the year. In *Caltex Oil (SA) Pty Ltd v CIR*, the taxpayer had entered into two unconditional foreign transactions (in sterling) relating to trading stock during the year of assessment. Sterling devalued during the year of assessment and the taxpayer settled and claimed as a deduction the value in Rand, which the taxpayer actually paid to settle this debt. The second transaction remained unpaid. As the expense was unconditional and had been "actually incurred", the debt needed to be quantified and claimed as a deduction in the current year of assessment. The taxpayer attempted to deduct the value of the transaction before the devaluation of the sterling (the original invoice price that was reflected in the company's accounting records), but the court ruled that the value of the deductible amount must be calculated based on the amount outstanding at the end of the year (taking into account the devaluation of Sterling).

In *CIR v Edgars Stores Ltd*, the taxpayer was subject to a rental turnover clause in its lease agreements. In terms of the lease agreements, the taxpayer would pay the lessor a basic rental and an additional amount based on the taxpayer's annual turnover. The additional amount would only be paid where the turnover exceeded the basic amount. As the lease year and taxpayer's year of assessment did not end concurrently, the "turnover rental" could not be determined for the relevant year of assessment. The taxpayer, however, attempted to deduct the "turnover rental", not in the year in which it was paid, but in the year in which the taxpayer "estimated" the liability to have arisen. The deduction claimed was based on an estimate of future expected turnover.

The court held that a contingent liability had arisen as the amount of the "turnover rental" was conditional upon the happening of a future event (the end of the lease year and the

calculation of the final “turnover rental”). As the “turnover rental” was conditional, it was not “actually incurred” and therefore not deductible. Corbett JA, in delivering the judgment stated (at 90):

It is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s11(a) from the income return for the year... (own emphasis).

As the words “actually incurred” do not merely mean actually “paid” (Stiglingh *et al*, 2014:140), the taxpayer may, in certain circumstances, argue that a contingent liability has actually been incurred. A company that has made provision for a bonus may argue that, should it have an agreement to pay a director the bonus based on profit, and the profit is likely to be achieved, it is more than likely to incur the bonus expense, and therefore the expenditure has actually been incurred. Similarly, if a company has offered a warranty on its product and has based the warranty provision on past experience and the number of returns, expressed as a mathematical calculation based on the number of past sales and returns extrapolated to current sales, it may argue that the warranty expense has actually been incurred, as it is more than likely to incur the warranty repair costs. However, this would not be sufficient to constitute expenditure for the purposes of section 11(a).

In *CIR v Golden Dumps (Pty) Ltd*, 1993, 40 SA 110 (A), as summarised by Haupt (2014:115), it was held that the word “actually” incurred must be given its full weight, and if a dispute is unresolved at the end of the tax year, the liability cannot be classified as “actually” incurred.

The principles established in the court decisions discussed above indicate that the liability will be considered as actually incurred only when the liability becomes unconditional. As a contingent liability is conditional upon the happening of (a) future event(s), based on the principles established in the tax cases presented, it cannot be classified as “actually incurred” in terms of the general deduction formula. Only when the contingent liability becomes unconditional can it be classified as actually incurred and therefore deductible in terms of section 11(a), read with section 23(g).

In the case that will form the centre point of the discussion in chapter 3 (the *Ackermans* case), the taxpayer claimed that the reduction in the selling price as a result of the transfer of the contingent liabilities constituted an expense actually incurred and therefore would be deductible under the general deduction formula. The facts and circumstances of this case will be presented and discussed in chapter 3.

2.3.3 During the year of assessment

Section 11(a) of the Act does not stipulate that the expense must be incurred during the current year of assessment. However, the courts have held that deductible expenditure is restricted to expenditure actually incurred during the year of assessment. In *Concentra (Pty) Ltd v CIR*, 1942 CPD 509, the principle was established that expenses can be deducted only in the year of assessment in which they were incurred (irrespective of whether or not the expenses were paid).

There are two exceptions to the rule that expenditure incurred in a particular year of assessment must be deducted in that year. The first exception arises where the expenditure which the taxpayer incurred during the year of assessment is deductible under sections 11(a), 11(c) or 11(d) of the Act, but the benefit associated with this expenditure will only be received in a future period. Although the amount has already been paid, or is payable (therefore it has been incurred), the deduction is postponed until the benefit has been enjoyed (the goods delivered or the service provided). This is often referred to as “prepaid expenditure” and is provided for under section 23H of the Act. The second exception is under section 23F(1) and (2) of the Act which deals with the deduction of the cost of trading stock. Section 23F of the Act is an anti-avoidance provision that prohibits a taxpayer from deducting an expense relating to the purchase of trading stock under section 11(a) of the Act, where the trading stock has not been sold or included in closing stock under section 22(1) of the Act. Stiglingh *et al* (2014:692) summarise sections 23F(1) as follows:

Section 23F(1) was introduced to prevent a taxpayer from claiming a deduction in respect of the acquisition of such trading stock by denying the deduction if the trading stock was not disposed of by the taxpayer during the year (i.e. no proceeds were included in gross income in terms of sales), nor held by him at the end of the year.

In a situation where a taxpayer purchases trading stock, that has not yet arrived (e.g. the goods are in transit), section 23F(1) prohibits the taxpayer from claiming the trading stock purchased as a deduction under section 11(a) of the Act as no amount has been included in the taxpayers taxable income in terms of closing stock. The taxpayer is only entitled to claim the deduction for the trading stock purchased in the subsequent year in which the trading stock is sold and the sales are recorded in gross income or the value of the trading stock is included in closing stock.

Section 23F(2) denies a section 11(a) deduction for trading stock purchased where the taxpayer purchased and then subsequently sold trading stock in the ordinary course of his trade, but the consideration received from the sale does not accrue to him in the same year of assessment that the trading stock was purchased and the section 11(a) deduction claimed.

A contingent liability would not have been created in relation to a prepaid expense or the purchase of trading stock, as there is no uncertainty relating to the liability, and these two exceptions would therefore not be applicable to contingent liabilities.

As identified earlier, a contingent liability is not considered to have been “actually incurred” in accordance with the general deduction formula, and therefore, in accordance with the *Concentra* case, the expense is not considered to have been incurred in the year of assessment in which the contingent liability arose.

2.3.4 In the production of income

An important case for the determination and meaning of “in the production of income” was the *Port Elizabeth Electric Tramway* case. In that case it was held that expenditure must be closely linked to a company’s business operations for the expense to have been incurred “in the production of income”. The judge held (at 13) that:

...all expenses attached to the performance of a business operation *bona fide* performed for the purposes of earning income are deductible, whether they are necessary for its performance or attached to it by chance, or are *bona fide* incurred for the more efficient performance of such operation provided that they

are so closely connected with it that they may be regarded as part of the cost of performing it.

The principles established in the *Port Elizabeth Electric Tramway* case have been applied in numerous later cases in which determining the meaning of “in the production of income” was an issue and therefore only this case will be considered and discussed.

An expense incurred does not have to be directly related to a business activity to be considered to be incurred “in the production of income”, provided that the act giving rise to the expense is done *bona fide* for the purpose of carrying on the trade in which the taxpayer is engaged.

The nature of each contingent liability will need to be considered individually when determining whether it has been incurred in the production of income, and the principles established by the *Port Elizabeth Electric Tramway* case will be applied. For the following examples of contingent liabilities, the principles would be as follows:

- Leave pay: The employment of employees is necessary in order for an entity to produce income, and therefore any accumulated leave pay is an indirect consequence of employing the employee. Leave pay paid to an employee would therefore have been incurred in the production of income. The principles of the *Port Elizabeth Electric Tramway* case have been satisfied as the expense is closely linked to the income earning operations of the entity, and therefore the expense has been incurred in the production of income.
- Warranty provision: A payment with regard to a warranty claim on a previously sold product is not directly linked to the production of income. However, the warranty expense paid would be paid for *bona fide* business purposes. A product that carries a warranty will be more desirable to the purchaser, and therefore more easily sold than a product with no warranty. The provision of a warranty would thus result in sales of the entity, and therefore any expenses incurred to honour the warranty on products sold would have been incurred in the production of income.
- Bonus: Similar to leave pay, a bonus provision is a staff cost that relates indirectly to the generation of profit. As the cost has been incurred *bona fide* for business purposes it is considered to have been incurred in the production of income.

The contingent liabilities claimed as a deduction in the *Ackermans* case, that were under dispute, included similar items to those identified above, being provisions for post-retirement medical aid benefits, bonuses and repairs to leasehold property. In order for the contingent liabilities (in the *Ackermans* case) to be deductible under the Act, they will need to have been incurred in the production of income. While the provisions for bonuses and warranties clearly relate to expenditure that, if it had actually been incurred, would have been incurred in the production of income. The position with an undertaking by a firm to provide for post-retirement medical aid benefits is not as clear, as the employees would no longer be producing income. However, should these benefits be provided in terms of the employment contracts or in terms of an acknowledged policy to provide such benefits in the interest of attracting and retaining staff, the expenditure would qualify for deduction as having a close connection with the production of income (*Provider v COT*, 1950 SR 161, 17 SATC 40). Should the contingent liabilities not have been transferred to the purchaser and become unconditional, it can be submitted that the expenses would have been incurred in the production of income as the employment-related expenses (bonuses, warranties and post-retirement medical benefits) are incurred as a result of the taxpayer's trade and are revenue in nature. The cost of repairs would have been incurred on properties from which the taxpayer conducted its trade and therefore would have been incurred in the production of income. It would therefore appear that the contingent liabilities incurred by the taxpayer (in the *Ackermans* case) would have been incurred in the production of (Ackermans) income.

2.3.5 Not of a capital nature

The purpose of an expense should be considered when determining whether an expense is capital or revenue in nature. The true nature of the transaction should also be considered. Watermeyer CJ, in *New State Areas Ltd v CIR*, 1946 AD 610, SATC 155 (at 170), summarised it as follows:

The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact, and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for a business it is capital expenditure, even if it is paid in annual

instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure, even if it is paid in a lump sum.

The contingent liabilities in the *Ackermans* case were revenue in nature and had been incurred in the production of income. The contingent liabilities were not linked to an income earning structure or to a specific asset. In *ITC 1241* (1975) 37 SATC 300 and *ITC 1267* (1977) 39 SATC 146, it was held that where an expense had been incurred that did not result in the creation or improvement of an income-producing asset, or to establish an income-earning structure, it was not capital in nature and therefore deductible, provided it satisfied the other requirements of the general deduction formula. The contingent liabilities in the *Ackermans* case would therefore not be of a capital nature. However, in that case the Commissioner claimed that the reduction in the price paid for the business as a result of the assumption of the contingent liabilities was of a capital nature. This will be discussed in chapter 3, where the case is analysed in detail.

No capital/revenue test is conclusive, and each case needs to be considered in terms of its own facts. Should an expense be of a capital nature, it cannot be deducted under the general deduction formula, whether contingent or non-contingent.

2.4 Sections of the Act that cater for contingent liabilities

A contingent liability is prohibited from being deducted under the general deduction formula as it has not been “actually incurred”, due to its conditional nature. The Act does, however, allow for certain “contingent liabilities” to be deducted for tax purposes.

Section 11(j) of the Act provides for the deduction of a doubtful debt provision. A doubtful debt provision would be classified as a contingent liability as it is conditional upon the happening of a future event (the debtor not being able to honour its debt). Stiglingh *et al* (2014:184) summarise the allowance provided for in section 11(j) as follows:

An allowance each year for any debt due to the taxpayer that he considers to be doubtful, but only if that debt would have been allowed as a deduction under any other

provision had it become bad (therefore it must have previously been included in the taxpayer's income).

The allowance is at the discretion of the Commissioner and is usually granted at a rate of 25% of the listed doubtful debts at the end of the year of assessment.

Where a taxpayer has entered into a contract and received payment, but is only expected to incur costs relating to the contract in the future, section 24C of the Act provides a deduction in the current year of assessment for the future expenditure that the taxpayer will incur. The future expenditure would be regarded as a contingent liability as the liability is conditional upon the happening of a future event (the incurral of future expenditure). The section 24C allowance is calculated as follows (Stiglingh *et al*, 2014:202):

- cost as a percentage of contract price as calculated with reference to the amount of the future expenditure that relates to the contract (s 24C(2));
- less actual expenditure incurred in the year.

Both the deductions in terms of section 11(j) and section 24C are reversing allowances and the prior year allowance must be added back at the beginning of the following year of assessment, before a taxpayer can claim the current year's allowance. Neither of these allowances would provide relief in respect of the contingent liabilities that were the basis of the appeal in the *Ackermans* case (discussed in chapter 3).

2.5 Inter-group relief

Section 45 of the Act provides for tax relief where assets have been transferred from one company to another company. The companies must be South African resident companies and must form part of the same group of companies. The effect of section 45 is to grant the transferring company tax relief (normal income tax on the recoupment of the asset transferred as well as relief on any capital gain made by the transferring company). Before section 45 can be applied, both taxpayers need to ensure that the specific requirements of section 45 have been complied with.

Section 45 only provides tax relief for the transfer of assets, and not liabilities, between group companies. In the *Ackermans* case, the taxpayers formed part of the same group of companies

and the transfer of the contingent liabilities from the one entity to the other occurred as a result of a company re-organisation. The taxpayers could not apply the tax relief provided for by section 45 of the Act, as the section only provides for relief relating to assets, not liabilities.

2.6 Prohibited deductions

Section 23 of the Act provides that no deductions will be allowed for certain expenses incurred. Specifically relating to contingent liabilities, section 23(e) of the Act provides that no deductions may be made in respect of “income carried to any reserve fund or capitalised in any way”. Stiglingh *et al* (2014:150) state that “income carried to any reserve fund or capitalised in any way (for example a provision made out of income to provide for a contingent liability) will be denied as a deduction”. Section 23(e) of the Act therefore prohibits the deduction of an amount set aside in the form of a reserve fund for a contingent liability. In creating the contingent liabilities that were the disputed deductions in the *Ackermans* case, the company would have created these provisions for the contingent liabilities by way of a credit to a contingent liability account or accounts and a consequent reduction of the profit before tax. In terms of section 23(e) these deductions would not have been granted for income tax purposes at that stage. The question is whether the subsequent transfer of the contingent liabilities would have converted these non-deductible expenses into deductible expenses. This is the question that was addressed in the *Ackermans* case.

2.7 Conclusion

A contingent liability is a provision relating to a probable future expense that has been measured and raised in a company’s annual financial statements, in accordance with the accounting standard *IAS 37* (2013:A1152). Expenditure, other than expenditure specifically provided for in the Act, is deductible in terms of the Act under the general deduction formula. For a contingent liability to be deductible under the general deduction formula, it needs to satisfy all the requirements of the general deduction formula.

A contingent liability, in terms of the Act and the tax cases discussed in this chapter, would not appear to have been “actually incurred” in accordance with the general deduction formula. As no expense has been “actually incurred” it cannot be deducted under the general

deduction formula. A contingent liability is conditional upon the happening of a future, unknown event and therefore remains conditional. An expense does not need to be physically paid at year-end but the taxpayer must have an unconditional liability to make the payment for it to be considered “actually incurred” (*Nasionale Pers Bpk v KBI*). As the taxpayer has no unconditional liability to make payment for a contingent liability, it cannot be deductible under the general deduction formula.

The Act further prohibits the deduction of any expense that has been incurred in the creation of a reserve fund (section 23(e)). When a contingent liability is raised, the expense has not yet become unconditional, and the taxpayer is effectively creating a reserve fund (provision) from which the future payment can be paid (when the liability becomes unconditional). As transfers to reserve funds are prohibited, section 23(e) would therefore prohibit the deduction of a contingent liability as it has been raised in the creation of a reserve fund.

The accounting and tax treatments of a contingent liability differ. For accounting purposes, in accordance with the accounting statement *IAS 37* (2013:A1152), a provision is raised in a reserve fund for the payment of future (currently conditional) liabilities. When determining the final accounting profit for the year, the expense debited to the income statement in creation of the reserve fund (or provision) is deducted from the total accounting profit of the company. For tax purposes, the deduction made in creating the reserve fund (or provision) is not deductible for tax purposes under the general deduction formula from the taxpayer’s taxable income, and the deduction of the expense is further prohibited in terms of section 23(e).

It would appear that, on the face of it, a contingent liability does not meet the requirements of the general deduction formula, as a contingent liability is uncertain and conditional and is not considered to be “actually incurred” under the general deduction formula. This chapter has discussed the theoretical framework for the deduction of expenditure in terms of the general deduction formula and therefore forms the basis for the analysis of the *Ackermans* case that will be discussed in the next chapter. The *Ackermans* case is an important tax case in South Africa as it deals with the deductibility of a contingent liability that is taken over by the purchaser of an entity that is sold as a going concern.

Chapter 3: A discussion of the *Ackermans* case

3.1 Introduction

This chapter addresses the second goal of the thesis - to present and analyse the facts and the decision in the *Ackermans* case. The *Ackermans* case was heard in the Supreme Court of Appeal and has become a landmark case in South Africa for the tax treatment of a contingent liability assumed by the purchasing company in the sale of the business as a going concern.

This chapter will review and analyse the *Ackermans* case from the perspective of the appellant (Ackermans) and the respondent (the Commissioner). The *Ackermans* case, was heard before the Supreme Court of Appeal, on appeal from the Judgement in *ITC 1839* (2010) 72 SATC 61, where the South Gauteng Income Tax Court ruled in favour of the respondent (the Commissioner).

The *Ackermans* case (and the preceding Income Tax Court case – *ITC 1839*) concerned the deductibility of contingent liabilities amounting to approximately R17 million assumed by the purchaser of the business as a going concern. Before the two decisions are discussed in detail, the nature of the contingent liabilities will be considered, as well as their deductibility should they become unconditional.

3.2 The contingent liabilities

As the Supreme Court of Appeal focused on whether the contingent liabilities (the expenditures) were “actually incurred”, it is necessary to obtain a thorough understanding of the nature of the contingent liabilities that Ackermans attempted to deduct against its taxable income. The contingent liabilities that Ackermans attempted to deduct amounted to R17 million and were transferred from Ackermans to Pepkor Ltd (referred to as “Pepkor”). The contingent liabilities comprised of the following:

3.2.1 Post-employment medical aid benefits

Post-employment benefits are defined by International Financial Reporting Standard, *Part A, International Accounting Standards 19 Employee Benefits (IAS 19, 2013:A826)* as:

Employee benefits (other than termination benefits and short-term benefits) that are payable after the completion of employment.

For accounting purposes, post-employment benefits are valued in accordance with actuarial principles, partly based on the life expectancy of employees. The definition of a contingent liability (as presented in chapter 2) states that a contingent liability is a liability that will be confirmed only by the happening of a future event. As the post-employment benefit will be confirmed only by the happening of a future event (the retirement and life expectancy of future employees), the post-employment benefit will be classified as a contingent liability for accounting purposes, as the payment of the post employee benefits is based on a conditional event. Contingent liabilities are not considered to be “actually incurred” in terms of section 11(a) of the Act and are prohibited by section 23(e), and are therefore not deductible.

A provision created for post-employment benefits is therefore not deductible under section 11(a) of the Act as it usually represents a future actuarial risk (the actuaries’ subsequent calculations may indicate that the employer’s obligation may have increased from the original calculation) and therefore not an amount actually incurred (Kroukamp, 2006:29). In other words, an increase in a provision (or the creation of a new provision) for post-employment benefits (an expense debited to the income statement) will not qualify for a deduction under section 11(a) of the Act. The expense cannot be considered to be “actually incurred” in terms of section 11(a) because the expense is based on actuarial calculations which are not certain as they have been determined using actuarial estimations (such as life expectancy) and therefore are contingent upon the happening of a future event. As the post-employment benefits are contingent they will not qualify for deduction. The post-employment benefits are further prohibited by section 23(e) of the Act as they have created a “reserve fund”.

3.2.2 Future bonus payments

The bonus provision transferred from Ackermans to Pepkor as part of the sales agreement related to the provision for long term bonuses payable to staff who were employed by Ackermans before the entity was sold to Pepkor. The payment of the bonus was dependent on the employee still being employed by Pepkor at the time the bonus became due for payment. The payment of the staff bonuses therefore remained uncertain and met the

definition of a contingent liability as they were conditional upon the happening of a future event.

An amount is not deductible under the general deduction formula unless it has been “actually incurred” and, as the bonus provisions were conditional, they were not deductible under the general deduction formula as they had not yet been “actually incurred”. Bonuses and leave pay fall into the definition of variable remuneration, in terms of section 7B(2) of the Act, which states that variable remuneration (that is, bonuses and leave pay) is deductible by the employer only on the date of actual payment to the employee (Stiglingh *et al*: 2014). Therefore, in terms of section 7B(2), a taxpayer will only be entitled to a deduction relating to leave pay or a bonus if the employer has effected actual payment to the employee (in other words, the employee has received the bonus or leave pay payment). An employer that has created a leave pay and/or bonus provision would therefore not have physically paid any amount relating to the leave pay provision and/or bonus to the employee. As no actual payment has occurred, the leave pay and bonus pay provision would not be deductible by the taxpayer (in terms of section 7(B) of the Act).

There may be instances where, at the end of the tax year, an employer has an absolute and unconditional liability for a portion of the bonus or leave payments, despite the fact that the date for payment has not yet arrived. For example, if, in terms of the employment contracts, the employees become entitled to a *pro rata* portion of the annual bonus or leave payment on the completion of each month’s service, then at the end of the employer’s tax year the employer will have an absolute and unconditional liability for a portion of the bonus or leave payments. However, even though the employer has an unconditional liability to the employee, no deduction will be allowed by the employer as section 7B of the Act states that a deduction is allowed only if actual payment has been incurred. Thus, in spite of the fact that an unconditional liability exists, section 7B will take precedence over section 11(a) of the Act because section 23B(3) prohibits a deduction under section 11(a) if a specific section deals with the deductibility of the expense. As section 7B (previously section 23E) deals with the deductibility of leave pay and bonuses, the seller cannot, under section 11(a), deduct expenditure incurred on leave pay (Olivier: 2007).

The contingent liability was not deductible by the seller in the *Ackermans* case as no expense had been “actually incurred”. The purchaser would further appear to be denied the deduction.

The bonus and leave pay expense would be eligible for deduction under section 7B of the Act when it is physically paid by the purchaser. However, the purchaser (Pepkor) would not have incurred the expense “in the production of” its “income” in terms of section 11(a) of the Act (as the liability arose before the sale took place) and therefore the expense would not qualify for deduction.

3.2.3 Repairs and maintenance of leasehold assets

In the *Ackermans* case, the company was required to maintain the buildings that it leased and used for its trade, and therefore raised a provision for the future repairs and maintenance that it would be required to carry out. The future repairs were contingent upon the properties falling into disrepair.

The repairs and maintenance provision would meet the definition of a contingent liability, as the payment of the future repairs and maintenance was conditional upon the happening of a future event. As the future repairs and maintenance were conditional, they would not have been “actually incurred during the year of assessment on repairs of property occupied for the purpose of trade”, as required by section 11(d) of the Act. In addition, the deduction of amounts carried to a reserve is specifically prohibited by section 23(e) of the Act.

The purchaser will be entitled to deduct the expenses once they have been incurred (provided that they are not of a capital nature) and have been incurred in the production of income.

3.2.4 Summary

No section of the Act specifically provides for the deduction of any of the above contingent liabilities, and therefore section 11(a) (the general deduction formula) and section 11(d) in the present case will need to be referred to in order to determine their deductibility. As already explained in chapter 2, for an amount to be deductible in accordance with the general deduction formula, the amount (in addition to satisfying the other requirements of the general deduction formula) must have been actually incurred (which is also a requirement of section 11(d)). For an amount to be actually incurred, it must be unconditional. The contingent liabilities involved in the *Ackermans* case are conditional upon the happening of future

events, and therefore cannot be held, in terms of the general deduction formula or section 11(d), to have been actually incurred.

Ackermans did not dispute the fact that the contingent liabilities were conditional, and therefore not deductible. However, Ackermans claimed that they did not deduct the contingent liabilities *per se*, but had deducted an amount paid to Pepkor (indirectly through the reduction of the selling price) to assume responsibility for the payment of the future contingent liabilities.

3.3 Income Tax Case 1839

Prior to the review and analysis of the judgment in the Supreme Court of Appeal in the *Ackermans* case, *ITC 1839* must be discussed in order to understand the ruling in the lower court. This is necessary as certain grounds raised by counsel for both Ackermans and the Commissioner in *ITC 1839*, were not discussed in the appeal to the higher court.

3.3.1 The facts of the case

On 1 March 2004, Ackermans (Pty) Ltd (“Ackermans”) sold its retail clothing chain, as a going concern, to Pepkor (Pty) Ltd (“Pepkor”). The sales agreement placed a net value of R800 million on the sale of the business. This value was determined, taking into account the assumption by Pepkor of the responsibility for certain of Ackermans’ liabilities. An annexure to the sales agreement disclosed a gross selling price of R1.1 billion, and liabilities (to be assumed by Pepkor, and therefore resulting in a decrease in the selling price) of R311 million. The net sales value of R800 million would be settled by Pepkor through the creation of a loan account between the two entities. The liabilities of R311 million included both actual and contingent liabilities. The purchaser of the business duly discharged its obligations in terms of the sales agreement.

The contingent liabilities comprised of post-retirement medical aid benefits, long-term bonuses for staff and obligations to carry out repairs in respect of certain leased property. The contingent liabilities in respect of the period prior to the “effective date” amounted to approximately R23 million and were valued for the purpose of the sale of the business. When submitting their tax return, Ackermans, claimed R23 million relating to the contingent

liabilities as a deduction against their gross income. The Commissioner issued an additional assessment and disallowed this deduction. The appellant (Ackermans) abandoned part of the appeal, but persisted in its claim for the deduction of approximately R17 million, on the grounds that it complied with the provisions of section 11(a), read with section 23(g) of the Act.

In *ITC 1839* it was reported (at 67) that the Commissioner (the respondent) disallowed the deductions, on the following grounds:

- (i) they do not constitute 'expenditure';
- (ii) they do not constitute expenditure actually incurred;
- (iii) they do not constitute expenditure actually incurred in the production of income;
- (iv) if they were expenditures, they were expenditures of a capital nature;
- (v) if they were expenditures, they were not incurred for the purposes of trade;
- (vi) they were, in any event prohibited from deduction in terms of s 23(e) of the Income Tax Act No 58 of 1962, as amended ('the Act');
- (vii) they were, in any event prohibited from deduction in terms of s23(f) of the Act;
- (viii) they were, furthermore, in any event prohibited from deduction in terms of s 23(g) of the Act.

3.3.2 The arguments presented

Willis, J reported (at 67) that counsel for the appellant, a Mr Rogers, had conceded, in the Judge's opinion fairly and correctly, "that if the respondent was successful in respect of any one of these grounds, his assessment would have to be confirmed." The Judge went on to discuss the sections of the Act referred to in the respondent's grounds (which, excluding section 23(f), have been discussed in detail in chapter 2 of the present thesis). He quoted (at 68) section 23(f), which prohibits deductions in respect of "any expenses incurred in respect of amounts received or accrued which do not constitute income as defined in section one" (underlined in the original).

The learned Judge then (at 68) proceeded to deal with the appellant's argument that the portion of the purchase price foregone represented expenditure incurred in terms of section 11(a) of the Act and that "expenditure incurred by a taxpayer to rid itself of anticipated or

contingent revenue expenses is generally itself of a revenue nature”, thus dealing with the respondent’s claim that the expenditure, if such it was, was of a capital nature. The appellant based his argument that the conclusion of the sale agreement gave rise to incurred expenditure in the amount of R17 million that “there had been a diminution of the appellant’s patrimony the same as a loss” and, relying on *Joffe & Co (Pty) Ltd v CIR* and *Port Elizabeth Tramway Co Ltd v CIR*, this amount was deductible. The learned Judge dismissed this argument stating (at 69) that “[r]ather than there being a diminution of the appellant’s patrimony, there was an increase” as the appellant had been “relieved of the risk, that the contingent liabilities in question would materialise”.

Mr Rogers, for the appellant Ackermans, argued (at 71) that, although the diminution was in the form of a lump sum, this constituted “compressed expenditure” incurred to free the taxpayer from anticipated revenue expenses and that such expenditure is generally of a revenue nature. He referred to a number of cases heard in England and Australia in support of his contention that the amount foregone was expenditure actually incurred, not of a capital nature, but the Judge dismissed these cases as being “interesting but . . . quite unhelpful” and stated that “[i]t will, no doubt be the appellant’s lament that this well-prepared argument does not assist in this case [and] . . . at no stage was the court in the slightest way beguiled, led astray, disturbed or perturbed by the lump sum character of the relevant amount”.

The Judge then went on to deal (at 71 - 72) with the respondent’s grounds for his argument and concluded that as the liabilities constituting the relevant amount had not yet come into existence and were therefore conditional they did not constitute expenditures actually incurred. With regard to whether the “expenditure” (that counsel for Ackermans claimed had been “incurred”) had been incurred “in the production of income” as was rejected by counsel for the Commissioner, the Judge concluded (at 72) that “the ‘notional agreement expenditure’ did not produce ‘income’ arising from the sale of the business”. With regard to the capital nature of the amount, which was postulated by counsel for the Commissioner, the Judge again concluded that, as the sale of the business would cause a cessation of trading, “the appellant has been unable to successfully argue that the expenditure incurred in relation to the sale would be more closely connected to its income earning operations.” In agreeing with the contention of counsel for the Commissioner that the relevant amount was not incurred for the purpose of trade in terms of section 23(g), the Judge stated (at 73) that the transactions were undertaken “for the purpose of bringing an end to the appellant’s trading activities”. In

relation to section 23(e), the Judge was of the opinion that no further discussion was required as to whether “income [was] carried to any reserve fund or capitalised in any way” as “[e]xpenditure [sought to be deducted by Ackermans] is clearly not income.” Finally, in relation to section 23(f), the Judge stated (at 74) that the court would treat this subsection as the “negative counterpart” of the “in the production of income” requirement of section 11(a) and that the “notional agreement expenditure” was “clearly ‘incurred’ in order to induce C to assume the liabilities, rather than incurred in the production of income prior to the sale of the business.”

The court concluded (at 64) that the deduction of the contingent liabilities, which the purchaser had agreed to assume, was not allowable in terms of section 11(a) of the Act. Ackermans thereafter took the matter on appeal to the Supreme Court of Appeal. The case heard by the Supreme Court of Appeal will be referred to as the “*Ackermans* case”.

3.4 The Ackermans case

Cloete, JA briefly (at 5) repeated the facts of the case and the arguments presented in *ITC 1839* and concluded that it would not be necessary to deal with the correctness of the submission by Ackermans’ counsel that “when lump sum expenditure is incurred by a taxpayer to free itself from anticipated or contingent revenue expenses, such expenditure is generally itself of a revenue nature, and that this applies to Ackermans’ expenditure in the present case.” He also concluded that it would be necessary to deal only with the first issue raised by the Commissioner that “the deduction claimed: (a) did not constitute ‘expenditure’ or ‘expenditure actually incurred’”.

Cloete, JA, in dealing with the arguments put forward by both the appellant and the respondent, stated (at 5) that “[t]he Commissioner submitted that Ackermans did not have any obligation to make a payment to Pepkor in terms of the sale agreement, and that the manner in which the purchase price was discharged did not involve any expenditure being incurred by Ackermans.” He repeated the appellant’s reply that deductible “losses” can “exist independently of a legal liability . . . and that being so . . . [t]he economic consequences of a transaction should thus be examined to ascertain whether it has resulted in an actual diminution of, or has had a prejudicial effect on, the taxpayer’s patrimony.” The learned Judge was unable to accept this argument as

[n]o liability was incurred by Ackermans to Pepkor in terms of the sale agreement. The manner in which the purchase price was discharged by Pepkor did not result in the discharge of any obligation owed by Ackermans to Pepkor . . . and one looks in vain for a clause in that agreement that has this effect. It is for this very reason that the appellant in its oral submissions abandoned any reliance on set-off, which would have been the inevitable effect if there had been these reciprocal obligations.

The Judge reported (at 5 – 6) that in its initial letter of objection to the assessment by SARS written by the appellant’s auditors on their behalf, reliance was placed on set-off. The purchaser undertook to buy Ackermans’ business and therefore owed an amount of R1 129 440 402 to Ackermans, and Ackermans undertook to pay the purchaser (and therefore owed) an amount of R329 440 402 (of which the contingent liabilities formed part) to Pepkor for taking over its existing and future liabilities. It is these two mutual and opposing debts that were set off against each other and the amount in respect of the contingent liabilities was actually paid through set-off. The Judge was of the opinion that the argument “was untenable” and that “the argument based on set-off was correctly abandoned.”

As far as the submission on behalf of the respondent that “unless the three contingent liabilities were allowed as a deduction in the hands of Ackermans, an anomaly would arise as they would never be deductible”, the Judge concluded (at 6) that the argument was “without foundation [as] [t]here would be no bar to Pepkor deducting the liabilities as and when they became unconditional, as counsel representing the Commissioner rightly conceded.”

The Judge then summarised (at 6) what had occurred – the net value of the business had dictated the purchase price and

[i]n the ordinary course of purchasing the business as a going concern on this basis it would follow that the liabilities would be discharged by the purchaser. The journal entries relied on by the appellants do not equate to expenditure actually incurred. . . . The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date no expenditure was actually incurred by Ackermans.

The Judge therefore concluded (at 6) that “[t]he appellants accordingly fail at the first hurdle” and that “[t]he appeals are dismissed”.

3.5 A discussion of certain issues raised in the *Ackermans* case

From the appellant’s case, a number of tax questions arose. These included:

1. Did the conclusion of the sales agreement, by set-off of the liabilities against the purchase price, result in expenditure?
2. Was the expenditure incurred by the taxpayer to rid itself of the responsibility of the contingent liability an expense of a revenue or capital nature?
3. Had the expense been actually incurred?

Ackermans was of the opinion that the answer to these questions was that the set-off against the purchase price and transfer of responsibility was an expense actually incurred, and not of a capital nature. Their contention was based on the arguments discussed below.

3.5.1 Does set-off equate to expenditure?

In the *Ackermans* case, it was argued that the value of the contingent liabilities was set off against the purchase price. In other words, the amount by which the purchase price was reduced was not a direct payment but a “set-off” of the contingent liability (assumed by the purchaser) against the purchase price. Christie (2001:552) states that set-off may be regarded as a form of payment, and even as the equivalent of payment in cash. A party is excused from performing if the other party owes him a debt that admits of set-off against the first party’s debt. Christie summarises that for set-off to operate the following requirements must be satisfied:

- The parties must be indebted to each other, and each of them must owe, and be owed, in the same capacity. So, for example, set-off does not operate if A owes B and B owes C, or if A owes B in B’s representative capacity (e.g. as trustees, liquidators or guardians) and B owes A in A’s personal capacity.
- The debts must be of the same kind. A money debt, for example, cannot be set off against a claim for delivery of property.

- The debts must be due and enforceable. Set-off does not operate if, for instance, one of the debts is subject to a suspensive condition, or is only enforceable at a future date.

In *Asco Carbon Dioxide Ltd v Lahner*, 2005 (3 SA 123 (N)), A owed L a debt in respect of a cost order, and L was indebted to A in terms of a suretyship undertaking. The court held that, as L's suretyship debt would become due and enforceable only once excussion of the principle debtor had taken place (which had not yet occurred), the two debts were not extinguished by off-set. A, accordingly, could not prevent L from executing the costs order.

- The debts must be liquidated, i.e. fixed by agreement or by law, or for amounts which are capable of being easily and promptly proved. So, a claim for damages (being generally unliquidated) is ordinarily not susceptible to set-off.

It would therefore appear that set-off operates *ipse iure* (*Schierhout v Union Government (Minister of Justice)*, 1926 AD 286 (at 289-90)) and that set-off is an acceptable manner in which to incur an expense.

When the requirements, as listed above, are considered in relation to the *Ackermans* case, for the set-off to be classified as an expense, the parties must be indebted to each other in terms of a legal agreement. Clause 6.1 of the Sales Agreement between Ackermans and Pepkor stated the following:

The Purchase Price shall be discharged as follows by the Purchaser:

6.1.1 as consideration for the Inter Company Loan and Other Loans, the Purchaser will assume an equivalent amount of the Accounts Payable, and

6.1.2 as consideration for the remaining Business Assets:

6.1.2.1 The Purchaser will assume the remainder of the Liabilities, and

6.1.2.2 the Purchaser will, with effect from (*sic*), the Effective Date owe the Seller R 800 000 000.00 (eight hundred million rand) as a loan which will be reflected as a loan account in the books of the Seller.

Van Coller (2011:456), after examining the sales agreement, concluded that:

The structure of payment of the purchase price in the sale agreement was therefore intended to achieve the effect of set-off, and was drafted in a practical manner and in accordance with the generally accepted accounting practice of valuing a business. Set-off can therefore be said to have occurred, as Ackermans received a release from their future contingent liabilities.

The appellant was therefore of the opinion that the requirements for automatic off-set would have been met, as Ackermans and Pepkor were indebted to each other, through a legal agreement. The set-off of the contingent liabilities would therefore be classified as an expense, even though it had not been physically paid.

3.5.2 Is expenditure to rid oneself of a contingent liability, revenue expenditure?

The expense can only be considered for deduction if it is not of a capital nature. In the tax case *CIR v Niko*, 1940 AD 416, 11 SATC 124 it was stated that a business as a whole should not be recognised as a single asset for income tax purposes. The sale of a business as a going concern comprises a number of assets and liabilities, and the purchase price should be allocated to these assets and liabilities. As the sales transaction is concluded as a whole for the entire “business unit”, and it can be argued that the purchase price allocated to each asset and liability within the business unit would be of a capital nature, and therefore not be deductible under the general deduction formula. The capital status of the allocation is determined as the “business unit” and would be seen as improving or adding to the income-earning structure of the entity. When an expense is incurred that relates to the income earning structure of an entity, the expenditure is considered to be capital in nature (*New State Areas Ltd*).

In the English case of *Hancock v General Reversionary & International Co Ltd*, 1919 1 KB 25, a retired employee, who had received an annual pension, exchanged this pension for a once-off lump sum. The Judge held that the lump sum paid by the company was revenue in nature and not capital and therefore was deductible by the company. He referred to the once-for-all test and said:

Applying that test, I think that it necessarily follows, on the facts found by the Commissioners, that the [lump sum] should be treated, as the pension was treated, as an ordinary business expense, and that the deduction should be allowed. It is the pension in another form; it is actuarially equivalent in value, and it is identical in character. It was paid to meet a continuing demand which was itself an ordinary business expense as the surveyor has treated it... It seems to me as impossible to hold that the fact that a lump sum was paid instead of a recurring series of annual payments alters the character of the expenditure, as it would be to hold that, if an employer made a voluntary arrangement with the servant to pay the servant a year's salary in advance instead of paying each year's salary as it fell due, he would be making a capital outlay.

The *Hancock* case therefore held that a lump sum payment was deductible by the taxpayer, and was not of a capital nature. When applied to the *Ackermans* case, the contingent liabilities would be revenue expenditure, should they become unconditional, and therefore the lump sum payment relating to the future revenue expenditure would be considered to be revenue in nature. The *Ackermans* case did not conclude that the contingent liabilities would be deductible, only that they would be revenue in nature. If the outcome of *Hancock* is applied to the facts of the *Ackermans* case it would have been concluded that the contingent liabilities would have been revenue in nature, and deductible.

In another English tax case, *Smith Incorporated Council of Law Reporting for England and Wales*, 1914 KB 675, a lump sum paid to an employee for a gratuitous recognition for past services was held to be deductible. In the English case *Rowantree & Co Ltd v Curtis*, 1925 1 KB 328 the company had previously provided relief to its employees, who were enduring hardships. The company decided to pay a lump sum payment to a trust so that the trustees could distribute the lump sum to employees as and when necessary. The court held that the lump sum was of a capital nature. The Judge referred to the *Hancock* case and stated that the difference between the two cases was that, in *Hancock*, actuarial calculations had been performed to determine the value of the lump sum, and therefore the expense was not conditional (it was accurately calculated, based on life expectancy) whereas in *Rowantree & Co Ltd* there was no manner in which to determine if the lump sum paid would be used in full, or would meet the required expenditure needed by the trustees. As the future expenditure could not accurately be determined, the court held that the payment was capital in nature.

Another English tax case, referred to by the appellant (in the *Ackermans* case) in their argument, was *British Insulated & Helsby Cables Ltd v Atherton*, 1926 AC 205 HL. The company formed a trust to fund past service benefits for current employees. The trust would obtain its funding from contributions paid by the company to the trust, as well as by the employees. The court had to determine whether these payments to the trust were capital or revenue in nature. Before the appeal, the court submitted that the contributions were revenue in nature, and therefore deductible. However, this was overturned on appeal and it was held that the contributions were capital in nature. Three of the five Judges concluded that the payment was capital in nature. Viscount Cave, in support of the capital nature argument, stated that when a payment is made that brings into existence an asset or advantage with an enduring benefit, such a payment is capital in nature. He concluded the following (at 214) in his closing remarks:

The object and effect of the payment of this large sum was to enable the company to establish the pension fund and to offer to all its existing and future employees a sure provision for their old age, and so to obtain for the company the substantial and lasting advantage of being in a position, throughout its business life, to secure and retain the services of a contented and efficient staff. I am satisfied, on full consideration that the payment was in the nature of capital expenditure . . .

Lord Carson, in support of a revenue nature argument, stated (at 225) the following:

It is clear from the terms of the trust deed, as already pointed out, that in no sense was the sum an investment, that it would be eventually exhausted in payment of the pensions, and that in the event of a winding-up of the company it could never form any part of the assets of the company. I cannot, under these circumstances, conceive any system of commercial accountancy under which this sum could ever appear in the capital account of the company. Nor is it capital withdrawn from the business, as it was admittedly paid out of the earnings of the year. It is not disputed that an annual sum contributed to the pension fund, on an actuarial basis for the purposes of making the fund solvent for paying the pensions of the older members of the staff, would be a proper deduction in arriving at the balance of profits and gains. It would be an ordinary business expense . . . Why, therefore, should the payment of the sum in question, which by an actuarial calculation represents the sum equal to the annual payments which would be necessary, not be considered as in the same position?

The final outcome of the case was that the payment was of a capital nature. However, what was important to note was the “borderline” nature of the court’s decision. A unanimous decision was not reached by the five Judges, and two of the five were of the opinion that the expense was revenue in nature.

The subjectivity associated with determining whether such a payment is capital or revenue in nature was noted by Lord Denning in *Heather v P-E Consulting Group Ltd*, 1973 1 All ER 8 (CA). In the case presented, the court needed to determine whether part payment of the company’s profits to a trust for the benefit of its employees was capital or revenue in nature. Lord Denning submitted that (at 12F): “Different minds come to a different conclusion with equal priority. It is like the border between day and night, or between red and orange”.

The court held, on appeal in *Vodafone Cellular Ltd v G Shaw (HM’s Inspector of Taxes)*, 1997 EWCA Civ 1297, that a once-off lump sum payment made in order to relieve itself of an annual payment for licence rights and know-how was revenue in nature and not capital.

A number of Australian cases were also identified in the *Ackermans* case that assist in determining whether a lump sum paid to rid a company of a future expense is capital or revenue in nature. In *Spotlight Stores (Pty) Ltd v CoT*, 2004 FCA 650 the company had paid \$15 million to a trust established for the future payment of bonuses to their employees. Spotlight had estimated that the future bonuses for the next five years would amount to the initial \$15 million paid into the trust. The company had a past practice of paying its staff annual bonuses. The court held that the initial payment of the \$15 million by Spotlight into the trust was not capital but revenue in nature and therefore deductible. The court, however, did find that Spotlight had paid the amount as part of a tax avoidance scheme. However, this was an additional aspect to the case and was not considered relevant to the discussion of the capital *versus* revenue nature of the payment. The court held in *Spotlight* that the payment related to future bonuses which would improve staff morale and loyalty, and thus was revenue in nature. The court referred to the *Hancock* case and supported the outcome of the case that the future payment of bonuses was not capital in nature. The court also referred to the *British Insulate & Helsby Cables Ltd* case and highlighted that the difference between that case and *Spotlight* was that the lump sum payment in the *British Insulate & Helsby Cables Ltd* case was made to ensure the long endurance of the company, whereas in *Spotlight*

the payment was for the payment of bonuses that would not exceed five years and, if the company had made the payment directly to its employees, it would have been revenue in nature, and therefore deductible. The case was taken on appeal but the Full Court upheld the decision of the lower court. The appealed case was reported as *Pridecraft Pty Ltd v Cot v Spotlight Stores Pty Ltd*, 2004 FCAFC 339.

If the facts of these cases are applied to the *Ackermans* case, it would be almost impossible to formulate a “rule” established through similarities in the cases. It can, however, be concluded that the facts and circumstances in each case need to be carefully considered in order to determine whether the payment is capital or revenue in nature. It should, however, be pointed out that the contingent liabilities would have been deductible by Ackermans, if and when they became unconditional, as they were clearly revenue in nature. It was also further noted that the contingent liabilities were not linked to a particular asset, and therefore no long-term enduring benefit was created as a result of the contingent liabilities. These factors strongly suggest that the contingent liabilities would be of a revenue nature and not of a capital nature, as was confirmed in *ITC 1839*.

3.5.3 Is the expenditure considered to have been “actually incurred”?

Ackermans was of the opinion that the expenditure incurred (through set-off in terms of the selling price) had been “actually incurred” and was therefore tax deductible as it had met the requirements of the general deduction formula. Ackermans did not attempt to deduct the actual contingent liabilities but rather the expense that has been created when Ackermans “paid” Pepkor (through the set-off in the purchase price) to assume responsibility for the contingent liabilities.

An expense need not necessarily be physically paid to be considered “actually incurred”, but must, however, be unconditional (*Nasionale Pers Bpk, Edgars Stores* and *Caltex Oil*). For the expense to be unconditional, Pepkor needed to be indebted to Ackermans (unconditionally). Ackermans claimed that the sales agreement between themselves and Pepkor created an (unconditional) liability between themselves and Pepkor and therefore claimed that it was indeed indebted to Pepkor for R17 million. Ackermans therefore concluded that the expense had been “actually incurred”.

To determine whether Ackermans had been indebted to Pepkor, the contract of sale had to be analysed. When clause 6.1 of the sales agreement was reviewed (for this paper and by the court in the *Ackermans* case) it appeared that no liability had been created between Ackermans and Pepkor. The sales agreement simply reduced the selling price by the value of the contingent liabilities, which did not appear to discharge any obligation owed by Ackermans to Pepkor.

Clegg (2010:20) stated that the proper enquiry is to ask why it was that the seller found himself in the position of needing to pay the purchaser to take over the contingent liability. Clegg claimed that the answer is:

- First, because he had employed a certain individual who had rendered services and earned him income in prior years, for which, subject to a contingency as to their continued loyalty for a further period, he would be obliged to pay them an already determined amount.
- Secondly, as identified by the Judge, that, in order to sell his business as a going concern, he needed to ensure that the purchaser could take over those employees, together with their contingent rights to payment of bonuses, and would not be out of pocket in so doing.

When consideration is given to the reason why Ackermans entered into the agreement with Pepkor, it would not appear that the agreement was entered into to compensate the employees, but rather to secure the sale of the business.

The outcome of the *Ackermans* case that, as no liability between Ackermans and Pepkor existed, it did not appear that Pepkor was indebted to Ackermans, and therefore no unconditional liability existed between Ackermans and Pepkor, appears to be sound. The expense would therefore not be considered to be “actually incurred”. Ackermans, however, claimed that an unconditional liability had been incurred, and therefore the expense should be considered, in terms of the general deduction formula, to have been “actually incurred.”

3.5.4 The expenditure was not incurred for the purpose of Ackermans' trade

Expenditure incurred is only deductible under the general deduction formula if that expenditure was incurred for the purpose of a trade. As the “payment” by Ackermans to Pepkor, to assume the contingent liabilities, would have occurred only after the sales agreement was concluded, it cannot be held that the payment was incurred in relation to the appellant’s trade. The reason is that upon the sale of the entity as a going concern, the appellant’s trade would have ceased.

In *ITC 1627*, 1997 60, SATC 26 it was held that a trade ceases only after all the debts of the business have been settled. This case has, however, been severely criticised. In the Income Tax Case *ITC 490*, 12 SATC 72, the taxpayer was the lessee of a hotel. The taxpayer ceased operations during the lease period of the hotel and attempted to deduct the lease payments against its taxable income for the period after the hotel ceased operations. The deduction of the lease payments was disallowed on the basis that it was not incurred in the production of income. The Judge was of the opinion that expenditure must result in income being received.

3.5.5 Section 23(e) and section 23(f)

Section 23(e) of the Act, which prohibits the deduction of an amount transferred to a reserve fund, was raised by the respondent as prohibiting the deduction of the “payment”. The respondent argued that the contingent liabilities were not deductible as they had been incurred in the creation of a reserve fund which is prohibited for deduction under section 23(e) of the Act. In the appellant’s argument, it was clear that in its view no reserve fund was created (the appellant’s argument was not for the deduction of the “contingent liability”, but rather for the deduction of a payment made in order to relieve itself of the responsibility for the payment of future contingent liabilities).

Expenditure incurred in respect of any amounts that are not included in the term “income”, as defined in section one of the Act, will not qualify as a deduction (Stiglingh *et al*, 2014:150). In the lower court (*ITC 1839*) the respondent argued that section 23(f) of the Act was not satisfied. This is best understood from the statement of Corbett JA in *Commissioner for Inland Revenue v Nemojim (Pty) Ltd*, v 1983 (4) SA 935 (A) (at 254 and 255):

Section 11(a) provides positively, and in general terms, in the case of a person deriving income from the carrying on of trade within the Republic, what expenditure and losses shall be allowed as deductions from income so derived, in order to determine his taxable income. The subsection limited the deduction to expenditure and losses incurred in the Republic in the production of income, other than those of a capital nature

Section 23 describes what deductions may not be made in the determination of taxable income. Subsection (f) and (g) represent, in a general sense, the negative counterpart of section 11(a) and, in determining whether a particular amount is deductible, it is generally appropriate to consider whether or not such deduction is permitted by section 11(a) and whether or not it is prohibited by sections 23(f) and (g)

The purpose of section 23(f) is to prohibit the deduction of an expense that has been incurred on an amount that is not included in income (as defined in terms of section 1 of the Act). The “expenditure” incurred to obtain relief in respect of the future payment of contingent liabilities does not result in “income” and therefore the deductibility would be prohibited in terms of section 23(f).

3.6 Conclusion

The deductibility of expenditure, incurred as a result of the reduction in selling price of a business as a going concern, rests on whether the expense was actually incurred, and is not of a capital nature (the requirements of the general deduction formula). The *Ackermans* case held that the reduction in the selling price of the business as a result of the transfer of the contingent liabilities did not constitute expenditure actually incurred, and was therefore not deductible. Cloete, JA held that the manner in which the transfer of the contingent liabilities was dealt with in the sales agreement did not result in a liability as the sales agreement created no obligation for Ackermans to pay Pepkor to assume the contingent liabilities. He further concluded that, as no obligation had been created in the form of a liability, the payment could not, in terms of the general deduction formula, be considered as an expense actually incurred in the production of income.

Christie (2001) argues that setting off of a liability against the purchase price on the sale of an entity as a going concern, will not preclude the set-off from being classified as an expense.

What does, however, appear to be of the utmost importance, is the manner in which the sales agreement documents each party's responsibility and liability towards the other for "set-off" expense.

Christie (2001) explains that a liability to be settled by the purchaser to the seller with regard to a contingent liability taken over by the purchaser can be documented in two different ways, having the same outcome, but leading to different tax consequences (when the judgment in the *Ackermans* case is applied). The first would be the reduction of the selling price (as in the *Ackermans* case). The Judge in the *Ackermans* case, however, ruled that, when the selling price is reduced by the value of the contingent liability, no expense has been incurred, and therefore the expense (reduction of the selling price as a result of the contingent liability) would not be deductible under the general deduction formula. This would result in adverse tax consequences for the seller. The second manner in which the transfer of the contingent liability could be documented in the sales agreement would be to divide the sale of the entity into a going concern sale and a contingent liability (effectively splitting up the transaction between the sale of the entity and the "sale" of the responsibility to assume the seller's contingent liabilities). This would be achieved by including a separate clause in the agreement whereby an unconditional obligation to make and receive payment is created between the two parties for the "sale" of the responsibility to assume the seller's contingent liabilities. Under the second method, the liability created would be deductible, as it would satisfy all the requirements of the general deduction formula. An expense would have been "actually incurred", as an unconditional liability had been created between the two parties. The expenditure would have been incurred in the production of income, as the agreement to transfer the liabilities would be effective before the transfer of the sale of the entity, and would therefore be incurred while the entity was still in operation. The set-off of the contingent liability payment against the selling price would not affect the deductibility of the expense in these circumstances, as set-off is still considered to be an expense. Further, the expense would not be capital in nature, as the contingent liabilities would not be linked to an asset, and no enduring benefit would have been created as a result of the payment.

It would appear that, if the sales agreement between Ackermans and Pepkor had been worded differently (making it clear that Ackermans was indebted to Pepkor, and that an unconditional liability had been created), the payment would have been considered to be "actually incurred" and not of a capital nature, and therefore deductible. The outcome of the *Ackermans* case

illustrates the importance of the sales agreement clearly creating an unconditional liability between the purchaser and the seller for the contingent liabilities transferred.

The *Ackermans* case dealt largely with the tax position of the seller. However, the position of the purchaser was not addressed and it is submitted that the statement by Cloete, JA with regard to the deductibility of the contingent liabilities once they become unconditional by the purchaser, may not hold in terms of the Act. It can be argued that the payment of amounts in respect of the contingent liabilities taken over by the purchaser of the business may not have been incurred in the production of the purchaser's income, but rather in respect of the seller's income. The proposed legislation (to be discussed in chapter 4) considers the tax treatment for both the purchaser and the seller.

The *Ackermans* case provided the seller of a business with some clarity regarding the deductibility of a contingent liability transferred from the seller to the purchaser as part of a sale as a going concern. The Commissioner appears to have recognised certain problems with the decision and addressed the tax consequences of the transfer of a contingent liability on the sale of a business in the Draft Bill and the Discussion Paper which, will be discussed in the next chapter.

Chapter 4: Proposed legislative changes

4.1 Introduction

The third goal of this research was to discuss the proposed amendments to the Act and the subsequent omission from the Taxation Laws Amendment Act, 24 of 2011, as well as the draft discussion paper issued by the Commissioner (SARS: n.d.) and to compare these proposals to the decision in the *Ackermans* case that was discussed in chapter 3. This chapter will therefore discuss the proposals made by the Commissioner in the Draft Bill and the Discussion Paper. As the two proposals differ substantially, a comparison will be made of the two proposals.

The problems relating to the deductibility of a contingent liability have resulted in many differing opinions of tax experts, and therefore it is surprising that more cases relating to the tax treatment have not previously come before the courts (Clegg, 2010:19). The *Ackermans* case has provided taxpayers with some guidance on the tax deductibility of a contingent liability. It has provided clarity for the seller in a transaction where the contingent liabilities were transferred from the seller to the purchaser in the sale of an entity as a going concern. However, the case did not provide the purchaser with guidance on the tax deductibility of the contingent liability, at the point where the contingent liability was taken over or subsequent to its transfer.

Following the *Ackermans* case, the Commissioner has proposed a number of amendments to legislation and issued a draft discussion paper on the deductibility of a contingent liability and the tax treatment for both the seller and the purchaser. The Commissioner proposed changes to legislation in the Draft Taxation Laws Amendment Bill, 2011, and the draft Discussion Paper (SARS: n.d.) on the deductibility of a contingent liability transferred in the sale of an entity as a going concern. The final version of the Discussion Paper has not yet been issued, and therefore the Discussion Paper discussed in this chapter is the first version issued by the Commissioner, which was open for comment up to 31 March 2014.

4.2 Proposed amendments in terms of the Draft Bill

The Commissioner appears to have recognised that the law relating to the deductibility of a contingent liability, which is transferred as part of the sale of a business as a going concern, is uncertain. In order to provide the taxpayer with more certainty, the Commissioner addressed this issue in the Draft Taxation Laws Amendment Bill, 2011 (the Draft Bill).

In terms of the Draft Bill, where a contingent liability forms part of a sale of an entity as a going concern, the position of the seller will be as follows in relation to the contingent liability. This will be effected in terms of the following proposed amendments to the Act:

1. Paragraphs (i) and (ii) of the definition of “gross income” in section 1 of the Income Tax Act will be amended to include in gross income:

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

The same amendment has been proposed in paragraph (ii), which deals with non-residents. Thus, any relief from having to pay a liability in the future that the seller has received from the purchaser, will be included (in full), in the seller’s gross income at its fair market value.

- 2 It was proposed that a new section 11F be introduced into the Act as follows:

Where, in terms of any transaction, a person disposes of a business undertaking as a going concern to a purchaser and –

- (a) that person is, in terms of the transaction, partially or fully relieved of any contingent liability of that person as a result of the assumption of that contingent liability by that purchaser;
- (b) the consideration payable by the purchaser in terms of the transaction has been determined by that person and that purchaser, after taking into account the assumption of the contingent liability by the purchaser; and

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

The effect of the section 11F is therefore to provide the seller with a deduction in respect of the fair market value of the contingent liability to set off against the same amount that was included in “gross income”. The effect of the two amendments is a neutral tax position in the hands of the seller of the business. However, as the original contingent liabilities enjoyed no tax deduction in the hands of the seller, the seller of the business appears to be in an inequitable tax position.

From an economic perspective it can be argued that the contingent liabilities arose as a result of the effluxion of time. The future liability to pay post-retirement medical aid benefits to retirees would have been calculated by the actuary, based on a number of actuarial assumptions including the life expectancy of employees and the probability that they would continue in employment until retirement date. Therefore each year, as the employees provided their services to Ackermans in the production of its income, they would have earned part of the right to the benefit and the company would have incurred an equivalent (contingent) liability. The same argument applies to the long-term bonuses. With regard to the repair and restoration of leasehold property, while the property is being used to produce income deterioration would have occurred, which would require restoration at the end of the lease period. Thus this liability would also be linked to the effluxion of time. However, no actual payment would have been made in respect of these contingent liabilities and the assumption of these future liabilities by the purchaser of the business at a cost equal to the reduction in the purchase price would place the seller in an equitable economic position, except for the fact that no tax deduction would have been granted in respect of the contingent liabilities and Ackermans would be out of pocket to the extent of the tax rate applied to the value of these contingent liabilities.

3 It was also proposed that a new section 24CA be introduced into the Act to address the purchaser's tax consequences, as follows:

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

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

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

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

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

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

The effect of this provision is that the fair market value of the contingent liability assumed is included in the income of the purchaser of the business, and the expenditure likely to be incurred in respect of the contingent liability in the future is deducted at the end of the year of assessment by way of an allowance, and added back at the beginning of the following year of assessment. To the extent that expenditure has actually been incurred in respect of the contingent liability, the expenditure likely to be incurred in the future will decrease and the allowance will therefore decrease to the same extent, while the expenditure actually incurred in

respect of the liabilities will be deductible provided it meets the requirements of section 11. If the expenditure is deductible, the purchaser of the business will be in a tax neutral situation.

From an economic perspective, the purchaser of the business would have enjoyed an economic benefit equal to the reduction in the purchase price of the business and would incur an economic outflow as and when the liabilities are actually paid. If part of the contingent liabilities never becomes unconditional and the outflows of funds are less than the original relief enjoyed by way of the reduction in the purchase price, the economic position, like the tax position, would be neutral and equitable, other than the impact of the time value of money. If the contingent liabilities exceed the estimated amounts, the cash outflow would exceed the original relief. But if the additional expenditure would qualify for deduction in terms of section 11, the tax position would be equitable. The fact that the purchaser will be subject to an adverse cash flow due to an undervaluation of the contingent liability at the date of transfer, is something that the tax Act cannot remedy.

Consequential amendments were also proposed to paragraphs 20(1)(a) and 35(1) of the Eighth Schedule to include in the cost of an asset, for the purchaser of the asset, the fair market value of the contingent liability assumed as part of the acquisition of the asset, and to include in the proceeds from the disposal of the asset, for the seller of the asset, the amount received or accrued by way of the relief from the contingent liability in respect of the asset disposed of. This clearly aims to address contingent liabilities that are embedded in the particular asset.

The provisions of the proposed new sections to the Act are best understood by means of an example:

Seller (Pty) Ltd sells trading stock as part of the sale of its business as a going concern to Purchaser (Pty) Ltd for R1 000. Purchaser (Pty) Ltd will also assume responsibility for certain contingent liabilities relating to the trading stock, amounting to R300 (the fair market value of the contingent liabilities). The parties agree on a net cash consideration of R700 (as was the case in the *Ackermans* case).

In accordance with the proposed new legislation, Seller (Pty) Ltd will include R1 000 in respect of the sale of the trading stock in its gross income – the R700 received for the sale of the trading stock plus the R300 in respect of the value of the relief from the future contingent liability (in accordance with the proposed change to the gross income definition). Seller (Pty) Ltd will, in terms of proposed section 11F, be deemed to have incurred expenditure to the value of R300. This results in Seller (Pty) Ltd including a “net” amount of R700 in its taxable income, effectively being granted a tax deduction in respect of the amount included in gross income, but not in respect of the contingent liabilities themselves.

Purchaser (Pty) Ltd will include R300 in its income (in terms of the proposed introduction of section 24CA), but will be able to deduct an allowance of R300 in terms of section 24CA (the expenditure that Purchaser (Pty) Ltd is expected to incur in the future, when the contingent liability becomes unconditional). This will have a nil effect on Purchaser’s taxable income. Subsequent to the purchase of the entity as a going concern, should Purchaser (Pty) Ltd incur R100 in respect of the contingent liabilities (actual expenditure), the adjustment in the subsequent year of assessment will be as follows: Purchaser (Pty) Ltd will add back R300 to its taxable income (reversal of the previously claimed section 24CA allowance of R300) and deduct R200 (R300 less R100 actually incurred). The adjustment will effectively grant the purchaser a total deduction of R300 – R200 in respect of the balance of the allowance and R100 in respect of a deduction in respect of the payment of the liability.

The proposed amendments therefore appear to have mirrored the decision in the *Ackermans* case, from the perspective of the seller of the business. The *Ackermans* decision did not address the position of the purchaser of the business.

The amendments proposed in terms of the Draft Taxation Laws Amendment Bill, 2011, did not survive the legislative process, and the subsequent Taxation Laws Amendment Bill, 2011 (and the Taxation Laws Amendment Act) did not include these provisions.

Subsequent to the *Ackermans* case, the Commissioner, clearly recognising the lack of clarity regarding the income tax implications relating to the assumption of contingent liabilities on the sale of a business as a going concern, issued a Binding Class Ruling (029 issued on 10 May 2011 in accordance with section 76R of the Act, valid for five years as from 24 December 2010) regarding sections 11(a), 23(a) and 23E of the Act in relation to the

deductibility of a contingent liability that was disposed of and taken over by an entity within the same group of companies. The ruling was issued in order to promote consistency with regard to the interpretation and application for deductibility of contingent liabilities taken over by another company within the same group of companies (van Coller: 2011).

The ruling states that the purchasing party will only be entitled to deduct expenditure relating to the contingent liabilities that has been actually incurred under the general deduction formula (provided section 23E is complied with in respect of leave pay). The seller, is however, not entitled to a deduction relating to the contingent liability, notwithstanding any reduction of the purchase price, arising from the purchaser assuming such contingent liabilities. This confirms that only when the purchaser of the contingent liabilities actually incurs an amount in satisfaction of the liability will the expense be deductible (provided it complies with the requirements for deductibility in terms of the Act).

Subsequent to the issue of the Binding Class Ruling, the Commissioner issued a Discussion Paper (SARS: n.d.) relating to the deduction of the contingent liabilities in part settlement of the purchase of assets acquired as part of a going concern. This discussion paper is discussed below.

4.3 The SARS Discussion Paper

The Commissioner issued a Discussion Paper: “Tax implications for the seller and the purchaser in relation to the assumption of contingent liabilities in part settlement of the purchase price of assets acquired as part of a going concern” (SARS, n.d.), which sets out the income tax implications for the seller and the purchaser where the sale of the entity as a going concern has been structured so that the purchase price is reduced by the value of the liabilities that have been transferred from the seller to the purchaser. The Discussion Paper was open for comment up to 31 March 2014 and, as yet, no Interpretation Note, or draft Interpretation Note, has been issued.

4.3.1 The provisions of the Discussion Paper

The Discussion Paper (at 2) defines a contingent liability as:

[a]n obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events and, if confirmed, will result in expenditure being incurred to settle the confirmed obligation.

The definition of a contingent liability in the Discussion Paper concurs with the definitions of a contingent liability discussed in chapter 2 of the presented thesis.

Selling price allocation

The selling price paid for an entity sold as a going concern must be allocated to the individual assets (and liabilities) that make up the entity, and the entity cannot be recognised as a single asset for income tax purposes (*Niko*). The allocation must be made, based on the actual facts and the true intentions of the parties. In *ITC 1235, 1975, 37 SATC 233 (T)*, the parties allocated a nominal value to certain assets. The court held that the allocation was fictitious and accepted a more reasonable allocation suggested by the Commissioner.

The purchase price needs to be allocated to each individual asset to enable the purchaser to claim the relevant tax deductions or allowances in respect of the individual assets, against its taxable income, if all the requirements for deductibility of the available tax allowance have been met. The tax implications relating to the purchaser and seller, in terms of the discussion paper, can be summarised as follows:

The seller

The definition of “gross income” in section 1 of the Act states that the total amount received in cash or otherwise must be included in gross income. The seller is therefore required to include in gross income the amount received from the sale of trading stock, account for recoupments in terms of section 8(4)(a) or losses in terms of section 11(o) in respect of allowance assets, or recognise as proceeds in terms of paragraph 35(1) of the Eighth Schedule the selling price in respect of capital assets. The total amount received will include the cash

consideration received, plus the value of the benefit received for relief from the obligation to settle the contingent liability.

The Discussion Paper (SARS, n.d.:5) makes it clear that the value of the benefit relating to the contingent liabilities needs to be determined objectively, according to arm's length principles of valuation, having regard to the particular facts and circumstances, and the intentions of the seller and the purchaser. The amount of the benefit will generally be equal to the amount of the free-standing contingent liability which has been negotiated and agreed to by the seller and purchaser, and which has been stipulated in the agreement of sale (SARS, n.d.: 6)).

The Discussion Paper (at 10) confirms that neither the seller of the business nor the purchaser are entitled to deduct the contingent liability in accordance with sections 11(a) and 23(g) of the Act, as no expenditure has been incurred:

When a purchaser assumes a free-standing contingent liability in settlement, or part settlement, of a purchase price owing to a seller for an asset, it is clear that at the date of sale the free-standing contingent liability itself would not have materialised in the seller's hands. The free-standing contingent liability still exists, and whether or not it will become unconditional is not known as at the date of sale. After the sale, the free-standing contingent liability no longer concerns the seller. Accordingly, the seller has not incurred, and will not incur, any expenditure in relation to the free-standing contingent liability assumed by the purchaser (own emphasis).

In confirming that the contingent liability will not constitute expenditure, the Commissioner referred to a number of tax cases, including *COT v Rendle*, 1965 (1) SA 59 (SRAD), 26 SATC 326, *ITC 1783* (2004) 66 SATC 373, *Labat Africa Ltd* and the *Ackermans* case. The principle established from these tax cases was that, in order to constitute expenditure, a taxpayer must outlay or expend cash or assets in a form other than cash, or must have an unconditional legal liability to outlay or expend cash or assets in a form other than cash. As a contingent liability is conditional at the time of transfer between the seller and purchaser, the Commissioner concluded that the contingent liability will not constitute expenditure, and therefore cannot be considered as a deduction (as it is conditional).

Therefore no deduction would be granted to the seller of the business in respect of the contingent liabilities.

The Discussion Paper highlighted (SARS, n.d.: 10) the Commissioner's view on alternative consequences (such as arose in the *Ackermans* case):

SARS's view is that one has to look at the specific facts that apply to the particular case and determine the tax consequences of those specific facts. Different courses of action and different facts may have different tax consequences, even when the economic effect is the same. Taxpayers are free to choose which course of action they wish to take, and the tax consequences will be based on what they choose, and not on the alternative choices they could have made.

In the *Labat Africa* case, Harms AP noted that:

The full court said that if the agreement had been that Labat-Anderson would have purchased the shares at an agreed price, and that the proceeds of the sale would be applied to the purchase price, there could be no doubt that the transaction would constitute an expenditure, by the company, of its share capital, and that it is difficult to see the difference between this construction and the present agreement. Whether or not the premise of the full court is correct, the conclusion misses the point. Because there is no suggestion that the contract is in any way simulated, we have to take it as we find it. The fact that the parties may have constructed their agreement differently and tax-efficiently is entirely beside the point.

As highlighted above, the Commissioner places an emphasis on the manner in which the sales agreement documents the transaction, and whether or not the sales agreement creates an unconditional liability for the seller to compensate the purchaser for assuming responsibility for the liabilities.

The purchaser

The purchaser will only be able to claim a deduction for expenditure actually incurred in respect of a contingent liability when the contingent liability materialises, becomes unconditional and when the purchaser is required to incur expenditure in order to settle the previously conditional obligation. The deduction will only be granted if the expenditure qualifies for deduction in terms of the Act.

At the date of the purchase of the entity as a going concern, the purchaser has not yet incurred expenditure relating to the contingent liabilities. The purchaser assumes responsibility for the contingent liabilities, but no expenditure has yet been incurred, as the purchaser merely takes responsibility for incurring the expenditure in the future, if and when the contingent liabilities become unconditional. As at the transfer date, no expenditure has been incurred, and the purchaser cannot deduct the value of the contingent liabilities in terms of section 11 of the Act. Once a contingent liability becomes unconditional and the purchaser has incurred expenditure or a liability to settle the obligation, deduction under section 11 of the Act can be considered. The deduction under section 11 is not automatic and the requirements of the section must be complied with. In terms of section 11(a), the expenditure incurred must have been incurred for the purposes of the taxpayer's trade, must not be of a capital nature and must be incurred in the production of income (the general deduction formula as discussed in Chapter 2 of the present thesis), or must comply with the requirements for deduction in terms of one of the other subsections of section 11.

The Discussion Paper guidelines are illustrated in the following example:

Example (adapted from the example in the Discussion Paper (at 18))

Seller (Pty) Ltd sells part of its business as a going concern to Purchaser (Pty) Ltd for R1 000. Purchaser (Pty) Ltd will also assume responsibility for certain contingent liabilities amounting to R300 (at their fair market value). The parties agree on a net cash consideration of R700. The Discussion Paper (SARS, n.d.) stipulates that the net selling price of R700 must be allocated to the individual assets and liabilities that form part of the sales transaction.

For example:

Cash	R 50
Plant and machinery	R 450
Trading stock	R 100
Receivables	R 300
Goodwill	<u>R 100</u> (internally generated)
TOTAL	R 1 000
Less: Contingent liabilities	<u>R 300</u>
Net consideration	<u>R 700</u>

The contingent liabilities are as follows: R100 in respect of a provision for employee accumulated leave pay and bonuses, and a provision of R200 in respect of product warranties.

In terms of the Discussion Paper (SARS, n.d.), Seller (Pty) Ltd will account for the disposal of the assets as follows:

- Cash: No tax consequences as the purchase price is equal to the amounts taken over.
- Plant and machinery: Include in gross income any recoupment of previously claimed allowances on the plant and machinery disposed of, in accordance with section 8(4)(a) of the Act. Should a loss be made, Seller (Pty) Ltd would be entitled to claim a deduction in terms of section 11(o) of the Act. Seller (Pty) Ltd would further be subject to Capital Gains Tax on any gain made on the disposal of the plant and machinery, should the proceeds received be greater than the base cost.
- Trading stock: The difference between the selling price allocated to the trading stock and the value of the trading stock would be taxed as a revenue gain or a revenue loss in terms of the definition of “gross income” and section 11(a) or section 22(1))
- Receivables: If the receivables are sold at less than their face value a loss will be incurred, which will not be deductible as the debts have not become “bad” (section 11(i)).

Goodwill: Goodwill will represent a capital gain (the proceeds, less the base cost if the goodwill was acquired and not internally generated, or proceeds, less RNil if it was) and Seller (Pty) Ltd will be subject to Capital Gains Taxation.

Contingent liabilities: No deduction is available to Seller (Pty) Ltd as no expenditure has been incurred at the date of sale (the liabilities remain conditional).

The purchaser will have to allocate the contingent liabilities to the selling prices of the assets in some acceptable manner. For example, the provision for employee leave pay and bonuses could be allocated proportionately to trading stock, receivables and goodwill and the product warranties proportionately to trading stock and receivables. Thus the consideration would be:

Cash	R 50
Plant and machinery	R 450
Trading stock	R 30 (R100 – (100/500 x R100 + 100/400 x R200))
Receivables	R 190 (R300 – (300/500 x R 100 + 300/400 x R200))
Goodwill	<u>R 80</u> (R100 – 100/500 x R 100))
Total selling price	<u>R 700</u>

The tax consequences for Purchaser (Pty) Ltd will be as follows:

Purchaser (Pty) Ltd will account for the tax consequences of each asset on an individual basis (and not at the full purchase price). Purchaser (Pty) Ltd will account for the tax consequences on the assets purchased as follows:

Bank and cash: No tax consequences

Plant and machinery: The amount allocated to the cost of these assets will be recorded. Once the assets are brought into use by Purchaser (Pty) Ltd the company will qualify for a wear and tear allowance in terms of section 11(e) or section 12C

Trading stock: The amount of R30 will be deductible in terms of section 11(a) as an amount actually incurred in respect of the acquisition of the trading stock. Should the contingent liability become unconditional in the future, the portion allocated to the trading stock would have to be

considered for deduction in terms of section 11, being leave pay and bonuses and repairs or replacement of faulty products.

Receivables

No tax consequences at the date of acquisition. Should any of the receivables prove to be irrecoverable in the future, no section 11(i) deduction (bad debt allowance) will apply, as the proceeds on the sale of the products were never included in Purchaser (Pty) Ltd's gross income, but a capital loss would be accounted for. Should the contingent liability become unconditional in the future, the portion allocated to the receivables would have to be considered for deduction in terms of section 11 (as above).

Goodwill

The asset will have a base cost equal to the acquisition price of R80. Should the contingent liability become unconditional in the future, the portion allocated to goodwill would have to be considered for deduction in terms of section 11 (as above)

As illustrated in the example above, neither the purchaser nor the seller is entitled to claim a deduction in respect of the contingent liabilities at the date of transfer. The purchaser will be able to claim a deduction relating to the future liability once it becomes unconditional, but only if the requirements of section 11 have been met.

4.4 Critical analysis of the Discussion Paper

The treatment of the deduction of a contingent liability transferred from the seller to the purchaser in the sale of a business entity as a going concern is consistent with the outcome of the *Ackermans* case (refer to chapter 3 of this thesis) insofar as it relates to the seller. The tax consequences for the purchaser were not addressed in the case, but the Discussion Paper has proposed a method of treatment for the purchaser that does not accord with the proposed amendments to the Act in terms of the Draft Taxation Laws Amendment Bill, 2011 (section 24CA).

Clearly the discussion paper has proposed nothing that will relieve the seller of the business from the tax inequity discussed earlier.

From the perspective of the purchaser of the business, the proposed tax treatment for the transfer of a contingent liability from the seller of a business as a going concern to the purchaser, effectively delays any deduction until the purchaser actually incurs expenditure relating to the contingent liability. The expenditure is further deductible only if the expenditure complies with the provisions of section 11 of the Act. This imposes a number of complexities for the parties to the contract in reaching an agreement on the terms of the contract of sale.

There could also be a possible mismatch between what the seller would have been entitled to claim as a tax deduction and what the purchaser may claim, which can be illustrated as follows: Company A raises a bonus provision for future bonuses payable to certain employees (which in terms of past practice have been paid consistently over a number of years). The bonuses are paid at year-end, and, as they are incurred during the year of assessment in the production of income, and are not of a capital nature, the expenses are therefore deductible by Company A in accordance with section 11(a). However, before year-end and payment of the bonuses, Company A sells its operations (as a going concern) to Company B. Company B immediately restructures its operations and retrenches the employees transferred from Company A to Company B. Company B still, however, honours the bonuses due to the previous employees of Company A. It can be argued that Company B would, however, not be able to claim a section 11(a) deduction for the bonuses paid to Company A's previous employees, as the expense would not have been incurred in the production of Company B's income as the employees were not there to produce income for Company B in the past and will not be there in the future.

As a result, an expense that would have been incurred in the production of income by Company A would not be deductible for tax purposes by Company B, and this would result in an asymmetrical tax treatment of the seller and the purchaser. This asymmetry should be avoided. In *Daishowa-Marubeni International Ltd v The Queen* (DMI 2013 SCC 29) (heard in the Supreme Court of Canada) it was noted that symmetry and fairness through a harmonious taxation scheme are to be preferred.

The ruling in an unreported tax case heard in the tax court on 11 May 2005 (case no 11107) resulted in the purchaser being entitled to the deduction of a contingent liability once it had become unconditional. In this tax case, the taxpayer acquired the business of the seller (as a

going concern). Included in the assets and liabilities transferred from the seller to the purchaser was a contingent liability relating to a bonus provision. Subsequent to the purchase of the entity, the purchaser paid the bonuses and claimed the expense as a deduction. The court held that the purchaser was entitled to deduct the bonuses paid to the employees taken over from the seller (even though the expense had not been incurred in the production of income of the purchaser and the requirements for deductibility in terms of section 11 had not been met). This decision appears not to have considered the fact that the bonuses were probably granted due to past services of the employees and that, in the hands of the purchaser of the business, these employees were not in the employment of the purchaser while the bonus was being earned and had therefore not produced income for the purchaser. The decision in this case runs contrary to the Discussion Paper and, as it appears not to have been founded on the underlying intention of the general deduction formula, may not have survived a subsequent appeal.

For a large number of transactions, the sale of an entity as a going concern is often a result of an inter-group re-organisation (as in the *Ackermans* case). Sections 41 and 45 of the Act provide tax relief where intergroup transactions occur. In brief, the result of the application of these sections is that the “tax history” of the asset is transferred from the “seller” to the “purchaser”, and the entity that purchased the asset, treats the asset as if it had acquired it at the date acquired by the transferring company (and assumed the initial cost on the initial date and any previously claimed allowances). Sections 41 and 45, however, do not apply to contingent liabilities, only to assets and certain non-contingent debt obligations. The Discussion Paper (SARS, n.d.) does not address the treatment of transactions that have occurred as a result of inter-group reorganisations and, consequently, does not recommend any adjustment to sections 41 or 45 of the Act. This may result in an unnecessary tax burden in the re-organisation of inter-group companies.

The Discussion Paper does not account for a situation where the contingent liability assumed by the purchaser never materialises. A situation may occur where, based on the provisions of the Discussion Paper, the seller would be taxed on the full selling price of the business and would be denied a deduction in respect of the contingent liabilities taken over by the purchaser. The purchaser would, however, as the contingent liability is never realised, not be entitled to any deduction. This would result in an inequity, as neither the seller nor the purchaser would be entitled to a deduction in respect of the contingent liability. There is no

recourse to the seller or the purchaser to rectify this “mismatch”, other than by way of contractual agreement regarding the negotiated price of the assets of the business.

4.5 Conclusion

The tax implications, more specifically the tax deductibility of a contingent liability transferred from the seller of a business to the purchaser, are unclear, and the uncertainty as to how to deal with contingent liabilities is a problem for taxpayers entering into transactions similar to the *Ackermans* case.

Current legislation does not provide for the tax consequences of a contingent liability transferred from the seller to the purchaser of a business. When the Act does not provide specific provisions relating to an area of uncertainty, the courts are often referred to for clarity. South African courts have, however, not ruled in many court cases relating to the deductibility of a contingent liability transferred from the seller to the purchaser as part of the sale of a going concern. The most recent case was that of *Ackermans*, and, in the past, a number of unreported court cases. However, the courts have not provided taxpayers with any clarity regarding these deductions (or non-deductions). The ruling in the *Ackermans* case left taxpayers confused and left many unanswered questions relating to the treatment of the deductibility of a contingent liability transferred from the seller to the purchaser in the sale of an entity as a going concern (refer to the discussion of the *Ackermans* case in chapter 3 of the presented thesis).

In order to provide a taxpayer with guidance on the deductibility of contingent liabilities, the Commissioner proposed changes to legislation that were aimed at reducing uncertainties and providing clarity on the deduction of a contingent liability upon its transfer, in the sale of an entity as a going concern. The Commissioner introduced this legislation by means of the Draft Taxation Laws Amendment Bill, 2011. The proposed amendments, however, were not incorporated in the subsequent Taxation Laws Amendment Act. The Commissioner thereafter sought to provide clarity through the (ultimate) issue of a General Binding Ruling or Interpretation Note, and accordingly issued the Discussion Paper (SARS, n.d.) as a preamble to such General Binding Ruling or Interpretation Note.

The proposed legislation in the Draft Bill includes in the gross income of the seller, the value of the relief granted in respect of the assumption by the seller of the contingent liabilities and provides the seller with a deduction of the contingent liabilities (valued at fair market value) in terms of the proposed section 11F. The effect for the purchaser of the business will be neutral in respect of the purchaser's taxable income as a result of the proposed provisions of section 24CA, which includes in the purchaser's income the value of the contingent liabilities taken over on the purchase of the business and then grants the deduction of a reversing allowance in respect of the liabilities not yet actually incurred. Once the liabilities become unconditional their deduction will depend on compliance with the provisions of section 11.

The proposals set out in the Discussion Paper (SARS, n.d.), however, would result in neither the purchaser nor the seller qualifying for the deduction of the contingent liability at the stage when it is transferred from the seller to the purchaser. The purchaser, subject to compliance with the requirements of section 11, would be entitled to claim a deduction in respect of the contingent liabilities only once they become unconditional.

The Discussion Paper did not provide for a situation where the sale of an entity as a going concern was a result of a company's re-organisation and no relief was provided to taxpayers in terms of the corporate restructuring provisions of the Act (sections 41 and 45). Furthermore, the future deductibility of the contingent liability (once the contingent liability has become unconditional and actually incurred) would, more than likely, not be deductible by the purchaser, as the requirements of section 11 (in that the expenses would need to be incurred in the production of income) would not be met.

From the examples presented, it is clear that the proposals in the Discussion Paper (SARS, n.d.), imposed a much higher tax burden on the taxpayers, as the contingent liability transferred between the seller and the purchaser is not deductible by either party at the time of transfer. The increased tax burden on the taxpayers involved may impede the sale of businesses as a going concern. Inter-group streamlining and reorganisation may not be possible as no inter-group relief has been proposed in respect of the transfer of contingent liabilities in Discussion Paper (SARS, n.d.).

The guidelines issued in the Discussion Paper (SARS, n.d.) appear to support the decision in the *Ackermans* case, but appear to contradict the proposed legislative amendments in the Draft Taxation Laws Amendment Bill, 2011.

Having analysed the *Ackermans* case in detail in chapter 3 and discussed the proposed changes to the Act, which did not find their way into legislation and the Discussion paper issued by SARS in the present chapter, the final chapter will summarise the findings of the research and conclude the discussion.

Chapter 5: Conclusion

5.1 Introduction

The *Ackermans* case and proposed amendments to the Act have been analysed and discussed and the findings will be summarised in this chapter and a conclusion provided on the achievement of the research goals. The sale of a business entity is a complex matter and can result in a number of tax consequences for both the purchaser and the seller. When a business entity has been sold as a going concern, the assets and in certain cases also the liabilities of the business entity are transferred from the seller to the purchaser. Contingent liabilities, such as leave pay, bonus provisions, etc. are often included in the liabilities transferred from the seller to the purchaser. These liabilities and contingent liabilities assumed by the purchaser of the business result in a reduction in the selling price of the assets.

A contingent liability has been defined as a liability that is conditional upon the happening of a future event. At the date of transfer from the seller to the purchaser, the contingent liability remains conditional, that is, payment of the liability is not yet certain and payment may, or may not, be made after the contingent liability has been transferred from the seller to the purchaser – the purchaser may never be called upon to settle part or all of this liability.

When the sales transaction between the seller and purchaser is concluded, the agreement therefore often caters for the transaction to be settled on the “net effect” basis. In other words, the value of the liabilities is set-off against the value of the assets, and the purchaser settles only the net amount (assets, less liabilities) in cash or otherwise. Once the contingent liabilities have been transferred to the purchaser, the purchaser is responsible to honour payments relating to the contingent liability, if and when they become due for payment. The seller no longer has any responsibility to honour the contingent liabilities (this is only the case where the sales agreement provides for the transfer of the contingent liabilities from the seller to the purchaser).

The uncertainty relating to the deduction of the contingent liabilities by either the seller or the purchaser of the business gave rise to the *Ackermans* case and the subsequent proposals by the Commissioner for SARS to address the problem.

5.2 Goals of the research

The goal of the research was to investigate the tax deductibility of the contingent liability transferred from the seller to the purchaser as part of the sale of a business as a going concern, from the perspectives of both the seller and the purchaser. The research was conducted in order to determine whether the seller or the purchaser would be eligible for the deduction of the contingent liabilities upon their transfer. In addressing the main goal of the research the following sub-goals needed to be addressed, in order to achieve the main goal of the research:

- an analysis of the current legislation relating to the deductibility of a contingent liability in terms of the Act;
- a discussion and critical analysis of the facts and decisions in the South African landmark case (the *Ackermans* case), relating to the deductibility of a contingent liability;
- a review and evaluation of the proposed amendments to the Act and the proposed treatment of the deduction of a contingent liability, issued by the Commissioner; and
- to highlight the apparent continuing uncertainty and the consequent need for legislative intervention.

The first sub-goal was achieved in chapter 2 by means of an extensive review of the provisions of the Act relating to the deductibility of an expense. Contingent liabilities are not deductible under a specific section of the Act and therefore the requirements for deduction in terms of the general deduction formula, were considered. Each requirement for deductibility in terms of the general deduction formula was carefully analysed and its applicability to a contingent liability determined, in order to establish whether a contingent liability would meet the requirements for deduction in terms of the general deduction formula. The second sub-goal was achieved in chapter 3 by providing a detailed analysis of the outcome of *ITC 1839* and the appeal against the decision in this case, reported in the *Ackermans* case. The third sub-goal was achieved in Chapter 4 after a review of the proposed amendments to the Act, and the manner in which the Commissioner proposes to deal with the deductibility of the contingent liabilities transferred from the seller to the purchaser, in terms of a Discussion Paper issued on the topic.

The present chapter sets out the findings flowing from the research, and the conclusions based on these findings.

5.3 Analysis of the current legislation relating to the deductibility of a contingent liability in terms of the Act

The Act does not make specific provision for the deduction of a contingent liability, and therefore the present research assessed the deductibility of a contingent liability against the general deduction provisions of the Act, namely the preamble to section 11, sections 11(a) and 23(g), commonly referred to as “the general deduction formula”.

The general deduction formula provides for the deduction of an expense that has been actually incurred, during the year of assessment, in the production of income which is not of a capital nature, and has been laid out for the purposes of a trade. For a contingent liability to be deductible under the general deduction formula, it must be “actually incurred”. For an expense to be considered “actually incurred”, the taxpayer must have either physically paid the amount (which would not be the case for a contingent liability as it represents a provision for future expenses), or the taxpayer must have an unconditional liability to make the payment in the future

A contingent liability relates to future expenses that may or may not be incurred by the taxpayer as a result of a future, unknown event. As the contingent liability is conditional upon the happening of this future event, the contingent liability is not unconditional and therefore has not been “actually incurred”. As the contingent liability has not been “actually incurred” it would not be deductible under the general deduction formula.

In addition to the expense not being deductible under the general deduction formula, section 23(e) of the Act prohibits the deduction of an amount set aside in the form of a reserve fund. As a contingent liability effectively creates a “reserve fund” for the possible payment of a future expense, the amount incurred would be prohibited from being deducted in terms of section 23(e) of the Act. The Act, as it currently stands, does not permit the deduction of a contingent liability.

5.4 The Ackermans case

The *Ackermans* case ruled on the deduction of a contingent liability upon its transfer from the seller to the purchaser as part of an entity sold as a going concern. The appellant (Ackermans) attempted to claim, as a deduction, an amount equal to the contingent liabilities transferred to the purchaser as part of the sales agreement. The transaction was concluded by the purchaser settling the net value of the assets less the liabilities (including the contingent liabilities). The appellant claimed a deduction in respect of the contingent liabilities on the grounds that, by way of a reduction in the selling price, the seller had paid the purchaser (indirectly) for assuming responsibility for the future payment of the contingent liabilities, and had therefore actually incurred the expense.

Cloete, JA ruled that the deduction was not permissible, as the sales agreement (in which it was agreed that the seller would off-set the liabilities against the assets, and settle the net value of the company) did not provide for a legal obligation in terms of which the purchaser was liable to compensate the seller for assuming responsibility for the future payment of the contingent liabilities. As no legal obligation between the two entities was created, no deduction (in accordance with the general deduction formula) could apply, as the expense was not unconditional and therefore could not be considered to be “actually incurred” as required by the general deduction formula. Cloete, JA further stated in his judgement that, should the agreement between the purchaser and seller have been worded differently and a legal liability between the two entities created, the amount would possibly have qualified for deduction.

The *Ackermans* case ruled that the seller is not entitled to the deduction of the contingent liability. The Supreme Court of Appeal issued the following summary of the case (The Registrar, Supreme Court of Appeal: 2010):

In 2004 Ackermans Ltd sold its retail business as a going concern to Pepkor Ltd. Ackermans claimed a deduction under the Income Tax Act of R17m in respect of three liabilities which Pepkor had assumed under the sale agreement. The Commissioner of SA Revenue Service disallowed the deduction. The SCA held that Ackermans had incurred no expenditure in respect of the three liabilities and was accordingly not entitled to any deduction.

The *Ackermans* case was concluded from the perspective of the seller (in that the seller was not entitled to deduct the contingent liability transferred). However, the perspective of the purchaser was not considered. This aspect was addressed by the Commissioner by proposed amendments to legislation and a Discussion Document setting out the views of the Commissioner.

5.5 Proposed legislation and the Discussion Paper

The Commissioner, in order to provide taxpayers with clarity concerning the deduction of a contingent liability transferred as part of a going concern between a seller and a purchaser, proposed certain amendments in the Draft Taxation Laws Amendment Bill, 2011 (the Draft Bill). The proposed amendments were not included in the Taxation Laws Amendment Bill, 2011, or the Taxation Laws Amendment Act, 2011. The Commissioner, however, in an attempt to provide clarity for the purchaser and seller by ultimate issue of an interpretation note or General Binding Ruling, issued a Discussion Paper.

The Draft Bill proposed a number of changes to the Act in order to provide for the tax treatment of contingent liability transferred from the seller to the purchaser as part of a sale of an entity as a going concern. In terms of the Draft Bill, from the perspective of the seller, the seller is required to include the full selling price (total asset value, including the value of the contingent liabilities at their market value) in gross income. It was proposed that the definition of gross income would be amended to include in gross income the amount of any partial or full relief received by the seller of any liability assumed by the purchaser. The seller would then be permitted, in accordance with a proposed new section 11F, to deduct for tax purposes the contingent liability (at the fair market value) transferred to the purchaser. This would have had the effect that the seller would not be able to claim a deduction in respect of the contingent liabilities so transferred.

It was also proposed that section 24CA would be introduced in order to provide for the tax treatment of the contingent liabilities assumed by the purchaser. This section would include in the purchaser's income the value of the contingent liabilities transferred from the seller to the purchaser and then grant the purchaser a reversing allowance in respect of the liabilities that have not yet been actually incurred. The purchaser is permitted to claim, as a deduction,

the liabilities when they become unconditional if they meet the provisions of section 11. In terms of section 24CA, the purchaser would include the reduction in the purchase price as a result of assuming the contingent liabilities of the seller in gross income. Until the liabilities are actually incurred, the purchaser would be in a tax neutral position by virtue of the allowance. Once the contingent liabilities are settled, a deduction would be claimed and the allowance reduced accordingly.

The Discussion Paper (SARS, n.d.), which appears to support the outcome of the *Ackermans* case, results in neither the purchaser nor the seller being entitled to claim the deduction of the contingent liabilities upon their transfer between the two entities. The purchaser, after meeting the requirements for deduction under section 11 of the Act, would be able to claim a deduction in respect of the contingent liabilities when they become unconditional. The proposed treatment in accordance with the Discussion Paper supports the non-deductibility of the contingent liability in the hands of the seller, as ruled in the *Ackermans* case. The Discussion Paper concludes that the contingent liabilities are not deductible (for the purchaser and seller) upon their transfer from the seller to the purchaser as part of the sale of an entity as a going concern.

The discussion paper does not provide any tax relieve (in terms of the corporate rules in section 45 of the Act) where the contingent liabilities have been transferred between the seller and purchaser as a result of a company restructure.

The Draft Paper supports the decision in the *Ackermans* case in that contingent liabilities are not deductible, but appears to contradict the proposed legislative amendments in the Draft Bill.

5.6 Conclusion

It is clear that the deductibility of a contingent liability, upon its transfer from the seller to the purchaser, in a sale of an entity as a going concern, is uncertain. The Commissioner has, in recent years, issued two different (and opposed) proposals for the tax deductibility of the contingent liabilities in the form of the Draft Bill and the Discussion Paper. This indicates that, not only are the taxpayers still uncertain of the correct treatment, but that the Commissioner appears also to be uncertain. The South African courts have also not provided

taxpayers with clarity regarding the tax deductibility, with only one significant case (the *Ackermans* case) having been heard on the matter and ruling that contingent liabilities are not deductible.

It can be concluded that the Act does not provide for the deductibility of a contingent liability, as the requirements for deductibility in terms of sections 11(a) and 23(g) are not met. Section 23(e) further prohibits the deduction. The *Ackermans* case concluded that the contingent liability is not deductible by the seller. The Judge in this case, however, did express the view that, should the sales agreement be correctly worded, and structured in such a manner as to create a liability in relation to the contingent liabilities between the purchaser and the seller, the contingent liability would qualify for deductibility. The tax consequences for the purchaser of the business were not dealt with in the case.

The provisions, in terms of the Draft Bill, allowed for the deduction of the contingent liability by the purchaser of the business, but the proposals did not survive to be included in the Taxation Laws Amendment Act, 2011. The Discussion Paper issued by the Commissioner, in contrast to the proposals in the Draft Bill, disallows the deduction of the contingent liability by both the seller and the purchaser at the stage when the transfer takes place.

Confusion will continue to reign until such time that the legislator, or the courts, provide a level of certainty with regard to the correct treatment for the deductibility of contingent liabilities transferred as part of the sale of a business. Based on the research conducted, it is clear that contingent liabilities that have been transferred from the seller to the purchaser as part of a sale of an entity as a going concern are not deductible by the seller or the purchaser.

From a cash-flow perspective, the seller of the business has foregone part of the selling price of the assets of the business as a result of the contingent liabilities being assumed by the purchaser, but has not actually settled the contingent liabilities and has therefore not suffered an outflow of cash or assets in respect of liabilities that arose before the sale of the business. It is therefore submitted that the *Ackermans* decision does not appear to prejudice the seller of the business. The purchaser of the business has a cash-flow advantage as a result of the decrease in the purchase price of the business, but has not yet settled the contingent liabilities. When the contingent liabilities are settled, an outflow of cash or assets will occur. Again, other than the advantage of the timing difference and the fact that certain contingent liabilities

may never become actual liabilities, the purchaser of the business has not been prejudiced (although the actual liabilities for which the contingent liabilities were raised may exceed the contingency provided for).

From a tax perspective, the position of the seller appears to be equitable. No tax deduction has been granted, but the contingent liabilities accumulated while the business has been carried on and the seller has been relieved of the future obligation to pay them. The purchaser of the business will claim the relevant deductions and allowances in respect of the business assets taken over at full selling price (and pay the actual liabilities that may have been taken over without an associated tax deduction). However, it is submitted that if the purchaser of the business also enjoys a deduction when the contingent liabilities become certain and are settled the purchaser will enjoy an unwarranted tax advantage. This would need to be addressed by way of legislation.

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