IN THE INCOME TAX SPECIAL COURT

BEFORE

The Honourable Mr Justice L I Goldblatt	President
RJ Hefter	Accountant Member
P Arthur	Commercial Member

In the appeal of:

CASE NO: 10999

(Heard at Johannesburg on 20 November 2003)

JUDGMENT

JOHANNESBURG 20 February 2004

GOLDBLATT J:

1. On 31 October 1995 the appellant and W (Pty) Limited concluded a written agreement in terms whereof the appellant acquired part of W's business.

2. An agreement provided a method whereby the value of the assets acquired

would be fixed and it was agreed that the purchaser would allot and issue to the seller in discharge of the value of such assets ("the purchase price") such number of ordinary shares in its capital, to be issued at par plus a premium, as would result in the seller holding that proportion of the entire issued share capital of the purchaser as the purchase price had to the total value of the purchaser's assets inclusive of the acquired assets.

3. After the transaction was given effect to W became the holder of

   30% of the issued share capital of the appellant.

4. A value of R5 280 000,00 was placed upon a license agreement belonging to W. This phrase was defined in the agreement as meaning:

   "The licensing agreement with B and D (Overseas)(Pty) Limited, a copy of which is annexed hereto marked appendix "D" and shall include all intellectual property and know how relating to the W " XYZ."

5. The licensing agreement referred to in the agreement of sale was not assignable or transferable and the rights granted therein were stated to be "Personal to the licensee". Thus W was not able to and did not transfer or assign the rights in the agreement to the appellant. The appellant did however enter into a new licensing agreement with the licensor on 29 August 1996 with retrospective effect to 1 November 1995 being the effective date of the sale agreement.

6. The appellant contended that the amount of R 5 280 000,00 was an expense incurred by it in the 1996 year of assessment and that it was accordingly deductible from its gross income in terms of section 11 (a) of the Income Tax Act 58 of 1962 ("the Act"). In the alternative the appellant contended that it was entitled to an allowance in respect of the aforesaid expenditure in terms of section 11 (gA) of the Act in that the rights acquired by it were of "a similar nature" to a patent, design, trademark or copyright as defined in the aforesaid section.

7. The Commissioner rejected all the appellant's contentions and submitted that –

(i) The appellant did not incur any expenditure given that the issue and

(ii) allotment of shares by a company does not constitute

expenditure by such company.

(ii) If the appellant did incur expenditure of R 5 280 000,00

deductible in terms of section 11

(a) of the Act, and

(b) such expenditure was not incurred "in acquiring by

assignment from any other person any such patent, design,

trade mark or copyright or in acquiring any other propeliy of

a similar nature or any knowledge connected with the use of

such patent, design, trade mark, copyright or other property

or the right to have such knowledge imparted".

8.1. The first question we were called upon to decide was whether or not the appellant incurred "expenditure" either as envisaged in section 11 (a) or 11 (gA) of the Act.

8.2. "Expenditure" in its ordinary dictionary meaning is the spending of money or its equivalent e.g. time or labour and a resultant diminution of the assets of the person incurring such expenditure. An allotment or issuing of shares by a

company 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.

8.3. “A share in a company consists of a bundle, complex or conglomerate of personal and hence incorporeal rights as against the company principally in regard to its assets and dividends when declared. Although a share is said to be "a share in the capital of the company", this does not mean that the holders of the shares of a company are owners of its capital. Rather, it means that they have certain rights against the company to capital on winding up (the right to participate in a distribution on liquidation) and on reduction of capital; for the company itself is the owner of its capital. Thus the holder of a share does not own, but merely has a right to, a part of the share capital of the company." (The Law of South Africa First reissues volume 4 parts 1 paragraph 97).

8.4. Support for the submission made by the Commissioner and the views expressed above is to be found in paragraph 7.4 of Silke on South African Income Tax ("Memorial Edition") where the authors make the following statement:

> " It is submitted that the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. For example, if a merchant were required to pay for his goods by tendering land or shares in a company, the value of the land or shares would constitute expenditure in terms of s 11 (a) and would be deductible. If a merchant were to buy his goods in the United States at a price fixed in dollars, the liability so contracted would be 'expenditure' and would have to be brought to account at its equivalent in South African Currency.

An interesting point arises when a company discharges an obligation by the issue of its own shares. For example, a company may remunerate one of its employees for services rendered by the issue of its own shares. Since the company has not lost or parted with any asset, it is submitted that it has not expended anything, and that it is not entitled to claim as a deduction from income the nominal value of the shares issued to the employee. The position, it is submitted, would be different if the employee agrees to work for a salary payable in cash but subsequently decides to subscribe for shares and uses the remuneration owing to him to pay for the shares. In such a situation the company will have incurred expenditure comprising the salary due, notwithstanding the fact that its obligation is subsequently discharged by the issue of shares. But when a company is obliged to allot shares in return for services rendered to it, there is no laying out or expending of any of its moneys or assets which, it is submitted, is an essential requisite of the words 'expenditure actually incurred' in s 11 (a). A similar problem arises when a company allots shares in return for trading stock.

Whatever the strict legal position may be in relation to a company that discharges an obligation by the issue of its own shares, SARS is prepared in practice to allow as a deduction from the income of the company the nominal value of the shares it issues. While the recipient will be liable to tax on the value of the shares issued when they are issued in return for services rendered, the company will in practice be allowed a deduction of an amount equivalent to the nominal value of the shares issued."

8.5. The appellant lead no evidence of a practice by the South African Revenue Services to treat the issue of shares by a company as expenditure by such company and the Commissioner's representative denied that any such practice existed.

8.6. In the circumstances we find that the appellant did not establish that it had incurred the alleged expenditure of R5 280 000,00.

9. On the basis that our finding in regard to whether the appellant incurred the expenditure of R 5 280 000,00 is incorrect we deal hereunder with the other grounds of appeal raised by the appellant in this matter.

10.1 In regard to section 11 (a) the appellant was obliged to prove that the expenditure incurred was, inter alia, "not of a capital nature".

10.2 The question of whether or not expenditure is of a capital nature has been the subject of enumerable cases in field of Income Tax Law and we do not intend traversing all these cases which are to be found in the standard text books. In this matter the test enunciated in CIR v George Forest Timber Company Limited 1924 AD 516 at 528 seems appropriate viz " Now, money spent in creating or acquiring an income producing concern must between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not."

10.3 The R 5 280 000,00 was spent to acquire an asset i.e. the right to produce a certain product and the "know how" required to do so. This, in our view, was part of the income earning structure of the appellant with long term benefits to the appellant and was not part of its income earning operations. The evidence led by the appellant was that it acquired both the license and the sellers' "know how "to effectively produce the goods previously manufactured by W. These assets clearly were enduring benefits which were essential to the carrying on of the business purchased.

10.4 We accordingly find that the expenditure of R 5 280 000,00 was to acquire assets of a capital nature.

11.1 The final issue to be decided is whether or not the appellant was entitled to an allowance in terms of section 11(gA) of the Act.

11.2 The relevant portion of the aforesaid section reads as follows: "(gA) an allowance in respect of any expenditure(other than expenditure which has qualified in whole or part for deduction or allowance under any of the other provisions of this section or the corresponding provisions of any previous Income Tax Act) actually incurred by the taxpayer –

(a) in devising or developing any invention as defined th the PatentsAct 1978 (Act No. 57 of 1978), or in crating or producing any design as defined in the Designs Act, 1967 (Act No. 57 of 1967), or any trade mark as defined in the Trade Marks Act, 1963 (Act No. 62 of 1963), orany copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any other property which is of a similar nature; or

(b) in obtaining any patent or the restoration of any patent under the Patents Act, 1952, or the registration of any design under the Designs Act, 1967, or the registration of any trade mark under the Trade Marks Act 1963, or

(c) in acquiring by assignment from any other person any such patent, design, trade mark or copyright or in acquiring any other property of a similar nature or any knowledge connected with the use of such patent, design, trade mark, copyright or other property or the right to have such knowledge imparted.

If such invention, patent, design, trade mark, copyright, other property or knowledge, as the case may be, is used by the taxpayer in the production of his income or income is derived by him therefrom..."

11.3 The appellant submitted that what it had acquired was property of a similar nature to a patent, design, trade mark or copy right as defined in section 11 (gA). However, for the reasons set out hereunder, the evidence did not in our view in any way support this submission.

11.4 In the first instance the appellant did not obtain the license to manufacture the goods from the sellers. It was common cause that the seller could not and did not assign these rights to the appellant and that the appellant obtained these rights directly from the licensor in X.

11.5 All that the appellant obtained from W was information in regard to the manner which the goods could be manufactured and the type of material most appropriate for this purpose. This information which was in the possession of W whilst confidential did not constitute a protectable right held by W and therefore it cannot be said that it was of a similar nature to the rights dealt with in the section. To put it simply if any other manufacturer used the same methods of manufacture the appellant would have had no right to restrain or prevent such manufacturer from using such method provided that the information was legitimately obtained. What was obtained was confidential information property acquired by it as envisaged in the section.

11.6 If the appellant did acquire rights as envisaged in section (gA) it failed to establish what its expenditure was in respect of the rights acquired. In view of the fact that the sum of R 5 280 000,00 was in respect both of the rights held by the seller in the licensing agreement and the know how there was no evidence before us as to what portion of the aforesaid amount was to be allocated to the “know how" acquired by the appellant as distinct from all the rights which were valued at R 5 280 000,00 and which were not received from W in their totality. Thus the appellant failed to prove what amount, if any, was to be allowed in respect of the partial assets acquired.

CONCLUSION

The appeal is dismissed and the assessments confirmed.

On behalf of Mr RJ Hefter (Accounting Member)

Mr P Arthur (Commercial Member) and myself

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This judgment should be reported YES .NO

Adv S Moerdijk, instructed by Price Waterhouse Coopers, appeared on behalf of the appellant

Adv M Jorge represented the Commissioner of the South African Revenue Services