REPORTABLE

IN THE INCOME TAX SPECIAL COURT
PRETORIA

BEFORE:

The Honourable Mr Acting Justice F J Jooste	President
Mr Y Waja	Accountant Member
Mr F F W Stockenströhm	Commercial Member

In the appeal of:

Case no: 11024

(Heard at Pretoria on 21 October 2004)

JUDGMENT

PRETORIA

18 MAY 2005

JOOSTE AJ:

INTRODUCTION:

1. This is an appeal against the revised income tax assessment issued by the Commissioner for the South African Revenue Services for the tax year ending on 29 February 2000. The dispute concerns the acquisition of a trade mark by the Appellant and the consequent claiming of an allowance in terms of section 11(gA) of the Income Tax Act, 58 of 1962 ("the Act").

2. No evidence was lead but a list of essential common cause and admitted facts were handed in by the parties as exhibit "X".

3. The essential common cause facts are the following:

   3.1 A Holdings Limited purchased the business of B (SA) (Pty) Ltd as a going concern. The name of the Appellant was changed from "A Holdings Limited" to "B Africa Limited" on 11 June 1999. The acquisition agreement was signed on 15 February 1999 and the addendum thereto on 30 March 1999. The agreement became unconditional on 1 June 1999.

   3.2 In terms of the agreement, the Appellant purchased the trademark "X" from B SA (Pty) Ltd.

3.3 The total purchase price was R120 million and the portion of the purchase price that was attributable to the acquisition of the trade mark was R44 462 000,00.

3.4 The Appellant acquired the rights to the trademark on 1 June 1999 and on 15 June 1999 issued 49 402 222,20 shares at an issue price of 90c per share to B SA (Pty) Ltd in compliance with its obligations to give consideration for the trademark.

3.5 On 1 June 1999 as well as 15 June 1999 the market value of these shares was in excess of R44 462 000,00 whilst the market value of the trademark acquired by the Appellant was at all relevant times R44 462 000,00.

3.6 On 18 May 1999 a prelisting statement was issued by the Appellant. In terms thereof, comprehensive information as regards the acquisition of the trademark and other company assets acquired by the Appellant was given. The shareholders were apprised of all these matters and the necessary resolutions were duly adopted.

3.7 As stated above, the Appellant acquired the trademark in its 2000 year of assessment and pursuant thereto, claimed an allowance in

terms of section 11(gA) of the Act. It is a requirement of section 11(gA) that the taxpayer should have incurred expenditure in acquiring the trademark concerned.

3.8 From the grounds of assessment it appears that the Commissioner disallowed the allowance on the following grounds (dossier pp 79 – 80):

"*11.1* *In terms of the agreement the performance required from the Appellant was stipulated as the issue of a specified number of shares.*

11.2 *In complying with its contractual obligation, the Appellant did not expend any monies or assets.*

11.3 *Accordingly, no expenditure was actually incurred by the Appellant in acquiring the trademark as required by section 11(gA) of the Act.*

11.4 *Alternatively, in so far as it may be held that expenditure was actually incurred when the appellant concluded the agreement and that the requirement of section 11(gA) of the Act have accordingly been*

fulfilled, the Commissioner is of the view that the provisions of section 8(4)(n) of the Act are applicable, due to the following grounds:

12.1 By the issue of shares and the acceptance thereof by the seller, the Appellant was relieved, or partially relieved from the obligation to make payment of the expenditure actually incurred and is deemed to have recovered or recouped an amount equal to the amount of the obligation, which was solely relieved or partially relieved".

3.9 The alternative ground of assessment was abandoned at the hearing of the appeal.

4. The Appellant's contentions are, in essence, as follows:

4.1 As regards the main ground of assessment: the Appellant contains that it incurred an unconditional obligation to pay the purchase price of the trademark to the amount of R44 462 000,00.

4.2 That the incurral of that obligation constituted expenditure incurred in acquiring the trademark; and that the fact that it discharged its obligation by issuing shares to the seller, does not detract from this circumstance.

THE MAIN GROUND OF ASSESSMENT: INCURRAL OF EXPENDITURE IN TERMS OF SECTION 11(gA):

5. The relevant part of section 11(gA)(iii)(aa)(A) reads as follows for purposes of the 2000 year of assessment:

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

(gA) An allowance in respect of any expenditure … actually incurred by the taxpayer –

(iii) in acquiring by assignment from any other person any … trademark ….

> *If such … trademark … is used by the taxpayer in the production of his income or income is derived by him therefrom: Provided that –*
>
> *(aa) where such expenditure exceeds R3000 and was incurred –*
>
> *(A) before 29 October 1999, the allowance shall not exceed for any one year such portion of the amount of the expenditure as is equal to such amount divided by the number of years, which in the opinion of the Commissioner, represents the probable duration of the use of the … trademark … or four percent of the said amount, whichever is the greater".*

6. As appears from the grounds of assessment, the only requirement of the subsection that is in dispute is that the taxpayer should have incurred expenditure in a certain amount. The Respondent accepts that, if the Appellant were to show that he did incur expenditure in the amount of R44 462 000,00, that expenditure was incurred in acquiring a trademark by

assignment, as intended in the subsection, and that all the other requirements of the subsection were also met.

7. The expression "expenditure actually incurred" means, for purposes of sections such as 11(gA) that the taxpayer should have incurred an unconditional legal obligation in respect of the amount concerned. It is not required that the obligation should also be discharged. Where the obligation has been incurred, the expenditure becomes deductible if it also complies with the other requirements for the deductibility laid down by the section concerned.

8. This was stated as follows in **<u>Edgars Stores Limited / CIR</u> 1988 (3) SA 876 (A) at 888G – 889C** (per Corbett, JA):

"*As my Brother (Nicholas, AJA) as pointed out, the case hinges on the application of the general deduction formula in section 11(a) of the Income Tax Act, 58 of 1962 – and more particularly the word 'expenditure … actually incurred …' (Afrikaans text: 'Onkoste … werklik … aangegaan') appearing therein. In the recent case of* ***<u>Nasionale Pers Beperk / Kommissaris van Binnelandse Inkomste</u> 1986 (3) SA 549 (A),*** *this Court had the occasion to consider the meaning of these words in section 11(a) and at 564 A-C Hoexter, JA stated the position as follows:*

> *'Dit is 'n bekende grondstelling dat, vir doeleindes van artikel 11(a) van Wet 58 van 1962, onkoste werklik aangegaan is in daardie belastingjaar waarin aanspreeklikheid daarvoor regtens ontstaan, en nie (vir geval betaling daarvan laat sou plaasvind) in die belastingjaar waarin daar werklike vereffening van die skuld geskied het nie …'*

Thus it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question, may be deducted in terms of section 11(a) from income returned for that year. The obligation may be unconditional (ab initio) though initially conditional, may become unconditional by fulfillment of the conditions during the year of assessment; in either case the relative expenditure is deductible in that year".

At 885 A-B, Nicholas, AJA in his minority judgment, stated the following:

"*'Actually incurred' does not mean 'actually paid', but means all expenditure actually incurred during the year, whether the liability has been discharged during that year or not".*

9. From paragraph 11.2 of the grounds of assessment quoted above, as well as paragraphs 3.1, 3.2 and 4 of the common cause facts (exhibit "X"), it is

clear that it is not denied by the Respondent that the Appellant incurred an unconditional obligation to give consideration of R44 462 000,00 in the 1999 year. From paragraph 11 of the grounds of assessment it appears that the Respondent rather contends that, by virtue of the fact that the Appellant's obligation had to be discharged by issuing shares in the Appellant, no expenditure was actually incurred by the Appellant in compliance with its contractual obligation.

10. In this regard Mr Derksen, who appeared for the Appellant, in his comprehensive heads of argument, submitted that this contention is clearly in conflict with the highest authority in both England and South Africa. He dealt extensively with these authorities in his written heads of argument.

11. In **Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA)** a company had acquired stock for which it paid by issuing shares in the company. The same argument as that put forward by the Commissioner in the present matter was put forward by the revenue authority and rejected by the court. At 637G-638A Lord Green MR stated:

"It was strenuously argued on behalf of the Crown that, if a company acquires stock in consideration of the issue of fully-paid shares to the vendor, that stock must, for the purpose of ascertaining the company's

profits, be treated as having been acquired for nothing, with the result that , when it comes to be sold, the Revenue is entitled to treat the whole of the purchase price obtained on the sale as a profit. This is a remarkable contention, and it would require conclusive authority before we could accept it. … The argument really rests on a misconception as to what happens when a company issues shares credited as fully paid for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but, when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash. A company cannot issue £1 000 nominal worth of shares for stock of the market value of £500, since shares cannot be issued at a discount. Accordingly, when fully paid shares are properly issued for a consideration other than cash, the consideration moving from the company must be at least equal in value to the par value of the shares and must be based on an honest estimate by the directors of the value of the assets acquired".

12. The same approach was followed in **<u>Craddock v Zero Finance Co Limited</u> [1944] 1 All ER 566 (CA)**. The company had acquired trading assets and gave as consideration therefore shares issued in the company

itself at their nominal value. The Revenue contended that in determining the company's profit for income tax purposes, the cost of the assets could not be regarded as being equal to the nominal value of the shares that had been issued.

Lord Greene MR set out the Revenue's argument as follows, and rejected it for the reasons stated (at 570E-571H):

"… Mr Stamp's argument rejects the whole basis of costs, and asserts that the transaction was not … one of sale and purchase, that there was no such thing as cost, that the investments cost the respondents exactly nothing and that a different basis to that of cost must, therefore, be adopted. (570E-F).

…

The argument then proceeded to assert that a reconstruction such as that now in question is in substance merely a private transaction between shareholders in which no element of bargaining or valuation is present, that there is no contract of sale, that what purports to be the price paid by the new company is no price at all; that the new company must be treated as having paid nothing for the investment; that a basis of valuation other than cost must, therefore, be looked for; and that the only basis which can be accepted is that of market value. (570G-H).

…

What, then, was the substance of the transaction under which the respondent acquired these investments? First of all, they acquired them by virtue of a contract of sale and purchase the validity of which, as importing legal rights and obligations between the parties to it, cannot be impugned… . The contract is described in cl.1 as a contract of sale and purchase. It is a contract under which the respondents acquired the investments in consideration of their undertaking to the [seller] … to issue the fully-paid shares. … and it seems to me quite impossible to accept the view upon which Mr Stamp's whole argument was based that they must be taken as having acquired the investments in a manner which was not in law contractual and for no consideration at all. (571A-E).

…

The consideration provided by the respondents for the purpose of that acquisition was a genuine consideration; and the Crown's attempt to attack it fails, in my opinion, both on the facts and on the law." (571H)

This judgment was upheld by the House of Lords in **Craddock v Zevo Finance Co Limited 27 TC 267 (HL)**. See at 287 and 289.

13. In **<u>Stanton v Drayton Commercial Investments Co Limited</u> 1982 1 All ER 121 (CA)** the Tax Act stated that, in computing the gain accruing to a taxpayer on the disposal of an asset, the taxpayer was entitled to a deduction of "the amount or value of the consideration, in money or money's worth, given by him …for the acquisition of the asset …" (123H-124C).

The taxpayer had purchased the assets concerned at a stated price, to be satisfied by the allotment of a stated number of shares to be issued at a nominal value plus a stated premium (122H-J).

The court followed <u>Osborne</u> and <u>Craddock</u> and held that the agreed issue price of the shares constituted consideration given by the company for the assets acquired by the company. The company was consequently entitled to a deduction of that amount. AT 126d-f the court stated:

"Counsel for the Crown says that the word 'given' is in the past tense and that therefore there is nothing to value before the issue of the shares. We do not think that is right; the consideration must have existed when the agreement became unconditional. That is consistent with the proposition that the consideration was the benefit of the agreement by Drayton to allot the shares and credit them as fully paid.

What then is the value of the consideration? The value cannot be less than the par value of the new shares. … But plainly it can be more since the shares can be issued at a premium. The parties, in fact, agreed on a purchase price in the clearest terms. They agreed that the purchase of the portfolio should be at a price of £3.9m. That price was to be satisfied by the issue of the new shares of 160p per share credited as fully paid up".

14. The Court of Appeal's judgment in Stanton was upheld by the House of Lords. See **Stanton v Drayton Commercial Investment Co Limited [1982] 2 All ER 942 (HL)**. It was held that the consideration given by the company was the shares issued by it (945F-J). The amount of the consideration should be regarded as being the issue price agreed upon for the shares, not the objectively determined open market value of the shares when the contract became unconditional (947D-H). This is, at any rate, the case where the contract as such is not tainted with dishonesty (947H-J).

15. Mr Derksen also referred, as far as South African authority is concerned, to the decision in **Lace Proprietary Mines Limited v CIR 1938 AD 267.** In that case the company had sold mineral rights to another company (the purchasing company). The consideration agreed upon was shares to be

issued by the purchasing company. The purchase price was stated to be "£250 000 to be paid and satisfied by the alottment and issue to the seller of 100 000 shares of 5s. each in the capital of the purchaser, credited as fully paid up" (at 270). The mineral rights have been sold in the course of carrying out a profit-making scheme and the proceeds of the sale therefore had to be included in the selling company's income. It was held that the value of the shares issued in the purchasing company had to be included in the selling company's income for this purpose. For this purpose, the shares had to be valued at their actual value and not at the agreed issued price of £250 000 (279 – 280).

16. We agree with the submission by Mr Derksen that the **Lace** decision confirms that an undertaking by a company to issue shares in itself, constitutes real consideration given by the issuing company, otherwise it would not have had to be included in the selling company's income.

17. On an application of the principle laid down in **Stanton v Drayton** *supra*, to the facts of the present matter, the amount of the expenditure incurred by the Appellant would be equal to the agreed issue price of the shares, being 90c per share. The total expenditure would thus be R44 462 000,00. The market value of the shares issued by the Appellant would then on this principle be irrelevant. On an application of the valuation to be done according to the basis as in **Lace Proprietory Mines Limited v CIR**, ***supra*** the consideration given by the Appellant in the present matter

would therefore be the market value of the shares issued as at the date when they were issued, being 15 June 1999. This would still cause the expenditure incurred on the trademark to be R44 462 000,00.

18. In this regard Mr Jorge, for the Respondent, relied on an (at that stage) unreported decision by Goldblatt in the Johannesburg Tax Court on 20 November 2003 (Case no 10999). In that matter, the taxpayer, a company had bought the business of another company, and settled the purchase price by issuing shares in itself. A licence agreement was amongst the assets comprising the business it had required. The taxpayer claimed a deduction in terms of section 11(gA) of the Act in respect of the expenditure incurred to buy this agreement. The Commissioner contended that the Appellant had not incurred any expenditure, for purposes of section 11(gA) due to the fact that the consideration given by the appellant consisted of shares issued by the Appellant. The Commissioner's argument was upheld.

19. Although the case was also decided on the basis that the licence agreement was not of a nature similar to the intellectual property described in section 11(gA) and that the expenditure in relation thereto, was of a capital nature, it was also held that the issue of shares could not be regarded as expenditure actually incurred. According to Goldblatt, J, expenditures should be given its ordinary dictionary meaning, that is the

spending of money or its equivalent, time or labour for example, and resultant diminution of the assets of the person incurring the expenditure. As an issue of shares did not in any way reduce the assets of the company, it was not expenditure incurred.

20. The court found support for these views in paragraph 7.4 of **Silke on South African Income Tax** "*memorial edition"*. This paragraph was quoted in the judgment. A perusal of the passage makes it clear that the writer cites no authority for the statements made therein. It contains the contention that the reason why no expenditure has been incurred where the *quid pro quo* consist of an issue of shares, is that the "company … has not lost or parted with any assets, …". Mr Derksen, in my view correctly argued that this ignores the fact that the requirement is that the company should have incurred an unconditional legal obligation and that, if it has done so, the deductibility requirement is met and that the concept of "expenditure actually incurred" is not dependent upon the making of payment as was clearly stated in **Edgars Stores Limited v CIR**, *supra*. The contention also does not take cognisance of the weightly English and South African autority, to which Mr Derksen referred to in his heads of argument and dealt with.

21. As part of his comprehensive heads of argument, Mr Derksen also attached the heads of argument filed on behalf of the Appellant and

Respondent in the matter dealt with by Goldblatt, J. From these heads of argument it would appear that the court was not referred to any of the English authorities referred to above, nor the **Lace** decision and consequently did not have the benefit of considering them. It would also appear that the matter was in any event not fully argued before the court. The Appellant's heads of argument contains no submissions or authority on the point, whilst the Respondent's heads of argument relies only on the above mentioned statement in **Silke.**

22. In the Tax Law Update section of De Rebus, September 2004 (at 61 to 62), Barry Ger, in an article "**Income tax – The problem of paying with shares"** also leveled some criticism at the decision in case 109999 (at 62). He stated it thus:

"*The judge's decision is not beyond criticism. His view of expenditure may be said to be exceedingly narrow and not necessarily correct.*

Indeed it could be argued that he confused the concept of 'incurral of expenditure' with the 'settlement' thereof. In this case, the taxpayer arguably incurred expenditure on the purchase of the licence agreement – the fact that it chose to settle this expenditure in shares should not change this reality.

Furthermore, by issuing shares in lieu of paying in cash for the licence, it could be said that the taxpayer was indeed reducing its assets. It was giving up the right it would otherwise have had to claim payment in cash for the shares it issued in exchange for the licence. The notion of expenditure should include all economic sacrifices associated with acquiring an item and should not be restricted to mere cash outlays as implied in the reasoning of Goldblat, J".

And further:

"*The approach taken by the court in case 10999 is also inequitable in the sense that shares issued as consideration for the disposal of an asset or for services would generally be taxable as income or capital gain in the hands of the recipient of those shares. To disallow a corresponding deduction that would ordinarily have been claimed if cash had been paid in the hands of the company issuing these shares, is incongruous".*

In support of these criticisms and conclusions, the writer also referred to the English decisions in **Osborn v Steel Barrel Company Limited**, *supra* and **Stanton v Drayton**, *supra*.

23. The decision in case 10999 is also discussed by D Meyerowitz, SC in an article in The Taxpayer, May 2004 at 86, entitled "Paying for goods and

services by issuing shares". The learned author criticises the decision broadly on the same basis as was done by Ger in his contribution in De Rebus. He however adds the following with reference to the Companies Act, 61 of 1973:

"*Section 82 of that Act directs that no company shall issue shares having no par value of a class of shares already issued and at a price lower than an amount derived at by dividing that part of the stated capital contributed by already issued shares of that class… .*

Section 81 does not permit the issue of par value shares at a discount except under certain conditions.

Section 92 prohibits the allotment or issue of shares unless the full purchase price of or other consideration for the shares has been paid to or received by the company.

These provisions require that a company must obtain a ***quid pro quo*** *in cash or other valuable consideration, not less, except in special circumstances, than the nominal value of the shares to be issued. It is therefore arguable that where in place of cash, the consideration received by a company are assets or services rendered, the company has by set off expended an amount equal to at least the nominal value of the shares.*

It is therefore, with respect, of little or no relevance to analyse the nature of a share. It cannot be issued without payment to the company in cash or kind".

24. We are of the opinion that the reasoning in the English and South African decisions referred to above, as well as those contained in the criticisms levelled at the decision in case 10999, are sound and represents a correct statement of the law. The decision in case 10999 is in our view, with respect, clearly wrong and not a reflection of the law. Tax issues should not unnecessarily complicate or frustrate ordinary commercial transactions.

25. Regarding the issue of the incurral of expenditure, Mr Jorge further submitted that the acquisition agreement must be seen as only one of the steps that the appellant intended and needed to fulfill in achieving his purpose, i.e. a reverse takeover of the appellant by the shareholders of B SA (Pty) Ltd. This issue was not directly raised in the grounds of assessment. In terms of Rule 12, the issues in any appeal will be those defining a statement of the grounds of assessment read with the statement of the grounds of appeal. Mr Derksen on this basis submitted that the argument should not be entertained under these circumstances. We are of the view that it is not necessary to make a finding on this basis,

but are rather in agreement with the further argument by Mr Derksen that in the present matter the validity of the relevant contract is not in dispute and that its purpose is therefore irrelevant. In any event, in view of the finding above, regarding giving consideration by the issuing of shares, the reverse takeover argument, in our view, falls by the wayside.

26. Lastly it might be mentioned that during the course of argument, Mr Jorge, when dealing with the **Osborne v Steel Barrel** decision, *supra,* in so many words conceded that when fully paid shares are properly issued for a consideration other than cash, the consideration moving from the company must be at the least, equal in value to the par value of the shares, based on an honest estimate by the directors of the value of the assets acquired. The par value of the shares in the present matter, being 4 cents. Such a concession really puts an end to the respondent's contentions in regard to the question whether the expenditure was actually incurred. In view of our findings above, regarding what the correct position in law is, it is unnecessary to decide the matter on the basis of such a concession and we do not do so.

CONCLUSION:

27. The appeal is upheld and the Commissioner is ordered to alter the assessment accordingly.

On behalf of Mr Y Waja (Accounting Member)

Mr F F Stockenströhm (Commercial Member) and myself.

F J JOOSTE –
PRESIDENT

This judgment should be reported **YES / NO**

Adv A G Derksen, SC and adv A R Bhana, instructed by Evan Scop Attorneys, appeared on behalf of the Appellant.

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