REPORTABLE

IN THE TAX COURT

(EASTERN CAPE, PORT ELIZABETH)

In the matter between: **Case No 12441**

ABC (PTY) LTD **Appellant**

and

THE COMMISSIONER FOR SOUTH

AFRICAN REVENUE SERVICE **Respondent**

Coram: **Chetty J with assessors Mr. P Ranchhod and Mr. Z Mzimela**

Dates Heard: **21 & 22 September 2010**

Date Delivered **28 October 2010**

Summary: *Income Tax – Act No 58 of 1962 - Trading stock – Appellant claiming deduction in terms of section 22 (4) of Act on basis that trading stock acquired for no consideration – Schedule 6 to agreement allocating nil value to inventory – Evidence - Admissibility – Parol evidence Rule – Evidence sought to be introduced to interpret agreement of sale – Such evidence tendered to establish that no consideration given – Such evidence inadmissible – Agreement of sale itself proving that consideration given – Interest levied – Section 89 quat (2) –*

Reasonable grounds envisaged by section 89 quat (3) established – Appellant absolved from paying interest

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JUDGMENT

Chetty, J

[A] Background

[1] Although the appellant's corporate structure is of recent vintage, the name ABC has been a feature of the city's landscape for decades. Its historical roots are common cause. It was established in South African in 1937 as a subsidiary of D Company and initially specialised in the manufacturing of square, zinc batteries. The ABC Company Limited in the United Kingdom ("ABC (UK)") acquired the majority shares of ABC (SA) (Pty) Ltd (ABC (SA) in 1945. In 1978 ABC (UK) bought the remaining shares to make it the sole owner of ABC (SA). In 1982 ABC (UK) sold their business to E Plc who in turn sold their worldwide ABC businesses to F Co, but retained ownership of ABC (SA). On 1 April 1996 E Plc sold ABC (SA) to G Co. Barely six months later, H Co bought G Co worldwide. After it acquired ABC (SA) business, H Co rationalised its business structure and in the process consolidated the sales teams from ABC, G Co and H Co. Some time thereafter H Co concluded that the ABC business was not generating the anticipated return and decided to dispose of all its zinc battery businesses

around the world, including ABC in South Africa. At the time the South African operation was managed by Mr. W. His direct supervisor was Mr. X, who was based in India. The latter's immediate supervisor in turn was Mr. Y, who was based in the USA. Dr. Z, together with the three gentlemen, aforesaid, then negotiated with H Co to acquire the ABC business in South Africa.

[2] A corporate structure, J (Pty) Ltd was then formed. It purchased the ABC business for a purchase consideration of R80 million. In terms of the agreement of sale concluded between H Co Group South Africa (Proprietary) Limited and J (Pty) Limited the purchase price was, in terms of Schedule 6 to the agreement, allocated as follows:-

Allocation price

Purchase price to be allocated in the order below, each up to the maximum value shown

Description	Maximum value
Immovable Property	R 30 million
Other Fixed Assets	R 25 million
Trademarks	R 25 million
Display Inventory	
Inventory	
Receivables less payables	

[3] In its income tax and financial statements for the year of assessment ended 30 June 2004, the appellant contended that trading stock with a market value of R105 532 719, 00 was acquired from H Co for no consideration. It accordingly claimed a deduction of the amount as aforesaid in terms of s 22 (2)

read with sections 22 (3) and 22 (4) of the Income Tax Act[1] (the Act). Section 22 (4) provides as follows:-

> "(4) If any trading stock has been acquired by any person for no consideration or for a consideration which is not measurable in terms of money, such person shall for the purposes of subsection (3), unless subsection (3) *(a)* (iA) applies, be deemed to have acquired such trading stock at a cost equal to the current market price of such trading stock on the date on which it was acquired by such person: Provided that any capitalization shares awarded by any company to shareholders of that company on or after 1 July 1957 shall have no value as trading stock in the hands of such shareholders: Provided further that options or any other rights to acquire shares in any company which have been acquired as aforesaid shall have no value."

[4] The Act defines trading stock as including:-

> *"(a)* anything-
> (i) produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by him or on his behalf; or
> (ii) the proceeds from the disposal of which forms or will form part of his gross income, otherwise than in terms of paragraph *(j)* or *(m)* of the definition of 'gross income', or as a recovery or recoupment contemplated in section 8 (4) which is included in gross income in terms of paragraph *(n)* of that definition; or
> *(b)* any consumable stores and spare parts acquired by him to be used or consumed in the course of his trade, but does not

[1] Act No 58 of 1962

> include a foreign currency option contract and a forward exchange contract as defined in section 24I (1);"

It will be gleaned from the aforegoing that the term 'trading stock' is not defined as such, the Act merely specifying a *numerus clauses* of things falling within its domain. In their authoritative work[2] the learned authors opine that section 22 (4) of the Act would normally apply to trading stock acquired by donation or inheritance. The question which arises is whether, in the world of business, and, in *casu*, a multi million rand business, it can ever be contended that H Co donated its trading stock to the appellant.

[5] It is common cause that initially the respondent allowed no deduction in respect of trading stock although it subsequently allowed a deduction of R21 562 918, 00, not in terms of section 22 (4) of the Act, but in respect of what it contended was the consideration given. In addition it imposed interest in terms of section 89 *quat* (2) of the Act in the amount of R7 750 628, 17. The objection lodged by the appellant was disallowed, hence the present appeal. When the appeal was eventually argued, the issues between the parties had largely crystallized and before us the only matters which fell for adjudication were articulated as follows viz:-

1. Whether the trading stock acquired by the appellant from H Co in terms of the agreement was acquired for no

[2] Silke on South African Income Tax, Memorial Edition, Volume II

consideration as envisaged in section 22 (4) of the Act, and

2. Whether, in the event of a finding adverse to the appellant on the first issue, it had nonetheless established reasonable grounds as envisaged by section 89 *quat* (3) of the Act to be absolved from paying interest levied in respect of the underpayment of provisional tax in terms of section 89 *quat* (2) of the Act.

[6] In response to the appellant's request for reasons following the disallowance of the deduction claimed in the sum of R103 532 719, 00 the respondent, in conformity with its obligations in terms of Rule 3 (1) (a) of the Rules regulating objections, articulated its position thus under the rubric, *A. Inventory Deduction Disallowed*[3]. It reads:-

"A. INVENTORY DEDUCTION DISALLOWED

1. The 2004 Income Tax return (IT14) includes a deduction for "Trading stock" acquired for no consideration' of R103 500 000. The said Income Tax return states that his deduction 'is claimed under section 22 (2) read with section 22 (4) of the Income Tax Act'.

2. Section 22 (2) of the Income Tax Act states that

[3] I have reproduced the response in full including references to the legislative regime for it, in essence, encapsulates the submissions advanced on behalf of the respondent before us.

'The amount which shall in the determination of the taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the beginning of any year of assessment, shall –

a) if such trading stock formed part of the trading stock of such person at the end of the immediately preceding year of assessment be the amount which was, in the determination of the taxable income of such person for such preceding year of assessment, taken into account in respect of the value of such trading stock at the end of such preceding year of assessment; or

b) if such trading stock did not form part of the trading stock of such person at the end of the immediately preceding year of assessment, be the costs to such person of such trading stock' (own emphasis)

- It is clear from the above quotation that the section applies to the value of trading stock held on hand at the beginning of the year of assessment
- It is concluded that section 22 (2) (a) would not be applicable to ABC (Pty) Ltd as 2004 was its first year of trading.
- It is concluded that section 22 (2) (b) could be applicable to ABC as it directs that the inventory, which was on hand at the beginning of the 2004 year of assessment, should be

valued at the costs of acquiring the said inventory.

3. Section 22 (3) of the Income Tax Act provides a basis for determining the cost price of trading stock for purposes of section 22, and states that:

> "For the purposes of this section the cost price at any date of any trading stock in relation to any person shall . . ."

4. Section 22 (4) of the Income Tax Act states that:

> "If any trading stock has been acquired by any person for no consideration or for a consideration which is not measurable in terms of money, such person shall for the purpose of subsection (3) be deemed to have acquired such trading stock at a costs equal to the current market price of such trading stock on the date on which it was acquired by such person . . ." (own emphasis)

- Section 22 (4) provides a basis for valuing trading stock acquired for no consideration (or for an amount, which is not measurable). This section applies only for the purpose of Section 22 (3), which in turn lays down a basis for determining the cost price of trading stock for purposes of section 22 (discussed above).
- It is clear that section 22 (4) would only be applicable to ABC (and would only prescribe the cost price of trading stock to be used in terms of section 22 (2) (b) as being the market price at date of acquisition) if the trading stock were acquired for nil consideration (or for an amount, which is not measurable).

- Kindly note that section 22 (4) does not provide a deduction in terms of the Income Tax Act – merely a basis of determining the cost of stock (for use in section 22 (3)).

5. While the term 'consideration' is not defined in the Income Tax Act, the VAT Act defines it as follows:

> '. . . in relation to the supply of goods or services to any person, includes any payment made or to be made or to be made . . . whether in money of otherwise, or any act of forbearance . . . (own emphasis)
> (Section 1 of the VAT Act)

6. It is our conclusion that section 22 (4) is not applicable to ABC in the circumstances as the trading stock was not acquired 'for no consideration or for a consideration which is not measurable in terms of money'. It is our opinion that the liabilities assumed by ABC represented the consideration given for the trading stock. This opinion is supported by the following quotation from Silke (regarding expenditure incurred):

> 'The word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash . . . in accordance with the principle of the decision in Caltex Oil (SA) v SIR . . . it would appear that in a transaction of barter the commodity promised in satisfaction of the obligation incurred would have to be value in rands, and that it values would constitute the amount of the expenditure incurred.'

7. The following information, which was obtained either from the 'Sale of Business Agreement' or from the records of ABC,

supports our opinion that the liabilities assumed by ABC at the purchase of the business represented the consideration given for the trading stock:

a) The purchase agreement states (in clause 4.1) that:

> 'The sale of the Business constitutes an indivisible transaction and comprises the acquisition by the Purchaser of the Business Assets . . .' (my emphasis)

b) The Business Assets are defined in the purchase agreement as:

> 'those specified assets owned or used by the Seller in or in connection with the Business at the Effective Date, compiling (*sic*) Contracts, Moveable Assets, Display Inventory, Immovable Property, Intellectual Property, Trade Marks, Custom Orders, Licences, Inventories, Goodwill and Sundry Debtors . . .' (own emphasis)

It is clear that while the contract specifically allocates the R80 000 000 to three different classes of assets, the contract does not ascribe value to the other assets, which were acquired by the Purchaser in terms of the contract. This is stated as clause 5.5 states that if the "Working Capital', which includes Debtors, Inventory and Accounts Payable, is less than or more than R34 997 041 at the 'Effective Date', an adjustment will be made to the purchase

price. It should be noted that the purchase consideration was adjusted as a result of changes in the 'Working Capital'. It is therefore clear that the value of the 'Working Capital' and 'Business Assets' was taken into account in the calculation of the purchase consideration. It can therefore be concluded that consideration was given for Inventories acquired.

c) ABC accounted for the purchase of the business (prior to taking any reserve/ excess value obtained at the date of acquisition of the business) in its accounting records as follows:

DESCRIPTION	**AMOUNT**
Land & Building	30 000 000
Plant & Equipment	25 000 000
Trade Marks	25 000 000
Inventory	21 562 918
Debtors	193 287
Sundry Debtors	9 115 977
Accounts Payable	(20 182 371)
Provisions	(10 699 313)
Cash	9 500
Total	80 000 000

While the contract split the R80 000 000, which represented the cost of the business to ABC, between the first three assets (above), it is clear that this was done as the other assets and liabilities had a net value of zero. ABC recognized in their Accounting records, when entering the take on balances at the purchase of

> the business, that the value placed upon the Inventory acquired was R21 562 918.
>
> It is clear from the above that the 'consideration', which ABC gave the Seller for the 'Inventory', 'Debtors', 'Sundry Debtors' and 'Cash' was the liabilities assumed (ie 'Accounts Payable' and 'Provisions'), which liabilities were also not specified in the allocation of the Purchase Price. When ABC assumed certain of H Co SA's obligations/liabilities it gave consideration to H Co SA for the 'Inventory', 'Debtors', 'Sundry Debtors' and 'Cash' acquired." (my emphasis)

[7] Notwithstanding the force of the reasoning advanced by the respondent in disallowing the deduction claimed, on appeal before us, counsel for the appellant submitted that *ex facie* the agreement itself, it was manifestly clear that no consideration had been given for the trading stock, Schedule 6[4] to the agreement, he submitted, constituted irrefutable proof that no such consideration had been given. In developing his argument Mr. *Marais* submitted that the agreement was a kosher one and not a simulated transaction designed to

[4] Allocation price

Purchase price to be allocated in the order below, each up to the maximum value shown

Description	Maximum value
Immovable Property	R 30 million
Other Fixed Assets	R 25 million
Trademarks	R 25 million
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disguise its true nature. I was referred to a plethora of eminent and interesting authority on the point which I do intend traversing for the simple reason that it is not contended on behalf of the respondent that the agreement is one *in fraudem legis*. The submission advanced by Mr. *Buchanan* was that a proper analysis of the agreement compels the conclusion that the "inventory" to which Schedule 6 allocated no value, in fact constituted the trading stock. The submission is, in my view, well founded. The following clauses of the agreement clearly establish that the inventory constituted the trading stock.

[8] Clause 1.2.17 of the agreement defines inventories as meaning:-

> "means all of the stock of the Seller relating to the Business at the Effective Date, including but not limited to:
>
> raw materials;
>
> machine spares;
>
> finished products
>
> work-in-progress (semi-finished and raw materials)
>
> consumables"

[9] Clause 8 of the agreement in turn provides as follows:-

> "8. Stocktaking
>
> 8.1 The Parties wil cause a stocktaking to be conducted on the day prior to the Effective Date, of all the Inventories and

Display Inventories in accordance with the following provisions:

8.1.1. each of the Parties will be entitled to be present personally or by a representative at the stocktaking;

8.1.2 after the stocktaking has been completed schedules reflecting the Inventories and Display Inventory will be prepared and initialled by the Parties;

8.1.3 any Inventory which is:

8.1.3.1 damaged; or

8.1.3.2 unsaleable or unusable as being incomplete, redundant, slow moving (that is, of a type which has not been sold within the last twelve months), obsolete or out of normal commercially accepted standards or not reflected on the Seller's current price list;

8.1.4 any Display Inventory which is:

8.1.4.1 damaged; or

8.1.4.2 unusable as being incomplete; or

8.1.4.2 redundant,

will be excluded for the purpose only of valuing the Display Inventory unless the Parties agree in writing on the value thereof.

8.2 Should there by any dispute as to whether any item of Inventories or Display Inventory falls within any category set

out in 8.1.3 or 8.1.4 respectively, the dispute will be determined by the Seller's auditor:

8.2.1 whose decision wil be made within 14 (fourteen) days of his appointment; and

8.2.2 who will act as an expert and not as an arbitrator, and

8.2.3 whose decision will, in the absence of manifest error, be final and binding on the Parties, and

8.2.4 who will determine the liability for his charges as between the Parties, which will be paid accordingly.

8.3 Upon completion of the schedule reflecting the Inventories referred to in clause 8.1.2, the value of the Inventories (other than those items excluded pursuant to clause 8.1.3) shall be determined on the basis of the lower of market value or cost as is consistent with previous practice. Any dispute between the Parties shall be determined in accordance with the provisions of clause 8.2.

8.4 Upon completion of the schedule reflecting the Display Inventory referred to in clause 8.1.2, the value of the Display Inventory referred to in clause 8.1.2, the value of the Display Inventory (other than those items excluded pursuant to clause 8.1.4) shall be determined on the basis of the lower market value or cost and as is consistent with previous practice. Any dispute between the Parties shall be determined in accordance with the provisions of clause 8.2.

8.5 Once the value of the items of Inventories and Display Inventory have been agreed or determined by the Independent expert, that value will be used for the purpose of the Effective Date Accounts and the Working Capital Statement."

[10] In addition to the aforegoing clauses, clause 5.5, 11 and 12 provide further *indiciae* that a proportion of the R80 million and a proportion of the liabilities in respect of the purchase of the trading stock constitutes consideration for the acquisition of the stock. The final working capital statement summary, which Rayner insisted was nothing more than an incomplete internal management document, shows that consideration was paid.

[11] The entire edifice of the appellant's case was predicated upon Schedule 6 which, as adumbrated hereinbefore, assigned a nil value to inventory and display inventory. Such assignation is to my mind of little probative value. The arbitrary allocation of the purchase price does not establish that no consideration was given for the trading stock. The sale agreement and in particular clauses 1.2.17, 3, 5.1, 5.5 and 8, itself proves the contrary.

[12] It is not surprising therefore that the appellant's opening gambit was to seek to adduce evidence relating to the negotiations which preceded the conclusion of the agreement of sale in order to place a particular interpretation thereon. This strategy was in fact pre-empted in the statement of its grounds of appeal in terms of Rule 11 of the rules promulgated in terms of the Act, in which the appellant, under the guise of providing a history of its previous incarnations, attempted to establish that H Co was so desirous of disposing of its South

African operations that it concluded the sale of the business irrespective of the substantial losses it would incur.

[13] Mr. *Marais* however submitted that the evidence of Dr. Z was being tendered merely to establish what the true intention of the contracting parties was, that it was moreover clearly permissible and, a fortiori, admissible. He submitted further that in a case where the respondent seeks to place a different gloss on the contract the parol evidence rule does not apply.

[14] After hearing argument on this preliminary issue I ruled in favour of the respondent. The appellant's reliance on the judgment in **KPMG Chartered Accountants (SA) v Securefin Ltd and Another**[5] is entirely misplaced. The judgment is in fact against the appellant as the following paragraphs from the judgment of Harms DP, clearly indicate. The learned judge states the legal position thus:-

> "[38] Much of the evidence dealt with the interpretation of the verification contract. Indeed, each party called an expert on the issue and they testified for about 14 days on the interpretation of the contract. The factual witnesses, too, spent most of their time dealing with interpretation issues. The parties were able to create a record consisting of 6600 pages of evidence and exhibits. It is difficult to understand why the trial judge permitted the evidence or the cross-examination or overruled the objection to the leading of some of the evidence. Obviously, courts are fully justified in ignoring provisionally objections to evidence if those objections interfere with the flow of the case. It is different if a substantive objection is raised which could affect the scope of the evidence that will follow. In such a case a court should decide the issue and not postpone it. It is accordingly necessary to say something about the role of

[5] 2009 (4) SA 399 (SCA)

evidence and, more particularly, expert evidence in matters concerning interpretation.

[39] First, the integration (or parol evidence) rule remains part of our law. However, it is frequently ignored by practitioners and seldom enforced by trial courts. If a document was intended to provide a complete memorial of a jural act, extrinsic evidence may not contradict, add to or modify its meaning (*Johnson v Leal* 1980 (3) SA 927 (A) at 943B). Second, interpretation is a matter of law and not of fact and, accordingly, interpretation is a matter for the court and not for witnesses (or, as said in common-law jurisprudence, it is not a jury question: Hodge M Malek (ed) *Phipson on Evidence* (16 ed 2005) paras 33 - 64). Third, the rules about admissibility of evidence in this regard do not depend on the nature of the document, whether statute, contract or patent (*Johnson & Johnson (Pty) Ltd v Kimberly-Clark Corporation and Kimberly-Clark of South Africa (Pty) Ltd* 1985 BP 126 (A) ([1985] ZASCA 132 (at www.saflii.org.za)). Fourth, to the extent that evidence may be admissible to contextualise the document (since 'context is everything') to establish its factual matrix or purpose or for purposes of identification, 'one must use it as conservatively as possible' (*Delmas Milling Co Ltd v Du Plessis* 1955 (3) SA 447 (A) at 455B - C). The time has arrived for us to accept that there is no merit in trying to distinguish between'background circumstances' and 'surrounding circumstances'.

The distinction is artificial and, in addition, both terms are vague and confusing. Consequently, everything tends to be admitted. The terms 'context' or 'factual matrix' ought to suffice. (See *Van der Westhuizen v Arnold* 2002 (6) SA 453 (SCA) ([2002] 4 All SA 331) paras 22 and 23, and *Masstores (Pty) Ltd v Murray & Roberts Construction (Pty) Ltd and Another* 2008 (6) SA 654 (SCA) para 7.)

[40] Trollip JA in *Gentiruco AG v Firestone (SA) (Pty) Ltd* 1972 (1) SA 589 (A) at 617F - 618C dealt with the admissibility of expert evidence in interpreting a document (a patent specification in that case) and quoted with approval from a speech of Lord Tomlin in *British Celanese Ltd v Courtaulds Ltd* (1935) 52 RPC 171 (HL):

'The area of the territory in which in cases of this kind an expert witness may legitimately move is not doubtful. . . . He is entitled to explain the meaning of any technical terms used in the art. . . . He is not entitled to say nor is counsel entitled to ask him what the [document] means, nor does the question become any more admissible if it takes the form of asking him what it means to him as an [expert].'

Lord Tomlin spelt out the disadvantages of allowing expert evidence on interpretation:

'In the first place time is wasted and money spent on what is not legitimate. In the second place there accumulates a mass of material which far from assisting the Judge renders his task the more difficult, because he has to sift the grain from an unnecessary amount of chaff.

In my opinion the trial Courts should make strenuous efforts to put a check upon an undesirable and growing practice.'

That was in 1935, but the chaff is still heaping up, the undesirable practice keeps growing and courts make no effort to curtail it. An

> expert may be asked relevant questions based on assumptions or hypotheses put by counsel as to the meaning of a document. The witness may not be asked what the document means to him or her. The witness (expert or otherwise) may also not be cross-examined on the meaning of the document or the validity of the hypothesis about its meaning. Dealing with an argument that a particular construction of a document did not conform to the evidence, Aldous LJ quite rightly responded with, 'So what?' (*Scanvaegt International A/S v Pelcombe Ltd* 1998 EWCA Civ 436.) All this was sadly and at some cost ignored by all."

[15] Although the judgment related to expert evidence the legal principles enunciated are of equal application to the evidence of a non-expert witness such as *Rayner* whose involvement in the conclusion of the agreement of sale was clearly not peripheral. The appellant's true intention soon manifested itself. In his testimony, which I was informed would comprise the appellant's history and certain background information, Dr. Z attempted to elaborate upon the circumstances in which H Co concluded the agreement of sale. He acknowledged that although G Co paid E Plc 135 million dollars for the business it was acquired by the management team for substantially less (i.e. R80 million) for the simple expedient that H Co was so desirous of disposing of the business irrespective of the associated losses, that the trading stock was in effect donated to the appellant.

[16] I am satisfied that upon a proper analysis of the agreement consideration was given for the trading stock as contended for by the respondent and that the appellant's reliance on the provisions of section 22 (4) of the Act is entirely misplaced.

Have reasonable grounds for the non levying of interest been established

[17] Section 89 *quat* (3) of the Act provides as follows:-

> "(3) Where the Commissioner having regard to the circumstances of the case is satisfied that any amount has been included in the taxpayer's taxable income or that any deduction, allowance, disregarding or exclusion claimed by the taxpayer has not been allowed, and the taxpayer has on reasonable grounds contended that such amount should not have been so included or that such deduction, allowance, disregarding or exclusion should have been allowed, the Commissioner may, subject to the provisions of section 103 (6), direct that interest shall not be paid by the taxpayer on so much of the said normal tax as is attributable to the inclusion of such amount or the disallowance of such deduction, allowance, disregarding or exclusion."

[18] Relying on the authority of *Dennis Davis et al* in ***Juta's Income Tax***, **Volume 2,** and certain *dicta* in **SARS v Foskor (Pty) Ltd**[6], counsel for the appellant has urged us, on a rehearing of the matter, to direct that no interest is payable.

[19] The question which falls for decision is whether the opinions expressed in the two reports commissioned by the appellant, objectively considered, afforded

[6] 72 SATC 174 at 186B-C

reasonable grounds for the appellant claiming the section 22 (4) deduction. Mr. *Buchanan* submitted that the opinions were, at best for the applicant equivocal and, a fortiori, the appellant's conduct unreasonable. Whilst it is so that the opinions expressed by Mr. *Du Toit* and Advocate *Meyerowitz* may be construed as being equivocal, I am nonetheless satisfied that objectively, the appellant's conduct was reasonable. Consequently, no interest shall be payable for claiming the deduction.

_____

D. CHETTY
PRESIDENT

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