



SOUTH AFRICAN REVENUE SERVICE

INCOME TAX INTERPRETATION NOTE NO. 7

DATE: 27 March 2002

ACT : INCOME TAX ACT, 1962 ("the Act")
SECTION : SECTIONS 1, 11(cA) and 23(l)
SUBJECT : RESTRAINT OF TRADE PAYMENTS

1. Introduction

In the Budget Speech on 23 February 2000 the Minister of Finance announced that payments in respect of a restraint of trade (i.e. sterilisation of a person's income earning capacity) made to natural persons or employment companies should be included as income in the hands of the recipient and deducted in the hands of the payer over the period of the restraint or three years, whichever period is longer.

To give effect to the announcement, a new paragraph (cA) was inserted in the definition of "gross income" in section 1 of the Act. Sections 11(cA) and 23(l) were introduced to regulate the deductibility of these payments.

The above provisions came into operation on 23 February 2000, and apply to all restraint of trade payments received or accrued, or incurred on or after that date. [Sections 13(1)(f) and 22(2)(a) of the Taxation Laws Amendment Act, No. 30 of 2000]

2. The Law and its Application

2.1 Gross income

On the income side, section 1 of the Act was amended by the insertion of the following paragraph in the definition of "gross income":

"(cA) any amount received by or accrued to any person who-

- (i) is a natural person;
- (ii) is or was a labour broker as defined in the Fourth Schedule (other than a labour broker in respect of which a certificate of exemption has been issued in terms of that Schedule);
- (iii) is or was a personal service company as defined in the Fourth Schedule; or
- (iv) is or was a personal service trust as defined in the Fourth Schedule,
as compensation for any restraint of trade imposed on such person;”

The effect of the amendment is to specifically include restraint of trade payments received or accrued in “gross income” as defined, irrespective of whether it is a receipt or accrual of a capital nature or not. The payment will be taxable in full in the year of receipt or accrual, irrespective of the fact that the deduction may be spread over a period.

Where a payment received or accrued in respect of a restraint of trade is of a capital nature, it will be taxable in full if it was received by or accrued to a natural person, a labour broker not in possession of a certificate of exemption, a personal service company or a personal service trust. A company includes a close corporation.

If a sole proprietor sold his business on condition that he may, for example, not open a new business within three years in a radius of 50 kilometres, and he received compensation in respect of the restriction, the amount so accrued will be fully subject to income tax in the hands of the recipient.

Amounts paid to companies and trusts that are not defined as personal service companies or trusts do not form part of “gross income”, provided the receipt or accrual is of a capital nature.

Inevitably the new provision dealing with restraint payments could be susceptible to abuse. The provision “any amount received by or accrued to” should be interpreted according to the general principles pertaining to “accrued to”; viz. that accrual takes place when the taxpayer becomes unconditionally entitled to the receipt. Cases where taxpayers allege that

the accrual took place prior to the effective date should be carefully considered.

Both the payer and the receiver of the restraint of trade payment may be prosecuted where the date of accrual is recorded incorrectly.

2.2 Deduction

On the deduction side, section 23(l) provides for a general prohibition of deductions in respect of a restraint of trade payment. However, provision has been made for a deduction in terms of section 11(cA) in certain specific circumstances. These provisions are discussed below.

The new section 11(cA) provides that:

“an allowance in respect of any amount actually incurred by such person in the course of the carrying on of his trade, as compensation in respect of any restraint of trade imposed on any other person who-

- (i) is a natural person;
- (ii) is or was a labour broker as defined in the Fourth Schedule (other than a labour broker in respect of which a certificate of exemption has been issued in terms of such Schedule);
- (iii) is or was a personal service company as defined in the Fourth Schedule; or
- (iv) is or was a personal service trust as defined in the Fourth Schedule,

to the extent that such amount constitutes or will constitute income of the person to whom it is paid: Provided that the amount allowed to be deducted under this paragraph shall not exceed for any one year the lesser of-

- (aa) so much of such amount so incurred as is equal to such amount divided by the number of years, or part thereof, during which the restraint of trade shall apply; or
- (bb) one-third of such amount so incurred;”

Section 23 provides:

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

(a) --- (k)

(l) any expense incurred in respect of the payment of any restraint of trade, except as provided for in section 11(cA).”

The effect of the amendment is that restraint of trade payments incurred in carrying on a trade will be deductible from the income derived from such trade on the following conditions:

- The amount constitutes or will constitute income in the hands of the person to whom it is paid.
- The qualifying amount will be deductible in equal instalments over the longer of-
 - three years; or
 - the period of the agreement.

For example, if a restraint is to endure for one year, the taxpayer may only deduct a third of the amount in the first year of assessment and a third in each of the next two succeeding years. The recipient of the amount will be taxable in full in the year of receipt or accrual.

2.3 Employees' tax

A further amendment was also inserted into the Act to subject restraint of trade payments to the deduction of employees' tax with effect from 6 December 2000. All such payments received or accrued on or after this date are, therefore, subject to employees' tax deductions. Paragraph (a) of the definition of "remuneration" in paragraph one of the Fourth Schedule to the Act was, therefore, amended to include amounts referred to in paragraph (cA) of the definition of "gross income". [Section 53(1)(b) and (2) of the Revenue Laws Amendment Act, No. 59 of 2000]