

**INTERPRETATION NOTE 94**

DATE: 19 December 2016

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : SECTIONS 1(1) (DEFINITION OF “GROSS INCOME”) AND 11(a), AND PARAGRAPH 35(1) OF THE EIGHTH SCHEDULE**  
**SUBJECT : CONTINGENT LIABILITIES ASSUMED IN THE ACQUISITION OF A GOING CONCERN**

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### ***Preamble***

In this Note unless the context indicates otherwise –

- “**Eighth Schedule**” means the Eighth Schedule to the Act;
- “**embedded obligation**” has the meaning set out in **3**;
- “**free-standing contingent liability**” has the meaning set out in **3**;
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides referred to are available on the SARS website at **www.sars.gov.za**.

## **1. Purpose**

This Note sets out the income tax implications for the seller and purchaser when the purchase price of assets acquired as part of a going concern is settled or partly settled by the assumption of contingent liabilities.<sup>1</sup>

## **2. Background**

The expression “sale of a business as a going concern” is generally used to refer to the circumstances in which a person sells all or a part of a business which is capable of separate operation and constitutes an income-earning activity in its own right at the date of sale. The nature of the particular business will dictate the assets which need to be transferred in order to ensure that the business (or part of it) is capable of operating in its own right.

A business, generally speaking, does not need to be transferred with any liabilities in order to be able to operate as an income-earning operation in its own right. Liabilities may, however, need to be transferred for legal reasons (for example, a requirement under environmental laws) or commercial reasons (negotiated between the parties). The nature of the liabilities transferred or taken over could be absolute and unconditional (for example, trade creditors or loan obligations) or conditional (for example, leave pay provisions, bonus provisions, post-retirement medical aid provisions and warranty provisions).

The sale of a business as a going concern can be structured in a variety of ways. The purchase price is often settled by the purchaser through a combination of a cash payment to the seller, the undertaking to settle specified debts on behalf of the seller, the assumption of specified contingent liabilities (that is, the undertaking to settle a seller's contingent liabilities if and when the contingent liabilities materialise), a loan

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<sup>1</sup> Once the purchaser has assumed the contingent liability, it means that if the contingent liability crystallizes the purchaser, not the seller, is responsible for incurring the relevant expenditure and settling any related third debt directly.

account and the issue of shares (when the purchaser is a company). This Note considers the income tax implications for the seller and purchaser when a portion of the purchase price is settled by the purchaser assuming the seller's contingent liabilities.

### 3. Contingent liabilities

A contingent liability means an 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. For example, a provision for bonuses which will be paid out if employees are still in the employer's employment on a specific date is a contingent liability because –

- there is a distinct obligation to pay the bonus under specific circumstances; but
- the existence of the liability can be confirmed only on a specific date; and
- to the extent it is confirmed, it will result in expenditure being incurred to settle it.<sup>2</sup>

A contingent liability must be distinguished from a valuation provision. A taxpayer may raise a valuation provision in the accounting records if the circumstances prevailing at the time indicate that the value of an asset has been impaired below its cost.<sup>3</sup> For example, shares acquired in 2007 for R5 million may have a current market value of R4 million. The decline in value may be recognised by raising a provision for diminution in value of R1 million in the accounting records. However, for income tax purposes, the taxpayer will not incur expenditure in relation to the provision merely because the market value of the shares at the end of the year of assessment is lower than cost. A loss may be allowable if the shares are disposed of and the loss is realised. Another example is a provision for doubtful debts.

Contingent liabilities and valuation provisions are often raised in accounting records. However, in the context of a sale of a business, additional contingent liabilities and valuation provisions may be negotiated and recognised by the seller and purchaser.

In *Daishowa-Marubeni International Ltd v Canada*<sup>4</sup> the appellant disposed of its right to harvest timber ("forest tenures"). The buyer assumed the appellant's statutory obligation to reforest the land on which it had previously felled timber. At issue was whether the appellant was obliged to include the value of those assumed contingent liabilities in determining its proceeds on disposal of the forest tenures. The Supreme Court of Canada distinguished between future costs which depress the value of an asset and an obligation which is a distinct existing liability.<sup>5</sup> The court held that the reforestation obligation was simply a future cost tied to the forest tenures that depressed the value of the asset and was not a separate obligation. The reforestation obligation did not represent proceeds on disposal. In appropriate circumstances the principle enunciated in this case may find application in a South African context. SARS accepts that a distinction must be drawn between an

<sup>2</sup> In *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55 the court upheld the disallowance of a bonus provision as a deduction under section 11(a) because it was dependent on the employees being in service at the time of payment.

<sup>3</sup> Valuation provisions may also be raised for increases in value.

<sup>4</sup> 2013 SCC 29.

<sup>5</sup> Distinct existing liabilities could include absolute and contingent liabilities.

embedded statutory obligation that depresses the value of an asset and a separately identifiable free-standing contingent liability.

Accordingly, in the context of transferring a business, from an income tax perspective a distinction must be drawn between contingent liabilities which are –

- embedded in the asset such that the contingent liabilities are inextricably linked to the asset and, should the asset be transferred, must be transferred by the seller to the purchaser under law or government regulation. This type of contingent liability has an impact on the market value of the asset and does not represent consideration for the asset. This is referred to as an “embedded obligation” in this Note; and
- distinct existing obligations which are separately identifiable and are not embedded in an asset that is separately recognised for tax purposes. The transfer of these free-standing obligations is not required by law or may be required but can be contracted out of.<sup>6</sup> This type of contingent liability is referred to in this Note as a “free-standing contingent liability” and does not have an impact on the market value of an asset recognised for tax purposes.

A reference to contingent liabilities in this Note includes embedded obligations and free-standing contingent liabilities.

Distinguishing between valuation provisions, embedded obligations and free-standing contingent liabilities is not always easy. Examples of items which, in the context of sales of businesses, are considered to be free-standing contingent liabilities include employee-related provisions such as bonus provisions and post-retirement medical aid provisions. These free-standing contingent liabilities do not suppress the value of an individual asset which is recognised for tax purposes – see 4 for a discussion on purchase price allocation and the recognition of individual assets for tax purposes.

SARS does not rule out the possibility that a contingent liability which is not required to be transferred by law or government regulation could be embedded in an individual asset recognised for tax purposes (as opposed to relating to the business as a whole).<sup>7</sup> Any such determination will depend on the facts of the particular case and the onus will be on the taxpayer under section 101 of the Tax Administration Act 28 of 2011 to show that the contingent liability is inextricably linked to an individual asset. Taxpayers requiring certainty can consider submitting a request for an advance tax ruling to SARS.

This Note discusses the treatment of free-standing contingent liabilities, which exist independently of the assets being disposed of, in the hands of both the seller and the purchaser when a business is transferred as a going concern.

A “provision” raised by a taxpayer in the accounting records could represent an embedded obligation, a free-standing contingent liability, a valuation provision or a combination of the three. It is necessary to consider the reason for raising the

<sup>6</sup> For example, see section 197 of the Labour Relations Act 66 of 1995.

<sup>7</sup> The Supreme Court in *Daishowa-Marubeni International Ltd. v. Canada* 2013 SCC 29 was not required to express a view on whether an obligation associated with a property right could be embedded in that property right without there being a statutory obligation to transfer it. The Court, however, in paragraph 36 noted that it did not exclude the possibility that it could be so embedded.

accounting provision and, when applicable, to distinguish between the extent to which a single provision has been raised in respect of an embedded obligation, a free-standing contingent liability and a valuation provision. For example, a “debtors provision” which includes an amount for the valuation of doubtful debts and an amount for credit notes<sup>8</sup> that the seller expects to issue for faulty goods returned to the seller, must be analysed into its component parts in order that the appropriate tax treatment may be applied to each component.

A contingent liability is also distinguishable from a fixed or absolute liability. A fixed or absolute liability already exists and is unconditional; it is a definite distinct obligation to a creditor. For example, in the case of an amount owed to a trade creditor the goods would usually have been delivered and the debtor would be liable for the outstanding amount. For completeness it is noted that in *Daishowa-Marubeni International Ltd. v. Canada*,<sup>9</sup> the court referred to the future cost of a repair, that is, a repair that had not yet taken place, as being an absolute cost. “Absolute cost” as used in that context is different to an “absolute liability” as used in this Note.

#### 4. Purchase price allocation

A business as a whole is not recognised as a single asset for income tax purposes. The business consists of a collection of assets (and possibly liabilities) and the total purchase price must be allocated to the individual assets (and possibly liabilities) which form the subject matter of the sale.<sup>10</sup> An allocation of the purchase price to individual assets is required regardless of whether the sale agreement reflects the purchase price as comprising a lump sum net amount or as an itemised list of assets less liabilities and contingent liabilities.

The assets acquired will often be reflected in the seller’s accounting records but it is possible that some assets may not have been recorded in the accounting records before the sale. Examples of such undisclosed assets may include a valuable customer distribution agreement, an internally developed trademark and self-generated goodwill.

A purchase price allocation is required irrespective of whether the purchase price exceeds or is less than the book values recorded in the seller’s accounting records.

SARS will generally apply the purchase price allocation specified in an agreement of sale to both the seller and purchaser. SARS may apply a different allocation if there is evidence to the effect that the specified allocation does not represent the actual facts and the true intention of the parties. For example, such a misallocation would arise if the seller has a significant assessed loss and the parties to the transaction agree to allocate the full purchase price to trading stock such that it is significantly overvalued and allocate a nil value to the fixed assets which have significant value. In ITC 1235<sup>11</sup> the parties allocated R1 to a plantation. The court held that the

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<sup>8</sup> The credit notes could relate to debtors’ balances already settled or to outstanding debtors’ balances.

<sup>9</sup> 2013 SCC 29 in paragraph 40.

<sup>10</sup> See *CIR v Niko* 1940 AD 416, 11 SATC 124 in which the court recognised that the sum received for trading stock, which was sold as part of a business disposed of as a going concern, was of a revenue and not a capital nature, and ITC 108 (1928) 3 SATC 343 (U) in which the court required an allocation of the purchase price to different assets in the context of the disposal of a going concern.

<sup>11</sup> (1975) 37 SATC 233 (T).

agreement was fictitious and not a real agreement and accepted the Commissioner's valuation.

SARS may review the purchase price allocation adopted by the taxpayer when an agreement of sale does not specify a purchase price allocation and request support for the allocation adopted. The seller and the purchaser are required to adopt the same purchase price allocation.

## 5. The seller

Two issues which must be considered from a seller's perspective when part of the purchase price of assets is settled by the assumption of a free-standing contingent liability by the purchaser are the following:

- Depending on the nature of the particular asset sold, what amount must be included in gross income or proceeds for capital gains tax purposes?
- Is the seller entitled to a deduction for the amount of the free-standing contingent liability?

### 5.1 Gross income and proceeds – amount

#### 5.1.1 The law

A resident's "gross income" as defined in section 1(1) includes –

"the total amount, in cash or otherwise, received by or accrued to or in favour of such resident ... excluding receipts or accruals of a capital nature ...".

Paragraph 35(1) of the Eighth Schedule describes "proceeds from the disposal of an asset" as –

"the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal, and includes ...".

#### 5.1.2 Application of the law

From both a gross income and proceeds perspective it is important to consider what constitutes an "amount". Although "amount" is not defined in the Act it has been the subject matter of various court cases. The judgment of the Supreme Court of Appeal of South Africa in *C: SARS v Brummeria Renaissance (Pty) Ltd and Others*<sup>12</sup> is authority for the following principles:<sup>13</sup>

- The word "amount" in the definition of gross income is to be interpreted widely.
- Even though the receipt or accrual of the right is in a form other than money that cannot be alienated or turned into money (in *Brummeria*, the benefit of the use of an interest-free loan), it does not mean that the receipt or accrual of that right has no money value.
- The test to be applied in order to determine whether the receipt or accrual has a monetary value is an objective test.

<sup>12</sup> 2007 (6) SA 601 (SCA), 69 SATC 205.

<sup>13</sup> Interpretation Note 58 (Issue 2) dated 4 October 2012 "The *Brummeria* Case and the Right to Use Loan Capital Interest Free".

- The value of the receipt or accrual in a form other than money constitutes an “amount” that “accrues” to the taxpayer and should be included in gross income in the year of assessment in which the right is received by or accrues to the taxpayer, provided the other requirements of the definition are met.

These principles apply in determining what constitutes an “amount” for purposes of the definition of “gross income” in section 1(1) and in establishing a person’s proceeds under paragraph 35(1) of the Eighth Schedule.

When the purchase price of assets acquired as part of a going concern is partly settled by an amount paid in cash and partly by the purchaser assuming a free-standing contingent liability, the seller is entitled to two “things” from the purchaser for the sale of the assets, namely, the cash and the benefit of being relieved of the obligation to settle the free-standing contingent liability if and when it becomes unconditional in the future. The amount of the cash received and the amount of the benefit received must be brought into account for tax purposes. Whether the amount is brought to account on a revenue basis or on a capital basis will depend on the asset to which it is allocated and the facts of the particular case.

Determining the amount of cash is self-evident, but determining the amount of the benefit received from a purchaser assuming a free-standing contingent liability can be more difficult. The amount of the benefit needs to be determined objectively<sup>14</sup> 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.

As noted in the *Brummeria* case and discussed in Interpretation Note 58 (Issue 2) dated 4 October 2012 “The *Brummeria* Case and the Right to Use Loan Capital Interest Free”, the key question is whether the receipt or accrual in a form other than money has a “money value”. The ability to turn the receipt or accrual into money was noted as not being a critical factor and was instead only one of the ways of establishing if it had a monetary value.

The amount of the benefit will generally be equal to the amount of the free-standing contingent liability which has been negotiated and agreed by the seller and purchaser and which has been stipulated in the agreement of sale.<sup>15</sup> The amount of the benefit would be equal to the face value of the agreed amount. No present value adjustment is made to the agreed amount to account for the fact that the actual payment by the purchaser, if any, is expected to be made only in the future.<sup>16</sup> The taxpayer bears the burden of proving the appropriateness of the amount determined.

When, in substance and in form, the parties have not placed a value on the assumption of the free-standing contingent liabilities, there is no additional amount

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<sup>14</sup> In the *Brummeria* case the court found that *Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 21 incorrectly reflected the law when it held that the determination of monetary value was a subjective test.

<sup>15</sup> An agreement must be read as a whole and due attention must be paid to the wording used in schedules attached to or referred to in the agreement – see *Eveready (Pty) Ltd v C: SARS* (2012) JOL 28648 (SCA), 74 SATC 185.

<sup>16</sup> The proviso to the definition of “gross income” in section 1(1) and paragraph 35(4) of the Eighth Schedule provide clarity in this regard. It is noted that in reaching the agreed amount, which may differ from the face value of the contingent liability previously recorded in the seller’s accounting records, the seller and purchaser may have incorporated an element of discounting. The agreed amount is, however, not subject to any further present value discounting for tax purposes.

for consideration. However, if the parties have agreed to and placed a value on the assumption of the free-standing contingent liabilities but the agreement does not reflect that agreed value or understates the agreed value, there would nevertheless be an additional amount of consideration.

The determination of the amount of the benefit takes place at the earlier of receipt or accrual, that is, the earlier of when the seller receives the amount or becomes unconditionally entitled to it.<sup>17</sup> The timing of the receipt or accrual will generally be upfront but the contract should always be reviewed to determine whether there are any clauses which contain conditions that result in the delay of the receipt or accrual.

In *Ackermans Ltd v C: SARS*, in discussing whether the seller had incurred expenditure as a result of the purchaser assuming some contingent liabilities, Cloete JA noted that –<sup>18</sup>

“the nett asset value of the business — the assets less the liabilities — was calculated and that this valuation dictated the purchase price”

and

“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”.

These comments are not authority for the view that the consideration does not include the value of liabilities and contingent liabilities assumed by the purchaser. The Court was considering the requirements of section 11(a) and it is considered inappropriate to extend the judgment to the requirements of gross income or proceeds, as appropriate, from the seller’s perspective. In context, SARS is of the view that the Court was expressing the view that a reduction in the cash portion of the purchase price did not mean the seller had incurred expenditure and this should not be extended to the requirements of a different section of or definition in the Act.

## 5.2 Free-standing contingent liability – availability of a deduction

### 5.2.1 The law

#### Section 11(a)

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

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

#### Section 23(g)

**23. Deductions not allowed in determination of taxable income.**—No deductions shall in any case be made in respect of the following matters, namely—

...

<sup>17</sup> The case of *SIR v Silverglen Investments (Pty) Ltd* 1969 (1) SA 365 (A), 30 SATC 199 provides authority for the principle that the Commissioner does not have a right of election over when to tax an accrual and must tax a receipt or accrual, whichever comes first.

<sup>18</sup> 2010 (1) SA 1 (SCA), 73 SATC 1 at 6.



(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;

### 5.2.2 Application of the law

The general deduction formula consists of a positive test [section 11(a)] and a negative test [section 23(g)]. These two sections must be read together in order to determine whether a taxpayer will be entitled to a general deduction.

In determining a person's taxable income derived from carrying on any trade, section 11(a) provides a deduction for –

- expenditure and losses,
- actually incurred,
- in the production of the income,
- which are not of a capital nature.

Any expenditure or loss must, in accordance with the opening words of section 11 and the words of section 23(g), also have been incurred in carrying on a trade. In addition, expenditure and losses must be claimed during the year of assessment in which the expenditure or loss is actually incurred.

If a purchaser assumes a free-standing contingent liability as settlement or part settlement of a purchase price of an asset, the seller will not have incurred any expenditure on assumption of the free-standing contingent liability by the purchaser. This Note discusses the meaning of "expenditure". The other requirements of section 11(a) are not discussed further in this Note.<sup>19</sup>

The words "expenditure" and "losses" used in section 11(a) are not defined in the Act.<sup>20</sup> In *Joffe & Co (Pty) Ltd v CIR*, Watermeyer CJ explained the distinction between the words "loss" and "expenditure" as follows:<sup>21</sup>

"In relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money."

A similar distinction was drawn between "disbursements" or "expenses" on the one hand and "losses" on the other in the English case of *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co*, in which Findlay J explained that the word "disbursements" –<sup>22</sup>

"means something or other which the trader pays out; I think some sort of volition is indicated. 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

<sup>19</sup> It is unnecessary to discuss the other requirements for deductibility of an amount under section 11(a) because in order for a taxpayer to qualify for a deduction under that provision, all its requirements must be met and in the absence of meeting the expenditure (or loss) requirement the taxpayer will not be able to qualify for a deduction under section 11(a).

<sup>20</sup> *Collins Essential English Dictionary 3 ed (1988)* William Collins Sons & Co Ltd, defines "expenditure" as "the total amount of money that is spent on something" and "loss" as "the fact of no longer having something or of having less of it than you had before".

<sup>21</sup> 1946 AD 157, 13 SATC 354 at 360.

<sup>22</sup> 17 TC 59 at 64.

thing which he expends or disburses. That is a thing which, so to speak, comes upon him *ab extra*".

In *COT v Rendle* Beadle CJ distinguished designed and fortuitous expenditure as follows:<sup>23</sup>

"For the purposes of this case, expenditure incurred for the purpose of trade may be grouped broadly under two heads. First, money voluntarily and designedly spent by the taxpayer for the purpose of his trade; and second, money which is what I might call involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer. For the sake of convenience, I will refer to the first type of expenditure as 'designed expenditure', and to the second as 'fortuitous expenditure'."

In ITC 1783<sup>24</sup> the taxpayer purchased a business and under the written agreement was required to settle the purchase price through the issue of its own shares. One of the assets acquired was a licence agreement and the court was required to consider whether the taxpayer had incurred "expenditure" under section 11(a) or section 11(gA). Goldblatt J held that the taxpayer had not incurred any expenditure and stated the following:<sup>25</sup>

"'Expenditure' in its ordinary dictionary meaning is the spending of money or its equivalent *eg* 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."

In *C: SARS v Labat Africa Ltd*<sup>26</sup> the Supreme Court of Appeal was also called upon to consider whether there had been any expenditure when the purchase price for a trademark, which was acquired as part of the acquisition of a business, was settled by the taxpayer issuing its own shares. The court held that irrespective of the fact that the issue of shares for the acquisition of assets amounted to "consideration" given by the company and that the consideration appeared to be fairly valued, there had been no expenditure. Harms AP noted the following:<sup>27</sup>

"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 v Secretary for Inland Revenue* 1975 (1) SA 665 (A) at 674D-E, namely that the expression 'any expenditure actually incurred' means 'all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during the year or not'.

(Emphasis added.)

.....

"The term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. ... In the context of the Act it would also include the disbursement of other assets with a monetary value.

<sup>23</sup> 1965 (1) SA 59 (SRAD), 26 SATC 326 at 329.

<sup>24</sup> (2004) 66 SATC 373 (G).

<sup>25</sup> At 376.

<sup>26</sup> 2013 (2) SA 33 (SCA), 74 SATC 1.

<sup>27</sup> At 5 in [8] and 6 in [12].

Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.”

In the *Ackermans* case<sup>28</sup> the court was required to consider the meaning of “expenditure incurred” in the context of free-standing contingent liabilities. The taxpayer sold its retail business which included the business assets, the liabilities and the contracts as a going concern. The purchase price was defined as the amount equal to R800 million plus the rand amount of the liabilities. The purchase price was to be discharged by the purchaser assuming agreed liabilities, which included three free-standing contingent liabilities, namely, those relating to post-retirement medical aid, long-term bonuses and lease repairs, and the creation of a loan account. The taxpayer claimed a section 11(a) deduction equal to the amount of the contingent liabilities on the basis that by foregoing a portion of the purchase price it had incurred expenditure equal to the amount of the contingent liabilities. Cloete JA disagreed with the taxpayer’s contentions, stating the following:<sup>29</sup>

“To my mind, ‘expenditure incurred’ means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability. No 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. Ackermans owed Pepkor nothing in terms of the sale agreement 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.

...

“It is clear that what occurred, as is usually the case in transactions of this nature, is that the nett asset value of the business - the assets less the liabilities - was calculated and that this valuation dictated the purchase price. In 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. On the contrary, the mechanism employed in the agreement of sale resulting in the journal entries was to facilitate the sale.

“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.”

Applying these principles, it is apparent 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. Whether the outlaying of such cash or other assets results in a change in a taxpayer’s overall or net asset position will depend on the particular reason for the outlay – in some situations there will be a dilution in total assets and in other situations merely a shift of assets. For example, if a taxpayer purchases an asset and settles the purchase price by transferring shares held in another company to the seller, then although the taxpayer has incurred expenditure in acquiring the asset, the

<sup>28</sup> *Ackermans Ltd v C:SARS* 2010 (1) SA 1 (SCA), 73 SATC 1.

<sup>29</sup> At 5 and 6.

taxpayer's overall asset position will be the same assuming the value of the asset outlaid equals the value of the asset acquired.

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,<sup>30</sup> the seller has not incurred any expenditure in order for the purchaser to assume the free-standing contingent liability. The seller has not outlaid any assets (in cash or otherwise) or undertaken an unconditional legal liability to do so and has, therefore, not incurred any expenditure.

In addition, 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 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.

Section 7B(2) provides that any amount to which an employee becomes entitled from an employer for variable remuneration<sup>31</sup> is deemed to constitute expenditure incurred by the employer on the date the amount is paid to the employee by the employer. A free-standing contingent liability, such as a contingent bonus provision, may relate to an amount included within the ambit of variable remuneration. When a purchaser assumes such a free-standing contingent liability in settlement or part settlement of a purchase price owing to a seller for an asset, the employee has not been paid an amount by anyone including the seller. No expenditure is therefore deemed to have been incurred under section 7B at the time of disposal of the business.

### 5.2.3 Alternative transactions

Views have been expressed to the effect that the settlement or part settlement of the purchase price by the purchaser taking over agreed contingent liabilities is effectively the same from an economic point of view as the seller paying the purchaser to take over the liabilities and, separately, receiving the full purchase price in cash.

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 to take and the tax consequences will be based on the course of action chosen and not on the alternative choices which could have been made.

In the *Labat Africa* case cited in **5.2.2**, Harms AP noted that –<sup>32</sup>

“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 sale would be

<sup>30</sup> There are alternative ways to structure transactions. As stated above under Purpose and Background, this Note deals with transactions in which the purchaser assumes a free-standing contingent liability in settlement or part settlement of a purchase price owing to a seller for assets acquired as a going concern. This Note does not deal with the situation in which the agreement is that the seller pays the purchaser to take over a free-standing contingent liability and this liability is set off against the liability owed by the purchaser to the seller for the acquisition of the going concern. In the latter situation the seller would need to consider, amongst others, whether the requirements of section 11(a) are met.

<sup>31</sup> As defined in section 7B(1).

<sup>32</sup> At 7 in [15].

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”.

## **6. The purchaser**

It is necessary to consider whether a purchaser is entitled to a tax deduction or allowance for the purchase price of the assets acquired and, if so, the timing of the tax deduction or allowance. The availability of a tax deduction or allowance and its timing is discussed below in relation to two points in time, namely –

- at the date of sale (see **6.1**); and
- when the free-standing contingent liability becomes unconditional (see **6.2**).

### **6.1 Expenditure actually incurred at the date of sale**

#### **6.1.1 The law**

From the purchaser’s perspective, the assumption of the free-standing contingent liability is a means of settling or partly settling the purchase price payable for the assets acquired and as such is directly related to the acquisition of the assets. Accordingly, when determining the purchaser’s entitlement to a tax deduction or allowance for the amount of the free-standing contingent liability assumed as at the date of sale, it is necessary to look at the particular asset acquired and the applicable deduction provision. Typical sections which may apply include section 11(a) and (e), and sections 12C and 13.

The appropriate section which applies will depend on the particular asset acquired. All of the possible sections will not be discussed in this Note. A number of sections refer to “expenditure incurred”, “expenditure actually incurred” or “cost incurred” as one of the requirements for deductibility. “Cost” is further defined in some of the sections to mean the expenditure incurred.

In relation to section 11(e) which uses the word “value”, which is not defined in section 11(e), it has always been the policy of SARS to, unless otherwise prescribed, regard the value of assets for purposes of determining an allowance as the taxpayer’s cost of acquisition of an asset (that is, the cash cost excluding finance charges).<sup>33</sup> Cash cost is regarded as expenditure incurred.

SARS’s view is that “cost” as used in the various allowance provisions generally requires an incurral of expenditure and that the allowances must be calculated on the expenditure incurred. Accordingly, the discussion in **5.2.2** on expenditure incurred is also relevant to the application of the capital allowance provisions.

See **6.1.2** for a discussion on whether the assumption of a free-standing contingent liability constitutes expenditure in the hands of the purchaser as at the date of sale.

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<sup>33</sup> Interpretation Note 47 (Issue 3) dated 2 November 2012 “Wear-and-Tear or Depreciation Allowance”.

### 6.1.2 Application of the law

The key issue for consideration is to what extent, if any, a purchaser assuming a free-standing contingent liability has incurred expenditure at the date of sale.

See **5.2.2** for the relevant case law and principles on what constitutes “expenditure”.

The form of consideration may impact on whether a purchaser has incurred expenditure for tax purposes at the time of sale and that will impact on the availability of deductions and allowances at the date of sale even if the purchaser has performed under the sale agreement. For example, assume that a purchaser must make a cash payment and assume trade creditors and a free-standing contingent liability as consideration for assets acquired as part of a going concern. Once the purchaser has paid the cash and assumed the trade creditors and the free-standing contingent liability, the purchaser will have performed under the sale agreement and will have incurred expenditure in relation to the cash paid and in undertaking the unconditional legal liability to pay the trade creditors. However, as at the date of sale it is not yet known whether and, if so, to what extent, the free-standing contingent liability will materialise. Consequently, the purchaser has not outlaid or undertaken to unconditionally outlay cash or assets in a form other than cash at that time. In other words, the purchaser has not incurred the expenditure to the extent of the assumption of the free-standing contingent liability as at the date of sale but has merely undertaken to incur expenditure in the future should the free-standing contingent liability materialise. The failure to incur expenditure at the date of sale is unaffected by the purchaser’s obligation to settle the free-standing contingent liability should it materialise in the future or by the fact that the assumption of the potential obligation has a value agreed to by the purchaser and seller. Therefore, if, for example, the purchase price of a depreciable capital asset in the context of a going concern is R100 and it is settled by the purchaser paying R60 in cash and assuming a free-standing contingent liability of R40, on the date of sale the purchaser would potentially be entitled to an allowance calculated on an amount of R60. The amount of R40 does not qualify for an allowance on the date of sale. If and when the free-standing contingent liability materialises and the purchaser incurs expenditure of R40, the R40 will potentially qualify for an allowance.

With reference to **5.1.2**, it is true that the benefit the seller receives from the purchaser having taken over the free-standing contingent liability comprises consideration for the sale of the asset which forms part of the seller’s gross income or proceeds, while, initially at least, the same amount does not comprise expenditure in the hands of the purchaser. This outcome is not inconsistent with the provisions of the Act; it is based on an analysis of the definition of “gross income” and section 11(a) and the various allowance provisions. In the *Labat Africa* case (see **5.2.2**) it was noted that “gross income is not limited to the converse of expenditures”.<sup>34</sup>

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<sup>34</sup> 2013 (2) SA 33 (SCA), 74 SATC 1 at 8 in [17].

It is necessary to determine which assets' purchase price the free-standing contingent liabilities relate to because it may have an impact on the availability and timing of tax deductions and allowances in the purchaser's hands (see the example in **Annexure A**).<sup>35</sup> When this aspect is not dealt with in the sale agreement, the purchaser will need to allocate the amount of the free-standing contingent liabilities to particular assets acquired at the date of sale and apply that allocation consistently when determining what, if any, tax deductions and allowances are available and the timing of those deductions or allowances. The purchaser should perform the allocation on a reasonable basis in light of the objective facts and circumstances.

## **6.2 Free-standing contingent liability becomes unconditional**

### **6.2.1 The law**

The deduction or allowance section that applies when a free-standing contingent liability becomes an actual liability will depend on the type of asset acquired (that is, the particular asset whose purchase price is settled or partly settled by the assumption of the free-standing contingent liability). All of the possible sections are not discussed in this Note; however, the common key issues are discussed in **6.2.2**.

### **6.2.2 Application of the law**

It becomes necessary to consider whether the purchaser is entitled to a deduction if and when the free-standing contingent liability becomes unconditional and as a consequence the purchaser incurs expenditure.<sup>36</sup>

Factors which may be relevant to a purchaser securing a deduction are whether the expenditure –

- is of a capital or revenue nature;
- has been incurred in the production of the purchaser's income,<sup>37</sup> and
- has been incurred for the purposes of the purchaser's trade.<sup>38</sup>

These key factors are discussed below.

#### **(a) Capital or revenue**

The capital or revenue nature of the expenditure is critical because it will often determine whether the expenditure qualifies for an immediate deduction under section 11(a) (assuming all the other requirements of the section are met and a more

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<sup>35</sup> The allocation of the total purchase price to particular assets acquired is discussed in **4**. In addition, from the purchaser's perspective it is necessary to know what portion of the purchase price of a particular asset is represented by the different forms of consideration given by the purchaser, such as cash, assumption of debt, assumption of free-standing contingent liabilities and issue of shares. This allocation is necessary because the form of consideration in respect of a particular asset acquired may impact on the tax consequences or their timing for the purchaser.

<sup>36</sup> When the free-standing contingent liability relates to amounts which fall within the ambit of variable remuneration, as defined in section 7B(1), section 7B(2) provides that the amount will constitute expenditure incurred by the employer only on the date that the amount is paid to the employee concerned. This date may be later than the date on which the free-standing contingent liability became unconditional. Section 7B does not alter the true nature of the transaction as discussed in **6.2.2 (a)**.

<sup>37</sup> The "in the production of income" requirement is, for example, found in section 11(a) and the preamble to section 11 refers to deductions from income.

<sup>38</sup> The "trade" requirement is, for example, found in the preamble to section 11 and in section 23(g).

specific section is inapplicable)<sup>39</sup> or whether it potentially qualifies for a capital allowance over a number of years.

The courts have developed a number of tests for distinguishing between capital and revenue expenditure.

In *New State Areas Ltd v CIR* Watermeyer CJ, after reviewing a number of decisions of the courts in the United Kingdom, said:<sup>40</sup>

“The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be enquired 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 the 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.”

Determining the true nature of the transaction which gives rise to the expenditure is not always as obvious as it may initially appear when the purchase price of an asset is discharged or partly discharged by the assumption of a free-standing contingent liability. For example, assume a taxpayer purchased a business which consisted only of fixed assets and the taxpayer settled the purchase price by assuming a contingent bonus provision. Assuming the bonus becomes payable, must the expenditure incurred by the purchaser in settling the bonus provision be evaluated from the perspective that the purchaser incurred it in relation to the acquisition of the fixed assets? Alternatively, must the payment be looked at in isolation and evaluated from the perspective that what is being paid is an employee’s bonus which is generally of a revenue nature?

The expenditure has arisen as a direct result of the purchaser’s assumption of the free-standing contingent liability which was assumed as a means of settling the purchase price payable for the assets acquired. It was an undertaking between the purchaser and the seller. Accordingly, in determining the capital or revenue nature of the expense, the nature of the particular asset acquired must be ascertained.

Under the above example, the expenditure is of a capital nature because it was incurred as a result of the acquisition of fixed assets<sup>41</sup> which are part of the purchaser’s income-producing structure. The expenditure creates an enduring benefit since the assets will be used over an extended period and the purchase is a “once-and-for-all” non-recurring expense. Although payments of remuneration are often of a revenue nature, this is not inevitably the case and it is important to consider the primary purpose of the particular salary and wage expenditure since it could be of a capital nature.<sup>42</sup> In the example above, the purchaser’s purpose and intention was related to the acquisition of fixed assets and not to the rewarding of services rendered and the expenditure is therefore of a capital nature.

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<sup>39</sup> Section 23B(3).

<sup>40</sup> 1946 AD 610, 14 SATC 155 at 170.

<sup>41</sup> The purchase of items of trading stock would be revenue in nature – see *CIR v George Forest Timber Company Limited* 1924 AD 516, 1 SATC 20.

<sup>42</sup> For example, salaries paid to employees assigned to a project for an extended period to build and install a capital asset would be of a capital nature (see *Christchurch Press Company Ltd v C of IR* (1993) 15 NZTC 10, 206; *IRC v Land Securities Investment Trust Ltd* (1969) 2 ALL ER 430).



Generally, if the asset is a fixed capital asset (for example, a machine used to manufacture goods), the various capital allowance provisions will need to be considered. By contrast, if the asset acquired is trading stock, section 11(a) will be relevant.<sup>43</sup> With allowances that are spread over a number of years of assessment, if the asset would have qualified for an allowance in an earlier year had the free-standing contingent liability been treated as expenditure incurred in that earlier year, then the allowance which is claimed in the year the expenditure is incurred must be adjusted to take into account the allowance which would have been claimable in those earlier years.

The purchaser cannot include the expenditure in the cost of the asset, and hence deduct an allowance when one is permitted under the Act, and also claim a deduction under section 11(a) based on what the nature of the expenditure would have been in the seller's hands. The same amount of expenditure cannot simultaneously be of a capital and revenue nature and it cannot be deducted more than once.<sup>44</sup>

In a New Zealand case, *Commissioner of Inland Revenue v New Zealand Forest Research Institute Limited*,<sup>45</sup> the Privy Council<sup>46</sup> was required to consider the nature of the payment in the purchaser's hands when the purchaser settled liabilities taken on as part of the acquisition of a business. The consideration given by the taxpayer for the acquisition of the assets was a sum of money plus the assumption of specified liabilities which included liabilities (actual and contingent) attaching to the transfer of employees. New Zealand legislation provided that transferred employees should be employed on similar terms and conditions and further that the period of service with the seller be carried across to the purchaser and considered to be unbroken continuous service. The Privy Council held that the taxpayer's liability to make payments to employees for accrued leave entitlements attributable to the period of employment with the seller was part of the consideration for the acquisition of the assets and was of a capital nature. Factually, the expenditure arose as a result of an agreement between the seller and the purchaser under which the purchaser assumed the liability (vested or contingent) in relation to the acquisition of the assets. The fact that the same payment, if made by the seller, might have been revenue in nature for the seller or that it might have been income in the hands of the employees, did not alter the capital nature of the payment in the purchaser's hands when it related to the purchase price of a capital asset.

Further, the Privy Council noted that the discharge of the seller's vested or free-standing contingent liability to a third party could be part of the purchase price even if the payments were not made at once.

In the circumstances discussed in this Note, the purchaser has assumed the free-standing contingent liability as settlement or part settlement of the purchase price of the assets acquired as a going concern. For example, assume that the various assets of the going concern had a purchase price of R100 000 which was settled by

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<sup>43</sup> Given that expenditure is incurred only if and when the free-standing contingent liability materialises and the purchaser incurs expenditure in settling it, it could happen that the deduction under section 11(a) may arise in a year of assessment subsequent to the year of assessment in which the trading stock was sold.

<sup>44</sup> Section 23B.

<sup>45</sup> (2000) 19 NZTC 15,689.

<sup>46</sup> The case was heard in the High Court and the Court of Appeal before being taken on appeal to the Privy Council.

a cash payment of R80 000 and the assumption of free-standing contingent liabilities of R20 000. The purpose of the expenditure that will be incurred by the purchaser if the free-standing contingent liabilities materialise is the acquisition of the relevant assets. As indicated above, the capital or revenue nature of the expenditure will depend on the nature of the asset acquired. Situations could arise in which a purchaser assumed a free-standing contingent liability without it being consideration for the acquisition of the assets. For example, assume that the various assets of the going concern had a purchase price of R100 000 which was settled by a cash payment of R100 000. In addition, the purchaser assumed a free-standing contingent liability incidental to business to which no value was assigned. The nature of the expenditure incurred, if this free-standing contingent liability materialises, would not be determined with reference to the assets acquired because the assumption of the contingent liability was not for the acquisition of those assets.

The same approach applies to determining the nature of the expenditure when the free-standing contingent liability is one which relates to employees. For example, assume that the various assets of the going concern had a purchase price of R100 000 which was settled by a cash payment of R80 000 and the assumption of a free-standing bonus contingent liability of R20 000, payable if the employee is still in employment on a date falling after the date on which the assets were acquired as a going concern by the purchaser. In the South African context, when a business is transferred the Labour Relations Act<sup>47</sup> provides that, unless otherwise agreed under section 197(6) of that Act –

- the new employer is automatically substituted in the place of the old employer in respect of all contracts of employment in existence immediately before the date of transfer; and
- all the rights and obligations between the old employer and an employee at the time of the transfer continue in force as if they had been rights and obligations between the new employer and the employee.

In this example there are two agreements, namely, the agreement between the seller and the purchaser and the agreement between the purchaser and the employees as a result of the transfer of the contract of employment. In determining the purpose and nature of the expenditure incurred by the purchaser when the free-standing bonus contingent liability materialises, it is the agreement between the seller and purchaser which is of particular relevance. That agreement identifies the purpose of the expenditure from the purchaser's perspective, that is, the reason why the purchaser assumed the free-standing bonus contingent liability and as a result incurred the expenditure when it materialised. The obligation to pay the contingent bonus if certain conditions are met continues in force against the purchaser as *if* it had been an obligation between the purchaser and the employee, but it is not one which, from the purchaser's perspective, arose as a result of the contract between the purchaser and employee in respect of services rendered to the purchaser. The obligation to pay the expenditure arose as a result of an agreement between the seller and the purchaser under which the purchaser assumed the free-standing contingent liability in settlement or part settlement of the purchase price of particular assets acquired.

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<sup>47</sup> 66 of 1995.

The linkage between the business assets acquired and the capital nature of the payment in the hands of the purchaser also appears to be recognised by the United Kingdom authorities.<sup>48</sup>

In *City of London Contract Corporation Limited v Styles (Surveyor of Taxes)*<sup>49</sup> the taxpayer acquired part of a business which consisted of unexecuted contracts. The court held that the purchase price paid for such contracts was part of the capital invested in the business and could not be deducted from the profits arising from the performance of the contracts.

Some commentators have mentioned an unreported South African tax court case<sup>50</sup> in which the Court held that the expenditure incurred in similar circumstances was of a revenue nature. SARS is of the view that the various issues and arguments discussed in this Note were not considered in that case and that it does not, therefore, provide any persuasive authority in this regard.

### (b) Income and trade

Once the free-standing contingent liability has become unconditional and the purchaser incurs expenditure in settling it, it becomes necessary to consider whether the expenditure incurred by the purchaser meets the trade and income requirements of, amongst others, section 11(a).

Questions to ask are whether the purchaser is conducting a trade, whether that trade produces income (or to what extent it produces income) and whether the expenditure was incurred in connection with the purchaser's trade and is linked to the purchaser's income-producing activities.

The term "trade" is defined in section 1(1) as follows:

"[T]rade" 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 or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature;

In *Burgess v CIR E M Grosskopf JA* stated the following on the meaning of "trade":<sup>51</sup>

"It is well-established that the definition of trade, which I have quoted above, should be given a wide interpretation. In ITC 770 (1953) 19 SATC 216 at p 217 Dowling J said, dealing with the similar definition of 'trade' in Act 31 of 1941, that it was 'obviously intended to embrace every profitable activity and ... I think should be given the widest possible interpretation.' "

In the context of purchasing a business as a going concern, the trade requirement is likely to be met. The specific facts of each case must, however, always be considered to ensure that the purchaser does not use the assets in a way which results in the trade requirement not being met. Generally speaking, the trade requirement is not an "all or nothing" requirement but will require apportionment to

<sup>48</sup> <https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim30000> in BIM33710 and BIM33730, and <http://www.hmrc.gov.uk/manuals/bimmanual/BIM35655.htm> [Accessed 19 December 2016].

<sup>49</sup> 91. Supreme Court of Judicature (Court of Appeal), 10 November 1887.

<sup>50</sup> Case 11107, Pretoria Tax Court, 29 April 2005, unreported.

<sup>51</sup> 1993 (4) SA 161 (A), 55 SATC 185 at 196.

the extent that it is not met.<sup>52</sup> For more detail on the trade requirement see Interpretation Note 33 (Issue 4) dated 22 July 2014 “Assessed Losses: Companies: The ‘Trade’ and ‘Income from Trade’ Requirements”.

The extent to which the income requirement is met will depend on whether the activities conducted as part of the business produce “income” as defined in section 1(1) and whether the expenditure is sufficiently closely linked to an activity that produces income so as to be regarded as having been incurred in the production of income. Expenditure incurred with a dual purpose may be apportioned.

The specific facts are always critical and must be taken into account.

### **(c) Other**

In the *Ackermans* case discussed in **5.2.2** the taxpayer (being the seller) argued that if it was not allowed a deduction for the free-standing contingent liabilities assumed by the purchaser an anomaly would arise as the “expenditure” underlying the free-standing contingent liability would never be deductible. The court disagreed and stated the following:<sup>53</sup>

“There would be no bar to Pepkor [the purchaser] deducting the liabilities as and when they became unconditional, as counsel representing the Commissioner rightly conceded.”

It is inappropriate to interpret this statement as implying that the purchaser will automatically be able to deduct the free-standing contingent liabilities on revenue account if and when the contingent liabilities materialise. The court did not consider and evaluate whether the various requirements for deductibility were met from the purchaser’s perspective. There is no automatic bar to deduction in the hands of the purchaser just because the free-standing contingent liability arose in the hands of the seller. However, for the purchaser to be entitled to a deduction all the requirements for deductibility under the relevant section must be met. When the assets acquired are fixed assets in the hands of the purchaser, the expenditure incurred is of a capital nature [see **6.2.2(a)**] and the purchaser would accordingly not qualify for a section 11(a) deduction. The purchaser may qualify for the deduction of a capital allowance if the requirements of the particular allowance section are met. A deduction under section 11(a) would be available for the acquisition of trading stock.

## **7. Transactions falling within sections 41 to 47**

The scope of this Note does not necessarily consider all the effects of the application of the corporate rules contained in sections 41 to 47.

However, two questions frequently arise in the context of the corporate rules when free-standing contingent liabilities are assumed by a transferee in settlement or part-settlement of the purchase price of assets acquired as part of a going concern.

- First, are the requirements for deductibility of expenditure incurred by the transferee when a free-standing contingent liability materialises, considered independently of the transferor?

<sup>52</sup> Section 23(g) permits apportionment through the use of the words “to the extent”. For more on the subject of apportionment in the context of the general deduction formula, see AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: March 2015) in § 7.11A.

<sup>53</sup> 2010 (1) SA 1 (SCA), 73 SATC 1 at 6.

- Secondly, does the assumption of a free-standing contingent liability by the transferee mean that the transaction does not qualify for roll-over relief under an asset-for-share transaction under section 42(4)(b) read with section 42(8)(b), or an amalgamation transaction under section 44(4)(b)(i)(bb)(B)?

### 7.1 Deductibility in the transferee's hands

The comments below are based on the assumption that –

- a transferee has assumed a free-standing contingent liability in settlement or part-settlement of the purchase price of assets transferred as part of a going concern that are subject to relief under the corporate rules in sections 41 to 47; and
- expenditure is incurred by the transferee when the free-standing contingent liability materialises.

In determining whether the transferee qualifies for a deduction in respect of the expenditure incurred, it is necessary to assess whether the requirements of the relevant deduction section have been met. The principles for deductibility discussed in this Note apply equally in these circumstances. However, *to the extent* that the relief in sections 42 to 47 applies to the assets acquired, the expenditure that is incurred by the transferee when the free-standing contingent liability materialises must be evaluated within the context of the nature of the going concern business as carried on by the transferor before the transfer and by the transferee after the transfer. In making such an evaluation no regard must be had to the fact that the assumption of the contingent liabilities by the transferee was part of the consideration for the acquisition of the assets. The circumstances under which the free-standing contingent liability arose in the hands of the transferor as well as the transferee must therefore be taken into account in determining the deductibility of the expenditure.

The sections requiring consideration will usually encompass but are not limited to section 11(a), section 7B and section 23(g).

For example, assume the transferor originally assumed the free-standing contingent liability as consideration for a capital asset when it acquired the business as a going concern from an unrelated third party. The transferor subsequently transferred the business to the transferee and the transferee assumed responsibility for the free-standing contingent liability as part settlement of the purchase price. The transferee continued the business in the same way as the transferor. The nature of the expenditure when subsequently incurred by the transferee will remain of a capital nature.

In the next example assume the facts are as set out in the preceding paragraph. However, immediately after the acquisition of the business the transferee uses one of the capital assets (A) acquired from the transferor to produce exempt income in its existing business. The transferee also discontinues the use of another capital asset (B) acquired from the transferor when a new model of the asset becomes available. Assets A and B do not meet the requirements of “in the production of income” and “used in the taxpayer’s trade” respectively even though the transferor might originally have met those requirements.

The expenditure incurred when a contingent liability materialises may retain the same character regardless of whether it would have arisen in the transferor or transferee’s

hands. For example, assume the transferor raised a bonus provision for employee services rendered in the earning of taxable sales income and that had it materialised the expenditure incurred would have been of a revenue nature. After the acquisition of the business the transferee carries on the going concern in the same manner as the transferor and settles the bonus provision when it becomes unconditional. The expenditure incurred by the transferee would be of a revenue nature assuming no additional facts emerge to impact the transaction.

## **7.2 The part-disposal rules in sections 42(4) and 44(4)**

Section 42(4) provides that the provisions of section 42 may be applied only to the extent that the consideration for the asset or assets concerned is in the form of equity shares issued by the company acquiring the asset or the debt specified in section 42(8).

Free-standing contingent liabilities generally represent potential debt which may or may not arise depending on the occurrence or non-occurrence of one or more uncertain future events. However, in the context of a transfer of a going concern, SARS accepts that “debt” as used in section 42(8)(b) includes free-standing contingent liabilities. In this regard, section 42(8)(b) specifically deals with the transfer of a business as a going concern and it is submitted that the legislature clearly envisaged that such a transfer would include the assumption of free-standing contingent liabilities as other consideration.

Similarly, debt in the context of section 44(4)(b)(i)(bb)(B) will be interpreted to include free-standing contingent liabilities which are assumed as other consideration for assets acquired as part of the acquisition of a going concern.

## **8. Conclusion**

In summary, when the seller disposes of a business as a going concern and the purchase price of the assets disposed of is partly settled by the purchaser assuming a free-standing contingent liability –

- the seller must include the agreed value of the free-standing contingent liability assumed by the purchaser in gross income and proceeds (as appropriate);
- the seller does not incur expenditure in relation to the assumption of the free-standing contingent liability by the purchaser and is not entitled to a deduction;
- the purchaser will incur expenditure only if the free-standing contingent liability materialises and the purchaser is required to incur expenditure in settling the liability at that time; and
- in the purchaser’s hands the assumption of the free-standing contingent liability relates to the assets acquired and any deduction must be determined with reference to the deduction and allowance provisions which apply to the particular assets whose purchase price was settled or partly settled by the assumption of the free-standing contingent liability.

Embedded obligations and valuation provisions (see 3) depress the value of the asset and do not represent an additional amount of proceeds.

**Legal Counsel**  
**SOUTH AFRICAN REVENUE SERVICE**

**Annexure – Example**

X and Y enter into an agreement of sale under which X acquires the assets detailed in the table below. The assets constitute the acquisition of a business as a going concern.

| <b>Asset</b>  | <b>Purchase price<br/>R</b> |
|---|-----------------------------|
| Bank account  | 50 000                      |
| Debtors (expected to be fully recoverable, no provision for doubtful debts) | 50 000                      |
| Trading Stock   | 200 000                     |
| Computers   | 150 000                     |
| Plant and Machinery   | 400 000                     |
| Goodwill  | <u>250 000</u>              |
| <b>Total purchase price</b>   | <b>1 100 000</b>            |

The purchase price is to be discharged by X by –

- paying cash of R120 000;
- assuming the trade creditors of R160 000; and
- assuming the estimated contingent warranty liability of R820 000.

X determines that the cash and the assumption of the trade creditors and contingent warranty liability will be allocated to bank, debtors, trading stock, computers, plant and machinery and goodwill. That is, the cash of R120 000 will be allocated to bank (R50 000), debtors (R50 000) and trading stock (R20 000); the trade creditors of R160 000 will be allocated to trading stock and the contingent warranty liability will be allocated to trading stock (R20 000), computers (R150 000), plant and machinery (R400 000) and goodwill (R250 000).

**Seller – tax considerations as at the date of sale**

| <b>Asset</b>  | <b>Purchase price<br/>R</b> | <b>Tax impact</b>   |
|---|-----------------------------|---|
| Bank account  | 50 000                      | No gain or loss – purchase price equal to base cost.  |
| Debtors (expected to be fully recoverable, no provision for doubtful debts) | 50 000                      | Proceeds of R50 000 – sold at original face value therefore no gain or loss on disposal.  |
| Trading Stock   | 200 000                     | Gross income of R200 000  |
| Computers   | 150 000                     | Proceeds of R150 000 – consider whether there is – <ul style="list-style-type: none"> <li>a) a recoupment/revenue loss [section 8(4)(a) and section 11(o)] and</li> <li>b) a capital gain (Eighth Schedule).</li> </ul> |
| Plant and Machinery   | 400 000                     | Proceeds of R400 000 – consider whether there is – <ul style="list-style-type: none"> <li>a) a recoupment/revenue loss [section 8(4)(a) and section 11(o)] and</li> <li>b) a capital gain (Eighth Schedule).</li> </ul> |



|  |                             |  |
|--|-----------------------------|--|
| Goodwill   | 250 000                     | Proceeds of R250 000, internally generated and no base cost therefore a capital gain of R250 000.  |
| Contingent warranty liability  |                             | No deduction because Y has not incurred any expenditure as at the date of sale.  |
| <b>Purchaser – tax considerations as at the date of sale</b>   |                             |  |
| <b>Asset</b>   | <b>Purchase price<br/>R</b> | <b>Tax impact</b>  |
| Cash   | 50 000                      | N/A  |
| Debtors (expected to be fully recoverable, no provision for doubtful debts)  | 50 000                      | N/A  |
| Trading Stock  | 200 000                     | Expenditure incurred and deductible under section 11(a) at the date of transaction equals R180 000 (cash R20 000 and trade creditors R160 000). R20 000 is not deductible because as at the date of sale the expenditure has not yet been incurred.* |
| Computers  | 150 000                     | As at the date of sale the purchaser has not incurred expenditure and will not qualify for a section 11(e) allowance.*   |
| Plant and Machinery  | 400 000                     | As at the date of sale the purchaser has not incurred expenditure and will not qualify for a section 12C allowance.*   |
| Goodwill   | 250 000                     | As at the date of sale the purchaser has not incurred expenditure and will not have base cost at that date.*   |
| <p>* If the free-standing contingent liability materialises and X incurs expenditure in settling it, X must consider whether X is entitled to a deduction or allowance under section 11(a), section 11(e) and section 12C as appropriate, taking into account that the expenditure was incurred partly for the settlement of the purchase price allocated to trading stock, computers, plant and machinery and goodwill, in that order.</p> <p>The amount of expenditure actually incurred is the amount which is taken into account – if the amount of expenditure actually incurred is less than the amount of the free-standing contingent liability as valued at the date of sale, X will be limited to the amount of expenditure actually incurred; if the amount of expenditure actually incurred is more than the amount of the free-standing contingent liability (as valued at the date of sale) it means the assets were more expensive than X originally envisaged and X may take the actual amount of expenditure incurred into account when determining what allowances and deductions are available.</p> |                             |  |