Synopsis

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Is an issue of shares expenditure? – the SCA settles the dilemma

Over the past seven years there has been debate over whether a company that acquires goods or services and tenders payment for such goods and services by way of an allotment of shares incurs expenditure for tax purposes.

Two matters with conflicting outcomes were decided in the South Gauteng Tax Court and the North Gauteng Tax Court respectively. In ITC 1783 (2004) 66 SATC 273, Goldblatt J held that the issue of shares was not expenditure as contemplated in section 11(gA) of the Income Tax Act. Jooste AJ ruled to the contrary in ITC 1801 (2006) 68 SATC 57, holding that the issue of shares did indeed represent expenditure as contemplated in section 11(gA). The High Court upheld the decision in ITC 1801 in the matter of *C:SARS v Labat Africa Limited* (2010) 72 SATC 75.

The Supreme Court of Appeal (*C:SARS v Labat Africa Limited* (2011) ZASCA 157, judgment delivered 28 September 2011) has finally determined the issue, and established the principle that the issue of shares as consideration for the acquisition of an asset does not constitute expenditure actually incurred in respect of qualifying intellectual property.

The facts

The facts of the matter are relatively simple. The taxpayer entered into a contract to acquire the business of another company for a price of R120 million and agreed to discharge this obligation by the issue of 133 333 333 ordinary shares at an issue price of 90 cents per share. The agreement allocated the purchase price to the net tangible assets at their book values, to a trademark at a value to be determined by an independent valuation and any balance remaining was allocated to goodwill. The company claimed a deduction of allowances in respect of the trademark. SARS disallowed the deduction on the basis that the deduction was to be calculated in respect of expenditure incurred in acquiring the trademark and SARS asserted that, in issuing shares, the company incurred no expenditure.

The original decision

In the Tax Court, the judgment had proceeded on the basis that a taxpayer incurs expenditure when it becomes unconditionally obliged to make payment. In this case, the company had become obliged to make payment of R120 million and it discharged this obligation by issuing the shares. The Tax Court also found UK decisions on similar issues persuasive and ruled that the company had incurred expenditure in acquiring the trademark. These views had been confirmed by a full bench in the High Court.

The decision on appeal

The SCA adopted a more reductionist approach. The relevant section of the law allows a deduction based on expenditure on the asset concerned. Therefore the issue was that one must establish what "expenditure" means.

It rejected earlier decisions which established the meaning of

The Court had been referred to a series of UK decisions which have stood for almost 70 years which allowed deduction for "consideration" given in payment for the acquisition of assets.

"expenditure actually incurred" on the basis that they were directed towards determining when expenditure is incurred and not with what constitutes "expenditure" (*Edgars Stores Ltd v CIR* 50 SATC 81 (A), *Nasionale Pers Bpk v KBI* 48 SATC 55 (A), and *Golden Dumps (Pty) Ltd v CIR* 55 SATC 198 (A)). These cases held that expenditure is incurred when a liability or obligation arises.

The true approach, said the SCA, is to be found 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 that year or not'" (the Court's emphasis added).*

Thus, the issue was not whether a liability had arisen or an obligation had been imposed on the taxpayer; the question was whether there was a liability requiring expenditure.

The Court found that the contract was not a sale, as it did not require the payment of money. Here it relied on the decision in *Lace Proprietary Mines Ltd v CIR* 9 SATC 349 (A), in which it had been held (at 361):

"The reference in [the contract] to the sum of £250,000 and to the nominal value of the shares (five shillings) cannot override the true intention of the parties which was that the true consideration was 1,000,000 shares in the purchasing company. No cash consideration could be demanded from the purchaser who was entitled and obliged to deliver these shares in fulfilment of its obligation to pay for the assets bought."

It should be noted that the matter at issue in the above case was not whether the company had incurred expenditure, but the determination of the amount that had been received by or accrued to the taxpayer.

Reliance was also placed on the decisions in *CIR v Estate Kohler & others* 18 SATC 354 (A) and Estate Furman & others v CIR 25 SATC 4 (A). In those matters the Courts had found that the issue of shares by a company is not a donation by the company (for purposes of estate duty determination) because nothing passes from the company.

The kernel of the SCA decision is to be found in paragraph [12] of the unanimous judgment of the Court, delivered by Harms AP:

"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. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends."

Applying this principle, unless the company parts with cash or another asset in consideration for the asset that it acquires, the company does not incur "expenditure".

An opportunity lost?

The Court had been referred to a series of UK decisions which have

stood for almost 70 years which allowed deduction for "consideration" given in payment for the acquisition of assets. The most recent of these, a decision of the *House of Lords in Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd* [1982] 2 All ER 942, included a review of the position on company law and two earlier decisions on tax law.

The judgment of Lord Roskill referred to the following statement from *Ooregum Gold Mining Company of India Limited v Roper* [1892] AC 125 at 136 -137, in which the Court had opined that the issue of shares in consideration for an asset was no different than receiving a subscription in cash and then repaying the cash to the subscriber in consideration for the acquisition of an asset.

"'A company is free to contract with an applicant for its shares; and when he pays in cash the nominal amount of the shares allotted to him, the company may at once return the money in satisfaction of its legal indebtedness for goods supplied or services rendered by him. That circuitous process is not essential. It has been decided that, under the [Companies] Act of 1862, shares may be lawfully issued as fully paid up, for considerations which the company has agreed to accept as representing in money's worth the nominal value of the shares."

Lord Roskill (at page 951) concluded:

"My Lords, it is thus established beyond question that, in ascertaining the cost of acquiring 'stock' for the purpose of arriving at the taxpayer's trading profit when that stock has been acquired in return for shares credited as fully paid, being issued for a consideration other than cash, it is the cost to the taxpayer of that stock which is, at least prima facie, the relevant figure, and that, unless the agreement can for some reason be 'impeached', the Revenue is not entitled to go behind the price which the taxpayer has paid whatever the means by which that obligation to pay that price has by agreement between the parties been discharged."

This decision was dismissed as apparently not having bearing on the meaning of "expenditure" as used in the Income Tax Act. With respect, it encapsulated precisely the position argued by Labat Africa Limited. A company had agreed to pay a price and the parties had agreed that the discharge of that price should be effected by way of an issue of shares. The logic applied by Lord Roskill was supported by impeccable authority at company law and by an earlier decision of the House of Lords. In contrast, the SCA relied on a decision that related to the valuation of receipts and accruals and on two decisions that related to whether there had been a donation (all of which might equally have been distinguished as not being directly in point).

As a result, an opportunity to align our legal principles with current commercial practice and the principles applied in other jurisdictions has slipped by and we are left with a binding principle that runs counter to conventional thinking that the company parts with value when it issues shares as consideration for an asset.

A partial solution has been provided by Parliament

It should be noted that Parliament introduced a statutory resolution of the issue which took effect retrospectively to 1 October 2001 for capital gains tax purposes and from 24 January 2005 in any other case. Section 24B of the Income Tax Act provides, as a general principle, that the issue of shares will be deemed to be expenditure and sets out the basis to be applied to determine the amount of the expenditure. This was a pragmatic step that aligned the law with generally accepted commercial principles.

But, section 24B is of limited application. It does not extend to payments for services, for example. In an age in which share incentives are a widely-used form of remuneration, this raises issues of concern. There are, on the one hand, clear rules to establish when and how the employee will be taxed in respect of any benefit from a share incentive scheme, but no consistent corresponding rule, on the other hand, that establishes how the employer company should treat the benefit that has clearly been given by it.

A deduction is permitted in respect of the market value of any equity share issued in terms of a broad-based employee share participation scheme which meets the requirements of section 8B. However, this deduction does not extend to any other share incentive schemes.

On the basis of the *Labat Africa Limited* decision, a company that issues shares as a form of remuneration, other than in terms of a broad-based equity participation scheme, incurs no expenditure. An extension of the principles set out in section 24B to all payments for services in the form of an issue of shares to remove this anomaly would be a welcome addition to the Income Tax Act.

Amending a trust deed – a cautionary tale

It is vital that the consent of beneficiaries be sought in the event of any agreement to bring about a change in the composition of the class of beneficiaries.

A businessman, acting on the advice of his attorney, formed a trust in 1999.

The capital beneficiaries were his two (minor) children and the income beneficiaries were a class of persons determined at the discretion of the trustees comprising the two capital beneficiaries and persons related to them by consanguinity and affinity, determined. The capital was to vest in the capital beneficiaries not earlier than the date that the younger beneficiary attained the age of 21 years and not later than the date such beneficiary attained the age of 25 years.

The trustees were the founder, his attorney and his accountant.

The deed contained a clause giving power to the trustees to amend the capital beneficiaries of the trust during the lifetime of the founder and, with his consent, subject to certain restrictions limiting the class of persons who may be added as capital beneficiaries.

Following a bitter divorce, the founder remarried in 2003 and his spouse had two children by a former marriage. The founder then determined to amend the deed of trust, to add to the class of beneficiaries his (new) spouse and her children. A deed of variation giving effect to this was drawn and duly executed in 2004.

The founder died in 2008 and the children who had been named as the original capital beneficiaries contested the validity of the agreement to amend the deed of trust.

The High Court had determined the matter and issued an order that effectively divided up the trust capital among the competing parties, and both groups of litigants found the order unacceptable and appealed against the High Court order to the Supreme Court of Appeal (*Potgieter v Potgieter* [2011] ZASCA 181 – judgment delivered 30 September 2011).

Modern trust deeds seek to achieve flexibility, on the understanding that the circumstances of a family may change unexpectedly.

Power to amend a deed of trust

The law relating to this issue is well-established, as noted in the judgment of Brand JA, who delivered the unanimous decision of the Court (at [18]):

"... [A] trust deed executed by a founder and trustees of a trust for the benefit of others is akin to a contract for the benefit of a third party, also known as a stipulatio alteri. In consequence, the founder and trustee can vary or even cancel the agreement between them before the third party has accepted the benefits conferred on him or her by the trust deed. But once the beneficiary has accepted those benefits, the trust deed can only be varied with his or her consent. The reason is that, as in the case of a stipulatio alteri, it is only upon acceptance that the beneficiaries acquire rights under the trust (see eg Crookes NO v Watson *1956 (1) SA 277 (A) at 285F; Ex parte Hulton 1954 (1) SA 460 (C) at 466A-D;* Hofer v Kevitt *NO 1998 (1) SA 382 (SCA) at 386G-387E; Cameron, De Waal & Wunsh Honoré's South African Law of Trusts 5 ed (2002) para 304)."*

The attack on the validity of the amendment

The children contended that the benefits conferred on them in terms of the deed of trust had been accepted on their behalf by their father, as their legal guardian at the time of execution of the trust deed. The deed of trust had stated in its

preamble (as translated by the Court from the original Afrikaans text at [19]) as follows:

"And whereas the beneficiaries have indicated (Afrikaans – 'aangedui') their acceptance of the benefits conferred upon them in terms hereof"

They had only become aware of the amendment after the death of their father, and therefore claimed that there was a lack of consent to the amendment.

The attorney who had prepared the deed of trust gave evidence that the words had been incorporated because he had slavishly copied another document, and that the founder had never intended that there should be acceptance of the benefits at the time of execution of the document. The other trustee who had been a party to the document made the statement that the founder had never expressly stated that he accepted the benefits on behalf of the capital beneficiaries.

The Court rejected the evidence of the trustees (at [21]):

"There is no reason to think that the deceased, who was by all accounts a careful and astute businessman, had realised that his attorney wanted him to confirm a meaningless statement in a formal document which was destined to be notarially executed. On the contrary, the fact that the deceased had initialled every page of the document that was to be notarially executed, gave rise to the presumption of fact that he intended to confirm the pronouncement embodied in that document (see eg Glen Comeragh (Pty) Ltd v Colibri (Pty) Ltd *1979 (3) SA 210 (T) at 216A-C, referred to with approval by Harms DP in* KPMG Chartered Accountants (SA) v Securefin Ltd *supra para 28). Moreover, common sense dictates that at that stage the deceased indeed intended to give effect to this essential purpose for the creation of the trust by accepting the benefits conferred upon his two minor children on their behalf. Absent any evidence to the contrary, it must therefore be accepted as an established fact that the deceased intended to confirm the contents of the document that he signed."*

The Court rejected arguments that the pronouncement in the preamble was vague and could not be interpreted as an acceptance on behalf of the children. On the contrary (at [22]) it found:

"... [O]nly two capital beneficiaries were expressly named in the trust deed. Confirmation that these beneficiaries had accepted the benefits conferred upon them could therefore refer to no-one else. As a matter of law, their father and natural guardian had authority to accept these benefits on their behalf and that is plainly what he intended to confirm."

Contingent rights were involved

It was argued then that the rights of the beneficiaries were contingent rights in the sense that, at the time of the variation of the deed of trust, no right to receive the capital of the trust had vested in the beneficiaries. The Court made short shrift of this submission, holding (at [28]):

"The import of acceptance by the beneficiary is that it creates a right for the beneficiary pursuant to the trust deed, while no such right existed before. The reason why, after that acceptance, the trust deed cannot be varied without the beneficiary's consent, is that the law seeks to protect the right thus created for the first time. In this light, the question whether the right thus created is enforceable, conditional or contingent should make no difference. The only relevant consideration is whether the right is worthy of protection, and I have no doubt that it is. Hence, for example, our law affords the contingent beneficiary the right to protect his or her interest against mal-administration by the trustee (see Gross v Pentz *1996 (4) SA 617 (A) at 628I-J)."*

The variation was accordingly declared invalid.

The moral

Modern trust deeds typically seek to achieve flexibility, on the understanding that the circumstances of a family may change unexpectedly. The "flexibility" in the form of power to amend the deed of trust that was apparently designed to cater for unforeseen changes in circumstances in this instance proved to be ineffective once the deed was signed. It is vital that the parties to a trust arrangement keep in mind the requirement that the consent of beneficiaries should be sought in the event of any agreement to bring about a change in the composition of the class of beneficiaries.

SARS' right to reopen assessments

A matter recently came before the Tax Court in the Western Cape (Cases No 12760, 12828 and 12756 – heard as a single matter – judgment given 14 September 2011) which dealt, inter alia, with the right of SARS to reopen an assessment.

The matter dealt with the taxation of benefits that accrue to participants in so-called deferred delivery share schemes. Two of the taxpayers (identified as "ABC" and "DEF") had not filed information relating to their participation in the scheme during the 2001 (ABC) and 2003 (DEF) years of assessment and had been duly assessed to tax in December 2001 (ABC 2001) and December 2003 (DEF). SARS had become aware of the share scheme in the course of an audit of the employer of the taxpayers and, following review of their returns for the 2001 and 2003 years of assessment, determined in 2008 to issue additional assessments imposing tax on the amounts identified.

Their appeal was based on two issues. The first was that SARS is precluded from issuing an additional assessment more than three years after the date of the original assessment unless it is satisfied that the failure to raise an assessment is due to fraud, misrepresentation or non-disclosure of material facts. The second was that an additional assessment may not be raised after a lapse of three years if the assessment was made in accordance with the practice generally prevailing at the time it was issued.

On the first issue, SARS had explained the issue of the additional assessments as follows:

"[a]ssessments in respect of the 2001 and 2003 tax years have been raised in terms of proviso (i)(aa) to Section 79(1) of the Act. The assessments that have expired have been raised due to the fact that the Commissioner is satisfied that there was non-disclosure or in the alternative misrepresentation, of material facts in your tax returns regarding the gains made in terms of Section 8A of the Act".

However, the letter did not state the obvious, namely, that the failure to disclose was the cause of the taxpayers' not having been assessed to tax in respect of the relevant amounts, and this causal connection was only made in subsequent correspondence. The Court found that the failure to state the necessary causal connection at the time of issue of the additional assessment was a fatal omission.

One might be tempted to inquire if, in the event that no information has been given, any other cause could conceivably exist for a failure to assess the amount to tax? The failure could only be because the amount was not brought to the attention of SARS.

That said, the taxpayers had a second string to their bow. This was that, at the time the original assessment was issued, the practice generally prevailing at SARS was that the acquisition of shares in terms of a deferred delivery scheme was not taxable.

The evidence of a SARS official was that, prior to the matter in issue, he had not found any evidence at any SARS office assessing a company or trust operating a deferred delivery scheme or any participant in any such scheme to tax. He testified that he had from 1996 considered that the schemes effectively avoided tax and that he had written two internal memoranda to the SARS legislative committee to that effect.

The SARS official investigating the matter also made concessions during cross-examination which indicated that, until she and the audit team engaged on the investigation of the relevant scheme had determined in February 2004 to raise a PAYE assessment on the employer of DEF in respect of benefits accruing to its employees, no assessor had done so before. The Court also examined the viewpoint of SARS as contained in its correspondence and concluded (at [62]):

"Ms M could not have been satisfied … that in May or June 2008 the SARS' assessors who had issued the original assessments for the 2001 and 2003 years would have assessed those gains to tax had the relevant facts been known to them and Ms M conceded as much during cross-examination."

The appeal was based on two issues: that SARS is precluded from issuing an additional assessment more than three years after the date of the original assessment; and that an additional assessment may not be raised after three years if the assessment was made in accordance with the practice generally prevailing at that time.

In the result, the taxpayers successfully contested the additional assessments issued more than three years after the date of the original assessments on the basis that they would not, in any event, have been assessed to tax in terms of a practice generally prevailing at the time of issue of the original assessments.

The onus of proof in disputing an estimated assessment

The Tax Administration Bill, currently under consideration by Parliament, provides in section 95(1) and (2) that if a person fails to submit a return as required or submits a return or information that is incorrect or inadequate, SARS may make an original, additional, reduced or jeopardy assessment based in whole or in part on an estimate.

The usual rule (see section 102 of the Tax Administration Bill, which is the counterpart to section 82 of the Income Tax Act which will be repealed when the Tax Administration Act comes into force) is that the onus of proving an assessment to be wrong rests on the taxpayer.

However, after the coming into force of the Tax Administration Act, the burden of proof in relation to an *estimated assessment* will be significantly different for section 102(2) provides that "The burden of proving whether an estimate under s 95 is reasonable ... is upon SARS".

SARS' right to reopen assessments

The "commercial purpose test" is brought into play

This matter is also noteworthy for the fact that the Court, for the first time since its enunciation by the Supreme Court of Appeal in *C:SARS v NWK Limited* 73 SATC 55 at 72 apparently sought to apply the newly developed "test" for a simulation, namely that a transaction is a simulation if its only real and sensible commercial purpose is the avoidance of tax. The Court's logic is to be found in the following extracts from its conclusions:

" [170] In terms of section 82, the appellants must prove that the gains are not taxable. They have to prove that they and not the respondent are correct as to the interpretation and true meaning and effect of the scheme and agreements.

[171] Conventional option schemes were until October 2004 taxable under section 8A. Conventional purchase schemes were taxable under paragraph 2(f) of the seventh schedule. [The employer's] 1997 scheme was an attempt to avoid both provisions. There is of course nothing sinister in seeking to avoid tax. Provided that tax avoidance is not the only *"real and sensible commercial purpose"* of the scheme. [see: NWK casesupra]

[172] I find that the gains made under the XYZ Share Option incentive Scheme prior to 26 October 2004 are taxable under Section 8A. Those gains made after 26 October 2004 are taxable under Section 8C."

This raises the very issue that commentators predicted might arise as a result of the statement of the law in *NWK Limited*, namely that, if the Courts apply the commercial purpose test and determine that there has been simulation, SARS has no need to invoke the more rigorous requirements of the general anti-avoidance provisions in the Income Tax Act. These require that tax avoidance must be the sole or main purpose of the transaction and, in addition, that the transaction should exhibit characteristics indicative of a lack of commercial substance. Typically, an employee incentive scheme has purposes other than the avoidance of tax, and it would have been interesting to consider whether the scheme would have been found to be a tax avoidance scheme under the general anti-avoidance requirements (particularly as it was the internal view of SARS that it would not).

Notwithstanding that the general view is that the statement of Lewis JA regarding the real and sensible commercial purpose were obiter and did not form part of the reasons for the decision in *NWK Limited*, this is not entirely clear from the judgment itself. Lower courts may therefore consider themselves bound to follow this principle, unless they are sufficiently bold to declare that the statement is not binding on them because it was not the reason for the decision.

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