THE INCOME TAX CONSEQUENCES OF CLOSING DOWN A DIVISION OR A BRANCH OF A COMPANY

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Abstract

It is a sign of today's economic realities that divisions and branches of companies are from time to time being closed down. This article investigates the income tax implications of this scenario with regard to the various expenses and costs incurred by the company. Special attention is given to the taxation implications of recurring expenses continuing after the actual close down as well as the aspects affecting trading stock, allowances in respect of capital assets and the position of debtors.

Key words

Bad debts
Capital allowances
Capital nature
Collection costs
Compromise payment
Delegation of obligations
General deduction formula
Interest
Irrecoverable debts
Lease instalment
Lump-sum payments
Maintenance contract
Production of income
Retrenchment pay
Rental
Scrapping allowance
Trade Test
Trading stock
Unexpired contracts
Warranty

1. INTRODUCTION

Due to the current economic situation, the reality is that companies find themselves in a position requiring the closing down of non-profitable or marginal divisions or branches.

Naturally the tax implications of such a step will be of vital importance to a company facing the decision of such a closure. Uncertainty in some areas

provides the opportunity for tax planning prior to the implementation of the decision.

With this in mind this article attempts to answer a number of contentious issues and will provide, to the extent possible, guidelines for those companies contemplating such a step.

2. UNEXPIRED CONTRACTS AT TIME OF CLOSURE

2.1 Expenditure deductible in terms of the general deduction formula

2.1.1 Section 11(a) of the Income Tax Act

For expenditure to be deductible of income from trade, the well-known requirements of section 11(a) of the Income Tax Act 58 of 1962 have to be met. When a business or part of it is terminated, the inevitable questions will be:

(a) Does the expenditure passes the trade test?

(b) Is the expenditure in the production of income?

(c) Is the expenditure of a capital nature or not?

Although these requirements are said to be so well-known that repetition of "the tests", enunciated by our Courts, will lead to you, the reader, peacefully dozing off, these tests are the cornerstone on which any investigation into the deductibility of expenditure rests.

2.1.2 The trade test

In the context of this enquiry, the existence of an observable trade is assumed, but the impact of the "cessation of certain operations" needs to be examined.

Once trading has ceased section 11(a) will prohibit the deduction of expenditure incurred after the event, if such expenditure relates specifically to that part of the trade that has been ceased. This statement, however, does not dispose of two difficulties, namely when does trading cease and when was the expenditure incurred.

In *ITC 411* (10 SATC 238) the court drew a distinction between a continuing business and a business which has completely ceased in order to find that interest expenditure incurred after the complete cessation of income-producing operations, is not deductible.

Although the court seemed to confuse the principles of the trade test with the other requirements of section 11(a), it was found in *ITC 1013* (25 SATC 321) that expenditure incurred after the dissolution of a professional partnership was deductible. The fact that the taxpayer continued in his profession after the dissolution, played a significant role in coming to this decision. The following *dictum* explains the Court's reasoning:

> "But in my view, with an individual who can carry on his profession either on his own or in partnership with others, there is a continuity of action even if he changes partners in the course of time, sufficient to warrant one saying that obligations incurred under one partnership which carry on even after formation of a new partnership are obligations incurred for the purpose of trade and not necessarily capital obligations".

The decision to which the Court came, is understandable in the light of its finding that the partnership, not being a legal entity, was merely a vehicle of association through which the taxpayer carried on his profession.

It can be deduced that, if there is a continuity of the trade carried on, albeit on different premises and in different circumstances, the expenditure incurred after ceasing to do business as before, will pass the trade test. If however a completely new trade is embarked upon, it will not give rise to a deduction of the expenditure unconnected with the new trade.

More problematic is the question of when the expenditure has been incurred in order to decide whether the expenditure can be related to a trade carried on. When a cessation of trade occurs, expenditure that can be related to the trade prior to cessation will be deductible. On the other hand continuous expenditure will only be deductible if it may be said to have been incurred for the purpose of a new trade.

In *ITC 1029* (26 SATC 54) expenditure incurred by an architect, after he had retired from active practice, was found to be deductible. In this case the expenditure namely payment in respect of a guarantee for faulty waterproofing of a building, related to work done prior to his retirement. The President of the Special Court said the following:

> "Accordingly, I consider that if expenditure is deductible by a taxpayer while he carries on business, the fact that he ceases to carry on that business does not render such expenditure non-deductible provided that it arises out of the taxpayer's activities prior to the cessation of his business operations."

Although the taxpayer lost his case on appeal [*COT v Cathcart* (1965(1) 507 (SRAD)], the Appeal Court did not disapprove of the abovementioned reasoning, but found against the taxpayer on a different ground.

Two similar cases, that of *ITC 1135* (31 SATC 228) and *ITC 1171* (34 SATC 80) dealt with interest paid after cessation of trade on moneys borrowed before the cessation of trade. Although in both instances the Court held that the initial borrowings were for the purpose of trade, the taxpayers were not allowed to deduct the interest expenditure when the trade was no longer in existence. The inference to be drawn from these cases may be summarised as follows:

(a) The taxpayer was at liberty to repay the loans whenever he so wished. Therefore the decision to repay the loans occurred after cessation of trade and could not be said to relate to the prior trade.

(b) The taxpayer could not show that the expenditure in the form of interest was incurred for the purpose of a continuing or new trade.

Divaris & Stein (1989:7-52) state that:

> "... it would appear that the general principle in operation is that expenditure incurred under an obligation assumed - in the production of income and wholly and exclusively for the purposes of the trade conducted in that business - during the course of its existence will continue to be deductible despite the cessation of the business."

For this proposition reliance is placed on *ITC 1029* (26 SATC 54) and *ITC 729*(18 SATC 96).

Why were the taxpayers in *ITC 1135* and *ITC 1171* then in the unfortunate position that the interest payments were disallowed as deductions notwithstanding the trade purpose when entering into the loan? It is submitted that these unfavourable results may be attributable to at least three causes, namely:

(a) A false doctrine in respect of the true nature of interest and the exact point in time when interest is actually incurred for income tax purposes.

(b) A misconception as to the scope of the phrase "carrying on any trade".

(c) A misapprehension with regard to the true meaning of the phrase "in the production of income".

Causes (a) and (b) shall be discussed here, while cause (c) will be dealt with under 2.2.1.

The fallacy that interest expenditure is incurred only from day to day, reached its climax in *ITC 1485* (52 SATC 337) and *ITC 1496* (53 SATC 229). In both cases, Melamet J, who presided in the Special Court found, albeit on dubious authority and contrary to the common law, that interest expenditure for which an unconditional liability was incurred, was incurred for purposes of income tax only on a day to day basis. However, the tide turned against this false doctrine, when Van Dijkhorst J in *ITC 1587* undertook a thorough investigation into the nature and characteristics of interest expenditure and the exact point in time when it was incurred for income tax purposes. In a well reasoned judgment, he convincingly refuted this false doctrine. The following passage clearly summarises the view of the Court:

> "For the reasons set out above we find that the proposition in these two cases that interest cannot be incurred prior to the time during which the money lent is used but only accrues from day to day is too widely stated and clearly wrong. We decline to apply such principle" (57 SATC:107).

In *ITC 1588* (57 SATC 148) Van Zyl J again covered the same ground. With regard to the judgments of Melamet J in *ITC 1485* and *ITC 1496*, he made the following statement:

> "These judgments have been criticised by Van Dijkhorst J ... . According to the learned judge at [p107] the proposition ... that interest cannot be incurred prior to the time during which the money lent is used but only accrues from day to day is too widely stated and (is) clearly wrong. See also the well reasoned criticism in the editorial of the Taxpayer 39.10 (1990) 181-4.
>
> I must respectfully associate myself with the said criticism inasmuch as it would appear that there is no binding or even persuasive authority to support the observation that interest is inherently characterised by its being incurred and accruing from day to day. If this view of the character or nature of interest prompted the learned judge to hold that the liability to pay interest is conditional and hence not an expenditure actually incurred it cannot, with respect, be endorsed" (57 SATC:152).

These two well-considered judgments, not only restored clarity as to the true nature and exact point in time when interest are actually incurred, but impelled Parliament to enact a new section 24J in the Income Tax Act which governs the

timing of the accrual an incurral of interest.

Abovementioned discussion justifies the conclusion that interest expenditure incurred prior to cessation of trade, will continue to be deductible after closing down a portion of the trading operations of a concern, if the "trade" and "production of income" - requirements can be met.

Normally the closure of a branch or division of a company will not entail that a continuous trade is no longer carried on by the company. This view was taken even a step further in CASE 9691 [as yet unreported, but discussed by K Mitchell with the taxpayer's consent in (1995) 9 Tax Planning 95-96] by Alexander J when he said that the:

> "...appellant pivots its case on the peculiar feature of a mining venture which by its very nature must come to an end sooner or later, when inescapable liabilities, always contemplated but as yet incalculable, will then become liquidated and payable."

In the course of his judgment Alexander J remarked that there was:

> "...always an obligation, albeit latent and not hitherto defined in monetary terms, which would be imposed on the appellant the moment it ceased to mine."

In finding in favour of the appellant, the following passage of Latham CJ in the Australian High Court in the case of *The Texas Co. (Australia) Ltd v Federal Commissioner of Taxation* [(1939-1940) 63 CLR 382 at 427] was quoted with approval:

> "Although assessments to income tax are made for separate years it is established that an expenditure made in one year which does not produce its income gaining effect till a subsequent year may nevertheless be deducted in the year in which it is made, **and so also an outgoing which arises out of income-gaining activities of a prior year may be deducted in a subsequent year when it is actually made".** (Emphasis added by Alexander J in his judgment in CASE 9691 as yet to be reported).

In the light of the abovementioned, it is submitted that expenditure incurred after discontinuing to trade in a particular branch or division of a company, will mean that the company still passes the trade test. The expenditure will be deductible if it is incurred in the production of income and if it is of a revenue nature.

2.1.3 In the production of income

Some cases that dealt with expenditure incurred after the cessation of business, turned on the "in the production of income-requirement". In *ITC 411* (10 SATC 238) the lack of continuity of business (by implication trade) gave rise to the Court finding that the expenditure could not be in the production of income. It does not, follow, however, that expenditure incurred for the purpose of trade will necessarily also be incurred in the production of income.

In this regard the dual test set out in *Port Elizabeth Electric Tramway Company Ltd v CIR* (1936 CPD 241) may also be kept in mind, namely that for expenditure to have been incurred in the production of income -

(a) The purpose of the act entailing expenditure must be examined. If it is performed for the purpose of earning income, then the expenditure will be deductible.

(b) There must be a close link between the expenditure and the performance of the business operated for the purpose of earning income.

In *ITC 1171* (34 SATC 80) reference was also made to "the production of income-test":

> "It seems to me that when the appellant ceased trading as a general dealer his election to retain the use of the money thereafter was not made for the purpose of earning income. It was never even suggested in evidence that the retention of the use of the money was to enable the appellant to earn income from the other sources, namely, director's fees, salary and commission ..."

In *Commissioner of Taxes, Southern Rhodesia v Pan African Roadways Ltd* [1957(2) SA 535 (SR)] a transport company discontinued its transport business pending a decision by its holding company as to its future. Counsel for the tax collector argued that, although the expenditure would have been deductible if trading had not ceased, no expenditure could have been incurred in the production of income, as no income had been earned during the period of discontinuance of the business. The Court however relied on the *Port Elizabeth Tramway* - case, *New State Areas Ltd v CIR* (1946 AD 610) and *Sub-Nigel Ltd v CIR* [1948(4) SA 580 (A)] to find that the expenditure was incurred in the production of income.

The taxpayer in *ITC 490* (12 SATC 72) was not so fortunate. The appellant was a lessee of an hotel under a lease entered into for a fixed period at a stipulated monthly rental. The business was discontinued during the term of the lease and the appellant sought to deduct the monthly rental payments subsequent to discontinuance of the hotel business. The deduction of the expenditure was disallowed on the basis that it was not in the production of income. The judgment seems to be based on the contention that expenditure has to result in income. This can no longer be correct as the *Port Elizabeth Tramway* - case and the *Sub-Nigel* - case clearly state that the purpose of incurring the expenditure must be looked at and that the expenditure need not result in income in the year that the deduction is sought.

In reaching its decision in *ITC 490*, it may well be that the Court attached too much importance to the word *"the"* in the phrase "in the production of *the* income".

It is submitted that as long as expenditure was incurred in the production of income, the subsequent cessation of the trading operations to which it relates, should not affect the **purpose** of the act entailing such expenditure. If the purpose was to produce income, the expenditure will continue to pass this test. This view is also in line with the judgment of Alexander J in CASE 9691 discussed in 2.1.2.

2.1.4 Not of a capital nature

Although most cases dealing with the cessation of business were decided either on the "trade-test" or the "in the production of income-test", the requirement of "not of a capital nature" may also be involved, especially where a taxpayer incurs expenditure to be released from long term obligations.

It is trite law that if expenditure can be regarded as part of the cost of performing the income-earning operations, such expenditure will be of a revenue nature. On the other hand expenditure incurred to improve, enhance, establish or add to the income-earning structure will be of a capital nature (*New State Areas Ltd v CIR* above).

If expenditure is incurred for the enduring benefit of the trade it would normally also be of a capital nature [*Atlantic Refining Co of Africa (Pty) Ltd v CIR* 1957(2) SA 330 (A)].

The case law dealing with the deductibility of lump-sum payments expended in order to get rid of an onerous contract, does not lay down uniform principles. *SIR v John Cullum Construction (Pty) Ltd* [1965(4) SA 697 (A)] and *ITC 1267* (39

SATC 146) support the contention that lump-sum payments on the cancellation of contracts do not provide an enduring benefit to the taxpayer and that consequently the expenditure is not of a capital nature.

In *John Cullum's* case the taxpayer had entered into a contract with a finance corporation to furnish guarantees to building societies. When the taxpayer, after a few years, found the contract to be too onerous, it paid an amount to the finance corporation as consideration for the cancellation of the contract. The court found that, since the object of the payment was to place the taxpayer in a position to conduct its business on more economical lines, the payment provided a temporary benefit only, which was not an asset of a capital nature.

In contrast, the taxpayer in *ITC 1539* (54 SATC 394) paid an amount to cancel a franchise agreement to enable the taxpayer as the franchisor to take over the business of the franchisee. The court found that the cancellation also entailed an acquisition of an income-producing asset, namely the business conducted by the franchisee. The expenditure was therefore held to be of a capital nature and not deductible.

On closing down a business, the taxpayer in *ITC 852* (22 SATC 187) negotiated a compromise with the lessor of light equipment in terms whereof a lump-sum was paid for the cancellation of an ongoing contract. The lump-sum was not allowed as a deduction because the court found that the appellant was minimising his losses and that therefore the expenditure was not incurred "in the course of the company's ordinary operations undertaken to earn a profit, but because of a decision by the company to discontinue its business operations."

In conclusion it may be said that as long as the expenditure relates to the income-earning operations of a company and does not result in an enduring benefit, the payment will not be of a capital nature notwithstanding the fact that the company is closing down a branch or a division.

2.2 Types of expenditure

2.2.1 Interest

This particular type of expenditure, was clouded with uncertainty, mainly due to unfavourable decisions for the taxpayer in the past. If the loan relates only and directly to the business conducted in the branch or division that has been closed down, the continued payment of interest after closure may not be deductible because it does not pass the "trade-test" [*ITC 1135* (31 SATC 228)] or the "in the production of income-test" [*ITC 1171* (34 SATC 80)] or due to the false doctrine

that according to the nature of interest, it is incurred only from day to day [*ITC 1485* (52 SATC 337) and *ITC 1496* (53 SATC 229)].

The "trade-test" and the false doctrine that due to the nature of interest, it is incurred only from day to day, were dealt with under 2.1.2. It remains to have a closer look at the requirement that interest expenditure must be "in the production of income" of the ongoing trading divisions, to be tax deductible.

Nestadt JA in delivering the minority judgment in *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* (49 SATC 132:156) said the following:

> "It is of course, clear that the words 'incurred in the production of income' do not mean that, before a particular item of expenditure may be deducted, it must be shown that it produced income for the particular year of assessment (*Sub-Nigel Ltd v CIR*). The income may be earned only in a future year. And I shall assume that the same principle applies to justify the deduction of expenditure relating to the income of a previous year".

It is interesting to note that while Nestadt JA in *CIR v Pick 'n Pay Wholesalers (Pty) Ltd* was willing to assume that a deduction of expenditure is allowable even if the income is to be earned only in a future year, Alexander J in CASE 9691 [as yet unreported but discussed by K Mitchell in (1995) 9 Tax Planning 95-96] was willing to go a step further and to allow expenditure relating to the income of a prior year, after trading operations has ceased, on the ground that:

> "... and outgoing which arises out of income-gaining activities of a prior year may be deducted in a subsequent year when it is actually made".

Abovementioned authorities leave little room for an argument that interest on a loan relating to the business of a branch or division, are not tax deductible after the branch or division has been closed down. It is submitted that this is a correct manifestation of the law regarding the deductibility of the incurral of interest after cessation of trade by a branch or division of a company.

2.2.2 Lease instalments/rentals

In the light of *ITC 490*(12 SATC 72), continued payment of rentals on premises utilised by a division that has been closed down, may result in a non-deductible expenditure. However, the firm opinion is held that *ITC 490* was incorrectly decided and that subsequent rental payments should be deductible. The pre-condition for the expenditure to be deductible is that the obligation to pay rental must be for a fixed term and must have been incurred before ceasing the branch

operations. Further support for this view may be found in *ITC 1013* (25 SATC 321) and *ITC 1371* (45 SATC 169).

ITC 1371, although decided in the Zimbabwe Special Court, must be persuasive authority that continued payment of rentals will be deductible after cessation of trading operations. In order to provide office facilities to the companies in its group, a subsidiary entered into a long term lease of a building. When the group decided to move its headquarters to Zambia, the appellant company, also a subsidiary in the group, took over the lease obligations. The building was sub-let with intermittent success, but no profit was ever realised. The court, in allowing the deduction, remarked the following:

> "It is occasionally the case, ... , that a company enters contracts that turn out to be a liability. It has to fulfil that contract even if there isn't any prospect of making a profit out of it. But if that contract is part of its business ... then expenditure in the fulfilment of such a contract is expenditure for the purpose of its business".

The court's decision may have been coloured by its acceptance that sub-letting was a trading activity, but nevertheless it also regarded the income from sub-letting not merely as a way to minimise losses.

A lease agreement which can be terminated with a month's notice will not give rise to a deductible expense after closure of a branch or division as the taxpayer is under no obligation to continue paying rentals, unless the premises is utilised for other trading operations of the company.

Lease agreements often provide not only for the payment of rentals but also for the payment of rates and taxes associated with the property and the insurance of the property. A lessee may also incur security costs in respect of the protection of the property.

If these costs are included in the lease agreement it can be accepted that the expenditure will be deductible if the rentals are deductible. In other words, if the obligation to incur the expenses is derived from the lease agreement it will be deductible as having been incurred before cessation of trade.

If security costs are not incurred in terms of the lease agreement, it cannot be said to be an expense arising from the obligation in terms of the lease agreement. Continued payments of, e.g., the salary of a nightwatchman will not be deductible as it is not incurred in the production of income. On the contrary, it may well be argued that the security costs are an inevitable concomitant of the

business and, therefore, deductible.

In the event that the taxpayer can prove that it has embarked on the trade of sub-letting, security costs may still be deductible as being incurred with the purpose of earning rental income, even though the lease agreement does not provide for the payment of security costs.

Our tax law does not generally draw a distinction between leases of movable and immovable property. The continued leasing of movable assets will be subject to the same rules as for immovables.

2.2.3 Lump-sum payments

This expenditure is more problematic, the reason being that the lump-sum payment cannot readily be said to be a fulfilment of the taxpayer's obligations incurred before cessation of trading.

The cases of *John Cullum* [1965(4) SA 697(A)] and *ITC 1267* (39 SATC 146) support the taxpayer claiming a deduction in respect of lump-sum payments made to get rid of onerous contracts. Thus, if a branch or division is closed down an argument along these lines may well succeed, because there is a continuity of the particular trade. If the taxpayer acquires an income-producing asset as was the case in *ITC 1539* (54 SATC 394), the expenditure will be of a capital nature and may not be deductible.

A case that may in certain circumstances provide the taxpayer with some difficulty is *ITC 852* (22 SATC 187) where the taxpayer on closing down its general dealer's business paid a once-off amount as consideration for the cancellation of the lease in respect of light equipment, and was not allowed to deduct this expenditure for income tax purposes.

It may be as well to bear this obstacle in mind. In this instance prevention is better than cure! If a company contemplates the closing down of a division, it would be better to renegotiate lease agreements for shorter periods and to build the "penalty" factor for earlier termination into renegotiated rentals and lease instalments. Alternatively a "penalty clause" in the agreement that fixes the amount payable on early termination of the lease, may be argued to be an obligation arising before cessation of trading of the division and therefore deductible. Broomberg (1983:118) suggests that a lump-sum fixed in the original agreement will be in the nature of a lease premium and thus deductible in terms of section 11(f). This suggestion is not convincing because a "premium" paid in these circumstances will not qualify for the section 11(f) deduction as it is not

paid for the use or occupation of the premises but for **not** using the premises.

2.2.4 Delegation of obligations under a maintenance contract or warranty

When a decision is made to discontinue some operations of a company, it may sell the business or a division as a going concern. In some instances obligations under unexpired maintenance contracts or warranties will have to be delegated to the purchaser.

To the seller will have accrued the income from such contracts and he will have claimed the "future expenditure" in terms of section 24C of the Income Tax Act. In terms of section 24C the amount claimed as a provision in a year must be added back to income in the succeeding year of assessment. Expenditure actually incurred in terms of maintenance and warranty claims will be deducted in terms of section 11(a).

When paying the purchaser an amount for the assumption of the obligations in terms of maintenance contracts and warranties the seller may "pay" a lump-sum equal to the amount to be added back as the previous year's section 24C allowance. Is this amount a deductible expense?

The first possibility is that the amount may be so closely linked to the obligation in terms of the maintenance contract/warranty that it can be fairly stated that the expenditure is incurred in respect of maintenance or warranty claims. This argument may succeed if the company still remains liable towards the client in terms of the contract and has expended the money to obtain the services of the purchaser for maintenance and settling of warranty claims.

If the company has completely divested itself of any liability in terms of maintenance and warranty claims by payment of the lump-sum, the link with the actual maintenance expenditure could be said to have been severed. This would mean that the amount has not been expended in the production of income and is furthermore of a capital nature as was the case in *ITC 852* (22 SATC 187).

2.2.5 Retrenchment pay

Retrenchment packages are a common phenomenon which could run into substantial amounts. Again, for retrenchment pay to be deductible for income tax purposes, the requirements of section 11(a) of the Act has to be met.

Generally speaking, the difficulty lies with the "in production of income-test" as, at first blush, a payment on the termination of services can almost by definition

not be in the production of income.

Where the employer and employee had contracted in respect of retrenchment pay when the service contract was entered into, the close link between the retrenchment pay and services rendered, being part of the cost of performing the business, would have been firmly established.

The parties to most service contracts, however, do not foresee the possibility of retrenchment and consequently no contractual arrangement would exist between employer and employee in anticipation of such an event.

It may be that the company has a policy to provide retrenched employees with retrenchment packages. Under such circumstances it can be said that it is a condition of employment that an employee will be given a retrenchment package should his services become redundant.

If there is a practice in a particular industry due to, for instance, union demands, the inference must be drawn that the employer/employee relationship accepts retrenchment pay as a condition of employment. Therefore, where a policy or practice exists, the employer will be able to tie in retrenchment pay with expenditure incurred before discontinuing operations of a branch or a division which had as its purpose the production of income when the employee commenced his contract of service with the employer. The expenditure will therefore be deductible.

Although there is no statutory obligation to effect retrenchment payments, in some instances failure to award a retrenchment package may constitute an unfair labour practice in terms of existing labour law. If the employer pays a retrenchment package and can show that failure to do so would amount to an unfair labour practice, it may be argued that the retrenchment pay will be deductible, as a close link with the cost of performing the business would have been established. The cost would be for services rendered which is in the production of income.

Lastly there is a further argument in respect of retrenchment pay on closure of a branch and a division which merits consideration. Inevitably, when a company continues with trade (whether the same or a different one), it will be concerned with labour relations in general. In the volatile environment of strikes by workers the company must maintain sound industrial relations to ensure continued production and as a consequence the earning of income. By not paying employees retrenchment packages, the employer may jeopardise future production of income as a result of a deterioration of the relationship with retained employees. Thus the

payment may be deductible as being a necessary concomitant of trade although the possibility exists that Inland Revenue may counter this argument with an attack on the revenue nature of the expenditure. The answer to this is that the benefit of awarding retrenchment packages, is only temporary, as the employer wishes to avoid the short term reaction by retained employees when laying off other employees.

Support for this contention can be found in the case of *Provider v COT* [1950(4) 289 SA(SR)] where amounts paid by employers to dependants of deceased employees were held to be deductible on the basis that the payments were "designed to provide settled conditions of employment and through these the production of income"[see also *ITC 1506* (53 SATC 418)].

The employer may also find himself in the position that he pays a "compromise" payment a year or two after closure of a division or a branch to avoid industrial action by unions. Again he may use the argument in *Provider v COT*, above, to show that the expenditure is in the production of income. Is the expenditure, however, "not of a capital nature"? Does the payment establish, enhance or improve the income earning structure? It is submitted that the expenditure is indeed of a revenue nature. The expenditure is a cost pertaining to the income-earning operations and have no connection with the capital structure of the business. It would be unwise, though, to ignore a possible attack from Revenue in respect of a payment of this kind.

In conclusion it can be stated that amounts expended on retrenchment packages would normally be deductible in terms of section 11(a). In practice Revenue accepts this position and allows the deduction of expenditure incurred in respect of retrenchment packages.

3. LOSSES OF TRADING STOCK

It often happens that a company will suffer increased losses of trading stock as a result of informing employees that they will be retrenched, which leads to increased stock losses through employee theft. Are these losses deductible?

3.1 Section 22(1) of the Income Tax Act

This section provides for the inclusion of an amount in respect of trading stock held and not disposed of, in the determination of taxable income. The value must be the cost price less an amount by which the value is diminished by reason of damage, deterioration, change in fashion, decrease in market value or for any other reason, subject to the discretion of the Commissioner.

It is obvious that any stock losses will result in the stock no longer being "trading stock held and not disposed of". The cost of trading stock being deductible when it is incurred, the subsequent loss will have no effect, but for the exclusion from closing stock and the resultant decrease in taxable income.

3.2 Case law

In a judgment by Dr Manfred Nathan KC in *ITC 207* (6 SATC 54) it was found that losses of "floating or circulating capital" were not deductible! The learned President argued as follows:

> "[I]n this particular case these goods had not been turned over. These goods were still in the hands of the appellants for the purpose of trading although no trade had been done with them. Therefore the goods were still capital, and in our opinion if capital, the loss in respect of these goods was a capital loss and not a trading loss".

It is submitted that this decision was incorrectly decided as a loss of floating capital or trading stock can surely not be on capital account!

The court in *ITC 303* (8 SATC 72) allowed the deduction of loss of trading stock through shipwreck, distinguishing the direct loss of stock-in-trade from the loss of cash in *Lockie Bros v CIR* (1922 TPD 42).

ITC 686 (16 SATC 490) followed the decision in the *Lockie Bros*-case in disallowing a loss of trading stock as a deduction, although it did mention that the result is harsh on the taxpayer.

Trading stock was lost through burglary in *ITC 1060* (26 SATC 313) and the loss was allowed as a deduction. The court found that section 22(1) did not exclude as an allowable deduction losses incurred through theft and that therefore the loss can still qualify as a deduction in terms of section 11(a).

Section 22(1) was not applied by the court in *ITC 1060* as it was considered that the circumstances enumerated for the diminishment of value of trading stock, did not extend to losses of trading stock through theft. It is submitted that section 22(1) does not refer to losses of trading stock as it is clear that such stock cannot be said to have been held and not disposed of at year end.

Meyerowitz & Spiro (1994:318) states that the Commissioner's practice is not to allow losses through theft unless it is a "necessary concomitant" of the trade that such losses may occur. Even if a taxpayer has to rely on this argument he must

be able to succeed, as theft by employees is a common risk in many industries, but especially retail, whether such employees have been retrenched or not. Retrenchment strengthens the argument that the losses occurring thereafter is an inevitable result of the decision to retrench.

In *Sentra-Oes Koöperatief Bpk v Kommissaris van Binnelandse Inkomste* (57 SATC 109), the Court made the following statement:

> "The question is, was the money which was lost fixed or floating (circulating) capital? If it was fixed capital, then the loss was of capital nature; if floating (or circulating) capital, then is was a non-capital loss".

Abovementioned decision seems to settle the matter in favour of the taxpayer. It is submitted that the judgment is a correct manifestation of the law and that losses of trading stock, should be regarded as tax deductible, irrespective whether the loss occurred during normal operating activities, or after a decision to close down a branch or division was taken, or even after the actual closing down of a branch or division.

4. CAPITAL ALLOWANCES

4.1 Section 11(e) of the Income Tax Act

Section 11(e) provides for the deduction of a depreciation allowance on machinery, plant, utensils and articles used by the taxpayer for the purposes of his trade.

If a taxpayer closes down a branch or division but continues to use the assets in his trade eg a delivery vehicle, he can continue to deduct the sum representing the wear and tear on such assets. Wear and tear cannot be deducted if the assets are no longer used in the trade.

4.2 Section 12C of the Income Tax Act

Section 12C allows a 20 per cent per year deduction of the cost of plant and machinery used by the taxpayer directly in a process of manufacture or similar process.

When the company has carried on a process of manufacture at different branches and decides on the closure of a branch, the cost of the machinery may still qualify for the section 12C allowance as it may be argued that the only requirement in terms of section 12C is that the machinery was brought into use for the first time

for the purposes of his trade.

Section 12C(3) contains certain instances where the deduction will not be allowed, more specifically section 12C(3)(c). In terms of section 12C(3)(c) no deduction will be allowed if the plant and machinery has been disposed of in a previous year. This may be a further indication that as long as the asset is still owned by the taxpayer the deduction would be allowed.

Section 11(x) of the Income Tax Act requires that for the purposes of determining a taxpayer's taxable income from carrying on any trade, a deduction be allowed of "any amounts in terms of any other provision in this Part, are allowed to be deducted from the income of the taxpayer".

It is submitted that section 11(x) does not require that for the allowance in terms of section 12C to apply, the plant and machinery must be used in carrying on the trade for which it was originally brought into use. Section 11 only requires that **a** trade be carried on before a deduction from income will be allowed. As a company ceasing operations of a branch or a division, will continue trading, this requirement will be met.

Conversely section 11(e) requires an asset to be used for the purposes of trade in order to be entitled to the wear and tear allowance.

On the other hand the further requirement that the machinery and plant is used in a process of manufacture may militate against the deduction of this allowance.

It is submitted that the requirement of "use in a process of manufacture" qualifies the wording "brought into use for the first time for the purposes of trade". It follows that the allowance does not fall away when the machinery or plant is no longer used in a process of manufacture.

4.3 Scrapping allowances

Section 11(o) of the Income Tax Act allows for the deduction of a scrapping allowance in respect of any machinery, plant, implements, utensils and articles used by the taxpayer for the purposes of his trade. The allowance is calculated as the amount by which the original cost of the asset exceeds the sum of the tax allowances and the proceeds. In effect this is the amount by which the proceeds fall short of the tax value (Huxham & Haupt 1995:115).

The predicament that a taxpayer faces when deciding on closing down a division or a branch, is whether the scrapping allowance will be allowed on assets

disposed of. Inland Revenue would obviously want to label the loss on disposal as a capital loss not deductible for income tax purposes.

The issue is not a new one and has frequently formed the subject matter of decided cases. Although earlier court cases seem to have supported the view that there must be a continuity of business (trade) for the scrapping allowance to apply, this "requirement" is accepted as being fallacious as the Income Tax Act does not lay down such a requirement.

In *ITC 657* (15 SATC 495) and *ITC 754 (18 SATC 424)* the earlier view was upheld but in *SIR v Kempton Furnishers (Pty) Ltd* [1974(3)SA 36 (AD)] the Appellate Division delivered a highly persuasive *obiter dictum* to the following effect:

> "In any event, in so far as any of these judgments seem to require the scrapping to be effected in the ordinary course of business for the purposes of s11(o) - or the earlier sections - it is clear that the requirement is not prescribed as a requirement by the language of s11(o), but seems to be relevant only to the question whether or not there was in fact a scrapping, for a taxpayer who disposes of his equipment or machinery after he had ceased trading would not normally be regarded as having scrapped such equipment or machinery within the meaning of s11(o)."

Thus, the difficult question remains. Has the asset in fact been scrapped or is it a disposal of a capital asset without it having been scrapped? It would be fair to say that the taxpayer has had dubious success over the years to show that a scrapping allowance should have been allowed.

It is trite law that a scrapping requires a decision to scrap followed by cessation of use. This principle was enunciated in *ITC 631* (15 SATC 100) where the following was stated:

> "It remains to consider whether disuse and discarding of old and unsuitable fixtures and fittings of branches should be regarded as scrapping. In the retail trade the disuse of fixtures and fittings ... is, in the opinion of the court, a scrapping. It was stated ... that fixtures and fittings were old - that whenever any fixtures and fittings from closed down branches were serviceable and suitable for use in other branches they were transferred to other branches. Only those that were definitely of no use in the remaining branches were sold. It was admitted in cross-examination that if the appellants had carried on with the branches which were closed down they would have continued to use the fixtures and fittings in the branches in question".

A company who is able to produce evidence of similar facts as those in *ITC 631* will stand a good chance of succeeding with an argument in favour of scrapping. Machinery and equipment may be different and their scrapping will perhaps be more difficult to prove, especially if they are still suitable for the taxpayer's trade but are nonetheless sold or disposed of.

Where a taxpayer sold fixtures and fittings at a public auction when closing down a separate business, ie a restaurant, the scrapping allowance was not granted [*ITC 657* (15 SATC 495). This case seems to have been lost on the basis that there was not a continuation of business].

In a case decided along the same lines as *ITC 657*, the taxpayer failed to prove that there was a scrapping of equipment used in the trade of general dealer, where this business was sold, although the taxpayer continued trading as a building contractor [*ITC 754* (18 SATC 424)].

ITC 769 (19 SATC 214) is support for the contention that a scrapping allowance may be available to a taxpayer ceasing to trade in respect of a separate business. The taxpayer was a ferry operator who also operated a tea-room on a boat. When the tea-room business was abandoned the appellant dismantled the boat and sold the remains as scrap. The appeal succeeded but the decision was not decided on the issue of "whether there was a scrapping" or not.

ITC 1380 (46 SATC 68) considered the intention of the taxpayer to scrap an asset as the primary indication of the scrapping of an asset. The *ipse dixit* of the taxpayer was a factor weighing heavily in his favour although Friedman J tempered this approach by stating that objective factors such as the cessation of trade or the disposal of a business may make it difficult for the taxpayer to show that there was a scrapping.

Melamet J in *ITC 1456* (51 SATC 125) examined the line of authorities before *ITC 1380* and held that the mere disposal of an asset because it is of no further use to the taxpayer will not necessarily have the effect that such assets were scrapped. This case entrenches the principle that the asset must be worn out, obsolete or unsuitable before it can be scrapped. The law as stated in *ITC 1456* is not entirely correct as it has been accepted that what might be considered scrap by one taxpayer may be something else in the hands of another taxpayer [*ITC 852* (22 SATC 187)].

From the above authorities it may be observed that a company will have quite a battle on its hands to show that there was a scrapping of assets when it has closed down a branch or a division. The company will be less exposed to an attack by

Revenue if it can show that a decision to scrap assets was taken before it was resolved to close down the branch or division.

Where there is no doubt that the assets were scrapped, especially assets with the qualities referred to in *ITC 1456* ie worn out, obsolete and possibly unsuitable, the taxpayer may claim the scrapping allowance afforded by section 11(o), notwithstanding the discontinuance of the business of the branch or division.

5. DEBTORS

5.1 Collection costs

When a branch or a division is closed down the taxpayer may continue to expend money in respect of the collection of trade debts arising at the time of trading. May these costs be deducted by the taxpayer for income tax purposes?

When a branch or division is closed down with the result that the company no longer carries on those particular trade operations, the collection costs should be deductible. In the *COT v Pan African Roadways Ltd* [1957(2) SA 539 (FC)] the taxpayer continued to maintain an office and to employ staff after discontinuing its business. The object was to collect as much of the value of outstanding debts as possible. The court found that the expenditure was incurred in the production of income. It can therefore be argued that the collection costs relate to the business operations prior to discontinuing the activities of the branch or division and as a result the expenditure is deductible.

In support of a contention that these costs are deductible reliance may be placed on *SIR v Kempton Furnishers (Pty) Ltd* above where the taxpayer disposed of its business and thereafter sought to claim the bad debt allowance in terms of section 11(i) of the Income Tax Act. The Appellate Division allowed the deduction. The preamble to section 11 of the Income Tax Act provides for the deductions to be allowed "for the purposes of determining the taxable income derived by any person from carrying on any trade", and this trade test is a requirement for a deduction under section 11(a) as well as section 11(i). It follows that just as bad debts relating to trade debts may be written off for tax purposes, costs incurred in the collection of those trade debts may be deducted.

5.2 Bad debts

The locus classicus on this issue is the aforementioned case of *Kempton Furnishers* where the taxpayer was allowed to write off bad debts in terms of section 11(i) notwithstanding the prior disposal of its business. Previous cases in

the Special Income Tax Court have followed a different approach and it is necessary to examine the facts in some of these cases.

The appellant had sold his business including bad debts to a private company in *ITC 342* (8 SATC 368). As seller, the appellant accepted liability for book debts proving to be bad within a certain period. The court dismissed the appeal against the disallowance of the bad debts written off on the basis that the debts were no longer the appellant's but that it had vested in the company. The court also mentioned that there was no recession or repurchase of the book debts.

In *ITC 449* (11 SATC 98) the assets including debts of a business were sold. The seller issued a guarantee to the purchaser against irrecoverable debts and it was agreed that although the purchaser must take steps to recover the debts, the seller would accept recession of the debts not recovered at a certain date. The appellant argued that losses made on the guarantees may be written off as bad debts and sought to distinguish his case from *ITC 342* on the basis that he took recession of the debts. The court disallowed the deduction and stated that the ratio in *ITC 342* was that the "loss" was a reduction in the purchase price which was on capital account and on this basis dismissed the appeal.

ITC 466 (11 SATC 251) followed *ITC 449* and found against the appellant on the same basis ie the guarantee of payment of book debts amounted to a loss on capital account and a subsequent reduction in the purchase price, and may not be allowed as a bad debt written off.

In the light of the *Kempton Furnishers* - case, it is submitted that the above cases, although distinguishable from the facts in *Kempton Furnishers*, do not reflect the current legal position. Botha JA in *Kempton Furnishers* referred to *ITC 449* and *ITC 466* and approved of the reasoning of the court a quo where the president stated the following:

> "In my respectful opinion, the reasoning in those cases is open to question. The effect of the payment and of the re-cession was not only to diminish the purchase price, but also to alter the subject-matter of the sale. The appellant was revested with the book debts concerned, and the purchaser was repaid the amount he had paid for such book debts. In effect the amount repaid to the purchaser was not a loss (whether capital or otherwise) but a readjustment of the purchase price and of the merx in terms of the provisions of the contract of sale. From a practical point of view, the position was no different from what it would have been if the book debts concerned had not originally been included in the sale."

Botha JA continued as follows after quoting the above:

> "I am in respectful agreement with the learned President's reasoning and the conclusion arrived at by him. All I need add is that the real underlying cause for the loss which the taxpayer sought to deduct from his income was the irrecoverability of the trade debts, and not the reduction of the purchase price at which the business, including the debts, had been sold, which reduction was merely an effect of the irrecoverability of the debts."

Based on the above dicta it is submitted that bad debts may be written off for income tax purposes subsequent to cessation of trade as long as the debts vest in the seller either because it did not form part of the sale, or because of recession thereof to the seller.

6. CONCLUSION

It is clear from the areas explored in this article that a company will have to be wide awake when it is contemplating the closure of a branch or division. In this way it may ensure that the income tax consequences of such a step are favourable and it can avoid unnecessary mistakes through ignorance of the complications that may arise.

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