Do share-based payments made for the procurement of services qualify as expenditure actually incurred?

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1 Introduction
The objective of this article is to verify whether a company actually incurs an expense when it makes a share-based payment for the procurement of a service. This would provide guidance as to whether or not the company may claim a deduction in terms of section 11(a) of the Income Tax Act1 for the procurement of the service, or whether the amount so incurred will form part of the base cost of an asset in terms of paragraph 20 of the Eighth Schedule (for purposes of capital gains tax).

There are not enough authoritative precedents in South African case law that deal with the specific issue of whether or not a share-based payment made for services rendered constitutes “expenditure actually incurred”, but there are solid South African tax law precedents regarding the principles to be applied in determining whether a particular expense has been incurred.

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1 58 of 1962. It is assumed for the purposes of this article that the other requirements of s 11(a) are complied with. The company is therefore carrying on a trade; the expense is incurred in the production of income and is not of a capital nature. The only criterion analysed in this study is whether the company has actually incurred an expense.
“actually incurred”. Both the tax law precedents and general legal principles pertaining to the issue and allotment of shares, including specific company law principles, are examined below in order to determine whether a company making a share-based payment for services rendered has actually incurred an expense. The decisions in ITC 1783 and ITC 1801 are critically analysed and commented on against the background of these generally applicable tax and other legal principles.

11 Background
A company may issue shares for various reasons. One is to procure funding. By issuing shares, a company can raise the capital that it needs to further its objectives. Another reason why a company may issue shares is to serve as a form of payment for an asset that the company has acquired or for a service that it has procured or wishes to procure. Instead of paying cash for an asset or service, a company may, for example, issue its own shares to the seller or service provider as a means of payment. This means of payment is referred to as a share-based payment.

The most pertinent question that arises from a South African income tax perspective is whether or not a company that makes a share-based payment is allowed to claim a deduction for such a payment for income tax or capital gains tax purposes. One of the requirements of section 11(a) of the Act that provides for a deduction against a taxpayer’s income is that the taxpayer must have “actually incurred” an “expenditure” or loss. Paragraph 20 of the Eighth Schedule to the Act, which provides for the computation of the base cost of an asset for capital gains tax purposes, mirrors this requirement of section 11(a). It is clear from these provisions that an amount may not be deducted from a taxpayer’s income, or may not be included in the base cost of an asset for capital gains tax purposes, if that amount does not qualify as an expense that has actually been incurred.

The Income Tax Court of Natal first had the opportunity to decide on the deductibility of share-based payments in 1950, in ITC 703. The court had to decide whether a share-based payment made for technical services in connection with the erection of a factory and the subsequent supervision of its production qualified for a deduction. The only question before the court, however, was whether or not the expenditure was of a capital nature. The court’s view was that the payment was to cover the cost of services rendered to the appellant company, both in respect of the erection of a factory and thereafter in respect of the conduct of its business.
With regard to the payment in respect of the conduct of the appellant company’s business, the court held that the expense was not of a capital nature.

In 2004, the Gauteng Tax Court in *ITC 1783* had to consider whether a company that made a share-based payment under an agreement of sale had actually incurred an expense. The court held that the appellant company did not incur an expense when it issued the shares, because the issue of shares did not result in a diminution of the company’s assets.7

The Gauteng Tax Court had an opportunity during 2005 in *ITC 180*8 to decide whether or not share-based payments qualify as “expenditure . . . actually incurred” for purposes of section 11(gA) of the Income Tax Act. The court held in that the decision in *ITC 1783* was “. . . clearly wrong and not a reflection of the law”.9 The court held that the appellant had actually incurred an expenditure for the purposes of section 11(gA) during 1999, when it acquire a trade mark by means of a share-based payment.

In 2006, the Pretoria Tax Court had to consider in *ITC 1822*10 whether the transfer of a taxpayer’s own shares to a supplier of a service constitutes payment or not. In this case Bertelsman J followed the judgment of Jooste JA in *ITC 1801* and referred to it as a “comprehensive and most persuasive judgment”.11

Two sections of the Act that specifically relate to the deductibility of share-based payments are sections 11(lA) and 24B. Section 11(lA)12 provides for a deduction of the market value of any qualifying equity share that is granted to an employee of the taxpayer in terms of section 8B of the Act. The application of this section is particularly limited and, furthermore, the deduction of the market value of the qualifying equity shares in terms of section 11(lA) is limited to R3 000 per employee per annum.13

The legislature inserted section 24B into the Act with effect from 25 January 2005.14 The Explanatory Memorandum of the Revenue Laws

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8 SATC 373.
9 *Idem* 376.
10 68 SATC 57.
11 69 SATC 200.
12 *Idem* 203.
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14 The section came into effect on 2004-10-26 and applies to any qualifying equity share granted in terms of a broad-based employee share plan approved on or after that date by the directors or some other person or body of persons with comparable authority conferred under or by virtue of the memorandum and articles of association of the company. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004, an employer may generally not deduct the issue or transfer of a share to an employee, even if that issue or transfer acts as compensation for salary. The insertion of s 11(lA) accordingly overturns this result in the case of broad-based employee share plans in order to encourage their further use.

15 Any excess amount is carried forward to the succeeding year of assessment and is deemed, for the purposes of s 11(lA), to be the market value of qualifying equity shares granted to the employee in that year.

16 This section applies to any asset acquired on or after 2001-10-01, in order to determine capital gains or losses for purposes of the 8th Schedule (other than in respect of trading stock) and 2005-01-24 in respect of other assets.
Amendment Bill states that, where a company acquires an asset by means of a share-based payment, it does not technically entail actually incurring any costs. However, disallowing the deduction thereof creates a significant hindrance to company formations and other forms of share financing. The legislature inserted section 24B in accordance with “widespread international practice”, despite “support for the principle (of disallowing the deduction) found in case law”.17 The effect of section 24B is to deem an amount of expenditure equal to the market value of an asset to have been actually incurred in circumstances where a company has acquired the asset in exchange for the issue of shares in the company.18 The section also provides that the seller is deemed to have disposed of the asset at its market value.19 These deeming provisions apply for the purposes of the Act and therefore also apply for the purposes of section 11(a) and paragraph 20 of the Eighth Schedule.

The provisions of section 24B are, however, limited to the acquisition of an asset in terms of a share-based payment. It is therefore clear that section 24B would not apply in circumstances where a share-based payment is made to procure services.20

It follows that, in cases where neither section 11(lA) nor section 24B applies, one has to consider the conflicting decisions of ITC 1783 and ITC 1801 on the one hand and ITC 1822 on the other.

1.2 Applying General Tax Principles on Share-based Payments

In order to evaluate whether a share-based payment made to procure services constitutes an expense that has actually been incurred, it is essential to consider the meaning of the terms “expenditure” and “actually incurred”. As these terms are not specifically defined in the Act, it is imperative to consider the interpretation thereof in existing case law.

1.2.1 Expenditure

Although section 11(a) refers to the terms “expenditure and losses”, Meyerowitz21 is of the opinion that it is difficult to assign a different meaning to “losses” from that assigned to “expenditure”. Clegg and Stretch22 submit that, although the word “expenditure” has not caused any problems of interpretation, some doubt surrounds the meaning of the word “loss”. According to them, the correct approach appears to be that expenditure signifies an outgoing payment resulting from a voluntary action on the part of the taxpayer, whereas a loss is an involuntary outgoing payment.

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17 Explanatory Memorandum to the Revenue Laws Amendment Bill, 2004 clause 22.
18 S 24B(1)(a).
19 S 24B(1)(b).
20 S 24B would also not apply where shares are issued to settle a liability. See Ger “The problem of paying with shares revisited” May 2005 De Rebus 55–57.
It was stated in the case of *Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue*, in the context of the difference between an “expense” and a “loss”, that “expenditure” usually means a voluntary payment of money. Watermeyer CJ, who delivered the judgment of the Appellate Division of the Supreme Court, said that “in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money”.

However, De Koker argues that the word “expenditure” is not restricted to an outlay of cash, but includes outlays in other forms. Meyerowitz is of the opinion that expenditure may take any form that has a value in money or monetary worth. Meyerowitz submits that where expenditure does not take the form of cash, the expenditure is the cost to the taxpayer of, for example, the asset transferred. Furthermore, where the asset has not been previously purchased by the taxpayer, the expenditure is the value of the asset transferred, for example, where the taxpayer has acquired the asset by inheritance or donation.

“Expenditure” is defined in the *Concise Oxford English Dictionary* as the “action of spending funds; the amount of money spent” and “expense” is defined as “the cost incurred in or required for something; something on which money must be spent”.

It appears that a key requirement of “expenditure” is that something must have come from the taxpayer’s pocket, or there must be an outgoing, diminishment or deprivation of the taxpayer’s patrimony, and that the deprivation should either be money or something that has a value in money. In order to determine whether a share-based payment made for the procurement of services qualifies as an expense, there should therefore have been a deprivation of the patrimony of the company that makes the share-based payment.

A company that makes a share-based payment parts with the right to receive cash as a consideration for the issue of shares. A question that arises from this is whether or not a taxpayer incurs an expense if he parts with or outlays the opportunity to receive cash or any other asset. According to Meyerowitz, the Act is not concerned with notional expenditure. A possible reason for this is that an expense is an outlay of an asset, which is something that the taxpayer has a legally enforceable right to. The outlay or forfeiture of an expectation could perhaps be classified as the

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23 1946 AD 157, also cited as 13 SATC 354.
24 Idem 360.
26 See also *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* 1975 1 SA 665 (A) (37 SATC 1); Divaris “The Caltex Case” 1975 Income Tax Reporter 1 11–12.
27 Meyerowitz 2006 *The Taxpayer* 11 32.
29 Burger *The Tax Deductibility of Share-Based Payments made as Consideration for Services Rendered* (MCom (Tax) mini dissertation 2005 UP) 35.
31 2006 *The Taxpayer* par 11 41.
forfeiture of a *spes*, which is not, in law, recognised as an enforceable right.\footnote{52}

### 2.2 Actually Incurred

In order for an expense to be deducted in terms of section 11(a), it should not only qualify as an “expense”, but should also be “actually incurred”. Although this is not stated expressly in the Act, it is inherent that the “expenditure” must be “actually incurred” during the particular year of assessment.\footnote{53}

In *Caltex Oil (SA) Ltd v SIR*,\footnote{54} it was held that expenditure actually incurred does not mean expenditure actually paid out during the year of assessment, but means all expenditure for which a liability has been incurred during the year of assessment, whether that liability has been discharged during that year or not. The court held that: “It is in the tax year in which the liability for the expenditure is incurred, and not in the tax year in which it is actually paid, if paid in a subsequent year, that the expenditure is actually incurred for the purposes of s 11(a).”\footnote{55}

It is noticeable that the court drew a clear distinction between the “expense” and whether the “expense” had been paid or whether a liability for the “expense” had been incurred.

In *Nasionale Pers Bpk v KBI*,\footnote{56} the court held the following with regard to the words “actually incurred”:\footnote{57}

“Die vereiste dat die onkoste 'werlik aangegaan' moet wees, het egter tot gevolg dat moontlike toekomstige uitgawes wat bloot as waarskynlik geag word nie ingevolge artikel 11(a) aftrekbaar is nie. Alleen onkoste ten opsigte waarvan die belastingbetaler [hom] 'n volstrekte en onvoorwaardelike aanspreeklikheid op die hals gehaal het, mag in die betrokke belastingjaar agetrek word.”

In delivering the judgment of the majority of the Appellate Division in *Edgars Stores Ltd v CIR*,\footnote{58} it was held by Corbett JA that\footnote{59}

“it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(a) from income returned for that year. The obligation may be unconditional *ab initio* or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it cannot be deducted under s 11(a).”

\footnote{52} Burger 37; *Estate Kemp v McDonald’s Trustee* 1915 AD 491; *Reek v Registrateur van Aktes, Transval* 1969 1 SA 589 (T).
\footnote{53} Meyerowitz 2006 *The Taxpayer* par 11 35; *Sub-Nigel Ltd v Commissioner for Inland Revenue* 1948 4 SA 580 (A); (15 SATC 381).
\footnote{54} 1975 1 SA 665 (A); 37 SATC 1. See also Divaris 1975 14 *Income Tax Reporter* 1 11.
\footnote{55} *Divaris idem* 12.
\footnote{56} 1986 3 SA 549 (A); 48 SATC 55.
\footnote{57} *Idem* 69.
\footnote{58} 1988 3 SA 876 (A); 50 SATC 81.
\footnote{59} *Idem* 90.
assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied)."

From the above quotations, it seems clear that the actual discharge of a liability is not necessary for such a liability to constitute “expenditure actually incurred”. Meyerowitz\textsuperscript{40} also agrees that expenditure is actually incurred not merely when it is paid, but when the taxpayer becomes legally liable to pay, even though no payment has been made by the end of the year of assessment, or it is not due and payable by that date. The determining factors are whether an “expense” exists and whether an unconditional liability has been incurred during the year in respect of such expenditure, regardless of whether or not the liability has been discharged.

Clegg and Stretch\textsuperscript{41} submit that if a liability is conditional in any way, or is contingent rather than actual, it cannot be said to have been actually incurred. The principle is illustrated in \textit{CIR v Golden Dumps (Pty) Ltd.}\textsuperscript{42} where the court held that:

\[\text{"[I]n a case where there is a claim which is disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay … the ultimate outcome of the situation will be confirmed only if the claim is admitted or if it is finally upheld by the decision of a court or arbitrator. Where at the end of the tax year in which a deduction is claimed, the outcome of the dispute is undetermined, it cannot be said that a liability has been actually incurred."}\]

In \textit{Edgars Stores Ltd v CIR}, it was held that a distinction must be drawn between:

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\begin{align*}
\text{“(a) the case where the existence of the liability itself is conditional and dependent upon the happening of an event after the tax year in question, in which event the liability is not incurred in the tax year in question; and} \\
\text{“(b) the case where the existence of the liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately determined at the tax year-end, in which event the liability is nevertheless regarded as having been incurred in the tax year in question."}\end{align*}
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In order for a share-based payment, made for the procurement of services to qualify as an “expense” that is “actually incurred”, it is apparent from the above that the taxpayer should incur an unconditional liability with regard to an expense. Burger\textsuperscript{45} argues that, although the word “expenditure” should be read in conjunction with the phrase “actually incurred”, it would seem that an “expenditure” should first exist before it can be “actually incurred”. Burger arrives at this conclusion from the excerpt quoted above from the \textit{Caltex Oil} case and submits that a liability for something that is not an “expense” may not constitute “expenditure . . .

\textsuperscript{40} Meyerowitz 2006 \textit{The Taxpayer} para 1137.
\textsuperscript{41} Para 10.2.5.
\textsuperscript{42} 1993 4 SA 110 (A); 55 SATC 198.
\textsuperscript{43} Idem 206.
\textsuperscript{44} \textit{Edgars Stores Ltd} supra 885.
\textsuperscript{45} 39.
actually incurred”. However, Burt argues, with reference to exactly the same phrase quoted above from the Caltex Oil case, that “expenditure” would also be “actually incurred” if an unconditional legal obligation has been incurred in terms of which some performance is due, provided that the performance due has a monetary value. Burt states the following:

“In terms of these dicta, expenditure will have been incurred if an unconditional legal obligation in terms of which some form of performance is due has been incurred, provided that the performance due has a monetary value. The incurral of the legal obligation as a fact cannot be affected by the means by which that obligation is discharged. There is nothing in these dicta to suggest that expenditure will be regarded as having been incurred only if the discharge of the legal obligation results in the diminution of the assets of the person who incurred that legal obligation.”

The correctness of this line of argument should be considered. The excerpt from the Caltex Oil case clearly refers to “… the tax year in which the liability for the expenditure is incurred” (own emphasis). A clear link is evident between the incurral of a liability and the expenditure. It appears that Burt suggests that a person that has actually incurred a legal obligation to render, for example, services with a specific monetary value would have “actually incurred” “expenditure” equal to the market value of such services, regardless of the fact that such a person’s patrimony would be undiminished upon rendering such services. According to Burger, such a situation is untenable, as, provided that the other relevant requirements of the Act are met, the service provider in the above scenario would be entitled to a deduction equal to the fees he or she receives when rendering services, presuming that his or her fees are equal to the market value of the services that he or she is legally obliged to deliver. He or she would therefore never be taxed, as his or her deductions would equal his or her “gross income” in every engagement that he or she accepts.

If a company enters into an agreement for the procurement of services by means of a share-based payment, it is submitted that it could generally be assumed that the company incurs an unconditional obligation to issue the shares. The question that still remains is whether or not the incurral of this unconditional obligation qualifies as an “expense” and not only whether some performance with a monetary value is due. It follows that in order to evaluate whether or not the unconditional liability of a company to issue shares under a share-based payment transaction would constitute an “expenditure actually incurred”, what has to be determined is the extent and specifics of the legal obligation on the company to provide the shares agreed upon, and whether such a liability that has been actually incurred would constitute an “expenditure”.

46 “Issuing shares as consideration” 2004 Tax Planning 135. The same line of argument is followed in the learned author’s follow-up article; Burt “Issuing shares as consideration – II” 2006 Tax Planning Corporate & Personal 47.
48 41.
49 It therefore remains to be discussed whether a company that makes a share-based payment has in fact, valued in money, an outgoing, diminishment or deprivation of its patrimony.
2 Analysis of Legal Principles Applicable to Share-based Payments

2.1 Legal Nature of a Share
It has been said that a share in a company constitutes a "...bundle, complex or conglomerate of personal and hence incorporeal, rights" in the hands of the shareholders and has been described as "...simply rights of action – iura in personam – entitling their owner to a certain interest in the company, its assets and dividends". Neither before, nor after, the issue of shares by a company could it ever be said that a company owns its own shares. This principle was stated in Lowry v Consolidated African Selection Trust Ltd: "Unissued shares are not an asset in any sense of the company; before allotment shares do not exist as a piece of property, what value they have comes when, and by the fact that, they are issued."

2.2 Rights and Obligations from the Issue of Shares
A shareholder can acquire shares in a company in one of two ways, namely, by acquiring shares from a current shareholder, or from the company itself. In the latter circumstance, the company issues shares in pursuance of a subscription of shares agreement concluded with the prospective shareholder. This is a specific kind of contract with its own particular elements, namely the company’s offer for subscription, the subscriber’s application, and the allocation of shares to the subscriber.

Section 92 of the Companies Act governs the allotment and issue of shares. In terms of this section, a company may only issue shares upon receipt of the full issue price, or “other consideration”. “Other consideration” includes both property and services. From a Company Law perspective, it is therefore clear that a company may issue shares pursuant to the settlement of the issue price in kind or for a consideration other than cash. This section therefore requires that the company receives a quid pro quo in cash or some other valuable consideration for the share issue. Read with sections 81 and 82 of the Companies Act, the quid pro quo may not, except in special circumstances, be less than the nominal value of the shares to be issued. Meyerowitz submits that it is therefore arguable that, where in place of cash the consideration received by a company is assets or services rendered, the company has by set-off expended an amount equal at least to the nominal value of the shares.

50 Blackman, Jooste and Everingham par 5.
51 Cilliers, Benade et al 224; Randfontein Estates GM Co Ltd v The Master 1909 TS 978 981.
52 1940 2 ALL ER 545 565.
53 Cilliers, Benade et al 247.
54 Blackman, Jooste and Everingham 241.
56 Blackman, Jooste and Everingham 246; Cilliers, Benade et al 250.
57 S 92 of the Companies Act furthermore provides that shares may not be issued until such time as the full issue price or consideration has been paid. In the context of this article, this would require services to be rendered to the company before shares may be issued.
58 Meyerowitz “Paying for goods and services by issuing shares” 2004 The Taxpayer 86.
According to Blackman,\(^{59}\) the company has a primary right to receive a subscription price in cash, even in circumstances where the parties have agreed that the subscription price is to be paid in kind. This “primary right”, however, is not enforceable against the subscriber if the subscription agreement provides for the settlement of the subscription price in kind. The subscriber would therefore, in the latter circumstance, still be performing properly under the subscription agreement if it pays the in-kind subscription price. This “primary right” is forfeit upon accepting a subscription price in kind.

It was argued in the United Kingdom case of *Osborne v Steel Barrel Co Limited*\(^{60}\) on behalf of the Crown that if a company acquires stock in consideration of the issue of fully-paid shares to the vendor, that stock must, for the purposes of ascertaining the company’s profits, be treated as having been acquired for nothing. The court held that:\(^{61}\)

“The argument really rests on a misconception as to what happens when a company issues shares credited as fully paid for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but, when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when, in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash.”

It has been observed that the forfeiture of an expectation could perhaps be classified as the forfeiture of a *spes*, which is not, in law, recognised as an enforceable right.\(^{62}\) However, it could be argued that the “right” that is given up as a result of the acceptance of a subscription price in kind is not merely a *spes*. It could perhaps be argued that the “primary right” so given up in the instance of a subscription agreement is a personal right against the allottee that would have been enforceable had the subscription agreement not provided for the subscription price to be settled in kind. On surrendering this personal right, the company is consequently parting with an asset, with an ensuing diminution of the company’s patrimony. It could therefore be argued that, in giving up its “primary right” to receive the subscription price in kind, the company is in fact incurring an expense.\(^{63}\)

### 3 Critical Analysis of *ITC 1783* and *ITC 1801*

The two tax court cases *ITC 1783*\(^{64}\) and *ITC 1801*\(^{65}\) are the only reported South African tax cases to date that have dealt directly with the deductibility of share-based payments and specifically with the question of whether or not they would constitute “expenditure . . . actually incurred”.

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59 Blackman, Jooste and Everingham 255.
60 1942 1 All ER 634 (CA).
61 *Idem* 637.
62 See par 1 2 1 Expenditure supra.
63 Burger 57.
3.1 **ITC 1783**

The facts of this case relevant to this discussion are that the taxpayer acquired a licence agreement for the issue and allotment of shares in the taxpayer. The taxpayer sought to deduct an amount of R5 280 000, the value placed on the specific asset, in terms of section 11(gA) of the Act. The Commissioner rejected the deduction because, *inter alia*, the taxpayer did not incur any expenditure, given that the issue and allotment of shares by a company does not constitute expenditure by such company.

The court considered the ordinary dictionary meaning of the word “expenditure” as “the spending of money or its equivalent eg time or labour and a resultant diminution of the assets of the person incurring such expenditure”. The court held that, although the allotment or issuing of shares by a company may reduce the value of the shares held by its shareholders, it does not in any way reduce the assets of the company.

The judgment quotes the following paragraph from *Silke on South African Income Tax*:

> “An interesting point arises when a company discharges an obligation by the issue of its own shares. For example, a company may remunerate one of its employees for services rendered by the issue of its own shares. Since the company has not lost or parted with any asset, it is submitted that it has not expended anything, and that it is not entitled to claim as a deduction from income the nominal value of the shares issued to the employee. The position, it is submitted, would be different if the employee agrees to work for a salary payable in cash but subsequently decides to subscribe for shares and uses the remuneration owing to him to pay for the shares. In such a situation the company will have incurred expenditure comprising the salary due, notwithstanding the fact that its obligation is subsequently discharged by the issue of shares. But when a company is obliged to allot shares in return for services rendered to it, there is no laying out or expending of any moneys or assets which, it is submitted, is an essential requisite of the words ‘expenditure actually incurred’ in s 11(a).”

This paragraph from *Silke on South African Income Tax* was essentially the basis for the court’s decision in ITC 1783. However, the decision has been subject to widespread criticism.

3.1.1 **Criticism Against the Decision in ITC 1783**

Meyerowitz argues that the decision in ITC 1783 is incorrect. Where a company remunerates a director or employee by way of shares in the company he submits that “...the expenditure is at least equal to the nominal value of the shares and may be more, ie the value of the shares *bona fide* agreed upon between the company and the other party”.

According to Ger, the judge’s view of expenditure in this case may be said to have been exceedingly narrow and not necessarily correct. He argues that it is possible that the concept of “incurred of expenditure” was

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66 De Koker par 7 4.
67 Meyerowitz 2006 *The Taxpayer* par 1133.
confused with the “settlement” thereof. The taxpayer arguably incurred expenditure on the purchase of the licence agreement. The fact that the taxpayer chose to settle this expense in shares should not change this reality. Ger further argues that because shares were issued in lieu of paying cash for the licence, it could be said that the taxpayer was indeed reducing its assets. The taxpayer was giving up the right it would otherwise have had to claim payment in cash for the shares it issued in exchange for the licence. He submits that the notion of expenditure should include all economic sacrifices associated with acquiring an item and should not be restricted to mere cash outlays, as implied in *ITC 1783*.

The above line of reasoning is supported by Clegg and Stretch. According to them, expenditure may be incurred in cash or in any other form that carries a monetary value, such as shares, fixed property, or the provision of a service. The deduction for the taxpayer who incurred the expense is the cost of transferring the asset, or of rendering the service. If the asset so transferred was acquired for no consideration, the value of the asset is deductible. According to them, where the asset concerned is shares in the taxpayer company, the argument that the company has not expended or lost anything in issuing the shares is not clear. They submit that it may be argued that the company has incurred a debt which is met by the issue of shares. If so, the nominal value of the shares issued, and any share premium, must rate as a deduction in the hands of the company.

Burt argues that it is established beyond question that the issue of shares is not a disposition or alienation of the company’s property and that it does not result in the diminution of its assets. However, he submits that the term “expenditure . . . actually incurred” was constructed too narrowly in *ITC 1783*. According to him, the question is not “. . . whether the person claiming the deduction has parted with cash or otherwise reduced his assets, but whether the term ‘expenditure actually incurred’ envisages anything other than the incurral of an unconditional legal obligation in terms of which some form of performance is due, provided that the performance due has a monetary value”.

Burt adds that a company that agrees to allot its own shares as a consideration for the acquisition of an asset or procurement of services incurs a legal obligation to allot its own shares. With reference to the decisions in the *Caltex Oil (SA) Ltd* case and the *Edgars Stores Ltd* case, Burt argues that such a company would be regarded as having incurred expenditure by incurring the legal obligation.

Burt’s view is apparently based on his interpretation of the judgment as indicating that the “some form of performance” that settles a liability does not need to be equated with an “expense”. It simply needs to have a monetary value. However, in response to Burt’s argument, it is submitted here that a “liability actually incurred” should not be equated with an “expense actually incurred”. What has to be determined is whether an

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69  Par 10 2 4.
70  2004 Tax Planning 133.
71  Ibid.
72  Ibid.
"expense" exists or would exist if the liability is discharged, so that it could be said that the taxpayer is impoverished by that obligation. Thereafter it should be determined whether such an expense has been "actually incurred". It is therefore submitted that Burt's criticism of ITC 1783 should be viewed in this context.

In order to qualify as having actually incurred an expense, it is imperative for a company which makes a share-based payment for the procurement of services to have incurred an unconditional liability for an expense. Hence, the key phrase pivotal to the judgment in the ITC 1783 case, namely that "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", deserves careful consideration. It may be true that the issue of shares does not per se reduce the assets of a company, but the forfeiture of the subscription price due to the company could be considered to reduce the assets of the company. It could be argued that, although the shares in a company do not constitute an asset of the company, the debt due by a subscriber to pay the issue price does constitute an asset of the company, as it is owed to the company itself. The expenditure therefore lies in the forfeiture of the subscription price due by the subscriber. This forfeiture may be affected as consideration for something different, such as the settlement of an amount due for the procurement of a service. This argument is in line with that of Ger.74

3.1.2 Support for the Decision in ITC 1783

A paragraph in Silke on South African Income Tax was quoted in the ITC 1783 case to strengthen the judgment.75 There is also some support for the decision reached in this case.

Williams is of the opinion that a company has not, strictly speaking, incurred any expenditure when it allots some of its own shares in discharge of an obligation or as a quid pro quo for the acquisition of trading stock.76 According to Williams, the reason for this is that the company's patrimony is undiminished when shares are issued in these circumstances.

Brincker distinguishes between three alternatives that are available to a company when shares are issued in settlement of debt:77

- shares can be issued directly in settlement of the debt;
- the company can pay cash to the recipient on the understanding that the proceeds will be used to subscribe for shares in the company; or
- the company can pay cash to the recipient where the recipient has a choice about whether or not to use the cash to subscribe for shares in the company.

73 Burger 48.
74 Sept 2004 De Rebus 63.
75 At 376.
According to Brincker, there is a grey area when the recipient is obliged to use cash proceeds to subscribe for shares. He submits that our courts tend to take one of two approaches. In one instance, our courts recognised that, as long as there is a time delay between the receipt of the cash and the subsequent subscription of the shares, it may be possible for a company to incur a cost or expense in the form of the cash paid to the recipient. In the other line of cases, it has been indicated that, if the overall arrangement results in the issue of shares and there is never any intention on the part of either party to transfer and retransfer the cash, the transaction ultimately amounts to the issue of shares. The recipient will then be taxed on the market value of the shares and no deduction will be allowed for the company, as no expenditure has actually been incurred.

3 2  ITC 1801

The facts of ITC 1801, which were decided in the Gauteng Tax Court on 18 May 2005 by Jooste AJ, were similar to those of ITC 1783. The appellant acquired the rights to a certain trademark during 2000 and issued some of its own shares in compliance with its obligations to give a consideration for the trademark. The appellant claimed an allowance in terms of section 11(gA) of the Act on acquisition of the trademark. The Commissioner, however, disallowed the deduction on the grounds that the appellant “did not expend any monies or assets” and “[a]ccordingly, no expenditure was actually incurred by the appellant in acquiring the trademark as required by s 11(gA) of the Act”. (own emphasis). In this regard, SARS relied on the decision of ITC 1783.

The appellant’s contentions were that it had incurred an unconditional obligation to pay the purchase price of the trademark and that the incurrence of that obligation constituted expenditure incurred in acquiring the trademark and that the fact that it discharged its obligation by issuing shares to the seller did not detract from this circumstance.

Jooste AJ held that the decision in ITC 1783 is “in our view, with respect, clearly wrong and not a reflection of the law. Tax issues should not unnecessarily complicate or frustrate ordinary commercial transactions.” The court held that the expression “expenditure actually incurred” means that the taxpayer should have incurred an unconditional legal obligation in respect of the amount concerned and that it is not a requirement that the obligation should be discharged. The court held that “where the obligation has been incurred, the expenditure becomes deductible if it also complies with the other requirements for the deductibility laid down by the section.

78 The events relevant to the case therefore occurred before the introduction of s 24B into the Act.
79 ITC 1801 supra 60.
80 From the heads of argument of the appellant and respondent in the ITC 1783 case, Jooste AJ held in ITC 1801 65 that the court was neither referred to any of the English authorities that were referred to in ITC 1801 nor to the Lace decision supra, and consequently did not have the benefit of considering these cases. He further held that it appears that the matter was not fully argued before the court in ITC 1783.
concerned” and that the appellant was accordingly entitled to the allowance in terms of section 11(gA) for the acquisition of the trademark.81

In his judgment, Jooste AJ referred to three English cases that dealt with the incurrence of expenses where assets were acquired by means of share-based payments. In *Osborne v Steel Barrel Co Limited*,82 the argument of the revenue authority was similar to that of the Commissioner in *ITC 1801*. The court, however, in rejecting the revenue authority’s argument, held that:83

“A company, therefore, when, in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash. . . . the consideration moving from the company must be at least equal in value to the par value of the shares and must be based on an honest estimate by the directors of the value of the asset acquired.”

In *Cradock v Zevo Finance Co Limited*,84 the revenue authority contended that, where a company acquired an asset and as a consideration issued shares in the company itself at nominal value, the cost of the asset could not be regarded as the nominal value of the shares issued. The court held that the consideration that was provided by the taxpayer in acquiring the asset was a genuine consideration and that any attempt that attacks it fails on the facts and on the law.85

In *Stanton v Drayton Commercial Investments Co Limited*,86 the taxpayer acquired certain assets at a stated price, to be satisfied by the allotment of a stated number of shares to be issued at a nominal value plus a stated premium. The court held that the taxpayer was entitled to a deduction, because the agreed issue price of the shares constituted a consideration given by the company for the assets acquired. The court then considered the value of the allowable deduction and held that the value cannot be less than the par value of the shares, but could be more, since shares may be issued at a premium. The court held that, as the parties had clearly agreed on a purchase price, the agreed purchase price should be the value of the consideration.87

After referring to the decisions in the above three English cases, Jooste AJ considered the judgment of *Lace Proprietary Mines Limited v Commissioner* ______________

81 In reaching this conclusion, Jooste AJ referred to the *Edgars Stores Ltd* case supra, where it was held at 888G–889C that “... it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(a) from income returned for that year”.
82 1942 1 All ER 634 (CA).
83 Idem 638.
84 1944 1 All ER 566 (CA).
85 The judgment in *Cradock* was upheld by the House of Lords in *Cradock v Zevo Finance Co Limited* 27 TC 267 (HL).
86 1982 1 All ER 121 (CA). The Court of Appeal’s judgment in *Stanton* case was upheld by the House of Lords in *Stanton v Drayton Commercial Investment Co Limited* 1982 2 All ER 942 (HL).
87 The court held at 947 that this is the case where the contract as such is not tainted with dishonesty.
It was held in this case that the value of shares issued in the purchasing company had to be included in the selling company’s income. The court held that the value to be included in the selling company’s income was the actual value of the shares and not the agreed issue price. Jooste AJ agreed with council for the appellant in *ITC 1801* that the *Lace Proprietary Mines* decision confirmed that, where a company makes a share-based payment, it constitutes a real consideration given by the issuing company.

By applying the principle laid down in the *Stanton* case, the court considered in *ITC 1801* that the expenditure incurred by the appellant in terms of the share-based payment should be equal to the agreed issue price of the shares. However, on applying the principles of the *Lace Proprietary Mines* case, the court considered that expenditure incurred should be equal to the market value of the shares. The court, in *ITC 1801*, did not decide on which of the two principles it considered to be correct, as the agreed issue price of the shares was equal to the market value thereof.

The court in *ITC 1801* referred to the articles of Ger and Meyerowitz, examined above, and held that these, together with the English and South African cases considered in the judgment, are a sound and correct statement of the law. It was therefore held that the taxpayer had, in fact, actually incurred an expenditure when it made a share-based payment to acquire an asset.

### 3.2.1 Comments on *ITC 1801*

It was held in *ITC 1822* that the question of whether the transfer of a taxpayer’s own shares to a supplier of a service constitutes payment or not, must be regarded as settled in the light of the “comprehensive and most persuasive judgment of Jooste JA” in *ITC 1801* “and the authorities referred to therein”.

Burt submits that the decision in *ITC 1801* is legally sound, as it accords with the highest authority in England and implicitly with the highest authority in South Africa. However, Burt deduces from the judgment that the court had rejected the notion that the incurral of expenditure necessarily involves a resultant diminution of the assets. The judgment, however, stated that:

> “It is not required that the obligation should also be discharged. Where the obligation has been incurred, the expenditure becomes deductible if it also complies with the other requirements for the deductibility laid down by the section concerned” (own emphasis).

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88 Supra.
89 Idem 66.
90 Supra 205.
91 It was held by Bertelsmann J in *ITC 1822* that “this judgment [ITC 1801] is binding on this court unless it was to be held to be clearly wrong, which is decidedly not the case” (idem 205). It is, however, submitted that the court in *ITC 1822* was not bound by the judgment of *ITC 1801* as the Tax Court is not bound by its own decisions (see CIR v City Deep Ltd 1924 AD 298).
92 Burt 2006 Tax Planning 47.
93 Idem 61.
It is therefore submitted here that *ITC 1801* is not authority for the argument that expenditure does not necessarily involve a resultant diminution of the assets of the taxpayer. In referring to the *Osborne* case, the judgment approved the contention that where a company makes a share-based payment for the procurement of services, it is giving up what it would otherwise have had, namely, the right to call on the allottee for payment of the issue price of the shares in cash. This right would have constituted an asset, as it would have been owed to the company. The expenditure therefore lies in the forfeiture of this right and hence the resultant diminution in the assets of the company.

### 4 Conclusion

In terms of an agreement for the acquisition of assets or procurement of services, a company can agree to settle the acquisition price by issuing shares in the company as a consideration. This practice is referred to as a share-based payment. The most pertinent question to consider from an income tax perspective where assets or services are acquired by means of a share-based payment, is whether or not the company could be said to have actually incurred an expense. Whether an expense is actually incurred is one of the essential requirements for section 11(a) and paragraph 20(1)(a) of the Eighth Schedule, which deal respectively with the deductibility of amounts for income tax and capital gains tax purposes.

To a certain extent, legislative clarity was attained on this issue after the insertion of section 24B into the Income Tax Act, which provides for an amount to be deemed to be an expenditure actually incurred when a company acquires an asset by means of a share-based payment. However, this section is not applicable when a company procures services or settles an existing debt by means of a share-based payment. In such cases, one has to rely on the conflicting decisions of the Gauteng Tax Court in *ITC 1783* and *ITC 1801*.

It was held in *ITC 1783* that a company that makes a share-based payment for the acquisition of an asset does not incur an expense, as the issue of shares in a company does not result in a diminution in the assets of such company. However, this decision was criticised in *ITC 1801* and it was held not to be a reflection of the law. It was held in essence in *ITC 1801* that the expression "expenditure actually incurred" means that the taxpayer should have incurred an unconditional legal obligation in respect of the amount concerned. When such an obligation has been incurred, the expenditure becomes deductible if it also complies with the other requirements of deductibility laid down by the section concerned.

The judgment of *ITC 1801* approved the contention, by referring to the *Osborne* case, that where a company makes a share-based payment to acquire an asset or to procure services, it is giving up what it would otherwise have had, namely, the right to call on the allottee for payment of the issue price of the shares in cash. It is submitted here that, where a company makes a share-based payment to procure services, it incurs an expense which lies in the forfeiture of this right and hence the resultant diminution in the assets of the company.
It is, however, submitted that, although the judgment in *ITC 1801* could be considered to be a correct statement of the law and that a company therefore actually incurs an expense when it procures services by means of a share-based payment, the case remains an Income Tax Court decision and is therefore not binding on the High Court. In conclusion, it is submitted that the legislature needs to take cognisance of the decision in *ITC 1801* and the deficiency of section 24B and needs to amend the Income Tax Act in order to provide legislative clarity in this regard.