

**THE TAX EFFECT OF SHARES-FOR-FUTURE
SERVICES**

by

Anton David Schoon

88663176

**SUBMITTED IN PARTIAL FULFILMENT OF THE
REQUIREMENT FOR THE DEGREE LLM**

UNIVERSITY OF PRETORIA

SUPERVISOR: ADVOCATE C LOUW

August 2011

DISCLAIMER

I, Anton David Schoon, hereby declare that this dissertation is my own, unaided work, which is being submitted in partial fulfilment of the prerequisites for the degree of Master's in Tax Law at the University of Pretoria. It has not been submitted before for any degree or examination at any other University.

.....

Anton David Schoon

August, 2011

TABLE OF CONTENTS

DISCLAIMER	II
CHAPTER 1. INTRODUCTION	1
1.1. Background	1
1.2. The new Companies Act	2
1.3. The nature of shares	4
1.4. Objective of the study	4
1.5. Research questions	5
1.6. Significance of study	6
1.7. Methodology	13
1.8. Limitations of the study	14
1.9. Literature review	14
1.10. Structure of the research	18
CHAPTER 2. TAX EFFECTS IN THE HANDS OF THE EMPLOYEE / INDEPENDENT CONTRACTOR	20
2.1. Distinguishing employees from independent contractors.....	21
2.2. Tax effect on employees	23
2.3. Section 8 (C)	23
2.4. Shares-for-services offered to employees are “restricted equity instruments” 24	24
2.5. Effect of section 8C	25
2.6. Tax effect at the time the share is issued to the employee	26
2.7. Tax effect on independent contractors: section 8C not applicable.....	27
2.8. Comparison between tax effect on “employees” and “independent contractors”	30
CHAPTER 3. DOES THE COMPANY WHICH PAYS FOR FUTURE SERVICES WITH SHARES INCUR EXPENDITURE?	32
3.1. Actual expenditure	33
3.2. ITC 1783 and ITC 1801 (the “Labat tax court decision”).....	35
3.2.1 ITC 1783	35
3.2.2 ITC 1801 (Labat tax court decision)	38
3.3. The nature of shares	39
3.4. Discussion of the Osborne decision.....	40
3.5. When is expenditure incurred?	45

CHAPTER 4. THE DATAKOR ENGINEERING CASE SHOULD HAVE HAD BEARING ON THE LABAT DECISION	48
4.1. Does section 20 (1) (a) (ii) apply to court sanctioned compromises only?....	53
CHAPTER 5. ADEQUATE CONSIDERATION	57
CHAPTER 6. SECURITIES TRANSFER TAX, CGT & VAT	60
6.1. Securities Transfer Tax (STT)	60
6.2. Capital Gains Tax (CGT).....	62
6.2.1 Asset for share transactions.....	62
6.2.2 Shares issued to employees	63
6.2.3 Shares issued to independent contractors.....	63
6.2.4 CGT in the hands of the trust?	64
6.3. Value Added Tax (VAT)	65
6.4. Secondary Tax on Companies (STC)	68
CHAPTER 7. THE TAXATION OF TRUSTS	70
7.1. Do the shares vest in the trust?	70
7.1.1 Section 7 (5).....	72
7.1.2 The application of section 7 (5) to shares-for-services	73
7.1.3 Section 7 (6) of the Income Tax Act.....	73
7.1.4 Section 7 (7) of the Income Tax Act.....	74
7.1.5 There is no tax effect in the hands of the trust	74
CHAPTER 8. CONCLUSION.....	76
8.1. Tax effect on recipients of shares for future services.....	79
8.2. Income tax and capital gains tax consequences arising from a transfer to the trust.....	80
8.3. “Adequate consideration”	81
8.4. The rule of law and legal certainty	82
8.5. SARS v Labat - the endgame	84
REFERENCES	87

CHAPTER 1. INTRODUCTION

This dissertation considers the effect of shares issued by a company, in terms of the Act 71 of 2008 (the “new Companies Act”), in exchange for services rendered in the future. In particular, it will examine the income tax effects on the company taxpayer issuing the shares to pay for future services; specifically whether the taxpayer company incurs expenditure by doing so. It will also consider VAT, CGT and STT issues.

1.1. Background

Shares-for-future-services, as provided for in the New Companies Act,¹ serve two diverse functions. First, a company may offer its shares as part of a share incentive scheme to its employees; second, shares-for-future services is an innovative financial instrument to allow companies to procure services without having to lay out cash.² This is significant in a cash-strapped society, and as such, services play such an important role in modern day global trade.³

Section 92 of the former Companies Act, the “1973 Companies Act”,⁴ provides that shares can be issued only if the company has received the nominal value for such shares in cash or in services already performed. Any allotment in contravention of section 92 is void.⁵ Furthermore, any agreement or arrangement which specifies that a company will allot or issue its shares without, or before, the consideration for such

¹ Act 71 of 2008.

² Kelly, R. 2009. *New Companies Act Offers Relief to Struggling Businesses*. [Online] Available at <http://www.bowman.co.za/LawArticles/Law-Article~id~2132417422.asp>.

³ In OECD countries, more than two thirds of output, and up to four-fifths of employment is in the services sector: Bishop, M, 2001. *Economics-an A-Z Guide*. London: Profile Books.

⁴ Act 61 of 1973.

⁵ *Bauermeister v CC Bauermeister (Pty) Ltd* 1981 (1) SA 174.

shares has been received or paid, is void.⁶ Additionally, any financial assistance to a person to buy shares in a company is prohibited in terms of section 38 of the 1973 Companies Act.⁷

1.2. The new Companies Act

In a sea-change, the new Companies Act,⁸ substituted for the 1973 Companies Act,⁹ mandates a company to issue shares for *future* consideration. Section 38 (1) of the new Companies Act¹⁰ provides that the Board of the company may resolve to issue shares at any time within the classes or to the extent that share have been authorised in the Memorandum of Incorporation in terms of section 36. Future consideration may be an instrument not yet negotiable, future services, benefits or payment by the subscribing party. This study will consider the issuing of shares-for-future-services.

In particular, s40 (5) of the new Companies Act¹¹ enables a company to secure services without having to lay out cash. The main position of this mini dissertation is that although the Labat decision¹² declared that companies which give up the right they would have had to receive money for shares bears economic sacrifices that constitute expenditure,¹³ this decision is challengeable. In this regard SARS is appealing the decision to the appellate division.¹⁴ On the one hand, shares-for-future-services is a

⁶ Etkind and Others v Hicor Trading Ltd 1991 (1) SA 111 (W).

⁷ Act 61 of 1973.

⁸ Act 71 of 2008.

⁹ Act 61 of 1973.

¹⁰ Act 71 of 2008.

¹¹ *Ibid.*

¹² C. SARS v Labat Africa Ltd, 72 SATC 75.

¹³ The Labat decision held that a company which accepts an unconditional legal obligation incurs expenditure. If Labat is correct, this principle should apply to shares for services, as a company that accepts an unconditional legal obligation to pay for services actually incurs expenditure.

¹⁴ SARS obtained permission to appeal in terms of section 20 (4) (b) of the Supreme Court Act, Act 59 of 1959, and lodged its heads of argument to the Supreme Court of Appeal:

financing mechanism which allows the company to fund service needs without having to “pay” until the service obligations are rendered. Although it is not a *sui generis* share, the rights which make up the share are suspended until the service obligations are fulfilled.

On the other hand, in the context of share incentive schemes, shares offered to employees for future services meet the requirements of the definition of “restricted equity instrument” in section 8C of the Income Tax Act.¹⁵ Consequently, the provisions of section 8C will be applicable to such shares.

Section 40 of the new Companies Act¹⁶ deals with the consideration required by a company before it may issue shares. On entering into the future services agreement, the company issues the shares. It is submitted that the shares are issued to the subscribing party, as shares may not be issued *in vacuo*.¹⁷ On issue, the company causes the shares to be “transferred” to a trust.¹⁸ The trust holds the shares. Unless the trust agreement provides otherwise, the service provider may not exercise any of the rights underlying the share prior to meeting the service obligations.¹⁹

Shares are transferred to the service provider to the extent that the service provider complies with the service agreement. In the interim, prior to the performance of the services, the service provider may not exercise voting rights or pre-emptive rights.²⁰ The service provider is entitled to the distributions only to the extent that the service provider has complied with the service agreement.²¹ The shares must be returned to

Appellant's Heads of Argument, Case no 435/201, March 2011.

¹⁵ Act 58 of 1962.

¹⁶ Act 71 of 2008.

¹⁷ Delpont, P. 2009. *The New Companies Act Manual*. Durban: Lexis Nexus.

¹⁸ Ss (5) (b) (i) and (ii).

¹⁹ Ss (6) (a), (b).

²⁰ Ss (6) (a), (b).

²¹ Ss (6) (c).

the company if the service provider fails to perform service obligations.²²

1.3. The nature of shares

Standard Bank of SA Ltd v Ocean Commodities held that, “a share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends.”²³ Section 35 (1) of the new Companies Act provides that a share is movable property. In the context of s40, read with the above Standard Bank decision,²⁴ and section 35 (1), nothing accrues or is received by the service provider until fulfilment of the service agreement – the service provider cannot vote, share in distributions or transfer shares (unless the company agrees).

Like an option, the vesting of rights is dependent on the shareholder fulfilling the contractual obligations - he has to perform the services. The shareholder therefore acquires a *spes* to obtain the share rights. If shareholder-for services fails to perform the services, the shares revert back to the issuing company.²⁵

1.4. Objective of the study

The main objective of this thesis is to show that the company which issues shares to pay for services or assets does not incur expenditure. The researcher examines court decisions and writers’ opinions, for and against. SARS has obtained permission from the Supreme Court of Appeal to appeal the Labat decision.²⁶ If the Supreme Court of Appeal were to hold that the issuing company does incur expenditure, then in the light

²² Ss (6) (d) (iv).

²³ 1983 (1) SA 276 (A).

²⁴ 1983 (1) SA 276 (A).

²⁵ Ss 40 (6) (d) (iv).

²⁶ 4 March 2011, “Appellant’s Heads of Argument” Appeal Case 435/2010.

of conflicting decisions relating to instruments with variable values, such as shares or foreign currency,²⁷ the researcher considers at what moment the shares accrue to the shareholder, and discusses how and when to calculate the expenditure incurred by the company.

The researcher examines whether the Commissioner has the discretion to adjust expenditure incurred. The research seeks to answer whether the various transfer events have CGT (Capital Gains Tax) and/or STT (Securities Transfer Tax) effects. The researcher also considers the VAT (Value Added Tax) effect of such transactions. As the income, in the form of shares, will be transferred to a trust, the provisions of the Income Tax Act²⁸ which relate to the taxation of trusts, such as section 25B and section 7, which deem income transferred to a trust to be that of the donor, may be applicable.

1.5. Research questions

The overall theme of the study is to consider the tax effect of the issue of shares-for-future-services, in terms of s40(5) of the Companies Act,²⁹ in the hands of the company issuing the shares and in the hands of an independent contractor or employee, respectively, who receive such shares. Shares-for-future-services is a novel concept and no case law exists on its interpretation.

In order to examine the above, the following questions will need to be considered:

- Does the company which pays for future services with shares incur expenditure?
- If so, what expenditure does the company incur, and when is it incurred?

²⁷ As referred to infra, Cadac Engineering Works, CIR v (1965 AD) 27 SATC 61, on the one hand, versus Mooi v Secretary for Inland Revenue (1972) 2 All SA 57 (A) and Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349 decisions, on the other.

²⁸ Act 58 of 1962.

²⁹ Act 71 of 2008.

- Whether the Datakor decision³⁰ should have been considered in the Labat case.³¹
- When is the recipient of the shares liable to tax?
- Whether the trust, to which the shares are transferred, is liable for taxation, or whether income may be deemed back to the donor company.
- Does s40(5)³² result in multiple transfer events entailing CGT and SST consequences?
- “Adequate consideration” - What is “adequate consideration”?
- Will the Commissioner deem that a portion of the value of the shares issued which exceeds the value of services provided be deemed a donation?
- Does the introduction of s24B³³ mean that SARS deems expenditure to have been incurred where shares are issued to settle an unconditional obligation?

1.6. Significance of study

The Income Tax Act³⁴ deems a purchasing company which issues shares in itself to have bought assets which incur expenditure³⁵. The Act³⁶ does not allow a similar concession to a company which issues shares to pay for services.

³⁰ CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

³¹ C. SARS v Labat Africa Ltd, 72 SATC 75.

³² *Ibid.*

³³ Income Tax Act, 58 of 1962.

³⁴ 58 of 1962.

³⁵ S 24B.

³⁶ 58 of 1962.

De Koker (2010) states that the debate as to whether shares issued for future services constitute expenditure “remains alive and relevant”.³⁷

The Labat decision³⁸ held that shares issued in exchange for a trademark constitutes expenditure for the issuing company as the latter incurs an unconditional obligation to pay the purchase price. The method it chooses to pay this expenditure is irrelevant. In terms of this principle, as set out in Labat,³⁹ the two scenarios, i.e. shares for services, or shares for assets, should in principle be treated similarly for the purposes of determining whether the company has incurred an expense, as in both instances the company which issues shares in itself to pay for expenditure (whether this is for assets or for services) has an unconditional obligation to pay and gives up the right to charge money for shares, thus incurring a loss. Labat⁴⁰ rejected the ITC 1783 decision⁴¹ stating that the real test as to whether a company incurs expenditure when it issues shares is not whether the company’s assets are diminished because it has to share its distributions or voting rights with a larger pool.

The Tax Court held, and this was confirmed on appeal to the Full Court,⁴² that the expression “expenditure actually” incurred means that a taxpayer should have incurred an unconditional liability and that the test is not whether the company’s assets were reduced. In this regard, the courts relied on the decisions in the *Nasionale Pers*⁴³ and *Edgars Stores* cases.⁴⁴ The Tax Court held, again relying on the *Edgars Stores* case⁴⁵,

³⁷ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. At 7.4: “but the debate as to whether an expenditure has been ‘actually incurred’, thereby giving rise to a s 11 (a) deduction remains alive and relevant where a company issues shares in return for services, as this situation falls outside the scope of s 24B (1)”.

³⁸ C. SARS v Labat Africa Ltd, 72 SATC 75.

³⁹ *Ibid.*

⁴⁰ *Ibid.*

⁴¹ ITC 1783, 66 SATC 373.

⁴² C.SARS v Labat Africa Ltd, 72 SATC 75.

⁴³ *Nasionale Pers Bpk v KBI*, 1986 (3) SA 549 (A).

⁴⁴ *CIR v Edgars Stores Ltd*, 1986 (4) SA 312 (T).

that once the taxpayer incurs an unconditional legal obligation, the deductibility requirement is met. The Tax Court held that Goldblatt J in ITC 1783 had erred because the judge had ignored the fact that an unconditional obligation came into existence.

However, it will be argued that the company which pays with shares does not incur an unconditional legal obligation to pay, but rather an unconditional legal obligation to issue its own shares.⁴⁶ It suffers no real loss. All that happens, figuratively, is that the cake is cut into smaller slices. For example, when it makes a dividend payment, it pays the same amount it would have paid, divided among *more* shareholders. So the company doesn't pay more, because it has more shareholders. In the alternative, if it is found that the company incurs actual expenditure, then the researcher argues that an agreement between the vendor and the purchasing company, which allows the latter to pay by issuing shares in itself, amounts to a concession or compromise between the vendor and the debtor company.

In terms of this concession, an obligation to issue shares is substituted for an obligation to pay. As a result, the purchasing company's assets are not diminished, as shares are not a company asset. Furthermore, the vendor loses the right to claim money. Before making the concession the vendor could enforce a claim for payment against the purchasing party, and take execution against company assets. Subsequent to the concession, it could receive dividend payments only, which were given at the whim of the directors. The researcher will therefore argue that the purchasing company is in fact receiving a benefit; it is not incurring an expense.⁴⁷

⁴⁵ *Ibid.*

⁴⁶ This is the argument that SARS is presenting in its appeal to the Supreme Court of Appeal, and at paragraph 6.1.4 of the Heads of Appeal it is stated: "Respondent clearly incurred an unconditional legal obligation to use its *own shares* in exchange for the trademark".

⁴⁷ CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

The principle set out in the Labat case⁴⁸ is that the company which foregoes the opportunity to exchange its shares for cash is suffering a loss. If it had issued those shares in the normal course of events it would have obtained cash, but it gives up this right. If this argument is correct, it is irrelevant whether the company pays for services or for assets with its shares; it would incur actual expenditure in both scenarios. In effect, the argument goes: the company foregoes the subscription cost it would have obtained if it had issued those shares in the normal course of events. This argument will be challenged in this study.

A company has, subject to the following conditions being fulfilled, an infinite capacity to issue shares. It must notably issue shares as specified in the Memorandum of Incorporation, as amended by shareholder special resolution,⁴⁹ and in compliance with prospectus conditions in the new Companies Act,⁵⁰ as well as in terms of the listing conditions of the stock exchange.

If it issues shares to pay for future services, its capacity to issue more shares to raise cash is undiminished. Secondly, shares may be issued for reasons other than raising cash. A share issue may contemplate diluting existing shareholders or empowering a new shareholder with a majority voting stake. In this scenario the object of the company is not to raise cash, and it cannot be argued that it is foregoing the issue price by giving the shares for future services. Finally, as shares are not a company,⁵¹ but may be a shareholder asset, the only persons who suffer losses on issue are existing shareholders.

Their power to vote and share in distributions is diminished. The company does not make an *economic sacrifice*,⁵² as expounded by Gerr,⁵³ as its capacity to raise further

⁴⁸ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁴⁹ S 38 of the new Companies Act, Act 71 of 2008.

⁵⁰ S 100.

⁵¹ Lowry v Consolidated African Selection Trust Ltd, 1940 2 ALL ER 545.

⁵² De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3): 475- 492. Notably there is no reduction in a

capital through share issues, provided the board and shareholders are in accord, and the company stays solvent and liquid subsequent to issue, remains unhindered.

The argument that a company foregoes the opportunity to exchange its shares for cash is suffering a loss was upheld in the Osborne⁵⁴ case. This decision formed the foundation to the Labat⁵⁵ decision. However, the Osborne case⁵⁶ was decided in the context of the capital maintenance rule. The capital maintenance rule, as expounded in the case of Trevor v Whitworth,⁵⁷ formed the foundation to English and South African company law for more than a century. Under this rule, the company was obliged to maintain the company capital to protect the creditors of the company.

The rule proved to be unenforceable and was to a large extent abolished in South Africa by the Companies Amendment Act 37 of 1999, which instead opted for the American rule of “Solvency and Liquidity”.⁵⁸

Subsequent to this change of course, the Companies Act⁵⁹ was amended. Hence, the company could give financial assistance to persons to buy shares in itself, make distributions out of its capital, and buy back its own shares, provided it remained solvent and liquid subsequent to such transactions. However, certain capital maintenance rules remained. Notably, shares could not be issued at discount. In terms of the new Companies Act,⁶⁰ par value shares have been abolished. The company issues shares at “no-par value”.

company's patrimony when it issues shares.

⁵³ Gerr, B. 2004. Income Tax- the Problem of Paying with Shares. *De Rebus*. September 2004.

⁵⁴ Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA).

⁵⁵ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁵⁶ Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA).

⁵⁷ Trevor v Whitworth (1887) 12 App Case 409.

⁵⁸ Pretorius, J.T., Delport, P.A., Havenga, M., Vermaas, M. 1999. *Hahlo's South African Company Law Through the Cases*. Cape Town: Juta, pg. 121.

⁵⁹ Act 61 of 1973.

⁶⁰ Act 71 of 2008.

Section 40 (5)⁶¹ obliges the company to issue such shares in exchange for “adequate consideration”. It will be argued, below, that “adequate consideration”, as set out in this section, does not mean “market value”. As the company is no longer required to issue shares at an objectively defined price, such as “par value”, nor “market value”, the argument in the Osborne⁶² case is no longer valid.

Osborne⁶³ held that a company which gives up the right it has to demand par value for shares suffers a loss. As discussed Chapter 3, the company, in terms of the new Companies Act,⁶⁴ no longer has the obligation to charge par value for the issue of new shares as capital maintenance has been abolished; nor for that matter is it compelled to demand market value for shares. Provided the directors acted in the best interest of the company, they would have complied with the “adequate consideration” requirement. For example, they would be doing so if they issued shares below market value to attract a key employee, which, although the company might receive less than it could have, would be to the greater good of the company. A share issue in exchange for services, the value of which may bear no relation to the value of the shares, can therefore no longer be attacked on the grounds that it diminishes the capital of the company as the foundation of this argument; i.e. the capital maintenance requirement no longer exists.

On the other hand, if the Appeal Court were to uphold the Labat⁶⁵ decision, and were to decide that a company which issues its own shares does incur expenditure, then the second issue is whether the shares are valued on the date of agreement or at the end of the year of assessment, and whether such expenditure is the amount actually incurred or the market value of the shares.

⁶¹ *Ibid.*

⁶² Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA).

⁶³ *Ibid.*

⁶⁴ Act 71 of 2008.

⁶⁵ C. SARS v Labat Africa Ltd, 72 SATC 75.

Caltex Oil⁶⁶ held that the value of foreign currency is valued at the end of year of assessment in which it accrued. Labat⁶⁷ held that expenditure is incurred at the time agreement is reached, for the value agreed for those shares.

There seems to be a clash between these two cases. For example, if the agreed value of the shares is x amount, but at the end of the year of assessment the market value of those shares has gone up R100 + x amount, then according to Caltex Oil⁶⁸ the company would have incurred the latter amount in expenditure. It is submitted that the correct approach should be to allocate market value of the shares on the transaction date as the amount of expenditure incurred.

This seems to be the attitude adopted by the legislature: section 24 B (1)⁶⁹ provides that the company which issues shares in itself is deemed to have an amount of expenditure equal to market value of the shares.⁷⁰ However, this issue is academic as the central tenet of this researcher is that a company that issues shares to pay for assets or services, future or current, does not incur expenditure. Furthermore, if the value of the shares is excessive in relation to the value of the services performed, does that portion of the value of the shares issued which exceeds the market value of the shares constitute a donation, which is subject to donations tax?⁷¹

In addition, if the issue price of the shares is deductible, which is disputed in this study, may the Commissioner reduce the amount which may be deducted if the value of shares is excessive in relation to the value of the services rendered? The answer to these questions also depends on whether the recipient receives the shares in his/her capacity of an “employee” or “independent contractor”, as defined in the Fourth

66 Caltex Oil (SA) Ltd v Secretary for Inland Revenue, [1975] 2 All SA 222 (A).

67 C. SARS v Labat Africa Ltd, 72 SATC 75.

68 Caltex Oil (SA) Ltd v Secretary for Inland Revenue, [1975] 2 All SA 222 (A).

69 Act 58 of 1962.

70 Or the market value of the asset acquired, whichever of the two is the lesser.

71 S 54 of the Income Tax Act 58 of 1962.

Schedule of the Income Tax Act.⁷² The answer will have an important tax impact in the hands of the issuing company and the service provider. Finally, as there seem to be several transfer events, STT and CGT may also be applicable.

1.7. Methodology

De Swardt⁷³ states that case law on whether a company which issues shares for the payment of services incurs expenditure is sparse; on the other hand, he argues that the courts have set out clear principles to ascertain what constitutes “expenditure actually incurred”.

These cases will be examined to analyse whether a company which issues shares to pay for future services incurs actual expenditure. It will be examined, specifically with reference to English case law⁷⁴ on this question, as referred to in the *Labat a quo* decision, in the Tax Court,⁷⁵ whether a similar payment structure is available in other jurisdictions, and what the tax effects thereof are. Alternatively, if it is found that the concept of shares-for-future-services is unique to this country, an analogical method will be employed to gauge the tax effect of shares-for-future-services.

As the concept is novel to South African law, and no case law is available on its interpretation, the principles crystallised in South African and English law on actual expenditure will be examined.

⁷² Act 58 of 1962.

⁷³ De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3), p. 475.

⁷⁴ *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA).

⁷⁵ ITC No 1801 68 SATC 57.

1.8. Limitations of the study

In terms of section 40(5),⁷⁶ future consideration for shares may be in the form of an instrument which becomes negotiable, or in the form of future -benefits, -payment or -services. This study is limited to the examination of the tax effect of shares-for-future-services. As stated above, De Koker⁷⁷ notes that the Labat case⁷⁸ provided certainty in one respect: shares issued to pay for assets does constitute expenditure; however, he opines that it is still uncertain whether shares issued for services result in an expense for the issuing company. The limitation of this study to shares for services exclusively is justified in a context of great uncertainty regarding the tax effect thereof, which needs to be clarified.

1.9. Literature review

Although the Income Tax Act⁷⁹ is silent on whether a company which issues shares to pay for future services incurs expenditure, there is some authority in the UK⁸⁰ and in South Africa⁸¹ to confirm that a company does incur actual expenditure where it commits itself to settle its contractual obligations by issuing shares in itself, specifically to pay for assets.

⁷⁶ Act 71 of 2008.

⁷⁷ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010.

⁷⁸ C.SARS v Labat Africa Ltd, 72 SATC 75.

⁷⁹ Act 71 of 2008.

⁸⁰ Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA).

⁸¹ ITC 1822 69 SACT 200, which adopted the decision of Jooste J in ITC 1801, as confirmed on appeal to the High Court in C. SARS v Labat Africa Ltd, 72 SATC 75.

On the other hand, De Koker⁸² states that no expenditure has been incurred where a company parts with shares to acquire value as the “company has not lost or parted with assets”. ITC 1783⁸³ relies on De Koker⁸⁴ in support of its contention that the appellant does not incur any expenditure; however he does not refer to any authority for its conclusions (at 7.4).

Ger⁸⁵ rejects Justice Goldblatt’s arguments in ITC 1783⁸⁶ as he feels the court confuses the concept of incurring of expenditure with the settlement thereof. This writer also raises the important concept that expenditure is not necessarily a diminution of assets but includes the notion of economic sacrifices (Ger, 2004).

Similarly, Meyerowitz⁸⁷ criticises the decision in ITC 1783⁸⁸ as it does not correctly announce the law, ignores English authority on the question, and is based solely on a textbook reference (De Koker at 7.4)⁸⁹ which in turn is not based on any authority.

De Swardt⁹⁰ states that there are not enough authoritative precedents in South African case law to determine whether or not shares offered in return for services constitute expenditure actually incurred.

⁸² De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Section 7.4.

⁸³ ITC 1783, 66 SATC 373.

⁸⁴ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Section 7.4.

⁸⁵ Gerr, B. 2004. Income Tax- the Problem of Paying with Shares. *De Rebus*, September 2004.

⁸⁶ ITC 1783, 66 SATC 373.

⁸⁷ Meyerowitz, D. 2006. Paying for goods and services by issuing shares. *The Taxpayer*. May 2006, pg. 86.

⁸⁸ ITC 1783, 66 SATC 373.

⁸⁹ De Koker, A. 2010. (June - Last Updated: sl 41). *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010.

⁹⁰ De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3): p. 475.

In the context of conflicting decisions, he calls on the legislature to provide greater clarity as to what the position is for shares issued to pay for services (De Swardt, 2008).⁹¹ He calls for a provision similar to section 24B⁹², which establishes that shares issued in a company to acquire assets constitute actual expenditure⁹³.

One of the tenets of the Rule of Law, a fundamental principle ossified in the SA Constitution, is that laws should be succinct and clear. De Swardt's study⁹⁴ was published before the release of the Full Court Labat decision,⁹⁵ which stated that a company which issues shares to pay for an asset incurs expenditure. However, this decision said nothing about the issue of shares for services. In addition, SARS is appealing Labat⁹⁶, which might be overturned.⁹⁷

It is submitted that the Labat decision⁹⁸ should have considered the Datakor decision,⁹⁹ which held that any concession or compromise whereby a debt is converted to shares has the effect of reducing a debtor company's assessed loss in terms of section 20 of the Income Tax Act,¹⁰⁰ and in effect constitutes a benefit to that company and not expenditure. It is hoped that this study will contribute to the debate as to whether the issue of shares for future services constitutes expenditure, by incorporating the

⁹¹ De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3), p. 491.

⁹² Act 58 of 1962.

⁹³ De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3), p. 491.

⁹⁴ *Ibid.*

⁹⁵ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁹⁶ *Ibid.*

⁹⁷ SARS obtained permission to appeal in terms of section 20 (4) (b) of the Supreme Court Act, Act 59 of 1959, and lodged its heads of argument to the Supreme Court of Appeal: *Appellant's Heads of Argument*, Case no 435/201, March 2011.

⁹⁸ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁹⁹ CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

¹⁰⁰ Act 58 of 1962.

Datakor decision's¹⁰¹ arguments which have hitherto not formed part of the discussion.

The CIR v Witwatersrand Association of Racing Clubs decision¹⁰² held that a taxpayer is liable for tax if receiving something; even if taxpayer receives it on behalf of someone. Is this situation analogous to shares-for-future-services, where the shareholder receives the shares on issue but then has to transfer them to a trust, or is the more correct position, as stated in the Mooi decision,¹⁰³ that accrual cannot take place until the taxpayer becomes unconditionally entitled to an amount?

Regarding the value of the adequate consideration that the company receives, and what value should be placed thereon, the case of Brummeria Renaissance¹⁰⁴ will be examined in as far as it sets out how to determine the value of non-cash amounts received by independent contractors in exchange for shares. However, share values fluctuate. The decisions of Mooi¹⁰⁵ and Lace¹⁰⁶, on the one hand, and the Caltex Oil decision¹⁰⁷ on the other, will be examined to determine when the value of shares should be determined for the purposes of expenditure and accrual.

Section 24B of the Income Tax Act¹⁰⁸ allows a company to deduct expenditure, which is the lesser of the market value of the share or of the asset acquired, as valued on the date of acquisition. SARS deems a company which acquires assets by issuing its own shares to have incurred actual expenditure. As the Act¹⁰⁹ does not make provision for a similar deduction for shares for services, does this mean that expenditure is not deductible in this scenario?

¹⁰¹ CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

¹⁰² CIR v Witwatersrand Association of Racing Clubs (1960 AD).

¹⁰³ Mooi v Secretary for Inland Revenue (1972) 2 All SA 57 (A).

¹⁰⁴ Brummeria Renaissance (Pty) Ltd, C: SARS v (6) SA 601, 69 SATC 205 (SCA).

¹⁰⁵ Mooi v Secretary for Inland Revenue (1972) 2 All SA 57 (A).

¹⁰⁶ Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.

¹⁰⁷ Caltex Oil (SA) Ltd. v Secretary for Inland Revenue, 37 SATC 1.

¹⁰⁸ Income Act 58 of 1962.

¹⁰⁹ *Ibid.*

The temptation is there to argue that shares issued in the taxpayer to pay for services must also be deemed expenditure actually incurred. SARS's explanatory memorandum on Section 24B has a bearing on this issue and extinguishes this possibility.¹¹⁰ The memorandum is clear: the reason why expenditure is deemed to have been incurred is not because SARS deems such transactions to technically entail the actual incurral of any cost; it is rather a concession to encourage company formations and share financing. Furthermore, from SARS's argument in the Labat¹¹¹ appeal, their position is clear: it does not consider any expenditure to have been incurred where shares issued in the purchasing company are given to a vendor in exchange for assets.

1.10. Structure of the research

Chapter 1: This Introduction introduced the problem statement and research questions broached in this study. It examined the significance of the study in the light of the new Companies Act¹¹² which abandons strict traditional company law principles, such as capital maintenance in favour of the solvency and liquidity principle, and allows shares to be issued in exchange for future services.

Chapter 2: The second chapter considers the effect of shares-for-future-services on independent contractors on the one hand, and employees on the other hand.

Chapter 3: The third chapter discusses whether a company which issues shares-for-future-services incurs expenditure. It examines when the shares accrue to the service provider.

¹¹⁰ Explanatory Memorandum to the Revenue Laws Amendment Bill, 2004, clause 22.

¹¹¹ C. SARS v Labat Africa Ltd, 72 SATC 75.

¹¹² Act 71 of 2008.

Chapter 4: The fourth chapter examines considers the Datakor decision¹¹³ and discusses whether a company which substitutes shares for a debt is a benefit to the company and not expenditure.

Chapter 5: This chapter looks at the concept of “adequate consideration”. It asks whether such consideration is the same as market value and whether the Commissioner may adjust such consideration if it is not, and whether a share issue of which the value exceeds the value of services rendered in return may constitute a donation to the service provider.

Chapter 6: The fifth chapter looks at CGT, VAT and STT issues in the context of shares-for-future-services.

Chapter 7: This chapter discusses the tax effect in the hands of the trust, and what the effects of the transfer from the shareholder to the trust are.

Chapter 8. The conclusion attempts to examine what the tax effect of s40 (5) of the Income Tax¹¹⁴ is – specifically, whether the issuing company is able to deduct the cost of shares-for-future-services as expenditure and when it may do so. It will consider the heads of arguments by Adv Piet Marais, as lodged with the Supreme Court of Appeal earlier this year,¹¹⁵ which will have a bearing on how this issue is settled. Secondly, it attempts to answer the subsidiary questions identified above.

¹¹³ CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

¹¹⁴ Act 58 of 1962.

¹¹⁵ SARS obtained permission to appeal in terms of section 20 (4) (b) of the Supreme Court Act, Act 59 of 1959, and lodged its heads of argument to the Supreme Court of Appeal: *Appellant's Heads of Argument*, Case no 435/201, March 2011.

CHAPTER 2. TAX EFFECTS IN THE HANDS OF THE EMPLOYEE / INDEPENDENT CONTRACTOR

In a new paradigm, section 40 (5) of the new Companies Act¹¹⁶ provides that the consideration for shares may be in the form of *future services*. In terms of the 1973 Companies Act,¹¹⁷ shares could be issued only if full consideration in the form of cash or services rendered had been received. The new Companies Act¹¹⁸ does not specify whether the term “future services” includes services rendered under a contract of employment, by an “employee”, or services carried out by an “independent contractor”, not considered an “employee” under the Fourth Schedule.¹¹⁹

If the term included both, the provision in section 40 (5)¹²⁰ would have diverse tax effects on the person rendering the services, depending on whether the recipient of the shares was an “independent contractor” or an “employee”. This is specifically so as the reason why shares are given to employees differs from why they are offered to service providers. When the offer concerns employees, the company’s purpose is to boost employees’ service performance and to ensure company loyalty.

In particular, in terms of the “matching principle” set out in the OECD commentary,¹²¹ the purpose is to match the period of service with the value of the shares. When the offer is made to independent contractors, the objective is to use the shares as a financing mechanism to pay for services, and to allow the company to ensure the

¹¹⁶ Act 71 of 2008.

¹¹⁷ Act 61 of 1973.

¹¹⁸ Act 71 of 2008.

¹¹⁹ Act 58 of 1962.

¹²⁰ Act 71 of 2008.

¹²¹ OECD. 2010. Commentary on Model Tax Convention, article 15, page 215. [Online] Available at <http://www.oecd.org/document>. Accessed on 13 July 2011.

provision of services without having to incur a cash expenditure. If the argument is accepted that the issuing of shares for services does constitute expenditure for the company, it does not incur any expenditure until the services are rendered, when the shares accrue to the service provider.¹²²

There seems to be a conflict between *Caltex*¹²³ and *Labat*¹²⁴ as to when and how expenditure incurred is calculated. In terms of *Labat*¹²⁵ it is the amount of expenditure incurred, as *bona fide* agreed to between the company and the other party, while in application of the principle expounded in *Caltex*,¹²⁶ it is the market value of the non-Rand instrument, such as foreign currency or shares, at the end of the tax year in which the expenditure was incurred. The researcher argues that the amount the taxpayer company which issues shares to pay for services rendered is not deductible as expenditure incurred because the company suffers no diminishment in its assets; specifically as shares are not company assets.¹²⁷

2.1. Distinguishing employees from independent contractors

It is important to distinguish between employees and independent contractors who receive shares in exchange for services rendered, as employees who receive share incentives may not, in terms of section 23 (m),¹²⁸ deduct expenditure incurred to perform those services. Independent contractors are not restricted by section 23 (m)¹²⁹ and may deduct any expenditure incurred to perform the services.

¹²² In terms of section 40 (6) (d) (iv) of the new Companies Act, the shares may be claimed back until the service obligations have been fulfilled. Therefore once the services have been performed the shares accrue to the shareholder for services.

¹²³ *Caltex Oil (SA) Ltd. v SIR 37 SATC 1.*

¹²⁴ *C. SARS v Labat Africa Ltd, 72 SATC 75.*

¹²⁵ *C. SARS v Labat Africa Ltd, 72 SATC 75.*

¹²⁶ *Caltex Oil (SA) Ltd. v SIR 37 SATC 1.*

¹²⁷ *Lowry v Consolidated African Selection Trust Ltd, 1940 2 ALL ER 545.*

¹²⁸ Act 58 of 1962.

¹²⁹ *Ibid.*

Furthermore, the provisions of section 8C will be applicable to employees only. In particular, the gain included in the employees' income is determined in terms of section 8 (C) (2). As a result, the principles expounded in SARS's Interpretation Note on Brummeria Renaissance¹³⁰ are applicable to any non-money amount, such as shares, received by independent contractors.

SARS's Interpretation Note 17 distinguishes between "employee" and "independent contractor".¹³¹ The common law versus the tax law approach to distinguish between the two categories is narrowing.¹³² Interpretation Note 17¹³³ sets out the statutory and common law tests to classify a worker as an employee or independent contractor. The Fourth Schedule of the Income Tax Act¹³⁴ provides that any employer who pays remuneration to an employee is subject to employee's tax.

The definition of "remuneration" in the Fourth Schedule¹³⁵ sets out two statutory tests to determine whether a person is an independent contractor for employee's tax purposes.¹³⁶ The first test asks whether the services are performed mainly at the premises of the client. If this is satisfied, the second test is applied. This test asks whether the worker was subject to the control or supervision of any other person in performing the services. If either of these two tests is positive, the worker will be deemed to be an employee. Irrespective of the answer to these two tests, a worker may still escape being defined as an employee if he/she employs three or more full-time employees who are not connected persons.¹³⁷

¹³⁰ SARS Interpretation Note 58.

¹³¹ SARS 2010. Interpretation Note 17, Employees' Tax: Independent contractors (Issue 3).

¹³² Louw, C. 2009. An Independent Contractor under Labour Law and the Income Tax Act. (72) *THRHR*.

¹³³ SARS 2010. Interpretation Note No 17. Employees' Tax: Independent contractors (Issue 3).

¹³⁴ Act 58 of 1962.

¹³⁵ *Ibid.*

¹³⁶ Ss ii of the definition of "remuneration".

¹³⁷ Ss ii of the definition of "remuneration".

Finally, even though a person may be classified as an employee, the application of the common law dominant impression test may lead to him/her being classified as an independent contractor. The Interpretation Note sets out a grid of common law dominant impression criteria to determine in which category an employee falls.¹³⁸ Case law may also be examined to determine in which category a worker falls. For example, in *Liberty Life Association of Africa Ltd v Niselow*¹³⁹ it was held that an employee makes his/her productive capacity available to the employer; while an independent contractor makes a commitment to deliver a specific result. It is submitted that this is the correct approach to distinguish between the two concepts.

2.2. Tax effect on employees

Paragraph 2 of the Seventh Schedule¹⁴⁰ pertaining to taxable benefits obtained in terms of paragraph (i) of the definition of gross income, states that the Seventh Schedule¹⁴¹ does not apply to any equity instrument contemplated in section 8 (C).¹⁴² Consequently, the provisions of 8C¹⁴³ will prevail for such shares.

2.3. Section 8 (C)

Section 8 C of the Income Tax Act¹⁴⁴ is applicable if the person rendering the services receives “remuneration” as defined in the Fourth Schedule.¹⁴⁵ The OECD commentary on article 15¹⁴⁶ which pertains to the taxation of employees’ remuneration for services,

¹³⁸ Annexure B to SARS Interpretation Note 17, 2010.

¹³⁹ (1996) 17 ILJ 673 (LAC).

¹⁴⁰ Act 58 of 1962.

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ *Ibid.*

¹⁴⁴ *Ibid.*

¹⁴⁵ *Ibid.*

¹⁴⁶ OECD 2010. *Model Tax Convention on Income and on Capital*. [Online] Available at

in the form of equity instruments, states that a “matching principle” applies to determine the taxable income. The principle behind awarding employees with share incentive schemes is to match the period of service with the compensation received.

For example, if a shareholder receives shares for working for a period of three years, the matching principle states that employee’s tax is received over a three year period.

2.4. Shares-for-services offered to employees are “restricted equity instruments”

Any restricted equity shares granted after 26 October 2004 are governed by the provisions of section 8C.¹⁴⁷ Shares-for-future services, as provided for in section 40 (5),¹⁴⁸ offered to “employees”, are *restricted equity instruments* as they meet the following requirements, as set out in section 8C:

- Restrictions are placed on their disposal: In particular, section 40 (6) d (i)¹⁴⁹ states that shares may not be transferred by the employee-shareholder-for-shares, unless the company consents;
- Taxpayer forfeits shares under certain conditions: In this regard section 40 (6)¹⁵⁰ provides that the company may demand the return of shares if the employee fails to perform service obligations;
- The equity instrument is not deliverable to the taxpayer until the happening of a

www.oecd.org/publications/distributors. Accessed 12 February 2011.

¹⁴⁷ Act 58 of 1962.

¹⁴⁸ Act 71 of 2008.

¹⁴⁹ *Ibid.*

¹⁵⁰ Act 71 of 2008.

future event: In this regard section 40 (5) (b) (ii)¹⁵¹ provides that once the company issues shares to the shareholder employee, it simultaneously causes shares to be transferred to a trust. The shares are transferred back to the employee once the future event, in this case service delivery, takes place.

2.5. Effect of section 8C

Section 8C¹⁵² sets out the requirements, circumstances, exclusions, valuation methodology, as well as procedural matters concerning amounts to be included or deducted on the vesting of an “equity instrument” acquired by an employee by virtue of employment. Taxation of a restricted equity instrument is triggered on vesting of the share.

Restricted equity instruments, such as shares contemplated in s40 of the Companies Act,¹⁵³ vest once all the restrictions imposed on the instrument cease to have effect. In terms of section 40 (6),¹⁵⁴ once the contractual obligations are fulfilled the company may no longer claim back the shares. The employee holds those shares, no longer in the capacity of an employee but as an investor, entitled to encumber or sell such instruments freely.

On vesting, the taxpayer employee includes the amount by which the market value of the share on date of vesting exceeds the consideration given for such share.¹⁵⁵ The value of the services rendered does not constitute consideration for such shares, as the definition of “consideration” in section 8C¹⁵⁶ specifically excludes services

¹⁵¹ *Ibid.*

¹⁵² Act 58 of 1962.

¹⁵³ Act 71 of 2008.

¹⁵⁴ *Ibid.*

¹⁵⁵ S 8 (C)(2) (a) (i).

¹⁵⁶ Act 58 of 1962.

rendered.¹⁵⁷ Consequently, the shareholder employee acquires the share for zero consideration and will have to include the full market value of the shares as a gain, as they were on the date of vesting.

2.6. Tax effect at the time the share is issued to the employee

Upon entering into the agreement, the company issues the shares to the employee; simultaneously, the shares are transferred to a trust to be held until the service obligations are satisfied.¹⁵⁸ Section 10 (1) (nD) of the Income Tax Act¹⁵⁹ provides that any share which was received or accrued in terms of section 8C,¹⁶⁰ but which has not yet vested, shall be exempt from normal tax. Therefore, even though it may be argued that some value accrues to the employee on issue, the statute expressly exempts such income. However, shares-for-future services received by independent contractors is not covered by this provision.

Consequently, if it were possible to determine the value of shares which had been received by the shareholder for shares, in its capacity as an independent contractor, such independent contractor would have to include this value. However, as discussed above, shares consist of rights.¹⁶¹ As none of the rights underlying the share may be exercised until the fulfilment of the service conditions, nothing accrues to the shareholder-for-shares prior to this event.

Paragraph 11A (1) of the Fourth Schedule¹⁶² provides that remuneration of an employee includes any gain made as a result of the vesting of an equity instrument

¹⁵⁷ S 8 (C) (7)

¹⁵⁸ S 40 (5) (b) (ii) of Act 71 of 2008.

¹⁵⁹ Act 58 of 1962.

¹⁶⁰ *Ibid.*

¹⁶¹ As set out in the Standard Bank v Ocean Commodities case.

¹⁶² Act 58 of 1962.

contemplated in section 8C.¹⁶³ As the employee acquired the shares at no consideration, the full market value of the shares on the date of vesting is included in the employee's income. The person who granted the share right to the employee deducts employees' tax.

The Commissioner issues a tax directive to the employer dictating how much employees' tax should be deducted from the gain on vesting.

2.7. Tax effect on independent contractors: section 8C not applicable

The provisions of section 8C¹⁶⁴ do not apply to independent contractors as section 8C requires a causal link between employment and the vesting of an equity instrument before the employer taxpayer is obliged to deduct any gain from the recipient taxpayer's remuneration. The money value of the shares must be ascertained and included in the contractor's gross income.

How is this value determined? In application of the cases which allowed deductions for non-money amounts, such as foreign currency or shares, the following questions arise: Is it the market value of the non-Rand instrument at the end of the year of assessment,¹⁶⁵ or is it the agreed value of the instruments at the time of the transaction¹⁶⁶ that is included as a gain in the taxpayer's income? Where shares (a benefit "other than money") are granted in exchange for services to independent contractors, section 8C¹⁶⁷ is not applicable. It is submitted that the principles of the *Brummeria Renaissance* decision¹⁶⁸ should apply, because shares, a benefit other than

¹⁶³ *Ibid.*

¹⁶⁴ *Ibid.*

¹⁶⁵ As set out in the *Caltex* case.

¹⁶⁶ As stated in the *Labat* case

¹⁶⁷ Act 58 of 1962.

¹⁶⁸ *SARS v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA 601 (SCA).

money, are given in exchange for services.

This is confirmed by SARS' Interpretation Note 58¹⁶⁹ which states: "...the principles of the (*Brummeria Renaissance*) judgment may be applied in all cases in which benefits in a form other than money (such as the right to use an interest-free loan) are granted in exchange for goods supplied, services or any other benefit given"¹⁷⁰. Interpretation Note 58,¹⁷¹ in response to the Supreme Court of Appeal decision in *SARS v Brummeria Renaissance*,¹⁷² sets out the treatment of receipts or accruals in non-money form.

In the *Brummeria* case,¹⁷³ the taxpayer companies had granted life occupation rights in retirement villages to pensioners. The life-right beneficiaries granted the taxpayer companies interest-free loans in exchange. The taxpayers argued that the interest-free loans did not constitute an "amount".

The SCA held the interest-free loan had an ascertainable cash value, and that this amount should have been included in the taxpayers' gross income. The SCA set out general valuation principles to be applied to non-cash amounts: the primary question is whether the receipt/accrual has a money value. A receipt or accrual which cannot be sold may still have a money value.

Interpretation Note 58¹⁷⁴ states that such receipts or accruals should be valued and included in the gross income of the taxpayer in the year of assessment in which it is received or accrued.

¹⁶⁹ SARS. 2010. Interpretation Note 58, *The Brummeria Case and the right to use loan capital interest-free*. 30 June.

¹⁷⁰ At paragraph 6.1.

¹⁷¹ SARS. 2010. Interpretation Note 58, *The Brummeria Case and the right to use loan capital interest-free*. 30 June.

¹⁷² *SARS v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA 601 (SCA).

¹⁷³ *Ibid.*

¹⁷⁴ SARS. 2010. Interpretation Note 58, *The Brummeria Case and the right to use loan capital interest-free*. 30 June.

Arm's length valuation principles should be applied to determine the value of the consideration. In the *Brummeria* case,¹⁷⁵ SARS had applied the weighted-average prime overdraft rate of banks to calculate the amount which accrued to the taxpayer. Interpretation Note 58¹⁷⁶ states that each case must be evaluated on its own merits and that a person may use a different valuation method, provided she/he can prove its appropriateness.

It is submitted that principles of valuation enunciated in the *Lace Proprietary* case¹⁷⁷ are appropriate to shares given to independent contractors in exchange for services. The *quid pro quo* given for the services, i.e. the shares, accrue once the service provider has fulfilled the contractual obligations. Accrual only takes place at this time, as the taxpayer becomes unconditionally entitled to the shares.¹⁷⁸ Prior to completing the services to the satisfaction of the company, the company may demand the return of the shares held in trust.¹⁷⁹ Furthermore, at the time of accrual, arm's length principles of valuation should be applied to ascertain the value of the shares.

In terms of the *Lace Proprietary*¹⁸⁰ decision, the middle market value of the shares on the date of accrual should be included in the service provider's income. *Caltex Oil*¹⁸¹ held, in respect of foreign currency, that that the amount of expenditure incurred under section 11 (a)¹⁸² is the exchange rate at the end of the year of assessment, while *Labat*¹⁸³ held that the amount of expenditure incurred was the agreed value of the

¹⁷⁵ SARS v *Brummeria Renaissance* (Pty) Ltd 2007 (6) SA 601 (SCA).

¹⁷⁶ SARS. 2010. Interpretation Note 58, *The Brummeria Case and the right to use loan capital interest-free*. 30 June.

¹⁷⁷ *Lace Proprietary Mines v CIR* (1938 AD) 9 SATC 349.

¹⁷⁸ In accordance with *Lategan v CIR* 1926 CPD 203.

¹⁷⁹ Section 40 (6) (d) (iv).

¹⁸⁰ *Lace Proprietary Mines v CIR* (1938 AD) 9 SATC 349.

¹⁸¹ *Caltex Oil (SA) Ltd. v SIR*, 37 SATC 1.

¹⁸² Act 58 of 1962.

¹⁸³ C. SARS v *Labat Africa Ltd*, 72 SATC 75.

shares at the time of the transaction. It is submitted that the Lace Proprietary¹⁸⁴ decision, read with the Brummeria Renaissance decision,¹⁸⁵ is the more appropriate judgment for determining the value of shares to be included in a taxpayer's income. Therefore the middle-market value on the date the shares accrue to the taxpayer should be included.

2.8. Comparison between tax effect on “employees” and “independent contractors”

In practice, the tax treatment of the gain in the hands of independent contractors or employees is similar. In terms of section 8(C)¹⁸⁶ employees include market value on the date of vesting. In terms of the Brummeria Renaissance¹⁸⁷ decision, the money value of the non-money instrument is included. The taxpayer must prove that it used an “appropriate” evaluation method. The evaluation method used in Lace Proprietary¹⁸⁸ should be appropriate. It requires that the middle market value of the shares is determined. Furthermore, as set out below, the independent contractor should be able to deduct the costs of the services rendered from the gain, whereas the employee may not deduct such costs under section 8C.¹⁸⁹

Section 8C (2)¹⁹⁰ sets out the amount to be included in the employee- taxpayer's income on vesting of shares. This amount is the amount received or accrued, less the consideration for those shares. “Consideration”, as defined in section 8C(7),¹⁹¹

¹⁸⁴ Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.

¹⁸⁵ SARS v Brummeria Renaissance (Pty) Ltd 2007 (6) SA 601 (SCA).

¹⁸⁶ Act 58 of 1962.

¹⁸⁷ SARS v Brummeria Renaissance (Pty) Ltd 2007 (6) SA 601 (SCA).

¹⁸⁸ Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.

¹⁸⁹ Act 58 of 1962.

¹⁹⁰ *Ibid.*

¹⁹¹ *Ibid.*

specifically excludes services rendered. As a result, in terms of section 8C,¹⁹² the recipient employee-shareholder may not deduct the value of the services rendered from the market value of the shares on vesting.

The question arises whether the independent service provider may deduct the value of the services rendered as expenditure from the value of the shares on accrual. The provisions of section 11 (a)¹⁹³ should be read with section 23 (g).¹⁹⁴ In terms of section 11 (a),¹⁹⁵ the service provider may deduct expenditure actually incurred in the production of income, from income, provided such expenditure and losses are not of a capital nature.

Section 23 (g)¹⁹⁶ supports and substantiates 11 (a).¹⁹⁷ It prohibits the deduction to the extent that it was not expended for the purposes of trade. The independent contractor may deduct the market value of the services rendered. In particular, if the service provider is not an employee, and performs the services as an independent contractor, and is not a labour broker or service provider as defined in the Fourth Schedule,¹⁹⁸ it is not limited by the provisions of s 23 (k) or (m).¹⁹⁹ In this scenario the service provider may deduct expenditure.

¹⁹² *Ibid.*

¹⁹³ *Ibid.*

¹⁹⁴ *Ibid.*

¹⁹⁵ *Ibid.*

¹⁹⁶ *Ibid.*

¹⁹⁷ *Ibid.*

¹⁹⁸ *Ibid.*

¹⁹⁹ *Ibid.*

CHAPTER 3. DOES THE COMPANY WHICH PAYS FOR FUTURE SERVICES WITH SHARES INCUR EXPENDITURE?

Section 11 (a) of the Income Tax Act²⁰⁰ states that a company may deduct *expenditure actually incurred* to determine its taxable income. Section 23 (g) of the Income Tax Act²⁰¹ sets out what may not be deducted. If the company contracting for services meets the requirements of section 11 (a)²⁰² and section 23 (g)²⁰³ amounts paid to an employee or independent contractor as remuneration are deductible to determine the company's taxable income.

One of the key elements of section 11 (a)²⁰⁴ is that expenditure must have been actually incurred. A company which issues shares to obtain services will apply these sections in tandem to determine if it is entitled to deduct expenditure. To qualify for a deduction, the taxpayer company must satisfy the following key requirements, as set out in sections 11 (a) and 23 (g).²⁰⁵ The company will have to show that the issuing of shares for services constitutes actual expenditure, is incurred in the production of income, that it is not expenditure of a capital nature, is laid out for the purposes of trade, and that the deductions are not prohibited. The researcher specifically considers whether expenditure is actually incurred.

²⁰⁰ Act 58 of 1962.

²⁰¹ *Ibid.*

²⁰² *Ibid.*

²⁰³ *Ibid.*

²⁰⁴ *Ibid.*

²⁰⁵ *Ibid.*

3.1. Actual expenditure

Arguments for and against the proposition that a company which issues shares incurs expenditure may be made. In a battle pitting SARS against taxpayer companies claiming such share-issues as expenditure, there is a decision against the proposal, namely ITC 1783,²⁰⁶ and Tax Court Case, ITC 1801, as confirmed on appeal by the High Court,²⁰⁷ hereinafter referred to as the “Labat decision”, in favour of the proposition.

De Swardt²⁰⁸ states that there are not enough authoritative precedents in South African case law to determine whether or not shares offered in return for services or assets constitute expenditure actually incurred. Although this opinion was penned prior to the Labat High Court decision, which supported the proposition, SARS has obtained approval from the SCA to appeal Labat.²⁰⁹ For this reason it is vital that judicial clarification is obtained as to what the correct position is.

Counsel for SARS, Adv Piet Marais,²¹⁰ will argue on appeal that the only issue before the Supreme Court of Appeal is whether or not expenditure was incurred by the respondent by issuing its own shares in exchange for a trademark, as envisaged in section 11 (gA).²¹¹ SARS will assert that a company which pays with shares incurs an obligation to issue shares; it does not incur expenditure.²¹² SARS avers that the issuing company does not incur expenditure because none of its assets are

²⁰⁶ ITC 1783, 66 SATC 373.

²⁰⁷ C. SARS v Labat Africa Ltd, 72 SATC 75.

²⁰⁸ De Swart, R.D. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 3 (41).

²⁰⁹ SARS obtained permission to appeal in terms of section 20 (4) (b) of the Supreme Court Act, Act 59 of 1959, and lodged its Heads of Argument to the Supreme Court of Appeal: *Appellant's Heads of Argument*, Case no 435/201, March 2011.

²¹⁰ Heads of Argument, page 6.

²¹¹ Act 58 of 1962.

²¹² Heads of Argument, at point 6.1.4.

encumbered or diminished, particularly as shares are not the property of the company. The debate as to whether shares issued in the production of income, for example to procure future services, and to which this study pertains, remains very topical.²¹³ In terms of the argument for the proposition, the rationale is that the company which issues its shares to produce income is in effect forgoing the opportunity to obtain cash for those shares.²¹⁴

The argument against states that there is no real expenditure where a company churns out shares, as the shares are not its property.²¹⁵ It therefore suffers no loss or expenditure by issuing shares. A company which issues shares to pay for future services incurs expenditure only if something comes from its pocket.²¹⁶ A company can incur expenditure only if its patrimony is deprived through the share-based payment.²¹⁷

The Labat decision²¹⁸ concerned the issue of shares in exchange for a trademark. The basis of the decision, based on English law, is that the company incurs expenditure once it incurs an unconditional obligation to pay. In a new paradigm, the 2008 Companies Act²¹⁹ provides that a company may issue shares in exchange for future services. If the Labat²²⁰ decision is correct, the decision should be applicable to shares issued in exchange for services, as the company incurs an unconditional obligation to pay once it agrees to remunerate an employee with shares or to finance the services of independent contractors through this payment method.

²¹³ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010.

²¹⁴ C. SARS v Labat Africa Ltd, 72 SATC 75.

²¹⁵ Lowry v Consolidated African Selection Trust Ltd (1940 2 ALL ER 545) held that unissued shares are not a company asset.

²¹⁶ De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3): p. 475. At 479, De Swardt states that a key requirement of “expenditure” is that something must have come from the taxpayer’s pocket.

²¹⁷ *Ibid.*

²¹⁸ C. SARS v Labat Africa Ltd, 72 SATC 75.

²¹⁹ Act 71 of 2008.

²²⁰ C. SARS v Labat Africa Ltd, 72 SATC 75.

The counter argument presented by SARS, in its Head of Argument to the Supreme Court of Appeal,²²¹ is that the company does not incur an unconditional obligation to pay; it incurs an obligation to issue shares, which are not its property, and which does not result in it suffering any loss or expenditure.

3.2. ITC 1783 and ITC 1801 (the “Labat tax court decision”)

As stated, there are two conflicting decisions as to whether a company which issues its own shares to acquire something incurs expenditure. These two cases are discussed below.

3.2.1 ITC 1783

In ITC 1783,²²² a taxpayer purchased a trademark, and settled payment through the issue of shares in itself to the vendor. The court held that the ordinary dictionary meaning of “expenditure’s” is the spending of money or its equivalent in time or labour which leads to the diminution of the assets of the person incurring the expenditure. It found that the share issue did not reduce the assets of the company. The only persons affected by the share issue were the remaining shareholders, as their rights to dividends and voting were diluted. The court relied on *Silke* in support of the above arguments.²²³ In this decision²²⁴, Goldblatt J gave the example where a company remunerates an employee for services rendered by tendering shares.

Objectively considered, a company which grants it employees cash on condition that they buy shares is incurring expenditure.

²²¹ *Heads of Argument*, Case no 435/201, March 2011.

²²² ITC 1783, 68 SATC 373.

²²³ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Par 7 4.

²²⁴ ITC 1783, 68 SATC 373.

The Labat decision²²⁵ concurred with this argument and stated that it is difficult to see any distinction between a transaction which offers cash to a person and gives such person the option to buy shares, and one where shares are the only consideration, as was the case in Labat. It is submitted that this statement is incorrect. Where a company pays money, its assets are physically diminished; however, where it issues shares, which are not company assets, its patrimony is not reduced. In a counter argument, presented in Chapter 4, based on the arguments in the Datakor decision,²²⁶ it is submitted that the company which pays with shares issued in itself is in fact obtaining a benefit as its obligation to pay is extinguished, and its erstwhile creditors are demoted to dividend recipients. Alternatively, the agreement to issue shares, and the extinguishment of the debt could be a recoupment for the company which issues shares in itself, as the debt is extinguished.

Gerr²²⁷ argues that a company incurs expenditure when it issues shares to pay expenses. He refers to the notion of “economic sacrifices”, as coined in the Osborne decision.²²⁸ In terms of this notion, a company which issues shares to pay for services or assets is giving up the right, which it would otherwise have had, to demand cash for those shares. He states: “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 the reasoning of Goldblatt”.²²⁹

Authorised, un-issued shares are not company assets.²³⁰ Secondly, in terms of section 35 (3) of the new Companies Act,²³¹ a company can never issue shares to itself.

²²⁵ ITC 1801.

²²⁶ CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

²²⁷ Gerr, B. 2004. Income Tax-the problem of paying with shares. *De Rebus*, September 2004, p. 61-62.

²²⁸ Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA); Craddock v Zevo Finance Co Limited [1944] 1 All ER 566 (CA).

²²⁹ Gerr, B. 2004. Income Tax-the problem of paying with shares. *De Rebus*, September 2004, p. 61-62.

²³⁰ Lowry v Consolidated African Selection Trust Ltd, 1940 2 ALL ER 545.

²³¹ Act 71 of 2008.

Consequently, a company is not making any sacrifice where it issues its shares.

Another argument raised by Gerr²³² is that the Goldblatt judgment²³³ could lead to inequities, as the shares issued to an employee or independent contractor are taxable in the hands of the recipients, and it would be incongruous not to allow a corresponding deduction in the hands of the issuing company. Meyerowitz²³⁴ disagrees with Goldblatt, as the ITC1783 judgment²³⁵ failed to consider the provisions of the Companies Act,²³⁶ and the English High Court decisions,²³⁷ which aver that a company which pays for something by issuing shares *does* incur expenditure.

It is submitted that Meyerowitz²³⁸ is correct in one respect: the provisions and principles underlying company law should be examined to determine who incurs expenditure when the company issues shares to pay for services. It is submitted that Labat²³⁹ and Osborne²⁴⁰ should have examined the inherent nature of the underlying rights constituting a share.

It is furthermore submitted that had the courts closely considered the nature of shares, as set out in the Standard Bank decision,²⁴¹ they would have seen that share issues do not diminish the company's assets. On the contrary, such an issue encumbers existing shareholders only as their rights to vote, or to share in distributions, are reduced.

²³² Gerr, B. 2004. Income Tax-the problem of paying with shares. *De Rebus*, September 2004, p. 61-62.

²³³ *ITC 1783* (2004) 66 SATC 373.

²³⁴ Meyerowitz, D. 2004. Paying for Goods and Services by Issuing Shares. *The Taxpayer*, par 1133.

²³⁵ *ITC 1783* (2004) 66 SATC 373.

²³⁶ Act 71 of 2008.

²³⁷ *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA); *Craddock v Zevo Finance Co Limited* [1944] 1 All ER 566 (CA).

²³⁸ Meyerowitz, D. 2004. Paying for Goods and Services by Issuing Shares. *The Taxpayer*.

²³⁹ *ITC 1801*.

²⁴⁰ *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA).

²⁴¹ *Standard Bank v Ocean Commodities*.

The Labat tax court decision²⁴² based its conclusions on Gerr²⁴³ and Meyerowitz's²⁴⁴ comments on the Goldblatt decision²⁴⁵. The court adopted the English High Court decisions,²⁴⁶ as advised by Meyerowitz.²⁴⁷

3.2.2 ITC 1801 (Labat tax court decision)

In this matter, the company obtained an asset in the form of a trade mark. Section 11 (gA)²⁴⁸ allows a deduction where a taxpayer incurs actual expenditure to acquire a trade mark. The court held that a company which issues shares in itself to pay for a trademark incurs actual expenditure if this contractual commitment is an unconditional legal obligation. It is not required that the obligation should actually be discharged.

The court held that the expression "expenditure actually incurred" meant, for the purposes of section 11 (gA),²⁴⁹ that the taxpayer should have incurred an unconditional legal obligation in respect of the amount concerned.

As submitted above, it is the shareholders who suffer a loss where more shares are issued, as their rights to vote and to share in distributions are diminished. It may therefore be asked how a company incurs an unconditional obligation where the shareholders shoulder the expense? The only persons whose assets are diminished in terms of such a transaction are the existing shareholders.

²⁴² C. SARS v Labat Africa Ltd, 72 SATC 75.

²⁴³ Gerr, B. 2004. Income Tax-the problem of paying with shares. *De Rebus*, September 2004, p. 61-62.

²⁴⁴ Meyerowitz, D. 2004. Paying for Goods and Services by Issuing Shares. *The Taxpayer*, May issue.

²⁴⁵ ITC 1783 (2004) 66 SATC 373.

²⁴⁶ Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA); Craddock v Zevo Finance Co Limited [1944] 1 All ER 566 (CA).

²⁴⁷ Meyerowitz, D. 2004. Paying for Goods and Services by Issuing Shares. *The Taxpayer*, May issue.

²⁴⁸ Act 58 of 1962.

²⁴⁹ *Ibid.*

As a share consists of a bundle of personal rights,²⁵⁰ the existing shareholders' rights to dividends, to vote, and to share in the surplus on liquidation are diluted.

The court refers to English authority²⁵¹ in support of the argument that a company which issues fully paid up shares in exchange for an asset or services incurs expenditure as it 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".²⁵²

3.3. The nature of shares

Authorised un-issued shares are not company assets.²⁵³ Section 35 of the new Companies Act²⁵⁴ sets out the legal nature of shares. Section 35 (3)²⁵⁵ provides that a company may not hold shares in itself. Shares are rights which have a money value, and on issue they will give the recipient the rights to dividends and to vote. In particular, *Borland's Trustee v Steel Brothers & Co Ltd*, Farwell²⁵⁶ held that, "A share...is an interest measured by a sum of money and made up of various rights contained in the contract...".

These rights are quantifiable in monetary terms. Companies raise money to fund ventures through the issue of shares and debentures. In this regard, the company obtains cash by issuing shares. Some jurisdictions provide that authorised un-issued shares constitute assets in the hands of the company; for example, where a company buys back its own shares, such shares become assets of the company, and these are

²⁵⁰ *Standard Bank V Ocean Commodities*.

²⁵¹ *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA); *Craddock v Zevo Finance Co Limited* [1944] 1 All ER 566 (CA).

²⁵² *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA).

²⁵³ *Lowry v Consolidated African Selection Trust Ltd* (1940 2 ALL ER 545) held that unissued shares are not a company asset.

²⁵⁴ Act 71 of 2008.

²⁵⁵ *Ibid.*

²⁵⁶ 1901 1 Ch at 288.

termed “treasury shares”.²⁵⁷

However, in South Africa a company cannot hold rights against itself. For example, if a company buys back its own shares, such shares are extinguished. In terms of the new Companies Act²⁵⁸, shares which are bought back by the company are authorised un-issued shares. In terms of section 35 (4) of the new Companies Act,²⁵⁹ such shares have no rights prior to issue. As shares are a conglomeration of rights, a share without rights has no value - it is an empty shell. Consequently, prior to issue, authorised shares do not constitute company assets as they have zero value. When the company issues shares, existing shareholders’ rights to dividends and votes are diluted. In effect, existing shareholders “incur expenditure” as their assets are diminished. As set out above, a company cannot hold shares in itself, nor may it issue shares to itself. Consequently, shares, issued or non-issued, cannot be company assets.

3.4. Discussion of the Osborne decision

The Labat decision²⁶⁰ relied on English law, as expressed in the Osborne case.²⁶¹ This decision held that a company which issues shares in itself to acquire assets *does* incur expenditure.

It is submitted that the company law historical context should be examined to determine whether the principles in this case are still applicable. The reasoning behind the prohibition against the issue of shares at discount forms part of the capital maintenance regime. Capital maintenance aims to protect the company’s creditors against the dilution of the company’s assets. In this regard, Lord Halsbury, L.C., in *The*

²⁵⁷ SARS Comprehensive Guide to Capital Gains Tax. Issue III, page 72-73. [Online], Available at www.SARS.gov.za. Accessed on 22 July 2011.

²⁵⁸ Act 71 of 2008.

²⁵⁹ *Ibid.*

²⁶⁰ C. SARS v Labat Africa Ltd, 72 SATC 75.

²⁶¹ Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA).

*Ooregum Gold Mining Company of India Ltd v Roper*²⁶², stated: “[T]he capital is fixed and certain, and every creditor of the company is entitled to look to that capital as his security”. Under the current South African company law regime, the principles of solvency and liquidity have been substituted for capital maintenance.²⁶³

Previously, in England, at the time of the Osborne decision, a company could not issue shares at a discount.²⁶⁴ In the Osborne decision, Green J gave the following example: “A R1 000’s nominal worth of shares cannot be given for assets with the market value of R500, since shares cannot be issued at discount.”²⁶⁵ However, in South Africa shares may now be issued at a discount: In terms of the 1973 Companies Act,²⁶⁶ shares could be issued at par value or at no par value.²⁶⁷

In terms of the 1973 Act,²⁶⁸ section 81 provided that par value shares could be issued at a discount to par if a court resolution was obtained and a special resolution was passed; while section 82 provides that no-par value shares may be issued at a lower value than shares in the same pool if the company passes a special resolution.

As far as the new Companies Act²⁶⁹ is concerned, all shares are no-par value shares.²⁷⁰ The price of shares is no longer determined with reference to the par or nominal value of the shares, nor in relation to the price of other non-par shares forming part of the same pool. Instead, section 40²⁷¹ requires that *adequate consideration* is

²⁶² [1892] A.C. 125 at 133.

²⁶³ Pretorius, J.T., Delport, P.A., Havenga, M., Vermaas, M. 1999. *Hahlo’s South African Company Law Through The Cases*. Lansdowne: Juta & Co, Ltd. Pg. 138.

²⁶⁴ *Osborne v Steel Barrel Co Ltd* (1942) 1 All ER.

²⁶⁵ At page 638.

²⁶⁶ Act 61 of 1973.

²⁶⁷ Section 73.

²⁶⁸ Act 61 of 1973.

²⁶⁹ Act 71 of 2008.

²⁷⁰ Section 35 (2).

²⁷¹ Act 71 of 2008.

paid. Consequently, the safeguard in English law, requiring that shares had to have some fixed value, and that the market value of assets purchased with shares had to be equal to the nominal value of the shares, no longer exists. The crux of the Osborne case²⁷² is that a company incurs expenditure when it issues shares in itself to pay for assets because it “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”.²⁷³ As shown above, it was, at that time in English company law, not just a company right to call on the allottee to pay the par value, it was an *obligation* - specifically as shares could not be issued below par.

This obligation was imposed on the company to force it to maintain its capital for the protection of creditors. However, once this obligation disappears - as has now happened in SA company law, as no-par shares may be issued at adequate consideration, a value which does not necessarily have to correspond with market value²⁷⁴ - then the company is not giving up this right or obligation, as these rights or obligations have been extinguished due to the scrapping of the capital maintenance requirement.

Consequently, as the company’s right or obligation to demand par value for shares has disappeared along with the capital maintenance requirement, in terms of the new Companies Act²⁷⁵, the crux of the Osborne decision²⁷⁶ fades; a company, acting through its duly authorised board of directors, no longer has a right, nor obligation, to demand par value, so it is not giving up this right, or obligation, as required in terms of Osborne²⁷⁷. Applied to Judge Green’s example in the Osborne decision²⁷⁸, as referred

²⁷² Osborne v Steel Barrel Co Ltd (1942) 1 All ER.

²⁷³ *Ibid.*

²⁷⁴ See discussion on “adequate consideration”.

²⁷⁵ Act 71 of 2008.

²⁷⁶ Osborne v Steel Barrel Co Ltd (1942) 1 All ER.

²⁷⁷ *Ibid.*

²⁷⁸ *Ibid.*

to above, a R1000's worth of shares *could* in terms of the new Companies Act²⁷⁹ be given in exchange for assets with a market value of R500, as shares may now be issued at discount.

This would lead to incongruity and unfairness, as the company issuing the shares would be allowed to deduct a R1000's worth of expenditure which would bear no corresponding relation to the value of the R500-asset acquired. Secondly, this right to demand a certain, fixed monetary amount for shares was not an asset in the company's hands. Instead, it was an obligation on the company's part to maintain its capital for the benefit of creditors. Thirdly, as de Swart states,²⁸⁰ the contention that a company suffers a loss because it gives up the right to charge money when it issues shares for assets or services is hypothetical at best, as the company cannot prove for certain that those shares would have been bought.

Even if the English courts' argument²⁸¹ is accepted that the company incurs expenditure by issuing shares for services or assets, the timing and method the tax court used to determine the amount of expenditure allowed is questionable. The House of Lords held that the amount of the consideration offered in the form of shares is the issue price agreed upon for those shares and not the objectively determined open market price of the shares when the contract became unconditional, and the shares accrued.²⁸² Therefore, by way of practical example, if a company's directors and a vendor were to decide that shares were worth x when they were in fact worth y when the contract came to fruition, even though the former value would have no relation to market value of the shares, the company would be allowed to deduct a fictional amount based on the contracting parties' belief as to what the value was at that time.

²⁷⁹ Act 71 of 2008.

²⁸⁰ De Swardt, R. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 41(3): 475- 492. Notably there is no reduction in a company's patrimony when it issues shares.

²⁸¹ *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA); *Craddock v Zevo Finance Co Limited* [1944] 1 All ER 566 (CA).

²⁸² *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA).

If the Lacey Proprietary decision²⁸³ is considered, it also seems that the English authorities are incorrect as to the valuation method. The Stanton case²⁸⁴ sets out how English courts calculated the amount of expenditure incurred by the purchasing company. The taxpayer argued that the value to be placed on the shares was the contractually agreed price. The Crown parried that the consideration given for the assets were the shares themselves, and that the value to be allowed as a deduction was the market value of those shares on the date the agreement became unconditional. The court *a quo* concurred with the revenue authorities, that the value of the shares was reflected in the market value on the date the sale/purchase agreement became unconditional.

However, this decision was overturned on appeal.²⁸⁵ The Appeal Court held that the consideration given is the agreed amount, not the shares themselves. In other words, the court decided that the expenditure the company incurs is the unconditional obligation to pay a specified amount in terms of a contract. This judgment²⁸⁶ could lead to absurdity; for example, if the parties were to agree to sell an asset for a R100 in exchange for shares to be issued at an agreed price of R100, and the price fell to R0 by the time the agreement became unconditional, the purchasing company would be allowed to deduct expenditure to this amount, and the vendor would have to include R100 event even though shares were worthless.

It is submitted that the Lacey Proprietary decision²⁸⁷ presents a more realistic approach as to the valuation of shares. In Lacey Proprietary case,²⁸⁸ a company purchased rights in a mining company. The purchasing company paid for the rights with shares issued in itself. For the purposes of calculating the income received in the hands of the vendor company, the court decided that the shares should be valued at their middle

²⁸³ Lacey Proprietary Mines v CIR (1938 AD) 9 SATC 349.

²⁸⁴ Stanton v Drayton Commercial Investments Co Limited [1982] 1 All ER 121 (CA).

²⁸⁵ *Ibid*

²⁸⁶ *Ibid.*

²⁸⁷ Lacey Proprietary Mines v CIR (1938 AD) 9 SATC 349.

²⁸⁸ *Ibid.*

market value when the agreement became unconditional, and that the income the company received was not the agreed issue price. The court decided that the true intent of the parties was that the consideration should be shares in the purchasing company. At no stage could the vendor demand cash.

Similarly, SARS, in its Heads of Argument to the SCA,²⁸⁹ is arguing that the company which issues shares in itself to pay for expenditure incurs an unconditional obligation to issue shares.²⁹⁰ Therefore the company which issues shares in itself incurs an unconditional obligation to offer shares; it has no obligation to offer cash. However, in *Labat*²⁹¹ the court adopted the valuation principle laid down in the House of Lords,²⁹² and decided that the amount of expenditure incurred was equal to the agreed issue price of the shares, and not the market value - market value was irrelevant.

3.5. When is expenditure incurred?

If it were to be accepted that a company incurs expenditure in issuing shares for services in terms of section 40 (5),²⁹³ which the researcher argues it does not, the next question would be: when would it incur such expenditure?

Although section 11 (a)²⁹⁴ does not specifically say so, expenditure must be incurred in the year in which it is claimed. This was confirmed in the *Caltex* case,²⁹⁵ by Botha JA, who said: "It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment."

²⁸⁹ Heads of Argument, Case no 435/201, March 2011.

²⁹⁰ As argued by Adv Marais in SARS's Heads of Argument to the SCA.

²⁹¹ *C. SARS v Labat Africa Ltd*, 72 SATC 75.

²⁹² *Osborne v Steel Barrel Co Limited* [1942] 1 All ER 634 (CA).

²⁹³ Act 71 of 2008.

²⁹⁴ Act 58 of 1962.

²⁹⁵ *Caltex Oil (SA) Ltd. v SIR*, 37 SATC 1.

Issued shares held in trust until the fulfilment of a condition have not yet accrued, specifically as the company may claim the shares back if the subscriber fails to perform the service obligations under section 40 (6) (d) (i).²⁹⁶

In this regards Huxham and Haupt²⁹⁷ state that an expense is only incurred where the payer has no right to recover the funds. By analogy, where a company issues shares, but retains the right to claim back those shares, it has not incurred any expenditure until that right is extinguished. In ITC 1444, the taxpayer contracted for the delivery of materials in the future. The court held that payment was conditional on the vendor realising his obligations. Until such time as the seller complied with such obligations, no absolute and unqualified liability arose. The expense is incurred only when the vendor hands over supplies to the emptor.

By analogy, applied to shares for future services, expenditure is only incurred once the shareholder performs the services as per agreement.

Where an amount of expenditure is not expressed in Rand value, for example foreign currency, the question arises when expenditure incurred is calculated. This question arises as the value of foreign currency or shares in relation to the Rand equivalent will fluctuate depending on when it is determined. The Caltex case²⁹⁸ dealt with this situation. A company incurred expenditure in Sterling. At the time it incurred the expenditure sterling was strong in relation to the Rand, towards the end of the year the pound was devalued. The question when the amount is determined was crucial to the company. If the determination was made at the time of invoicing, when the Pound was strong, it would have to expend more Rand to cover the costs than if it was determined at the end of the year, when the Pound was weak, and it would have to set out less in Rand terms. The court held that it was only at the end of the year of assessment that it was possible to determine the expenditure incurred.

²⁹⁶ Act 71 of 2008

²⁹⁷ Huxham, K, Haupt, P. 2010. *Notes on South African Income Tax*. Roggebaai: H & H Publications.

²⁹⁸ Caltex Oil (SA) Ltd. v SIR, 37 SATC 1.

If it is accepted that the market value of the shares constitutes the company's expenditure and not the amount contractually agreed between the parties to the service contract, and the Caltex decision²⁹⁹ was applied to shares, the company issuing the shares would have to wait until the end of the tax year to determine the amount of expenditure incurred. This could have the absurd result, if the share price were to surge or slump, that the value of the share at the end of the year could be disproportionate and bear no relationship to the value of the services. A more realistic approach is taken by the Lace Proprietary case,³⁰⁰ dealing with the accrual or receipt of shares as consideration for mineral rights. The court held that the tax payer should include the middle market value of the shares on the transaction date.

In the context of section 24B,³⁰¹ for expenditure to be deductible, must the Income Tax Act³⁰² authorise shares for services as "expenditure"? Section 24B³⁰³ deems a company which issues shares in itself to pay for assets to have incurred expenditure. Why does the Act³⁰⁴ allow a concession for share-for-assets transactions but not for shares-for-services? The Explanatory Memorandum to section 24B sets out why this concession was allowed.³⁰⁵ The memorandum is adamant that a company which makes a share payment to purchase an asset does not incur actual expenditure. It states that the legislature allowed a concession to encourage company formations and share financing. On this ground, it cannot be argued that a deduction for shares issued for services should be allowed because a deduction is permitted for shares for assets - the motivation for allowing a deduction for shares for assets was not because the company incurred expenditure, it was a policy decision.

²⁹⁹ Caltex Oil (SA) Ltd. v SIR, 37 SATC 1.

³⁰⁰ Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.

³⁰¹ Act 58 of 1962.

³⁰² *Ibid.*

³⁰³ *Ibid.*

³⁰⁴ *Ibid.*

³⁰⁵ Explanatory Memorandum to the Revenue Laws Amendment Bill. 2004, clause 22.

CHAPTER 4. THE DATAKOR ENGINEERING CASE³⁰⁶ SHOULD HAVE HAD BEARING ON THE LABAT DECISION³⁰⁷

De Koker, with reference to shares-for- asset transactions, states: "...if the contract stipulates a monetary price and the newly-issued shares are merely an agreed method of discharging that money debt, the monetary price will constitute 'expenditure actually incurred' for the purposes of section 11(a)".³⁰⁸ The researcher considers this statement in the context of the Datakor decision.³⁰⁹ He argues that the discharge of a contractual obligation, to pay a debt, by the issue of shares amounts to a compromise. This discharge is a benefit to the company, not expenditure actually incurred. It is therefore respectfully submitted that De Koker³¹⁰ is incorrect: such a share issue does not constitute expenditure actually incurred but is a benefit to the company as the entity is absolved from its obligation to settle the debt.

Often takeovers are implemented to access the assessed loss of a company. This gives rise to a potential tax benefit.³¹¹ The acquirer can set the losses off against any gains. Section 20 (1) (a) (ii) of the Income Tax Act³¹² applies to the assessed loss of a company.

³⁰⁶ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

³⁰⁷ C. SARS v Labat Africa Ltd, 72 SATC 75.

³⁰⁸ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Paragraph 7.4.

³⁰⁹ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

³¹⁰ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Paragraph 7.4.

³¹¹ Jooste, R.D. 1989. Schemes of Arrangement – a new development. *Income Tax Reporter*, 28: 7.

³¹² Act 58 of 1962.

The section provides that the taxpayer's balance of assessed loss is reduced by the amount of *any benefit* resulting from a compromise for the taxpayer. "Benefit" is not defined in the Act.³¹³ The word was analysed in the *Datakor* case,³¹⁴ discussed below. Jooste, in *The Income Tax Reporter*,³¹⁵ submits that the assessed loss of any company which is, as a result of a scheme, vis-à-vis its creditors better off, is deriving a benefit.

The researcher submits that the effect of a scheme, such as the one accepted in the *Boltstone* case,³¹⁶ whereby a company's creditors' rights to enforce their claims were extinguished in exchange for preference shares, is to rid the company of its creditors. The creditors' claims are extinguished; in exchange, they receive shares. The researcher contends that there is a vital difference between a preference share and a creditor's claim, as a creditor can enforce his claim at any time, while a preference shareholder is only entitled to a dividend payment if the company has profits and the directors declare a dividend. Jooste states that the company which enters into a compromise is deriving "a clearly defined benefit (the face value of reduced claims) which will reduce the company's balance of assessed loss."³¹⁷

This argument is relevant to the *Labat*³¹⁸ decision. If the vending company sells a trademark, it has the right to demand payment from the purchasing company. The purchasing company derives a benefit if it is allowed to issue shares in lieu of payment, as the vendor company will not be allowed to enforce its right to demand payment. Whereas before it could approach a court of law to demand payment or place the company into liquidation, it now has to wait for a dividend payment.

³¹³ *Ibid.*

³¹⁴ *CIR v Datakor Engineering (Pty) Ltd* 19948 (4) SA 1050 (SCA).

³¹⁵ Jooste, R.D. 1989. Schemes of Arrangement – a new development. *Income Tax Reporter*, 28: 7.

³¹⁶ *Sackstein No v Boltstone (Free State) (Pty) Ltd (in liquidation) & Others* 1988 (4) SA 556 (O).

³¹⁷ Jooste, R.D. 1989. Schemes of Arrangement – a new development. *Income Tax Reporter*, 28: 7.

³¹⁸ *C. SARS v Labat Africa Ltd*, 72 SATC 75.

On liquidation its rights to share in the remainder of the assets are subjugated to the rights of creditors: creditors are paid first, and shareholders share in the balance, while preference shareholders have a right to a surplus only if expressly set out in the share rights of that particular share.

It is therefore submitted that had the court in *Labat*³¹⁹ considered the *Datakor* decision³²⁰ it might have come to a different conclusion. The *Datakor* case³²¹ concerned a company takeover in terms of section 311 of the previous Companies Act.³²² The company taxpayer, which had been liquidated, entered into a scheme of arrangement in terms whereof the creditors of the company would give up their claims against the company in exchange for preference shares in the company. The actual objective of the scheme was to preserve the company's assessed loss and its assessed tax loss.

The taxpayer wished to carry over this loss to a subsequent tax year. Creditors' claims against the company were capitalised. The creditors received redeemable preference shares in exchange for waiving their claims against the company taxpayer. The court considered whether any benefit had been received by, or accrued to, the taxpayer. The court held that "any benefit" in the relevant section had a wide and indeterminate meaning. In this case the benefit resulted from the extinguishment of the debt. The court *a quo* held that, as it was impossible to quantify the value of the benefit, the assessed loss should not be reduced.³²³

The court *a quo* placed the burden of proof on the Commissioner to prove the value of the benefit. The Appeal Court held that the court *a quo* erred, and that the onus was

³¹⁹ *Ibid.*

³²⁰ CIR v *Datakor Engineering (Pty) Ltd* 19948 (4) SA 1050 (SCA).

³²¹ *Ibid.*

³²² Act 61 of 1973.

³²³ ITC 1613 (1996) 59 SATC 187.

not on the Commissioner. Again, it is submitted that had the Labat case³²⁴ considered the Datakor Engineering decision,³²⁵ the court might have come to a totally different conclusion. Section 20 (1) (a) (ii) of the Income Tax³²⁶ provides that, for the purposes of determining the taxable income derived by any person, any assessed loss incurred in a previous year may be carried forward provided that the balance of the assessed loss shall be reduced by any amount arising from a compromise with a creditor.

The Commissioner submitted that the conversion of the creditors' claims into shares in effect amounted to a compromise. Harms J³²⁷ concurred and held that the company had derived a benefit. The court found that the contract constituted a compromise between the creditors and the company. It stated that it was irrelevant whether the value of the shares exceeded the amount owing to the creditors, as section 20³²⁸ was concerned only with the benefit received by the debtor company taxpayer, not by the benefit received, or loss suffered, by the creditors.

Prior to the agreement to convert claims to shares, creditors could enforce their rights against any of the company's assets, after the agreement creditors had no rights against the company. For example, as shareholders, they could not force the company to declare a dividend. As a rule dividends are declared by the company in general meeting.³²⁹ Consequently, the taxpayer derived a benefit as it was freed from the obligation to pay its debts. The court declared: "Indeed, the concession by the creditors (to waive the balance of their eligible claims against the taxpayer in return for a nebulous right of redemption of redeemable preference shares) must of necessity

³²⁴ C. SARS v Labat Africa Ltd, 72 SATC 75.

³²⁵ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

³²⁶ Act 58 of 1962.

³²⁷ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

³²⁸ Act 58 of 1962.

³²⁹ Pretorius, J.T., Delpont, P.A., Havenga, M., Vermaas, M. 1999. *Hahlo's South African Company Law Through The Cases*. Lansdowne: Juta & Co, Ltd. Pg. 138.

translate into a benefit for the taxpayer”.³³⁰

It is submitted that these principles are equally applicable to the Labat decision³³¹ where the vendor sold a trademark and agreed to accept shares in consideration. In terms of the agreement, the vendor/creditor gave up its right to demand payment in cash. This concession amounts to a compromise. As a result of this concession, the purchasing company, which issued the shares, was in effect in a better position than it was before.

Wunsh J, in the court *a quo*, held that “any arrangement or dispensation by which a company is protected from action by its creditors so as to enable it to continue with its business, whether by means of a subordination agreement or the capitalisation of the claims, must redound to its benefit.”³³² Wunsh’s reasoning echoes those of Jooste’s article, “Schemes of Arrangement- A New Development”³³³ which said that although the scheme alters the capital structure of the company, it enables the company to rid itself of its creditors who no longer have any claim against the company. Prior to the concession, the debtor company had to pay cash; subsequent thereto, the debtor company no longer had an obligation to pay anything. In effect, its creditors (who had accepted the shares in lieu of claims) could no longer claim cash but only had a right to receive a dividend, if declared, and to share in the balance of the company’s assets on liquidation.

Shareholders can’t compel the company to make a distribution of dividends. A company may make a distribution of dividends if authorised by a Board resolution of the company, provided that the directors are satisfied that the company will remain liquid and solvent subsequent to the distribution.³³⁴ Furthermore, a company is not

³³⁰ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

³³¹ C. SARS v Labat Africa Ltd, 72 SATC 75.

³³² At 12.

³³³ Jooste, R.D. 1989. Schemes of Arrangement – a New Development. *Income Tax Reporter*, 28: 7 at 10 -11.

³³⁴ Section 46 of Act 71 of 2008.

obliged to distribute profits but may place profits in reserve.³³⁵ The substitution of a right to dividends, when declared, for a right to enforce a debt, in effect translates into the dilution of a (former) creditor's rights. Instead of incurring expenditure, the transformation of a creditor's claim for money into a right to claim dividends, when declared, is a benefit to the company issuing the shares. Similarly, on liquidation of the company, the shareholders may share in the remainder of the company's assets only when the claims of preferential and ordinary creditors are settled. Again, a creditor who accepts shares in lieu of a liquid claim against the company is giving up its rights to share in the distribution of the company's assets on liquidation, alongside other creditors.

4.1. Does section 20 (1) (a) (ii) apply to court sanctioned compromises only?

If Section 20 (1) (a) (ii)³³⁶ applies only to court sanctioned compromises, then the *Datakor* decision³³⁷ could not have applied to *Labat*,³³⁸ as the latter concerned an individual arrangement between a creditor and a debtor. The aforementioned section provides that the benefit must arise from "a concession granted by" or a compromise made with any creditor".³³⁹

Consequently, the question arises whether the section is applicable only to court-sanctioned compromises with a group of creditors, or does it also pertain to any agreement between a taxpayer and debtors to waive a debt?

³³⁵ Pretorius, J.T., Delpont, P.A., Havenga, M., Vermaas, M. 1999. *Hahlo's South African Company Law Through The Cases*. Lansdowne: Juta & Co, Ltd. Pg. 138.

³³⁶ Act 58 of 1962.

³³⁷ CIR v *Datakor Engineering (Pty) Ltd* 19948 (4) SA 1050 (SCA).

³³⁸ C. SARS v *Labat Africa Ltd*, 72 SATC 75.

³³⁹ Section 20 (1) (a) (ii), of Act 58 of 1962.

SARS is of the opinion that section 20 (1) (a) (ii)³⁴⁰ applies even in those cases where only one or more creditors release a company from its debts.³⁴¹ Melamet J,³⁴² in support of SARS pronounced: “Section 20 (1) (a) (ii) does not specifically require the concession to be granted by, or the compromise to be made with, the general body of the taxpayers’ creditors.³⁴³ There is nothing in the wording of the (sub) section to justify such a limitation.”

De Koker³⁴⁴ supports this view, stating that conversion of one type of debt for another, even though it is not part of a court sanctioned compromise, for example the substitution of shares for a shareholder’s loan, extinguishes the loan and results in a benefit for the taxpayer. This means that *Datakor*³⁴⁵ could have been applicable to *Labat*,³⁴⁶ even though the purchasing company did not enter into a court sanctioned compromise. In application of the above interpretation of section 20 (1) (a) (ii),³⁴⁷ any debtor company which is allowed to extinguish a claim for payment against it by issuing shares to its (former) creditor is obtaining a benefit it is not suffering a loss or incurring expenditure.

A concession or compromise with creditors will result in a reduction of debt only if such concession or compromise arises in the ordinary course of trade. A company which contracts for the provision of services becomes indebted to those service providers, and this liability arises in the ordinary course of trade.

³⁴⁰ Act 58 of 1962.

³⁴¹ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Paragraph 8.129.

³⁴² As yet unreported.

³⁴³ In a conflicting judgement the *Blue Moon Investments (Pty) Ltd v COT* decision, 1966 (4) SA 205 (RAD), held that s 20 (1) (a) (ii) applies only to court sanctioned compromises.

³⁴⁴ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010.

³⁴⁵ *CIR v Datakor Engineering (Pty) Ltd* 19948 (4) SA 1050 (SCA).

³⁴⁶ *C. SARS v Labat Africa Ltd*, 72 SATC 75.

³⁴⁷ Act 58 of 1962.

Therefore, if the company enters into an agreement with service provider, that the debt owed for the performance of service is extinguished by the issue of shares, section 20 (1) (a) (ii)³⁴⁸ applies. De Koker³⁴⁹ submits that debts incurred for the purchase of fixed capital assets are liabilities incurred on capital. Any compromise or concession extinguishing these debts will not affect a taxpayer's assessed loss. Where a capital debt is extinguished, paragraph 12(5) of the Eighth Schedule³⁵⁰ applies.

*Income Tax in South Africa*³⁵¹ discusses whether a compromise agreement, whereby a creditor's claims are extinguished by compromise might amount to a recoupment in the hands of the erstwhile debtor. In *CIR V Louis Zinn Organisation (Pty) Ltd*, the court considered whether an amount received in terms of a compromise should be included in the taxpayer's gross income. The question was not decided. The court left open the issue whether a reduction of a trade debt constitutes a taxable recoupment.

Subsequently, section 8 (4) (m) was included in the Act.³⁵² The section is subject to section 20, dealing with assessed losses.³⁵³ Section 8 (4) (m)³⁵⁴ stipulates that where any person is released from the obligation to pay expenditure, that person is deemed to have recouped such amount from which he is relieved and has to include this amount in the year in which he/she receives the relief. If this section had been applied in the *Labat* decision,³⁵⁵ the purchasing company, which was given a concession and was allowed to issue shares in itself to the vendor, thereby extinguishing the vendors right to claim payment against it, would have had to include such amount from which it

³⁴⁸ Act 58 of 1962.

³⁴⁹ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010.

³⁵⁰ Act 58 of 1962.

³⁵¹ Clegg, D. 2010. *Income Tax in South Africa*. Volume 1, December 2010, Paragraph 5.4.3.

³⁵² Act 58 of 1962.

³⁵³ De Koker, A. 2010. *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010. Paragraph 4.64B.

³⁵⁴ Act 58 of 1962.

³⁵⁵ C. SARS v Labat Africa Ltd, 72 SATC 75.

was relieved in its gross income in the year in which the relief was granted.

Where the reduction or discharge of a debt has not been taken into account under section 8 (4) (m)³⁵⁶ or section 20 (1) (a) (ii),³⁵⁷ paragraph 12 (5) of the Eight Schedule³⁵⁸ could apply. Paragraph 12 (5)³⁵⁹ stipulates that any debt reduction or discharge for no or partial consideration gives rise to a capital gains in the hands of the debtor, equal to the amount reduced or discharged. Therefore, if the assessed loss of a company is not reduced, or the taxpayer cannot recoup expenditure incurred, paragraph 12 (5)³⁶⁰ might apply. This would be the scenario where a capital debt is extinguished.

The effect of this paragraph,³⁶¹ if hypothetically applied to the Labat³⁶² scenario, is that the debtor company would have been deemed to have acquired a claim to that portion of the debt that was reduced or discharged for no consideration. Alternatively, if a consideration was paid, the debtor company would have been deemed to have acquired so much of the reduction or discharge as exceeds the consideration. It is submitted that where shares are accepted in an agreement to waive a debt, the latter scenario would apply in the case where a capital debt was charged. However, in the case of shares-for-services, the debt or obligation to pay for services arises in the ordinary course of trade, and paragraph 12 (5)³⁶³ cannot apply.

³⁵⁶ Act 58 of 1962.

³⁵⁷ *Ibid.*

³⁵⁸ *Ibid.*

³⁵⁹ *Ibid.*

³⁶⁰ *Ibid.*

³⁶¹ *Ibid.*

³⁶² C. SARS v Labat Africa Ltd, 72 SATC 75.

³⁶³ Act 58 of 1962.

CHAPTER 5. ADEQUATE CONSIDERATION

The new Act, in section 40³⁶⁴, authorises the board to issue shares for adequate consideration, but “adequate consideration” is not defined. Section 58 of the Income Tax Act³⁶⁵ may shine some light on the meaning of “adequate consideration”, as it states that where property is disposed for less than adequate consideration, then such property is deemed to have been disposed of as a donation.

A donation is defined in section 55³⁶⁶ as any gratuitous disposal of property. Section 62,³⁶⁷ which pertains to the value of property disposed of under donations, does not specifically state how shares donated are valued. Subsection (d)³⁶⁸ states that any property not defined in section 62³⁶⁹ is deemed disposed at fair market value on the date upon which the donation takes effect.

“Fair market value” is defined in section 55³⁷⁰. It is the price which could be obtained between a willing buyer and a willing seller dealing at arm’s length in an open market. The Commissioner has wide powers to amend any amount submitted in a return in terms of a donation and may “fix the fair market value of that property” in terms of section 62 (4)³⁷¹. Therefore, if any share is disposed of at a value which is less than fair market value, and where the fair value which exceeds the actual consideration paid, it is deemed a donation.

³⁶⁴ Act 71 of 2008.

³⁶⁵ Act 58 of 1962.

³⁶⁶ *Ibid.*

³⁶⁷ *Ibid.*

³⁶⁸ *Ibid.*

³⁶⁹ *Ibid.*

³⁷⁰ *Ibid.*

³⁷¹ *Ibid.*

Section 56 (1)³⁷² stipulates that donations tax is not payable in respect of the value of any property disposed of by way of a donation which constitutes a voluntary reward which is included in the gross income of the donee in terms of paragraph (c), (d) or (i)³⁷³ of the definition of gross income or the gain which must be included under section 8C³⁷⁴. Therefore, if the company gives away shares below market value as a voluntary reward to employees, it will not be held liable for donations tax. Section 56 (1) (k)³⁷⁵ could specifically speak to independent contractors, as paragraph (c) of the definition of gross income³⁷⁶ relates to any amount received or accrued in respect of services rendered.

It is submitted that these principles relating to donations are not applicable to the provisions of Section 40 of the new Companies Act³⁷⁷. Section 40 (3)³⁷⁸ provides that a determination by the board as to the adequacy of consideration may not be challenged on any basis other than in terms of section 76 read with section 77 (2)³⁷⁹. Section 76³⁸⁰ sets out the standards of directors' conduct, and is a partial codification of directors' common law fiduciary duties. In particular, a director may not knowingly cause harm to the company or its subsidiary (s 76 2(a)(ii));³⁸¹ the directors must act in good faith and for a proper purpose and in the best interests of the company, and with the degree of care and skill reasonably expected (s 76 (3)).³⁸²

³⁷² *Ibid.*

³⁷³ Act 58 of 1962.

³⁷⁴ *Ibid.*

³⁷⁵ *Ibid.*

³⁷⁶ *Ibid.*

³⁷⁷ Act 71 of 2008.

³⁷⁸ *Ibid.*

³⁷⁹ *Ibid.*

³⁸⁰ *Ibid.*

³⁸¹ *Ibid.*

³⁸² *Ibid.*

Directors are deemed to have acted in the best interests of the company and to have exercised the necessary degree of care, skill and diligence where they inform themselves about the matter, have no personal interest in the decision, and had a rational basis for believing the decision was in the best interests of the company (s 76 (4)).³⁸³ S 77 (2)³⁸⁴ provides that the company may claim delictual and contractual damages from directors where they fail to comply with the duties set out in section 76.³⁸⁵ If the principal responsibility of a company is to raise capital by the issue of shares, it would be correct to argue that the directors forego their fiduciary duties if they accept less than market value.³⁸⁶

However, shares are issued for multiple reasons, such as securing a change in voting rights. It is submitted that “adequate consideration” may not equate to “market value”. Rudnicki³⁸⁷ argues that a company may have justifiable reasons to issue shares below market value, and specifically mentions the rendering of future services by a key employee as an example where the consideration demanded, i.e. the value of services, may be less than the market value of the shares. Although US shareholders have been given limited power to determine share incentives, in terms of the Dodd-Frank³⁸⁸ financial reform legislation’s “say on pay” rule,³⁸⁹ South Africa does not have a similar provision in the new Companies Act³⁹⁰ and shareholders will not be able to overturn decisions of the Board of Directors.

³⁸³ Act 71 of 2008.

³⁸⁴ *Ibid.*

³⁸⁵ *Ibid.*

³⁸⁶ For example, it has been held that directors who issue shares at discount but fail to secure payment will be held liable for damages because of breach of fiduciary duty (*Hirsche v Sims* [1894] AC 654 (PC)).

³⁸⁷ Rudnicki, R. 2010. *The Companies Act and its Impact on the Income Tax Act*. *Business Tax & Company Law Quarterly*, Volume 1, Issue 2 (June).

³⁸⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act.

³⁸⁹ Hill, A. 2011. *Baby steps won't fix US governance*. *Financial Times*, Tuesday, July 12th.

³⁹⁰ Act 71 of 2008.

CHAPTER 6. SECURITIES TRANSFER TAX, CGT & VAT

Any transfer in the beneficial ownership of a share imposes an obligation to pay securities transfer tax. Shares issued in terms of section 40 (5)³⁹¹ are issued to the subscriber and are transferred simultaneously to a trust. Once the services have been fulfilled, the shares are transferred back to the subscriber. *Prima facie* there are three transfer events: issue to the subscriber, transfer to trust, retransfer to subscriber. If transfers in beneficial ownership take place in all three stages, securities transfer tax will be payable thrice. However, if none of the rights pertaining to a share are transferred until the subscriber meets his contractual obligations, can it be said that a transfer in beneficial ownership has taken place?

6.1. Securities Transfer Tax (STT)

Transfer, as defined in section 1 of the Securities Transfer Tax Act,³⁹² does not include the issue of the share. Consequently, the issue of the share to the subscriber is not a transfer in terms of the Act³⁹³ and no STT is payable. The definition provides, furthermore, that any event which leaves unchanged the beneficial ownership of the shares, is similarly excluded. Beneficial ownership is not defined in the Securities Transfer Tax Act,³⁹⁴ and the principles of company law will have to be considered to ascertain whether a change in beneficial ownership takes place in terms of section 40 (5)³⁹⁵ where a share without any rights is transferred to the trust and transferred back to the subscriber.

³⁹¹ Act 71 of 2008.

³⁹² Act 25 of 2007.

³⁹³ *Ibid.*

³⁹⁴ *Ibid.*

³⁹⁵ Act 71 of 2008.

In terms of the 1973 Companies Act,³⁹⁶ a person who subscribes to the company's memorandum acquires membership; however, "membership" is not synonymous with beneficial ownership of the share. For example, a person who subscribes to the memorandum could be holding the share as a trustee on behalf or for the benefit of another. Section 56 (1) of the new Companies Act³⁹⁷ stipulates that the board may allow shares to be registered in the name of one person for the beneficial interest of another person.

"Beneficial Interest", as defined in the new Companies Act³⁹⁸ means the right to share in company distributions and exercise share rights, such as the right to vote and to dispose of shares. There is no indication in section 40 (5) of the Act³⁹⁹ that the trust is entitled to the beneficial interest in the shares, specifically as the subscriber to whom those shares were issued did not have the right to vote, share in distributions or to dispose of shares (unless the company agreed to the latter).

In terms of common law, the transfer of the beneficial ownership of shares takes place by agreement, and the method of transfer is by cession of the share rights. A cessionary does not obtain more rights than the cedent enjoyed at the time of transfer. Consequently, as none of the rights integral to a share are transferred on issue, as such rights are subject to the fulfilment of service obligations, there is no change of beneficial ownership on transfer to the trust and Securities Transfer Tax cannot be imposed.

³⁹⁶ Act 61 of 1973.

³⁹⁷ Act 71 of 2008.

³⁹⁸ *Ibid.*

³⁹⁹ *Ibid.*

6.2. Capital Gains Tax (CGT)

6.2.1 Asset for share transactions

Two scenarios are possible. In the first scenario, the purchasing company and the asset vendor may decide to exclude the operation of section 42.⁴⁰⁰ SARS's Comprehensive Guide to Capital Gains Tax⁴⁰¹ provides the following example to illustrate what happens where a purchasing company purchases an asset from a vendor by issuing shares in itself and the asset is a capital asset for both the vendor and the purchaser: the market value of the asset less the base cost will constitute the capital gain in vendor's hands. There will be no CGT effect in the hands of the purchasing company as it is not a disposal in terms of paragraph 11 (2) of the Eighth Schedule.⁴⁰²

In the second scenario, where the purchasing company and the vendor do not elect to opt out of the roll-over relief under section 42,⁴⁰³ the vendor will not make a capital gain on the disposal of the capital asset. The vendor is deemed to have acquired the shares at the base cost which it paid for the capital asset originally,⁴⁰⁴ while the purchasing company issuing shares in itself is deemed to have acquired the asset at the same cost.⁴⁰⁵ As in the first scenario, the issue of shares by the purchasing company is not a disposal for capital gains tax purposes.

⁴⁰⁰ Section 42 (8A) of Act 58 of 1962.

⁴⁰¹ SARS. (n.d.) Comprehensive Guide to Capital Gains Tax. Issue 3. [Online] Available at www.sars.gov.za. Accessed on 8 August 2011.

⁴⁰² Act 58 of 1962.

⁴⁰³ *Ibid.*

⁴⁰⁴ Section 42 (2) (a).

⁴⁰⁵ Section 42 (2) (b).

6.2.2 *Shares issued to employees*

Section 9C⁴⁰⁶ contains a deeming provision. Shares held for less than three years are deemed to be of a revenue nature. Once the three-year threshold is passed, shares held for this period are automatically deemed to be capital in nature. Where shares are issued to employees or directors as remuneration, in terms of section 8C⁴⁰⁷, section 9C⁴⁰⁸ will not apply. As a result, capital gains tax will not be applicable to the proceeds of the sale of shares received as remuneration. The proceeds are of a revenue nature and are included in gross income. On the other hand, where independent contractors are awarded shares as a financing mechanism, the provisions of section 9C⁴⁰⁹ will be applicable.

6.2.3 *Shares issued to independent contractors*

Section 9C of the Act⁴¹⁰ is applicable to shares issued to independent contractors to pay for future services. Section 9C⁴¹¹ stipulates when amounts received or accrued from the disposal of shares they are deemed to be of a capital nature. Section 9C(2)⁴¹² provides that any amount, excluding dividends, received or accrued on the sale of a “qualifying share” is deemed to be capital. A “qualifying share” is defined as a share *owned* by a taxpayer for at least three years. It is submitted that ownership of share means beneficial ownership. A share issued to a shareholder in terms of section 40 (5)⁴¹³ is not owned by the subscriber while it is held in trust in terms of the same provision.

⁴⁰⁶ Act 58 of 1962.

⁴⁰⁷ *Ibid.*

⁴⁰⁸ *Ibid.*

⁴⁰⁹ *Ibid.*

⁴¹⁰ *Ibid.*

⁴¹¹ *Ibid.*

⁴¹² *Ibid.*

⁴¹³ Act 71 of 2008.

As set out in Chapter 4, the subscriber will become the beneficial owner of the share when the subscriber acquires the rights underlying the shares. Only once the services are rendered, do the rights which make up the share acquired by the subscriber come into effect. Therefore, the three year period commences on the date the subscriber becomes the beneficial owner of the shares.

Any proceeds from the sale of shares owned by the independent contractor for three years are deemed to be capital in nature. The proceeds accrued or received will not form part of gross income. In terms of the Eighth Schedule of the Act,⁴¹⁴ Capital Gains Tax is payable on any capital gain. If Capital Gains Tax is applicable to any capital gain resulting from a transfer, paragraph 20 of the Eight Schedule⁴¹⁵ is applicable. Consequently, transfer duties are included in the base cost of an asset. As a result, if the subscriber receives the shares as capital and not as revenue, and a capital gain results from a transfer, the subscriber may add the STT to the base cost of the share and so doing reduce the gain.

6.2.4 CGT in the hands of the trust?

If shares are issued under s 40(5),⁴¹⁶ the trust holds those shares, and once the service conditions are fulfilled, the shares are transferred back to the subscriber. It is submitted that there is no CGT in the hands of the trust. The trust will not pay any consideration for the shares, nor will it receive any amount on transfer back to the subscriber. Furthermore, the trust acts as a custodian of the shares; it does not acquire ownership, nor does it receive any amount. The Lategan decision⁴¹⁷ established the principle that an amount accrues only if a person becomes entitled thereto.

⁴¹⁴ Act 58 of 1962.

⁴¹⁵ *Ibid.*

⁴¹⁶ Act 71 of 2008.

⁴¹⁷ Lategan v CIR 1926 CPD 203.

At no stage does the trust become entitled to the shares, or to any of the rights associated with the share. Its role is analogous to that of the mother in the Geldenhuys case⁴¹⁸ who held a flock of sheep for the benefit of her children as a usufruct. The trust is in a similar position; although it receives the shares, it holds these in a caretaker capacity. If the subscriber fails to perform his service obligations the shares revert to the company; they do not become the property of the trust.

6.3. Value-Added Tax (VAT)

Section 7(1) of the Value-Added Tax Act, 89 of 1991 provides, subject to exemptions and exceptions provided in the Act, that VAT is to be levied and paid on the supply by a vendor of goods or services where the vendor carries on an enterprise. For the purposes of the VAT Act⁴¹⁹ the issue, allotment or transfer of ownership of an equity security are deemed to be “financial services”. The supply of financial services, unless they are zero-rated under section 11 of the VAT Act⁴²⁰, are exempt from VAT as imposed by section 7 (1) (a).⁴²¹

The issue of shares to a “resident”, as defined in the Income Tax Act⁴²², is an exempt supply, but a similar sale to a non-resident is zero rated. In the case of Kretztechnik AG -v- Finanzamt Linz (Case C-465/03), the European Court of Justice on 26 May 2005 held that the issue of shares by a company was not a *supply* for VAT purposes. The result of this landmark decision is that any VAT cost associated with the share issue is recoverable. This decision is a marked departure from the previous *status quo* in Europe which, as South Africa still does, considered the issue of shares as an exempt supply and which prohibited the claiming of VAT costs associated with a share issue.

⁴¹⁸ Geldenhuys v Commissioner for Inland Revenue 1947 (3) SA 256 (C).

⁴¹⁹ Value-Added Tax Act, 89 of 1991.

⁴²⁰ *Ibid.*

⁴²¹ *Ibid.*

⁴²² Act 58 of 1962.

In *Income Tax Case No. 1744, 65 SATC 154*, the taxpayer argued that the VAT arising from the costs of preparing the share issue had to be allowed as an input tax deduction as the proceeds of the share issue were to be used to generate taxable supplies. The court disagreed, and held that as there was no direct link between the share issue and the taxable supplies, the deduction would not be allowed. The court concluded that the issue of the shares, an exempt supply, was preparatory to the making of taxable supplies and was not for the purpose of making taxable supplies. Although SARS adheres to this decision as the authority for disallowing input VAT costs on preparing share issues, it might be obliged to consider the Kretztechnik decision⁴²³ in the future, if ITC 1444 is overturned.

Where a vendor supplies services to a company in the furtherance of an enterprise, and the consideration it receives is shares for future services, they will have to charge VAT to the company. Provided the services it supplies are not exempt, or zero rated, it will charge VAT at the standard rate. The value of the supply it gives in the form of services is determined in terms of section 10 (3) (b)⁴²⁴. As the consideration it receives is not in money, the value of such shares shall be the open market value of the consideration.

Section 3 of the VAT Act⁴²⁵ defines what the open market value of consideration is. The value of the services it provides shall be the open market value of such services, irrespective of the value of the shares it receives. "Future services" is not defined in the new Companies Act,⁴²⁶ and the term should take on its ordinary meaning.

The definition of "services" in the VAT Act⁴²⁷ is widely defined. It includes anything done or to be done, including the granting, assignment, cession or surrender of any

⁴²³ Kretztechnik AG -v- Finanzamt Linz (Case C-465/03).

⁴²⁴ Value-Added Tax Act, 89 of 1991.

⁴²⁵ Value-Added Tax Act, 89 of 1991.

⁴²⁶ Act 71 of 2008.

⁴²⁷ Value-Added Tax Act, 89 of 1991.

right or the making available of any facility or advantage.

The following scenario could arise. A company transfers all of its contracts, in terms of which future services are to be rendered by the company. These contracts form a substantial part of the company's business, and in effect constitute a transfer of the business. Section 45 of the Income Tax Act⁴²⁸ deals with inter-group transfer of assets. Such restructurings are without tax consequences as it amounts to a mere re-stirring of the pot.

In this scenario, section 8 (25) of the VAT Act⁴²⁹ applies. It provides that where assets, such as services as defined, are transferred for shares, in terms of section 45,⁴³⁰ that the vendor making the supply of services and the recipient vendor are deemed to be the same person and no VAT can be imposed. If the services constitute the assets of a company, then it could be an asset for share transaction under section 45 of the Income Tax Act.⁴³¹ The service provider and the company providing the shares would then be considered to be one and the same person, in terms of section 8 (25),⁴³² provided the requirements of section 45⁴³³ had been complied with.

In addition, the supply must constitute that part of the enterprise which is capable of a separate operation. For example, a company could agree to transfer the service provider division, which makes up the majority of its activities to the company. In this scenario there are no VAT consequences.

⁴²⁸ Act 58 of 1962.

⁴²⁹ Value-Added Tax Act, 89 of 1991.

⁴³⁰ Act 58 of 1962.

⁴³¹ *Ibid.*

⁴³² Value-Added Tax Act, 89 of 1991.

⁴³³ Act 58 of 1962.

The service provider company will not have to account for VAT. Treasury has, however, decided to suspend the operation of section 45.⁴³⁴ As a result, the abovementioned transaction would be subject to the payment of VAT.

6.4. Secondary Tax on Companies (STC)

The principal objective of STC is to encourage companies to implement a modest dividend distribution policy. STC is a company tax, not a withholding tax. Section 64 B⁴³⁵ is the charging section for the levying and collection of STC. As companies may try to sidestep the payment of STC, the legislature has introduced anti avoidance provisions in section 64 C⁴³⁶ whereby dispositions in favour of shareholders, such as loans or the transfer of shares are engineered to avoid STC.

If shares are so distributed to avoid STC, for example where a company distributed shares in favour of an existing shareholder, such amount could be deemed to be a dividend declared by the company. Section 64C (2)⁴³⁷ is complemented by section 64C(4).⁴³⁸ Section 64C (4)⁴³⁹ provides that where the amount distributed constitutes remuneration in the hands of the shareholder, or the settlement of a debt owed by the company to such shareholder, then the deemed dividend provision will not be applicable to such issue of shares.

As a result, the shares issued for services will qualify under one of the two provisions because shares issued to employees will be regarded as remuneration, while the payment of independent contractors will constitute the payment of a debt owing to recompensate such services.

⁴³⁴ *Ibid.*

⁴³⁵ Act 58 of 1962.

⁴³⁶ *Ibid.*

⁴³⁷ *Ibid.*

⁴³⁸ *Ibid.*

⁴³⁹ *Ibid.*

Consequently, shares issued for services, whether issued to employees or independent contractors, cannot constitute deemed dividends and cannot lead to the imposition of STC against the company.

CHAPTER 7. THE TAXATION OF TRUSTS

7.1. *Do the shares vest in the trust?*

Shares are movable assets transferred by agreement. Shares are delivered by transfer, and transfer of shares occurs by way of cession.⁴⁴⁰ Therefore, in order to effectively transfer ownership of shares, an agreement to transfer ownership and cession, usually a single agreement, is required.⁴⁴¹ Physical delivery of the share certificates is not a prerequisite for transfer.⁴⁴²

In terms of section 40 of the new Companies Act,⁴⁴³ the shares issued to the shareholder for shares are “transferred” to a third party to be held in trust. Shares are transferred back to the shareholder for services on the fulfilment of a condition: the shareholder for services must comply with his service obligations. If shares are effectively transferred to a trust - which it is submitted it is not as the cedent, who does not enjoy any of the rights adhering to a share, and cannot cede anything he/she does not own - the provisions of the Income Tax Act⁴⁴⁴ which relate to trusts need to be examined.

In order to determine whether the Income Tax Act’s⁴⁴⁵ provisions on the taxation of trusts apply, it has to be determined whether the “trust” mentioned in section 40 of the new Companies Act⁴⁴⁶ is a trust as defined in section 1 of the Income Tax Act⁴⁴⁷.

⁴⁴⁰ Cilliers, H.S., Benade, M.L., Henning, J.J., Du Plessis, J.J., Delpont, P.A, De Koker, L., Pretorius, J.T. 2000. *Cilliers and Benade Corporate Law*. Durban: Butterworths. Pg. 290.

⁴⁴¹ Botha v Fick 1995 (2) SA 750 (A).

⁴⁴² Jeffery v Pollak and Freemantle 1938 AD 1.

⁴⁴³ Act 71 of 2008.

⁴⁴⁴ Act 58 of 1962.

⁴⁴⁵ *Ibid.*

⁴⁴⁶ Act 71 of 2008.

This section defines a trust as: “Any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person”.⁴⁴⁸

Similarly, in *Thorne and Molenaar NNO v Receiver of Revenue*, van Wilsen J held that a trust relates to defined property transferred to a trustee who is obliged to administer such property for the benefit of a beneficiary, the latter whom is entitled to oblige the trustee to conform with the obligations towards such beneficiary. Similarly, in *CIR v Friedman and Others NNO*, Joubert JA held that a trust is an entity whose assets vest in its trustee for purposes of administration. In terms of the definition of a trust in Section 1,⁴⁴⁹ and in the context of the aforementioned cases, it has to be asked whether the shares, constituting “other assets”, are administered and controlled by a person acting in a fiduciary capacity? None of the rights making up the share are transferred to the trust. Consequently, the trust to be created in terms of section 40⁴⁵⁰ does not comply with the definition of trust as the trust does not have the power to administer and control the assets.

However, if the trust formed under section 40 (5)⁴⁵¹ were to qualify as trust in terms of the Trust Property Control,⁴⁵² it should be examined what the tax effect of the transfer to the trust is. A trust is a person for the purposes of income tax.⁴⁵³ In particular, section 25 B⁴⁵⁴ sets out how income allocated to a trust is taxed. The section provides that amounts received or accrued to the trustee which are derived for the immediate or future benefit of an ascertained beneficiary is an amount which is deemed accrued to

⁴⁴⁷ Act 58 of 1962.

⁴⁴⁸ S1 of Act 58 of 1962.

⁴⁴⁹ Act 58 of 1962.

⁴⁵⁰ Act 71 of 2008.

⁴⁵¹ *Ibid.*

⁴⁵² Act 57 of 1988.

⁴⁵³ S 1 of the Income Tax Act, Act 58 of 1962.

⁴⁵⁴ Act 58 of 1962.

the beneficiary.⁴⁵⁵ Where an amount is not so derived, it is deemed accrued to the trust. Shares allocated in terms of section 40 (5),⁴⁵⁶ whether these are allocated to independent contractors or to employees, will be revenue in nature. CIR v Visser⁴⁵⁷ held that shares issued to a taxpayer in return for his “wits and energy” are non-capital in nature. In particular, the case⁴⁵⁸ compared a person’s profession to a tree and earnings from such profession to be the fruit of the tree.

However, section 25B⁴⁵⁹ is subject to section 7 of the Income Tax Act.⁴⁶⁰ Section 7 contains the anti-avoidance provisions of the Income Tax Act.⁴⁶¹ These provisions tax the donor on income which results from a donation. Section 7⁴⁶² may be applicable to companies which transfer shares to third party trustees to be held in trust in terms of section 40 (5) (b) of the Companies Act.⁴⁶³

7.1.1 Section 7 (5)

Section 7 (5)⁴⁶⁴ stipulates that if any person makes a donation, settlement or similar disposition, subject to a condition made by the donor or any one else that the beneficiaries will not receive the trust income until the happening of a fixed or contingent event, then any such income is deemed to be the income of the donor. Section 7 (5)⁴⁶⁵ is theoretically applicable to section 40 (5) of the Companies Act,⁴⁶⁶ as

⁴⁵⁵ S 25B of Act 58 of 1962.

⁴⁵⁶ Act 71 of 2008.

⁴⁵⁷ CIR v Visser, 8 SATC 271.

⁴⁵⁸ *Ibid.*

⁴⁵⁹ Act 58 of 1962.

⁴⁶⁰ *Ibid.*

⁴⁶¹ *Ibid.*

⁴⁶² *Ibid.*

⁴⁶³ Act 71 of 2008.

⁴⁶⁴ Act 58 of 1962.

⁴⁶⁵ Act 58 of 1962.

⁴⁶⁶ Act 71 of 2008.

the shares transferred to the trust are subject to such a condition. In particular, the shares are not transferred until the services have been rendered to the satisfaction of the donor.

7.1.2 *The application of section 7 (5) to shares-for-services*

There are practical difficulties in applying section 7 (5)⁴⁶⁷ in the above situation. If this section is applied literally, the shares and their proceeds shall be deemed to be the income of the company. However, a company may not hold shares in itself.⁴⁶⁸ Therefore, if the shares were deemed income of the company, this could lead to the absurd situation that an amount is deemed to have been received by a company which it cannot legally hold.

7.1.3 *Section 7 (6) of the Income Tax Act*

Section 7 (6)⁴⁶⁹ may also be applicable to the scenario created by section 40 (5).⁴⁷⁰ Section 7 (6)⁴⁷¹ provides that if the deed of donation or other disposition stipulates that the right to receive the income may be revoked or conferred on another, such income is deemed to be income of the donor for as long as it retains those powers. In this regard, section 40 (6) (iv)⁴⁷² states that the shares revert back to the company if the shareholder for shares fails to perform the service conditions.

As the rights afforded may be revoked, the shares, and any dividends resulting there from are deemed the income of the company. Once again, a company cannot hold

⁴⁶⁷ Act 58 of 1962.

⁴⁶⁸ S 35 (3) of the new Companies Act.

⁴⁶⁹ Act 58 of 1962.

⁴⁷⁰ Act 71 of 2008.

⁴⁷¹ Act 58 of 1962.

⁴⁷² *Ibid.*

shares in itself, in terms of section 35 (3) of the Companies Act.⁴⁷³ Consequently, section 7 (6)⁴⁷⁴ cannot be applied.

7.1.4 *Section 7 (7) of the Income Tax Act*

Section 40 (6) (c) (ii)⁴⁷⁵ gives a company the discretion to allocate dividends to the shareholder for shares, even though the shareholder may not yet own those shares. The dividends may be set off against the outstanding amount due on those shares. In this regard, section 7(7) of the Income Tax Act⁴⁷⁶ may be applicable. It stipulates that where the company cedes the right to receive the fruits of assets, such as interest or dividends, but retains ownership or an interest in the underlying assets, then any such income is deemed the income of the donor. The company does not retain ownership in the shares, as a company cannot hold shares in itself. However, it will retain an interest in the shares, as it determines when shares are issued. Consequently, any dividend paid on such shares will be deemed income of the company.

7.1.5 *There is no tax effect in the hands of the trust*

As the provisions of section 25B⁴⁷⁷ are subject to section 7,⁴⁷⁸ the latter section could prevail. A company which allocates shares to a trust for the benefit of shareholders for services may therefore have to consider the consequences of section 7.⁴⁷⁹ This section could have adverse tax consequences for the company, as the shares and their proceeds, in the form of dividends, could be deemed to be income of the

⁴⁷³ Act 71 of 2008.

⁴⁷⁴ Act 58 of 1962.

⁴⁷⁵ Act 71 of 2008.

⁴⁷⁶ Act 58 of 1962.

⁴⁷⁷ *Ibid.*

⁴⁷⁸ *Ibid.*

⁴⁷⁹ *Ibid.*

company. Theoretically, as the donor provisions in section 7 (2) to 7 (8),⁴⁸⁰ set out above, could apply, nothing would have accrued to the trust and the company as donor would have been deemed to have received such income. However, this argument stumbles over the obstacle set by section 35 (1),⁴⁸¹ as set out above, as a company cannot hold shares in itself. Consequently, the provisions in section 7⁴⁸² which deems income, in the form of shares, back to the donor, cannot apply.

Furthermore, the objective of section 7⁴⁸³ is to combat tax avoidance. Cameron JA said in *Land and Agricultural Bank of SA v Parker & Others*⁴⁸⁴ that the purpose behind section 7⁴⁸⁵ was to allow the legislature to pierce the veneer of a trust if its intention was to hide the founder's assets from creditors or to avoid taxation. If dividends are not paid out to the shareholder for shares, votes are not exercised, and no one benefits from the transfer of such shares, nothing accrues until the service conditions are satisfied. Under these circumstances, it is submitted, avoidance does not take place. It would therefore be inappropriate to apply section 7.⁴⁸⁶

Finally, although section 40 (5)⁴⁸⁷ states that the company must issue the shares and cause the shares to be "transferred" to a third party, presumably a trustee, to be held in trust, it is submitted that none of the rights which constitute the complex of rights making up a share are ceded. As a result, there is no accrual or receipt until the time the services are rendered, and consequently there is no tax effect in the hands of the trust on "transfer" of the shares.

⁴⁸⁰ Act 58 of 1962.

⁴⁸¹ Act 71 of 2008.

⁴⁸² Act 58 of 1962.

⁴⁸³ *Ibid.*

⁴⁸⁴ 2005 (2) SA 486 (SCA) 2004.

⁴⁸⁵ Act 58 of 1962.

⁴⁸⁶ *Ibid.*

⁴⁸⁷ Act 71 of 2008.

CHAPTER 8. CONCLUSION

The principal question considered above was whether shares-for-future services, in terms of the new Companies Act,⁴⁸⁸ constitute expenditure actually incurred. Scholtz⁴⁸⁹ argues that the Labat case⁴⁹⁰ should be applicable to shares issued to pay for services rendered, and that this expenditure should be claimable under the general deduction formula under section 11 (a).⁴⁹¹ It is submitted that this statement is incorrect for the following reasons:

De Swardt rightly avers that 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 for services constitutes ‘expenditure actually incurred’”.⁴⁹² The researcher submits that solid South African tax law precedents does exist as to whether expenditure has actually been incurred.⁴⁹³ These principles are enshrined in *Nasionale Pers Bpk v KBI*⁴⁹⁴ and *Edgars Stores Ltd v CIR*.⁴⁹⁵

The crux of these two cases is that a company which incurs an unconditional legal obligation to pay, incurs expenditure which may be deducted in terms of section 11 (a) of the Income Tax Act.⁴⁹⁶ It is agreed that a company which engages a person to render future services incurs a conditional legal obligation to pay for such services.

⁴⁸⁸ Act 71 of 2008.

⁴⁸⁹ Scholtz, W. M. 2010. Are share-based payments deductible? [Online] Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/>. Accessed on 22 November 2010.

⁴⁹⁰ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁴⁹¹ Act 58 of 1962.

⁴⁹² De Swart, R.D. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 3(41).

⁴⁹³ *Ibid*, at 475 to 476.

⁴⁹⁴ *Nasionale Pers Bpk v KBI*, 1986 (3) SA 549 (A).

⁴⁹⁵ *CIR v Edgars Stores Ltd*, 1986 (4) SA 312 (T).

⁴⁹⁶ Act 58 of 1962.

Once the services are fulfilled, this legal obligation to pay becomes unconditional.

However, the researcher's contention is that the obligation to pay should be distinguished from the agreement to tender payment in shares. As illustrated in the *Datakor* decision⁴⁹⁷, any agreement to substitute an issue of shares for the right to claim a debt in money in exchange amounts to a compromise or concession which diminishes the purchasing company's assessed loss. Instead of suffering a loss, the purchasing company is actually receiving a benefit: the vendor can no longer enforce its claim against the company.

Applied to transactions whereby services are rendered in exchange for shares, a creditor service provider no longer has the right to demand payment and has to wait for the payment of a dividend, which is dependent on the whims of the company directors. Furthermore, on liquidation, the rights which the creditor service provider had to join the *concursum creditorum* and to demand a share of the company assets is denied and it is relegated to a group of persons who share in what remains after the company creditors have had their feed.

Blackman⁴⁹⁸ states that a company which makes a share-based payment gives up the right to receive cash in return for the issue of shares. This statement is supported by Meyerowitz⁴⁹⁹ and forms the foundation to the decision in the *Labat* decision⁵⁰⁰. It is submitted that this argument is incorrect for two reasons. Firstly, this right to receive cash is no more than a *spes*: the forfeiture of an expectation is the forfeiture of a *spes* which, according to de Swardt, is "not in law recognised as an enforceable right".⁵⁰¹

⁴⁹⁷ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

⁴⁹⁸ Blackman, M.S., Jooste, R.D., Everingham, G.K., Larkin, M., Rademeyer, C.H., Yeats, Y.L. 2002. *Commentary on the Companies Act (CD-ROM)*. Cape Town: Juta, p. 255.

⁴⁹⁹ Meyerowitz, D. 2004. Paying for Goods and Services by Issuing Shares. *The Taxpayer*, May issue.

⁵⁰⁰ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁵⁰¹ De Swart, R.D. 2008. Do share-based payments made for the procurement of services

Objectively, it cannot be argued that the company suffered a loss, as it won't be able to prove that it would have sold the shares at the price it wished to obtain.

Secondly, Section 38 (1)⁵⁰² authorises the board of the company to issue shares, if permitted by the Memorandum of Incorporation, in terms of Section 36⁵⁰³. The Memorandum of Association may be amended by special resolution of the shareholders.⁵⁰⁴ Consequently, the company's capacity to issue shares remains, theoretically, unlimited. By analogy, it is as if the company has a money printing machine, which may be turned on at will to churn out shares. The company loses nothing by issuing shares to pay for assets or services, because its capacity to create shares remains undiminished.

Lowry v Consolidated African Selection Trust Ltd declared: "Un-issued shares are not an asset in any sense of the company".⁵⁰⁵ Consequently, in accordance with the patrimony test set out above, nothing goes out of the company's pocket when it issues shares. On the other hand, the person or persons who suffer out of pocket expenses are the remaining shareholders of the company. The rights of shareholders were discussed above. A shareholder has the right to vote and to share in dividends, when declared, and in the surplus on liquidation.

When a company issues shares to pay for services, future or current, the company suffers no loss. It is the remaining shareholders who are out of pocket as their right to share in the distributions and to vote are diluted. However, the Labat High Court decision, which upheld the decision in ITC 1801,⁵⁰⁶ remains binding until overturned.

qualify as expenditure actually incurred? *De Jure*, 3(41), at pg. 480.

⁵⁰² Act 71 of 2008.

⁵⁰³ *Ibid.*

⁵⁰⁴ Section 36 (2) (a) of the Companies Act, Act 71 of 2008.

⁵⁰⁵ 1940 2 ALL ER 545.

⁵⁰⁶ ITC 1801 68 SATC 57.

SARS is appealing the Labat High Court decision,⁵⁰⁷ and it has obtained the consent of the Supreme Court of Appeal to do so. At the date of the submission of this thesis, a date for set down had not yet been obtained from the SCA. The SCA's final judgment in this matter will determine whether shares for services, including future services, will be deemed expenditure incurred, and whether such expenditure may be deducted from income.

8.1. Tax effect on recipients of shares for future services

As discussed in Chapter 1, section 40 (5) of the Companies Act⁵⁰⁸ applies to services provided by employees and independent contractors, who are not labour brokers or service providers, in terms of the Fourth Schedule.⁵⁰⁹ Section 40 (5)⁵¹⁰ does not distinguish between these two categories. If the provision applies to both categories, it is submitted that, from the perspective of the recipient, the tax treatment for independent services will differ from services rendered by employees, as defined.

A share issue to an independent contractor is a financing tool, while a share issue to an employee aims to incentivise workers to perform future services. In the first scenario, the company is paying expenditure. In the second, it is doling out shares to employees to ensure their loyalty and long-term commitment to the company. This disparity should have an effect on the tax treatment of the two scenarios.

The Income Tax⁵¹¹, in Schedule Four, establishes different tax treatment for these two classification categories. As far as employees are concerned, shares-for-future services are “restricted equity instruments”, as defined in section 8C of the Income Tax

⁵⁰⁷ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁵⁰⁸ Act 71 of 2008.

⁵⁰⁹ Act 58 of 1962.

⁵¹⁰ Act 71 of 2008.

⁵¹¹ Act 58 of 1962.

Act.⁵¹² Employees may not deduct expenditure incurred in making available their services to an employer. Furthermore, section 8C (2)⁵¹³ determines the gain to be included in the employee taxpayer's income. The definition of "consideration: in 8C⁵¹⁴ provides that consideration offered for shares does not include the value of services rendered.

Prior to the vesting of restricted equity shares, the value of those shares received is exempt in terms of section 10 (1) (nD) of the Income Tax Act.⁵¹⁵ It appears that the value of shares for services by an independent contractor, if ascertainable, should be included in the taxpayer's income. The independent contractor should also be allowed to deduct the value of services rendered as a deduction from the income received. As the shares are non-money amounts, the principles applied in the *Brummeria Renaissance*⁵¹⁶ case, read with *Lace Proprietary*⁵¹⁷ should be applied to ascertain the monetary value of the shares received by independent contractors. Therefore, the middle-market value on the date the shares accrue to the taxpayer should be included.

8.2. Income tax and capital gains tax consequences arising from a transfer to the trust

On entering into the service agreement, the company issues the shares and causes them to be "transferred" to a third party to be held in trust, and later to be transferred to the subscribing party in accordance with a trust agreement. Section 25B⁵¹⁸ sets out how the income of a trust is taxed.

⁵¹² *Ibid.*

⁵¹³ *Ibid.*

⁵¹⁴ *Ibid.*

⁵¹⁵ Act 58 of 1962.

⁵¹⁶ *Brummeria Renaissance (Pty) Ltd, C: SARS v (6) SA 601, 69 SATC 205 (SCA).*

⁵¹⁷ *Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.*

⁵¹⁸ Act 58 of 1962.

Section 25B is subject to section 7 of the Income Tax Act.⁵¹⁹ If certain conditions are met, section 7⁵²⁰ deems income received by a trust back to the donor. In theory, sections 7 (5) and 7 (6)⁵²¹ could be applicable to shares for future services, and, any transfer of shares to a trust could be deemed the income of the company. Section 7 (7)⁵²² could under certain circumstance apply; however, if dividends are deemed back to the company in terms of section 7 (7),⁵²³ these are exempt in terms of section 10 (1) (k).⁵²⁴ However, if section 7⁵²⁵ is held to be applicable, this will give rise to an anomaly, as a company cannot hold shares in itself. Furthermore, as none of the rights constituting a share are transferred to the trust, the shares do not accrue to the trust, and there is no tax effect in its hands.

8.3. “Adequate consideration”

The value of the services rendered must constitute “adequate consideration” for shares issued.⁵²⁶ In terms of section 40 (3)⁵²⁷ long as the directors can show they acted *bona fide* in the best interest of the company, as defined in sections 76 and 77 (2) of the Companies Act,⁵²⁸ the company may not challenge their discretion. This means that “adequate consideration” may not necessarily mean “market value”.

⁵¹⁹ *Ibid.*

⁵²⁰ *Ibid.*

⁵²¹ *Ibid.*

⁵²² *Ibid.*

⁵²³ Act 58 of 1962.

⁵²⁴ *Ibid.*

⁵²⁵ *Ibid.*

⁵²⁶ S 40 (1) (a) of Act 71 of 2008.

⁵²⁷ Act 71 of 2008.

⁵²⁸ *Ibid.*

The meaning of “adequate consideration” in terms of the Companies Act⁵²⁹ and the Income Tax Act⁵³⁰ do not correspond. Section 5 of the Companies Act,⁵³¹ dealing with the interpretation of the Act, provides that if there is any inconsistency between the Companies Act⁵³² and any other national legislation such as the Income Tax Act,⁵³³ then the provisions of both Acts apply concurrently.

In this context, three scenarios may be distinguished, as far as services in exchange for shares are concerned. First, an employee who renders services in exchange for shares in terms of section 8C;⁵³⁴ secondly, an independent contractor, and lastly a person who receives shares as part of a key shareholder initiative. In the first scenario, the benefit received constitutes remuneration and is taxed in accordance with paragraph 11A of the Fourth Schedule.⁵³⁵ In the second and third scenarios, where the market value of the services rendered are less than adequate consideration, that portion of the value of the shares which exceeds the value of the services rendered constitutes a donation, in terms of section 58 of the Income Tax Act.⁵³⁶

8.4. The rule of law and legal certainty

The rule of law forms the foundation of South African law. The Constitution in clause 1, which declares the values on which the Republic is founded, refers to the “Supremacy of the Constitution and the rule of law”.⁵³⁷

⁵²⁹ *Ibid.*

⁵³⁰ Act 58 of 1962.

⁵³¹ Act 71 of 2008.

⁵³² *Ibid.*

⁵³³ Act 58 of 1962.

⁵³⁴ Act 58 of 1962.

⁵³⁵ *Ibid.*

⁵³⁶ *Ibid.*

⁵³⁷ Constitution of South Africa, 1996

One of the tenets of the rule of law is that laws must be ascertainable.⁵³⁸ Specifically, in a business context, it is important that taxpayers know what their rights are. Lord Mansfield, the father of English Commercial law, said:

*“The daily negotiations and property of merchants ought not to depend upon subtleties and niceties; but upon rules easily learned and easily retained, because they are the dictates of common sense, drawn from the truth of the case.”*⁵³⁹

More recently, the European Court of Human Rights gave a similar ruling when it said:

*“The law must be adequately accessible: the citizen must be able to have an indication that is adequate in the circumstances of the legal rules applicable to a given case...a norm cannot be regarded as a “law” unless it is formulated with sufficient precision to enable the citizen to regulate his conduct: he must be able - if need be with appropriate advice - to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail.”*⁵⁴⁰

In the current context, the legal position of taxpayers who issue shares in themselves as payment for services is uncertain. On the one hand, section 24B⁵⁴¹ creates the impression that a company which issues shares to pay for assets incurs expenditure. However, the Explanatory Memorandum to this section,⁵⁴² states that the provision was introduced to bring SA revenue authorities in line with international trends - not because SARS considered expenditure to have been actually incurred under such circumstances.

⁵³⁸ Bingham, T. *The Rule of Law*. London: Penguin, p37.

⁵³⁹ *Hamilton v Mendes* (1761) 2 Burr 1198, 1214.

⁵⁴⁰ *Sunday Times v United Kingdom* (1979) 2 EHRR 245, 271, para.49.

⁵⁴¹ Act 58 of 1962.

⁵⁴² SARS Explanatory Memorandum to the Revenue Laws Amendment Bill, 2004.

On the other hand, judicial interpretation on the issue is sparse. There are two conflicting tax court decisions,⁵⁴³ and one high-court decision,⁵⁴⁴ which dealt with a related issue, i.e. shares issued to acquire assets, but not services. It is therefore of critical importance that this issue is resolved to ensure certainty, whether by the Appeal Court or the legislature, specifically as shares for future services will play such an important role in South Africa's future company framework, seeing the important role that services plays in any economy.⁵⁴⁵

8.5. SARS v Labat - the endgame

SARS was granted special leave to appeal the Labat decision⁵⁴⁶ in terms of section 20 (4)(b) of the Supreme Court Act.⁵⁴⁷ To discuss the issues on appeal, brief reference is made to those questions decided in the tax court and the full court. The tax court and the full court held that the expression "expenditure actually incurred" meant that a taxpayer should have incurred an unconditional liability. In this regard, the courts relied on the decisions of *Nasionale Pers*⁵⁴⁸ and *Edgars Stores*.⁵⁴⁹ The Full Court held, again relying on the *Edgars Stores* case⁵⁵⁰, that once the taxpayer incurs an unconditional legal obligation, the deductibility requirement is met.

The court held that Goldblatt J in *ITC 1783*⁵⁵¹ had erred because he had not taken into consideration that an unconditional obligation had come into existence.

⁵⁴³ ITC 1801 against SARS, and ITC 1783 for SARS.

⁵⁴⁴ C. SARS v Labat Africa Ltd, 72 SATC 75, which confirmed ITC 1801.

⁵⁴⁵ In OECD countries more than two thirds of output, and up to four-fifths of employment is in the services sector: Bishop, M. 2001. *Economics-an A-Z Guide*. London: Profile Books.

⁵⁴⁶ C. SARS v Labat Africa Ltd, 72 SATC 75.

⁵⁴⁷ Act 59 of 1959.

⁵⁴⁸ *Nasionale Pers Bpk v KBI*, 1986 (3) SA 549 (A).

⁵⁴⁹ *CIR v Edgars Stores Ltd*, 1986 (4) SA 312 (T).

⁵⁵⁰ *Ibid.*

⁵⁵¹ ITC 1783 66 SATC 373.

The full court also referred to the Lace Proprietary case⁵⁵² which held that the issuing of shares constitutes “real expenditure”. SARS’s argument, as presented in the Heads of Argument of the appeal of senior counsel, Piet Marais,⁵⁵³ is that although the respondent, Labat, clearly incurred an unconditional legal obligation to issue its own shares, “the existence or not of such an obligation does not determine the answer to the present issue, namely whether “expenditure” was incurred.”⁵⁵⁴ The Heads of Argument⁵⁵⁵ examine the meaning of “expenditure”:

Reference is made to Goldblatt J’s statement in ITC 1783⁵⁵⁶:

“The spending of money or its equivalent, e.g. time or labour, and a resultant diminution of the assets of the person incurring such expenditure.”

In the Heads⁵⁵⁷, SARS refers to the interpretation given by the courts as to whether a company which issues and allots shares is diminishing its assets or incurring expenditure. In this regard, in Commissioner for Inland Revenue v Estate Kohler and Others⁵⁵⁸ Centilivres J stated:

“But when a company issues shares to an allottee, no property passes from the company to the allottee. The allottee acquires a right against the company, but the company does not part with any of its property.”⁵⁵⁹

⁵⁵² Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.

⁵⁵³ 4 March 2011, “Appellant’s Heads of Argument” Appeal Case 435/2010.

⁵⁵⁴ At paragraph 6.1.4.

⁵⁵⁵ “Appellant’s Heads of Argument” Appeal Case 435/2010.

⁵⁵⁶ At 376F.

⁵⁵⁷ Appellant’s Heads of Argument, Appeal Case 435/2010.

⁵⁵⁸ 1953 (2) SA 584 (A).

⁵⁵⁹ At P593H.

Consequently, on the strength of this case,⁵⁶⁰ SARS's Heads of Argument⁵⁶¹ argue that the assets of a company are not diminished and no expenditure is incurred by it.⁵⁶² At the time of submission of this research, Labat's attorneys had not yet responded to SARS's Heads of Argument.⁵⁶³

In conclusion, it is submitted that SARS has presented valid arguments why a company which issues shares does not incur expenditure - the company does not part with any of its property. Furthermore, it is submitted that the principles expressed in the Datakor decision⁵⁶⁴ have a bearing on this issue and should influence the debate. Therefore, in terms of this decision,⁵⁶⁵ if a debtor company which owes money for future services is granted permission to issue shares to pay the debt, the debtor company is receiving a benefit as it is absolved from a previous obligation it had to pay; it is not incurring expenditure.

⁵⁶⁰ CIR v Estate Kohler and Others.

⁵⁶¹ Appellant's Heads of Argument, Appeal Case 435/2010.

⁵⁶² At 6.3.3.

⁵⁶³ 4 March 2011, Appellant's Heads of Argument, Appeal Case 435/2010.

⁵⁶⁴ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

⁵⁶⁵ CIR v Datakor Engineering (Pty) Ltd 19948 (4) SA 1050 (SCA).

References

Bingham, T. 2011. *The Rule of Law*. London: Penguin.

Cilliers, H.S., Benade, M.L., Henning, J.J., Du Plessis, J.J., Delport, P.A., De Koker, L., Pretorius, J.T. 2000. *Cilliers and Benade Corporate Law*. Durban. Butterworths.

Clegg, D. 2010. *Income Tax in South Africa*. Volume 1, December 2010, Paragraph 5.4.3.

De Koker, A. 2010. (June - Last Updated: sl 41). *Silke on South African Income Tax*. (Subscription-based service only) [Online] Available at <http://www.lexisnexis.co.za>. Accessed on 10 December 2010.

De Swart, R.D. 2008. Do share-based payments made for the procurement of services qualify as expenditure actually incurred? *De Jure*, 3(41).

Delport, P. 2009. *The New Companies Act Manual*. Durban: Lexis Nexis.

Gerr, B. 2004. Income Tax- the Problem of Paying with Shares. *De Rebus*, September 2004.

Huxham, K., Haupt, P. 2010. *Notes on South African Income Tax*. Roggebaai: H & H Publications.

Kelly, R. 2009. *New Companies Act Offers Relief to Struggling Businesses*. [Online] Available at <http://www.bowman.co.za/LawArticles/Law-Article~id~2132417422.asp>. Accessed on August 12 2010.

Louw, C. 2009. An Independent Contractor under Labour Law and the Income Tax Act: is there a difference? *THRHR*, Bd.72(3), p.461.

Meyerowitz, D. 2004. Paying for Goods and Services by Issuing Shares. *The Taxpayer*, May issue.

OECD. 2010. *Commentary on Model Tax Convention*. Article 15, page 215. [Online] Available at <http://www.oecd.org/document>. Accessed on 13 July 2011.

Pretorius, J.T., Delpont, P.A., Havenga, M., Vermaas, M. 1999. *Hahlo's South African Company Law Through The Cases*. Lansdowne: Juta & Co, Ltd.

Rudnicki, R. 2010. The Companies Act and its Impact on the Income Tax Act. *Business Tax & Company Law Quarterly*, Volume 1, Issue 2, June 2010.

SARS. 2008. Interpretation Note 17, Employees' Tax: Independent contractors (Issue 3). [Online] Available at www.sars.gov.za. Accessed on 25 June, 2010.

SARS. 2010. Interpretation Note 58, The Brummeria Case and the right to use loan capital interest-free. 30 June 2010. [Online] Available at www.sars.gov.za. Accessed on 25 June, 2010.

SARS. 2011. Comprehensive Guide to Capital Gains Tax [Online] Available at www.sars.gov.za. Accessed 8 August 2011.

SARS. (n.d.) Comprehensive Guide to Capital Gains Tax. Issue 3. [Online] Available at www.sars.gov.za. Accessed on 8 August 2011.

Scholtz, W.M. 2010. *Are share-based payments deductible?* [Online] Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax>. Accessed on 22 November 2010.

Cases

55 SATC 198(A).

Appellant's Heads of Argument, Case no 435/201

Bauermeister v CC Bauermeister (Pty) Ltd 1981 (1) SA 174.

Blue Moon Investments (Pty) Ltd v COT decision, 1966 (4) SA 205 (RAD),

Botha v Fick 1995 (2) SA 750 (A).

Brummeria Renaissance (Pty) Ltd and Others, C: SARS v 69 SATC 205 2007 (SCA).

C SARS v (6) SA 601, 69 SATC 205 (SCA).

C SARS v Labat Africa Ltd, (2009) 72 SATC 75.

Cadac Engineering Works, CIR v (1965 AD) 27 SATC 61.

Caltex Oil (SA) Ltd v SIR 1975 (1) SA 665.

CIR v Datakor Engineering (Pty) Ltd 1998 (4) SA 1050.

CIR v Edgars Stores Ltd, 1986 (4) SA 312 (T).

CIR v Estate Kohler and Others 1953 (2) SA 584 (A).

CIR v Friedman and Others NNO

CIR v Golden Dumps (Pty) Ltd.

CIR v Visser, 8 SATC 271.

CIR v Witwatersrand Association of Racing Clubs (1960 AD).

Craddock v Zevo Finance Co Limited [1944] 1 All ER 566 (CA).

Etkind and Others v Hicor Trading Ltd 1991 (1) SA 111 (W).

Geldenhuis v Commissioner for Inland Revenue 1947 (3) SA 256 (C).

Hamilton v Mendes (1761) 2 Burr 1198, 1214.

ITC 1444 (1987) 51 SATC 35.

ITC 1444 (1987) 51 SATC 35.

ITC 1613 (1996) 59 SATC 187.

ITC 1744 65 SATC 154.

ITC 1783 (2003) 66 SATC 373.

ITC 1783 (2003) 66 SATC 373.

ITC 1822 69 SACT 200.

ITC No 1801 68 SATC 57.

Jeffery v Pollak and Freemantle 1938 AD 1.

Kretztechnik AG -v- Finanzamt Linz (Case C-465/03)

Lace Proprietary Mines v CIR (1938 AD) 9 SATC 349.

Land and Agricultural Bank of SA v Parker & Others 2005 (2) SA 486 (SCA) 2004

Liberty Life Association of Africa Ltd v Niselow (1996) 17 ILJ 673 (LAC).

Lowry v Consolidated African Selection Trust Ltd, 1940 2 ALL ER 545.

Mooi v Secretary for Inland Revenue [1972] 2 All SA 57 (A).

Nash v. Golden Dumps (Pty) Ltd 1985 (3) SA 1 (A).

Nasionale Pers Bpk v KBI, 1986 (3) SA 549 (A).

Osborne v Steel Barrel Co Limited [1942] 1 All ER 634 (CA).

Sackstein No v Boltstone (Free State) (Pty) Ltd (in liquidation) & Others 1988 (4) SA 556 (O).

SARS v Brummeria Renaissance (Pty) Ltd 2007 (6) SA 601 (SCA).

Standard Bank of SA Ltd v Ocean Commodities.

Stanton v Drayton Commercial Investments Co Limited [1982] 1 All ER 121 (CA).

Sunday Times v United Kingdom (1979) 2 EHRR 245.

The Ooregum Gold Mining Company of India Ltd v Roper [1892] AC 125.

Thorne and Molenaar NNO v Receiver of Revenue.

Trevor v Whitworth (1887) 12 App Case 409.

Acts

Constitution of the Republic of South Africa, Act 108 of 1996.

Companies Act 71 of 2008.

Companies Act 61 of 1973.

Income Tax Act 58 of 1962.

Revenue Laws Amendment Bill, 32 of 2004.

Securities Transfer Tax Act 25 of 2007.

Value-Added Tax Act, 89 of 1991.

Other than South Africa:

Dodd-Frank Wall Street Reform and Consumer Protection Act (USA).