

**THE MEANING OF “ACTUALLY INCURRED” IN SECTION 11 OF  
THE INCOME TAX ACT IN THE CONTEXT OF THREE SPECIFIC  
TRANSACTIONS**

**Submitted in partial fulfilment of the requirements of the degree**

**Magister Legum (Tax)**

**by**

**MAROE MARTIN MOTA**

**29583099**

**prepared under the supervision of Adv. C. Louw**

**at the**

**University of Pretoria**

**October 2012**

## **ACKNOWLEDGEMENTS**

I wish to thank my family and friends for the successful completion of this dissertation.

## ABSTRACT

The Income Tax Act 58 of 1962 (“**Act**”) entitles taxpayers to deduct certain losses and expenses incurred by them from their taxable income if such losses and expenses comply with the requirements of section 11(a) of the Act. One of the requirements of section 11(a) is that, in order to be eligible for a deduction, the losses and expenses must have been “actually incurred” by the taxpayer.

The area of tax deductions in our tax law represents the frontline in the continuous and inevitable war between the taxpayer (almost always desperately trying to maximise her deductions) and the revenue authorities (as often times desperately trying to minimise the deductions to which the taxpayer is entitled). The stage on which the various battles which make up this mighty war between citizen and state are fought is the court and the arsenal with which each party comes armed is the Act and, more specifically, the absolute belief of each party in the correctness of their interpretation of the Act, which, each party hopes, will be ably demonstrated by their able (and often extremely expensive) counsel. Such is the determination of the taxpayer and the tax authorities alike that the body of case law relating to this specific area of our law is, especially when one considers that it essentially involves on only one section of the Act, relatively voluminous.

The author’s intention is to consider only one of the requirements with which the taxpayer must comply in order to be eligible for a deduction, namely, the requirement that the relevant loss or expenditure must have been “actually incurred” by the taxpayer. Despite the fact that the meaning of the phrase “actually incurred” has been considered extensively by our courts, significant uncertainty still exists as to its exact meaning. The author will deal with three specific contexts in which the meaning of this phrase remains a subject of uncertainty, namely, share-based payments, contingent liabilities and losses and expenses incurred in relation to illegal receipts.

The author will begin first by dealing with the interpretation of tax statutes, the author will then, in general terms, consider the general deduction formula after which the author will delve into the meaning of the phrase “actually incurred” in the contexts of each of the transactions mentioned above.

## TABLE OF CONTENTS

<b>1</b>	<b>CHAPTER 1 - INTRODUCTION .....</b>	<b>6</b>
1.1	BACKGROUND.....	6
<b>2</b>	<b>CHAPTER 2 - INTERPRETATION .....</b>	<b>9</b>
2.1	GENERAL.....	9
2.2	APPROACHES TO INTERPRETATION.....	12
2.3	LITERAL APPROACH .....	13
2.4	PURPOSIVE APPROACH.....	16
2.5	THE INFLUENCE OF THE CONSTITUTION ON STATUTE INTERPRETATION.....	20
<b>3</b>	<b>CHAPTER 3 - INTERPRETATION .....</b>	<b>23</b>
3.1	THE EFFECT OF THE CONSTITUTION ON THE INTERPRETATION OF STATUTES .....	26
<b>4</b>	<b>CHAPTER 4 - GENERAL DEDUCTION FORMULA .....</b>	<b>28</b>
4.1	GENERAL.....	28
4.2	REQUIREMENTS FOR DEDUCTIONS.....	28
<b>5</b>	<b>CHAPTER 5 - SALE OF A BUSINESS .....</b>	<b>34</b>
5.1	PROBLEM STATEMENT .....	34
5.2	CONTINGENT LIABILITIES .....	34
5.3	SHOULD CONTINGENT LIABILITIES BE DEDUCTABLE FOR TAX PURPOSES?.....	36
5.4	SECTION 11 (A).....	37
5.5	ARGUMENTS IN FAVOUR OF DEDUCTIBILITY OF CONTINGENT LIABILITIES .....	38
5.6	ACKERMANS V SARS.....	43
<b>6</b>	<b>CHAPTER 6 - DEDUCTIBILITY OF SHARE-BASED PAYMENTS .....</b>	<b>51</b>
6.1	PROBLEM STATEMENT .....	51
6.2	RELEVANT CASE LAW .....	52
6.3	CONCLUSION .....	62
<b>7</b>	<b>CHAPTER 7 - DEDUCTIBILITY OF ILLEGAL EXPENDITURE.....</b>	<b>64</b>
7.1	INTRODUCTION.....	64
7.2	TAXABILITY OF ILLEGAL RECEIPTS .....	65
7.3	DEDUCTIBILITY OF EXPENDITURE AND LOSSES ARISING FROM AN ILLEGALLY EARNED INCOME.....	71

## 1 CHAPTER 1 - INTRODUCTION

### 1.1 Background

The Act does not contain an exhaustive list of individual expenditure and losses which, *ipso facto*, can be deducted from one's income. Indeed any attempt by the legislature to provide for such a list would be an ill-advised one since any such list is bound to be incomplete, regardless of how extensive it is.

Instead, the Act provides, in section 11(a), for a formula known generally as the general deduction formula. It is against this formula that the deductibility of losses and expenses can be determined. The general deduction formula, then, is the litmus test which the revenue authorities and our courts utilise to determine the deductibility or otherwise of a particular expense or loss. The general deduction formula is discussed in greater detail in chapter 4 below.

It is therefore possible (and often happens) that a loss or an expense is incurred (as that word is used within its ordinary, grammatical meaning) by a taxpayer but is not "actually incurred" by that taxpayer within the meaning of section 11(a) of the Act. In those circumstances, even though the taxpayer has "incurred" the expense or loss within the ordinary meaning of the word "incurred", the taxpayer is unable to deduct the expenditure or loss against its taxable income because the taxpayer has not "actually incurred" the expense or loss within the meaning of section 11(a) of the Act.<sup>1</sup>

Because new facts and scenarios emerge on a daily basis, the question of whether a specific expense or loss has been actually incurred within the meaning of section 11(a) of the Act is a question that, like many other questions which involve the

---

<sup>1</sup> There are any number of examples in case law where this has occurred. See for example *Concentra (Pty) Ltd v CIR* 1942 CPD 509; 12 SATC 95 in which deductions claimed by a company in respect of its directors' travelling expenses were disallowed and *Nasionale Pers v KBI* 1986 (3) SA 549; 48 SATC 55 in which a deduction by an employer in respect of business payments paid to its employees was held by the court not to have been "actually incurred" within the meaning of section 11(a).

interpretation of a statute, will never be fully settled and therefore, it is always ripe for research, analysis and investigation. The author therefore intends to investigate the meaning of the words “actually incurred” within the meaning of section 11(a) of the Act i.e. to investigate when incurring an expense or loss will give rise to a deduction of that expense or loss from a taxpayer’s income. In conducting this investigation, the author will limit itself only to the three scenarios, being, share-based payments, contingent liabilities and losses and expenses incurred in relation to illegal receipts.

In the context in which it is used herein, share-based payment refers to a situation where a company fulfils its payment obligations towards a creditor by issuing shares in itself in favour of such creditor.

Contingent liabilities or provisions in the context of a sale of a business as a going concern refers to liabilities that will arise after a business has been transferred by a seller to a purchaser, upon certain conditions been met, it being a certainty that the conditions will be met and the liability will arise.

Losses and expenses incurred in relation to illegal receipts refers to losses and expenses incurred by a taxpayer in the course of conducting illegal activities.

The only way in which the meaning of a statutory provision can be ascertained is through interpretation. In essence, therefore, the intention of this mini-dissertation is to interpret a provision in a statute, being section 11(a) of the Act and more specifically, the phrase “actually incurred” as it is used in that section. Unlike other forms of interpretation, interpretation of statutes involves the application of specific rules of inquiry and approaches unique to the interpretation of statutes. Du Plessis explains it as follows:

“[S]tatutory (and constitutional) interpretation is about construing enacted law-texts with references to and reliance on other law-texts, concretising the text to be construed so as to cater for an actual hypothesised concrete situation.<sup>2</sup> “

---

<sup>2</sup> Botha *Statutory Interpretation: An introduction for Students (2005)*1.

Accordingly, this mini-dissertation aims to construe the words “actually incurred” as they appear in section 11(a) of the Act with reference to and reliance upon, amongst other things, decided cases and other relevant legal literature with the aim of establishing whether, properly interpreted, share-based payments, contingent liabilities and losses and expenses incurred in relation to illegal receipts can be said to be “actually incurred” within the meaning of section 11(a) of the Act.

This the author will achieve by, firstly, attempting to ascertain the meaning of the words “actually incurred” as they are used in section 11(a) of the Act using, amongst other things, the various theories of or approaches to interpretation which form part of our law. These theories, broadly speaking, can be divided into two categories namely, the literal and purposive theories of interpretation.

Secondly, with the aid of case law and relevant literature, the author will, in respect of each of the three categories of expenses and losses referred to above, attempt to ascertain whether, based on case law and the available literature, those categories of expenses and losses can be said to be “actually incurred” within the meaning of section 11(a) of the Act.

Finally, based on the combined outcomes of the first and second step, the author will advance several arguments, in respect of each category of expenses and losses, for their deductibility or otherwise under section 11(a).

## **2 CHAPTER 2 - INTERPRETATION**

### **2.1 General**

Statutory interpretation is central to the application of statutes. This is because in order for a statute to be applied, it must first be understood and, in order to be understood, its meaning must be ascertained. The manner in which the meaning of a statute is ascertained is through the interpretation of that statute. Accordingly, in one sense, interpretation of statutes can be described as a process through which the meaning of a statute is ascertained (for purposes of application of that statute).

If interpretation of statutes means the method through which the meaning of a statute is ascertained, the question arises, how does one go about interpreting a statute? Obviously, there can be no single answer to this question because any answer will invariably depend on who is asking the question, who is answering the question, the context in which the question has arisen, the specific statute which is sought to be interpreted etc. For example and as will be seen from the further discussion below, interpretation of a tax statute is unique and is informed by several very specific principles which may or may not be different to the principles applicable to the interpretation of other statutes..

The relationship between what is contained in a statute and the practical implementation thereof is often distant. Take, for example, section 9 of the South African interim Constitution<sup>3</sup>, which provided that “every person shall have a right to life.” Should this be interpreted as prohibiting the taking away of life under all circumstances or does it limit the circumstance under which a human life can be terminated? Whatever the correct answer to this question is, it does not appear from the wording of the statute. The Constitutional

---

<sup>3</sup> Act 20 of 1993.

Court was, in the case of *Sv Makwanyane and Another*<sup>4</sup>, called upon to answer this question. It is clear from the judgment that the court did not relish having being called to interpret the meaning of the most fundamental of the rights in the bill of rights with very little guidance from the text itself. Almost in frustration, the court, through Chaskalson P, as he then was, stated that:

“It would no doubt have been better if the framers of the Constitution had stated specifically, either that the death sentence is not a competent penalty, or that it is permissible in circumstances sanctioned by law. This, however, was not done and it has been left to this Court to decide whether the penalty is consistent with the provisions of the Constitution. That is the extent and limit of the Court's power in this case.”<sup>5</sup>

Of course, the need for judicial interpretation of statutes will always exist - there will never be a time when legislation is so comprehensively and clearly drafted that the need for the courts to interpret it is entirely negated. However, there is a real danger in vesting the courts with the power to interpret legislation as that power, in many cases, is the equivalent of legislation making which is an affront on the separation of powers doctrine<sup>6</sup>. The *Makwanyane* matter is a case in point. The right to life, which was a right provided for in the interim Constitution, does not inherently imply a prohibition against the death penalty. That this is so was the interpretation of the court. Accordingly, there is an element of value judgment which goes into judicial interpretation of statutes which may, and often does, result in judges making law. This practice of law-

---

<sup>4</sup> *S v Makwanyane and Another* 1995 (3) SA 391. This case was the first and final death penalty case decided under the South African Constitution. The two accused in this case had been convicted on four counts of murder and one count of robbery with aggravating circumstances.

<sup>5</sup> *id* at par 5.

<sup>6</sup> The doctrine of separation of powers seeks to limit the encroachment of the three arms of government (being the legislature, the executive and the courts) into each other's competences. See further, *Executive Council of the Western Cape Legislature v President of the Republic of South Africa* 1995 (4) SA 877 (CC); *Ex Parte Chairperson of the Constitutional Assembly: In Re Certificatio of the Constitution*, 1996 (4) SA 744 (CC).

making by judges is more comprehensibly discussed in chapter 8 below. Warning against this, in its very first judgment, the Constitutional Court held that:

“While we must always be conscious of the values underlying the Constitution, it is nonetheless our task to interpret a written instrument. The author is well aware of the fallacy of supposing that general language must have a single “objective” meaning. Nor is it easy to avoid the influence of one’s personal intellectual and moral preconceptions. But it cannot be too strongly stressed that the Constitution does not mean whatever we might wish it to mean. We must heed Lord Wilberforce’s reminder that even a constitution is a legal instrument, the language of which must be respected. If the language used by the lawgiver is ignored in favour of a general resort to “values” the result is not interpretation but divination.”<sup>7</sup>

In the same vein, the Constitutional Court in *Daniels v Campbell No* held that:

“To be permissible, the interpretation must not be fanciful or far-fetched but one that reasonably arises from the challenged text without unwarranted strain, distortion or violence to the language.”<sup>8</sup>

However, it is not so that the courts regard their roles as judicial officers as prohibiting them from making law. In general, the courts accept this as part of their duties and powers. For example, in *Minister of Health v Treatment Action Campaign*<sup>9</sup>, the

---

<sup>7</sup> *S v Zuma* 1995 (2) 642 (CC) at par 17 – 18.

<sup>8</sup> *Daniels v Campbell NO* 2004 (5) SA 331 at par 83.

<sup>9</sup> *Minister of Health v Treatment Action Campaign and Others* (2) 2002 (5) SA 721 (CC).

Constitutional Court held that:

“All arms of government should be sensitive to and respect [the separation of powers]. This does not mean, however, that courts cannot or should not make orders that have an impact on policy. The primary duty of courts is to the Constitution and the law, which they must apply impartially and without fear, favour or prejudice. The Constitution requires the state to respect, protect, promote, and fulfill the rights in the Bill of Rights. Where state policy is challenged as inconsistent with the Constitution, courts have to consider whether in formulating and implementing such policy the state has given effect to its constitutional obligations. If it should hold in any given case that the state has failed to do so, it is obliged by the Constitution to say so. In so far as that constitutes an intrusion into the domain of the executive, that is an intrusion mandated by the Constitution itself.”<sup>10</sup>

Of course, it goes beyond the scope of this mini-dissertation to deal with the intricacies of the doctrine of separation of powers, suffice it to mention only that it is, generally, our courts’ view that in the course of interpretation of statutes, the Constitution allows them to make law or repeal law, which, in itself, is a form of law making<sup>11</sup>.

## 2.2 **Approaches to Interpretation**

That, then, brings us neatly onto the subject of approaches to interpretation. In an attempt to deal with the central question inherent in statutory

---

<sup>10</sup> See *id* at par 98 – 99.

<sup>11</sup> See further example, where the courts have repealed laws or set aside actions of the *Executive and Legislature: Premier, Mpumalanga, and Another v Executive Committee, Association of State-Aided Schools, Eastern Transvaal* 1999 (2) SA 91 (CC); 1999 (2) BCLR 151 (CC).

interpretation of how one actually goes about interpreting statutes, several “approaches” have been developed over the years. As the principal interpreters of statutes, it is the courts which are, by and large, responsible for developing these approaches. The intention behind the development of the approaches to statutory interpretation is to create common principles which will guide our courts (and others who are involved in the administration of justice or have an interest in the meaning of specific laws) in ascertaining the meaning of statutes. This is partly due to the appreciation of the fact that the interpretation of statutes is a complex process, it “is not a mechanical process of join-the-dots or paint-by-numbers.”<sup>12</sup>

There are various approaches to interpretation (also known as theories of interpretation). All of these approaches can be categorised into two broad categories, being the literal (text based) approach and the purposive (text-in-context) approach.<sup>13</sup>

### 2.3 **Literal Approach**

As the name suggests, the literal approach dictates that the interpreter should interpret the law as it appears in the text of the legislation. In other words, the interpreter should not depart (or should depart as little as possible) from the text of the statute<sup>14</sup>.

Botha ascribes the following principles to the literal approach to interpretation:

- If the meaning of the words is clear, it should be given effect to and equated with the intention of the legislature.

---

<sup>12</sup> Botha 1.

<sup>13</sup> There are other approaches to interpretation however, these are generally seen as sub-categories of the literal and purposes approaches. Amongst these are the (a) systematic (b) teleological (c) historical and (d) comparative approaches.

<sup>14</sup> See: *Glen Aril Development Corporation Ltd VSIR 1975 (4) SA715 (A)* and *Ex Parte the Minister of Justice: In re tex v Jacobson and Levy 1931 AD 466*.

- If the plain meaning of the words is ambiguous, vague or misleading, or if a strict literal interpretation would result in absurdity, then it is permissible to deviate from the literal meaning to avoid such absurdity. In this scenario, regard must be had to the so called “secondary aids to interpretation”, which include having regard to the long title of the statute, headings to chapters and sections etc.
- Should the secondary aids of interpretation prove to be insufficient, then regard must be had to the so called “tertiary aids to interpretation”, i.e. the common-law law presumptions<sup>15</sup>.

One of the difficulties with the literal approach is that attributing meanings to words or phrases is often a subjective exercise i.e. different people ascribe different meanings to different words. In many instances, therefore, the meaning assigned to a particular word, although cloaked in the guise of being the literal and ordinary meaning of that word, could merely be the meaning of the word according to the specific judge or person. In *Savage v Commissioner of Inland Revenue*, it was said that:

“It is pointed out, in the passage... quoted by the Chief Justice that what seems an absurdity to one man may not seem absurd to another. So too what seems a clear meaning to one man may not seem clear to another. This consideration must also, I think, be borne in mind when one refers to the literal, ordinary, natural or primary meaning of words or expressions. The “literal” meaning is not something revealed to judges by a sort of authentic dictionary; it is only what individual judge’s thing is the lateral meaning.”<sup>16</sup>

Accordingly, giving meaning to a word or a phrase based on the literal approach is seldom a simple, objective and straight forward mechanical

---

<sup>15</sup> Botha 47-48.

<sup>16</sup> Emslie Davis and Hutton *Income Tax Cases and Materials* (1995)19.

process. It is inherently subjective and, often, complicated.

In addition to human subjectivity, the other potential problem with the literal approach to interpretation is what we may refer to as “geographical subjectivity”. By this the author means certain words have certain specific meanings in some places and completely different meanings in other places. For example, in *Moller v Keimoes School Committee*<sup>17</sup> it was accepted that the word “European” is often used in South Africa to refer to all white people, regardless of whether or not a specific white person comes from Europe whereas a black person who comes from Europe would not similarly be regarded as European. Similar interpretation challenges were faced in *Gandur v Rand Townships Registrar*.<sup>18</sup>

Further criticisms that have been levelled against the literal approach include the criticisms that:<sup>19</sup>

- The literal approach disregards the common principles of our law and are applied only if the text is ambiguous.
- Words are regarded as the primary index to legislative meaning.
- Other aids to interpretation are ignored.
- The intention of the legislature is made dependent on how clear the wording of the legislation is.
- In fact, very few texts can have only one interpretation.

Often, in applying this approach, the dictionary is used in an attempt to ascertain the “ordinary meaning” of words. In *Association of Amusement and Novelty Machine Operators v Minister of justice*,<sup>20</sup> the court indicated that it is

---

<sup>17</sup> 1911 AD 635.

<sup>18</sup> 1913 AS 250. See also Hoexter *School of Law University of the Witwatersrand Introduction to South African Law* (2006) 198 – 200.

<sup>19</sup> Botha 49.

<sup>20</sup> 1980 (2) SA 636.

appropriate to utilise “any authoritative dictionary” of the language of the statute to ascertain the meaning of a word. This principle was later confirmed by the Supreme Court of Appeal (“SCA”).<sup>21</sup>

## 2.4 **Purposive Approach**

In terms of the purposive approach, the intention of the interpreter is, utilising the text of the statute, to give meaning to the underlying purpose of the statute. In order to do so, the interpreter takes several factors into account, including the context in which the legislation was passed, the evil which the legislation is intended to prohibit and punish, the good which the legislation is intended to promote and protect and the political context within which the legislation was passed.

Accordingly, to an extent, the purposive approach involves the subordination or disregard of the literal meaning of the text in favour of the “underlying” meaning of the text as can be best ascertained from the text itself as well as all the relevant surrounding factors such as those listed above.

Borrowing from Canadian authority<sup>22</sup>, the Constitutional Court explains the purposive approach in the following manner:

“The meaning of a right or freedom guaranteed by the Charter was to be ascertained by an analysis of the purpose of such a guarantee; it was to be understood, in other words, in the light of the interests it was meant to protect. In the author’s view this analysis is to be undertaken, and the purpose of the right or freedom in question is to be sought by reference to the character and larger objects of the Charter itself, to the language chosen to articulate the specific right or freedom, to

---

<sup>21</sup> *Fundstrust (Pty) Ltd (in liquidation) v Van Deventer* 1997 (1) SA 710.

<sup>22</sup> Currie and De Waal *The Bill of Rights Handbook* (2010) 148.

the historical origins of the concept enshrined, and where applicable, to the meaning and purpose of the other specific rights and freedoms with which it is associated within the text of the Charter. The interpretation should be.... a generous rather than legalistic one, aimed at fulfilling the purpose of a guarantee and the securing for individuals the full benefit of the Charter's protection."<sup>23</sup>

Accordingly, the purposive approach does not have, as its primary concern, the text of the legislation. Instead, it is primarily concerned with the purpose of the legislation. The underlying principle is, in essence, that one can only understand the meaning of the text of legislation once one has understood the reasons for its enactment. Botha explains it thus:

“The search for the purpose of legislation requires a purpose-orientated approach which recognizes the contextual framework of the legislation right from the outset, and not only in cases where a literal text-based approach has failed. The purpose-orientated approach provides balance between grammatical and overall contextual meaning. The interpretation process cannot be complete until the object and scope of the legislation (i.e. its contextual environment) are taken into account. In this way the flexibilities and peculiarities of language and all the internal and external factors are accommodated in the continuing time-frame within which legislation operates.”<sup>24</sup>

Significantly, however, the determination of the underlying purpose of the legislation must be an objective one. It cannot be based on the interpreter's subjective outlook. The Namibian Supreme Court held in this regard that:

---

<sup>23</sup> *id.*

<sup>24</sup> Botha 51.

“It is a value judgment that requires objectively to be articulated and identified, regard being had to the contemporary norms, aspirations, expectations and sensitivities of the Namibian peoples as expressed in its national institutions and its Constitution, and further having regard to the emerging consensus of the values in a civilized international community (of which Namibia is part) which Namibians share. This is not a static exercise, it is a continually evolving dynamic. What may have been acceptable as just a form of punishment some decades ago, may appear to be manifestly inhuman and degrading today. Yesterday’s orthodoxy might appear as heresy.”<sup>25</sup>

The historical roots of the purposive approach in South Africa dates back to the 1950s. In *Jaga v Donges*<sup>26</sup>, Schreiner J gave the following guideless to the interpretation of statutes:

“Certainly no less important than the oft repeated statement that the words and expressions used in a statute must be interpreted according to their ordinary meaning, is the statement that they must be interpreted in the light of their context.”<sup>27</sup>

From a criticism perspective, predictably, the biggest criticism which this approach opens itself to is that it, at the least, undermines the text of the legislation and, at the worst, disregards it in favour of the “underlying” meaning of that text. Perhaps the clearest example of this occurred in *S v Mhlungu*.<sup>28</sup> That case involved the interpretation

---

<sup>25</sup> *id* at 149.

<sup>26</sup> 1950 (4) SA 653 (A).

<sup>27</sup> *id* at 662 – 663.

<sup>28</sup> 1995 (3) SA 391.

of section 241 (8) of the interim Constitution. That section provided that:

“All proceedings which immediately before the commencement of this Constitution were pending before a court of law, including any tribunal or reviewing authority established by or under law, exercising jurisdiction in accordance with the law then in force, shall be dealt with as if this Constitution had not been passed: Provided that if an appeal in such proceedings is noted or review proceedings with regard thereto are instituted after such commencement such proceedings shall be brought before the court having jurisdiction under this Constitution.”

Insofar as it governed how matters that were before courts prior to it becoming effective is concerned, the interim Constitution, as per section 241(8), could not be any clearer: Such matters were to “be dealt with as if [that Constitution] had not been passed.”

Disregarding the ordinary meaning of the text, the majority of the Constitutional Court held in *S v Mhlungu* that:

“An interpretation which withholds the rights guaranteed by Chapter 3 of the interim Constitution from those involved in proceedings which fortuitously commenced before the operation of the Constitution would not give that chapter a construction which is “most beneficial to the widest amplitude” and should therefore be avoided if the language and context of the relevant sections reasonably permits such course.”<sup>29</sup>

---

<sup>29</sup> Currie & De Waal 151.

The position adopted by the majority of the court in this regard demonstrates, the author thinks, the danger inherent in the purposive approach to interpretation. This was recognized by the minority of the court in that *S v Mhlungu*, with Kentridge J holding that:

“There are limits to the principle that a Constitution should be construed generously so as to allow all persons the full benefit of the rights conferred on them... and those limits are to be found in the language of the Constitution itself... With all respect to the judges who have taken a different view, I find it difficult to see what meaning other than that which I have suggested can reasonably be given to the language used.”<sup>30</sup>

## 2.5 **The influence of the Constitution on statute interpretation**

Prior to 27 April 1994, South Africa was a parliamentary supremacy state where the will of parliament was supreme. In terms of the system of parliamentary supremacy, parliament was empowered to enact any law and no authority was competent to challenge it.<sup>31</sup>

After the first democratic elections in South Africa, which took place on 27 April 1994, and the promulgation of the interim Constitution, South Africa became a constitutional democracy. That is to say, the Constitution was the supreme law. The supremacy of the Constitution is enshrined in section 2 of the Constitution which provides that “this Constitution is the supreme law of the Republic; law or conduct inconsistent with it is invalid, and obligations imposed by it must be fulfilled”.

---

<sup>30</sup> *id* at par 78.

<sup>31</sup> See *Carrie & Dewaal* at page 3 for further discussion on parliamentary supremacy.

Section 39 (2) of the Constitution further provides that:

“When interpreting any legislation, and when developing the common-law law or customary law, every court, tribunal or forum, must promote the spirit, purport and objects of the Bill of Rights.”

As a result of the Constitution and specifically sections 2 and 39 (2) thereof, legal interpretation in South Africa has been radically transformed. As prescribed by section 39 (2) of the Constitution, one of the primary objects of interpretation, post 27 April 1994, is to promote the spirit, purport, and objects of the Bill of Rights. In other words, when interpreting a statute or any other law, and regardless of whether one has chosen to employ the literal or purposive approach to interpretation, one must not restrict one’s interpretation to the statute which is the subject of the interpretation, but one must also have regard to the Bill of Rights. This principal is explained by Currie and de Waal as follows:

“Statutory interpretation must positively promote the Bill of Rights and the other provisions of the Constitution, particularly the fundamental values in section 1. In other words, the legislature is presumed to have intended to further the values of underlying the Bill of Rights by passing legislation that is in accordance with the Bill of Rights unless the contrary is established.”<sup>32</sup>

This principal applies even in respect of legislation which precedes the Constitution.

In light of the Constitution, it is unclear (and, the author thinks, improbable), whether the literal approach to interpretation can still be applied since, as section 39 (2) of the Constitution provides, when interpreting any legislation...

---

<sup>32</sup> Currie and De Waal 64 to 65.

every court has a duty to “promote the spirit, purport and objects of the Bill of Rights”. This, the author thinks, puts an end to the literal interpretation of statutes, at least as it was during the pre-constitutional era.

Indeed, the author finds it very difficult to imagine how one can interpret a statute by having regard to the wording alone (which is what is required by the literal approach) if the Constitution demands that the Bill of Rights be taken into account. Of course there are certain types of legislation, such as, perhaps, certain provisions of tax legislation, to which the Bill of Rights will find little or no application however, this does not mean that one must not attempt to apply it, for it is only in attempting to apply it that one reaches the conclusion that it has no application.

### 3 CHAPTER 3 - INTERPRETATION

It could be argued that the subject of interpretation is (perhaps only with the exception of statutes that affect people's fundamental rights such freedoms) most important in the context of tax statutes. This is because, save for life and freedom, what humans tend to value most, in general, is money. All tax legislation grants the state a right to dispossess citizens (natural and juristic) of this "hard earned" money. For the sake of both the citizen and the state, it is therefore crucial that those who are charged with the responsibility of interpreting tax statutes do so correctly.

For many years, the approach to the interpretation of tax statutes in South Africa has been decisively literal. As explained by De Koker<sup>33</sup>, jurisprudentially, the basis for this can be traced back to the English case of *Partington*<sup>34</sup>. It is from this case that one of the most famous of quotations in tax law originates. In that case, Lord Cairns stated:

"If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be admissible, in any statute what is called an equitable construction, certainly such a construction is not admissible in a tax statute, where you can simply adhere to words of the statute."<sup>35</sup>

---

<sup>33</sup> De Koker & Williams *Silke on South African Income Tax* (2009) 25-2.

<sup>34</sup> *Partington vs TB Attorney General* 21 LT 370.

<sup>35</sup> De Koker & Williams 25-2.

This dictum from Lord Cairns epitomises, in the author's view, the most purest of approaches to the literal interpretation of fiscal legislation. This quote was endorsed by South African courts in a number of subsequent cases.<sup>36</sup>

Another similar dictum which has also been endorsed by our courts is from the case English of *Cape Brandy Syndicate vs IRC*.<sup>37</sup> In that case, the court, per Rowlat J, stated:

“It simply means that in a taxing Act one has to look at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.”<sup>38</sup>

A further example is Hefer J's words in *Cactus Investments (Pty) Ltd V CIR*<sup>39</sup> wherein he said:

“I am aware of the fact that an application of the concept of accrual which does not take account of commercial realities may operate harshly in as much as it requires that tax be levied on income which may be received only in the very distant future... However, it is often said... that there is no equity in tax legislation (nor, I would add, complete rationality). The inequity of levying tax on income which will only be received in future is inherent in the system of receipts and accrual, which has been with us for many years. As long as the system prevails inequitable results cannot always be avoided. Of course, the Act must be interpreted and applied in the least onerous

---

<sup>36</sup> *Id.*

<sup>37</sup> [1921] 1 KB 64.

<sup>38</sup> De Koker & Williams 25-2.

<sup>39</sup> 1985 (2) SA 935 (A).

manner which its wording allows. But, if the wording is clear, it must be applied however harsh the result might be. The taxpayer's remedy is to arrange his affairs, so far as he is able, so as not to attract these results.<sup>40</sup>

Notwithstanding that the approach of our courts to the interpretation to tax statutes has been strictly literal, there have been instances where our courts appear to have felt that a departure from this approach is justified and that the principles of equity and justice should not be totally disregarded when interpreting tax statutes. For example, in *CIR vs Nemojim (Pty) Ltd*<sup>41</sup>, the Appellate Division stated that:

“This may in many instances be a relevant guiding principle in interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus.”<sup>42</sup>

These kinds of judicial sentiments were, however, few and far between. To the extent that they were expressed, these sentiments did not result in any identifiable change in approach by our courts. Until the beginning of the constitutional era, the approach of our courts to tax statutes remained steadfastly literal.

Admittedly, notwithstanding their loyalty to the literal approach, our courts have applied the *contra fiscum* rule consistently. The *contra fiscum* rule is a specific rule of interpretation applicable to tax statute interpretation and it dictates that where the text of a piece of legislation is ambiguous, that is, where the text is capable of more than one meaning, the text must be given

---

<sup>40</sup> De Koker & Williams 25-2 to 25-3.

<sup>41</sup> *CIR vs Nemojim (Pty) Ltd* 1983 (4) SA 935.

<sup>42</sup> *id* at 267.

the interpretation that is the least onerous on the taxpayer.<sup>43</sup>

As was indicated above where one has adopted the literal approach to interpretation, and the resultant interpretation leads to absurdity, the court may depart from the wording of the Act. The courts have adopted this approach even in tax matters. In *CIR v BP Southern Africa*<sup>44</sup> the court held:

“If it is possible to place a reasonable construction on the Schedule which does not lead to a *casus omissus*, while another construction does lead to that result, the construction which avoids such a result is to be preferred. The question, then, is whether it is possible to place a reasonable construction on the Schedule which avoids *casus omissus*. In my judgement there is such a construction, namely one which the words “taxable income derived... from mining operations” are interpreted as meaning ‘taxable income from the business of the mining operations in the sense of extracting minerals from the soil’.”<sup>45</sup>

### 3.1 The effect of the Constitution on the interpretation of statutes

With the advent of the constitutional era, it became clear that even the interpretation of tax statutes would be affected by the Constitution and that a pure literal approach to the interpretation of tax statutes would no longer be justifiable. De Koker summarises the post-Constitution position as follows:

Accordingly, it is now settled law that statutory interpretation should accord with that which promotes the general legislative purpose underlying a statutory provision. Legislative purpose

---

<sup>43</sup> See De Koker & Williams 25-4.

<sup>44</sup> 1926 (AC) 37.

<sup>45</sup> De Koker & Williams 25-6.

is a light that should guide the statutory interpretation. In ascertaining the purpose of the provision, wider textual consideration may be involved where the language is unambiguous...<sup>46</sup>

In 46 SATC 95, an argument was made by one of the litigants to the effect that, in the context of the Estate Duty Act 45 of 1995, it was not necessary to specifically provide in the legislation that the Commissioner for the South African Revenue Service (“SARS”) was authorised to issue an additional assessment as such authority could be implied from the common law. In response to this argument, which may very well have been accepted in the pre-Constitution era, the court, in describing the new constitutional era approach to fiscal statute interpretation held:

“But even if the legislature was mindful of the common law rule and therefore satisfied that a competence to issue additional assessments on the same return was by necessary implication conferred in the Act, the statute would nevertheless have to be construed subject to the presumption of a fair, just and reasonable lawgivers’ intention and in consequence with the new approach to interpretation of fiscal statutes, in terms whereof such measures are neither to be subjected to eviscerating formalism or strictness not to be treated with fawning respect as Holly Cows, and not as emanating from some revenue-hungry Draco, but as coming from a reasonable law giver intent even in matters fiscal, upon ordering its community fairly and justly.”<sup>47</sup>

Accordingly, as a result of the Constitution, the approach to the interpretation of tax statute has also been radically transformed. The new approach referred to above is now the dominant approach to the interpretation of tax legislation.

---

<sup>46</sup> *id* at 25-10-1.

<sup>47</sup> De Koker at 25.1D.

## 4 CHAPTER 4 - GENERAL DEDUCTION FORMULA

### 4.1 General

Section 11 (a) of the Act contains what is known as the “general deduction formula”. It is in terms of the provisions of this section that the deductions from income to which a taxpayer is entitled are determined. That is to say, in order for a taxpayer to be entitled to most of the deductions that are available in the Act in respect of income, the relevant losses and/or expenditure must meet the requirements of this section.

### 4.2 Requirements for deductions

Section 11 (a) contains certain specific requirements with which any particular loss or expenditure must comply with before the loss or expenditure can be eligible for a deduction. The text of section 11 (a) reads as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

- (a) expenditure and losses actually incurred in the production of income, provided that such expenditure and losses are not of a capital nature<sup>48</sup>.

Therefore, broken down into various components, the general deduction formula consists of the following specific requirements:

---

<sup>48</sup> In addition to the general deduction formula, section 11 also provides for a long list of what are known as “special deductions”. These deductions are deductions in respect of which it is not required that the requirements of the general deduction formula are met before a deduction can be allowed. Indeed, in respect of most of these items, it would not be possible to meet the requirements of the general deduction formula.

- expenditure and losses;
- must be actually incurred;
- in the production of income; and
- must not be of a capital nature.

In order to properly understand the purview of the general deductions, formula it is necessary also to bear the provisions of sections 23 (f) and 23 (g) in mind. These provisions read as follows:

No deduction shall in any case be made in respect of the following matters, namely –

- (f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section 1;
- (g) any monies, claimed as a deduction from income derived from trade, to the extent to which such monies were not laid out or expended for the purposes of trade.

Accordingly, the provisions of sections 23 (f) and 23 (g) qualify the general deduction formula. Indeed, our courts have held that section 11 (a) and section 23 (g) and (f) must be read together when one considers the deductibility of a specific amount.<sup>49</sup> The effect of this qualification is that, notwithstanding that any specific loss or expenditure may be eligible for a deduction in terms of the provisions of section 11 (a), if such loss or expenditure is of the nature contemplated in sections 23 (f) or 23 (g), then such loss or expenditure will not qualify for a deduction.

---

<sup>49</sup> De Koker & Williams 7-8-2.

For purposes of this mini-dissertation, the author is concerned only with the requirement that the expenditure or loss must have been “actually incurred”. Accordingly, the intention of this mini-dissertation is to interpret the meaning of this phrase as it is meant in section 11 (a) of the Act. In chapters 4 to 7 the author will consider the meaning of this phrase within particular contexts. Before the author does so, the author wishes to consider briefly the general meaning of this phrase.

It is a well established principle of our law that “actually incurred” does not mean necessarily incurred, nor does it mean actually paid. It means, rather, the existence of an absolute and unconditional legal liability to make payment.<sup>50</sup> The significance of the distinction is that the category of losses and expenditure which are eligible for a deduction is much wider where the requirement is “actually incurred” as opposed to “necessarily incurred”. “Necessary incurred” would imply that the loss or expenditure in question must be a necessary loss or expense. This is not the intention of the legislature.<sup>51</sup> In this regard, it has been held that:

“It is not suggested that it is the function of the Income Tax Acts or of those who administer them to dictate taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate on the result of the taxpayers activities as it finds them. If a taxpayer is in fact engaged in two businesses, one profitable and other showing loss, the Commissioner is not entitled to say he must close down the unprofitable business and cut his losses even if it might be better in his own interest and although it certainly would be better in the interest of the Commissioner if he did so...”<sup>52</sup>

---

<sup>50</sup> Emslie *et al* (1995) 289. See also De Koker & Williams 7-13

<sup>51</sup> De Koker & Williams 7-13

<sup>52</sup> *Id.*

There is also authority for the proposition that the word “incurred” does not merely imply “paid” but its meaning extends to the undertaking of an obligation to pay.<sup>53</sup>

In the case of *Port Elizabeth Electric Tramway Co Limited v CIR*<sup>54</sup> it was held, as per Watermayer AJP, that:

“Taking these in turn, the words of the statutes are “actually incurred” not “necessarily incurred”. The use of the word “actually” as contrasted with the word “necessary” may widen the field of deductible expenditure. For instance, one man may conduct his business efficiently or extravagantly, actually incurring expenses which another man does not incur such expenses therefore are not “necessary” but they are actually incurred and therefore deductible. But expenses “actually incurred” cannot mean “actually paid”. So long as the liability to pay them actually has been incurred they may be deductible. For instance, a trader may at the end of the income tax year owe money for the stocks purchased in the course of the year or for services rendered to him. He has not paid such liabilities but they are deductible.”<sup>55</sup>

The decision of Watermayer AJP was referred to in approval in *Caltex Oil (SA) Limited v SIR* 1975 (1) SA 665 (A).

In the case of *Edgars Stores Limited v CIR*<sup>56</sup> the taxpayer had leased premises from which it conducted its business. The taxpayer then claimed a deduction in respect of its lease expenses under section 11 (a) of the Act. There was more than one lease in place however, the various lease

---

<sup>53</sup> *Id.*

<sup>54</sup> 1936 CPD 241.

<sup>55</sup> Emslie *et al* 291.

<sup>56</sup> 1988 (3) SA 876 (a).

agreements were prepared on the same basis and all made provision for a payment of a “basis rental” and a “turnover rental”. The former was the minimum rent payable whereas the latter was additional rental based on the taxpayers turnover from the premises in question. On behalf of the majority of the appeal judges, Corbett JA:

“The problem of whether expenditure was “actually incurred” in the tax year concerned is a perennial one, and it has frequently been considered by the courts.... the principles which apply to this case are well established... for purposes of section 11 (a) a deduction of a rental is properly to be made in the tax year in which the rental is “actually incurred”. “Actually incurred” does not mean “actually paid”, but means all its expenditure incurred during the year, whether liability has been discharged during that tax year or not. A distinction must be drawn between;

- (a) the case where the existence of the liability itself is conditional and depended upon the happening of an event after the tax in question, in which event the liability is not incurred in that tax year; and
- (b) the case where the existence of the liability is set and established within a tax year in question, but the amount of the liability cannot be accurately determined at the tax year-end, in which event the liabilities nevertheless regarded as having the incurred in the tax in question.”

The application of those principles to the present case, is governed by the proper construction of the relevant provisions of the leases.

Accordingly, from the judgment referred to above it is clear that the meaning of “actually incurred” is wider than that of “actually paid”. Similarly it is clear that “actually” incurred does not mean “necessarily incurred”. Furthermore, it is also clear that the “trigger event” for the actual incurrence of a loss or an expense is the coming into existence of an unconditional obligation on the part of the taxpayer in question to make payment in respect of the loss or expenditure in question.

## 5 CHAPTER 5 - SALE OF A BUSINESS

### 5.1 Problem statement

There are a number of ways in which a purchaser and a buyer of a business can structure a sale of business transaction in so far as it relates to the purchase consideration and the payment thereof. One of the more popular ways of doing this is to calculate the net value of the business being sold (i.e. the assets less the liabilities) and to base the purchase price on this calculation. In implementing this kind of transaction, the liabilities of the business (which will, in effect, be the liabilities of the seller in respect of that business) will be assumed and discharged by the purchaser.

By way of example, let's assume that A wishes to acquire B's business and the parties agree on a purchase consideration of R 1000.00 (one thousand Rand). However, upon concluding a due diligence into B's business, A discovers that the business has outstanding liabilities in the amount of R 300.00 (three hundred Rand), which liabilities comprise of future payment obligations towards employees such as bonuses, retirement contributions and payments in consideration of restraints of trade. The parties then agree that the amount of the liabilities, being R 300.00 (three hundred Rand) will be subtracted from the agreed purchase consideration with the result that the net purchase consideration is reduced to R 700.00 (seven hundred Rand).

From a tax perspective, one of the critical issues that arise where this kind of transaction is implemented is whether the seller (A in our example) will be entitled to a tax deduction in respect of the amount of the liabilities which resulted in the purchase consideration being reduced to R 700.00 (seven hundred Rand).

### 5.2 Contingent Liabilities

Contingent liabilities (which are sometimes known as "provisions") are liabilities which may or may not be incurred at a future date depending on the

occurrence of a future event. Put differently, they are liabilities which will arise “or become unconditional” on the occurrence of a future event.

From a tax perspective and, as a general position, insofar as their deductibility is concerned, the treatment of contingent liabilities is fairly straight forward. As indicated in chapter 3 above, in order to be eligible for a deduction, an expense (such as a contingent liability) or a loss must be “actually incurred”. In order to be so incurred, such an expense or loss must relate to an obligation in respect of which there exists an absolute and unconditional legal obligation to make payment, irrespective of the fact that payment may be made in future.<sup>57</sup> Because the incurrence (or materialisation) of contingent liabilities is dependent on a future event, there does not exist in respect of contingent liabilities an unconditional obligation to pay. Contingent liabilities are therefore, per se, conditional and therefore, per se, not (yet) eligible for a deduction.

Accordingly, in the context of section 11 (a) of the Act, contingent liabilities represent amounts that a taxpayer has not yet “actually incurred” and therefore amounts which are not yet tax deductible against the taxpayers income. One important characteristic of contingent liabilities is that the future event on which the contingent will arise is a certainty i.e. it will materialise and, when it does, the contingent liabilities become “actually incurred” and therefore deductible against the taxpayers income.

As already demonstrated above, the problem with contingent liabilities arises where the “owner” of the contingent liabilities i.e. the taxpayer to which the liabilities have accrued sells the business to which the liabilities are attached before the future contingent event materialises. The question that arises in this context is whether the seller taxpayer is, at that stage i.e. at the stage of disposing of the business, entitled to a tax deduction in respect of the contingent liabilities. Expressed differently, the question is whether the mere sale of the business by the taxpayer results in the contingent liabilities

---

<sup>57</sup> Emslie *et al* 289.

becoming “actually incurred” for purposes of section 11 (a) of the Act for it is only when they are “actually incurred” in the sense that they become unconditionally payable to the employees that they are deductible against the income of the taxpayer.

Contingent liabilities in the context of a sale of business where the contingent liabilities are transferred as part of the business present a specific conceptual problem from a tax perspective. This is because, being liabilities, they, as demonstrated in the above example, are often set-off against the purchase consideration of the business because the purchaser is assuming those liabilities and will have to satisfy them when payment becomes due. The result is that, from the seller’s perspective at least, there has been “absolute and unconditional obligation” to make payment in respect of those liabilities because, as in our example above, the seller has received a reduced value in consideration for the business being disposed of because of the existence of the contingent liabilities. The question which obviously arise in this context is whether the seller of the business should be entitled to a tax deduction in respect of those liabilities on the basis of section 11(a) of the Act bearing in mind that the liabilities themselves are still conditional in that, if we use the example used above, the employees are still not entitled to receive payment in respect of those liabilities, although the seller has had to “make payment” in respect thereof to the purchase as part of the sale of business transaction.

### 5.3 **Should Contingent Liabilities Be Deductable for Tax Purposes?**

As already discussed above, in order for an expense or a loss to be deductible, it must comply with the requirements of section 11(a) of the Act. One of the requirements of section 11(a) is that the relevant loss or expenditure must have been actually incurred. As also already discussed and if we utilise our bonuses, retirement contributions and payments in consideration of restraints of trade example, the amounts themselves would not have, *pe se*, been actually incurred in the sense that the unconditional obligation to pay the amounts to the employees would not yet have arisen

however, the seller of a business would have incurred the expenditure in the sense that the seller would have had to pay the purchaser to assume them. No doubt, once the amounts are paid to the employees by the purchaser i.e. once there exists an “absolute and unconditional legal obligation” to make payment in respect thereof, the purchaser, too, would like to receive the benefit of a deduction.

Needless to say, there can never be more than one deduction in respect of the same expense or loss. This is specifically prohibited by the provisions of section 23B of the Act.”<sup>58</sup>

#### 5.4 **Section 11 (a)**

As noted in chapter 3 above, a taxpayer is entitled to deduct certain losses and expenses incurred by the taxpayer from its taxable income if such losses and expenses comply with the requirements of section 11 (a) of the Act. One of these requirements is that the losses and expense in question must have been “actually incurred” by the taxpayer. Therefore, whether or not the seller taxpayer in our example above will be entitled to deduct the R 300.00 from his taxable income turns on whether it can be said that the R 300.00 was “actually incurred” by the seller taxpayer within the meaning of section 11 (a) of the Act.

There are several arguments which a taxpayer in the position of the seller taxpayer in the example above can make in advancement of the contention that contingent liabilities are “actually incurred” for purposes of section 11(a)

---

<sup>58</sup> section 23B provides that:

- 1) Where, but for the provisions of this subsection, an amount-
  - a) qualifies or has qualified for a deduction or an allowance; or
  - b) is otherwise taken into account in determining the taxable income of any person,under more than one provision of this Act, that amount or any portion thereof, shall not be allowed or taken into account more than once in the determination of the taxable income of any person.

of the Act and should, therefore, be deductible. Each of these arguments has its own merits and demerits. The author's own contention is that contingent liabilities in the context of a sale of business should be deductible. The author's arguments in support of this contention are set out below.

### 5.5 **Arguments in favour of deductibility of contingent liabilities**

One of the more compelling arguments which can be made in favour of the deductibility of contingent liabilities by a seller of a business is, in the author's view, the argument that such liabilities, absent the sale of the business, would in any event have been deductible by the seller and there is no reason why the seller should be punished for selling its business. That is to say, had the seller not sold the business to the purchaser, the seller would have been entitled to a deduction of those liabilities. The taxpayer had not been able to deduct those liabilities only because they had not yet become unconditional however, their unconditional was inevitable. Accordingly, the argument would be that the intervening event of a sale of the business should not be sufficient to deprive the taxpayer of the deduction which a taxpayer would in any event have been entitled to. The strength of this argument lies in the fact that the only reason why the taxpayer would not have been entitled to a deduction during the period leading up to the sale would be that the liabilities had not arisen, due to certain conditions not having been met at the time however, it being a certainty that those conditions will be met on a future date.

For example, if we use liabilities in respect of restraints of trade payments as an example, where, in terms of an employment agreement between a taxpayer and its employees, it has been agreed that once the agreement comes to an end for whatever reason, the employee will be entitled to certain payments in consideration for not seeking employment elsewhere, it is obvious that, at some point in time, the liability of the employer to make good on the restraint of trade payments will arise.

Aside from being based in equity and logic, this argument is also based the purposive approach of interpretation as discussed in chapter 1 above. There is no doubt that the Act is silent as to how expenditure incurred by a taxpayer in the position of the seller taxpayer in our example should be treated in a sense that the Act does not specifically address this scenario. It is then up to the courts to interpreted the Act so as to ascertain the intention of the legislature.

As discussed in chapter 2 above, the purpose of the purposive approach is to ascertain the underlying meaning of a statute using the text of the legislation. As was explained by De Koker:

“Accordingly, it is now settled law that statutory interpretation should accord with that which promotes the general legislative purpose underlying a statutory provision. Legislative purpose is a light that should guide the statutory interpretation. In ascertaining the purpose of the provision, wider textual consideration may be involved where the language is unambiguous...”<sup>59</sup>

If the author were to apply the purposive approach to section 11 (a) in the current context, the author’s conclusion would be that it could not have been the intention of the legislature that a seller of a business in the position of the seller taxpayer in our example should be deprived of a deduction, although the expenditure has been incurred (at least within the ordinary meaning of the word), simply on the basis that it has sold its business. There is no reason that the author can conceive of on the basis of which the legislature could have intended that this be the case.

---

<sup>59</sup> See note 46 supra.

The author thinks that this is an important consideration and there is no reason why, the author thinks this should not be one of the decisive considerations. As Botha says:

“The search for the purpose of legislation requires a purpose-orientated approach which recognizes the contextual framework of the legislation right from the outset, and not only in cases where a literal text-based approach has failed.”<sup>60</sup>

The author thinks it is important to make the point that this argument is not based on equity alone or any equivalent consideration. Equity just happens to be the result of this interpretation and that this is so (i.e. that the interpretation results in equity) is not a basis upon which one can discriminate against such an interpretation i.e. the fact that equity is the result of the interpretation cannot be used to discredit the interpretation. As the Appellate Division said in *CIR v Nemojim*<sup>61</sup>:

This may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus  
62

The second argument in favour of the deductibility of contingent liabilities by a seller of a business is based on the literal approach of section 11(a) of the Act. As discussed in chapter 1 above, the literal approach concerns itself with the text of legislation. As noted in chapter 3 above “actually incurred” as used in section 11 (a) of the Act does not mean necessarily incurred nor does it

---

<sup>60</sup> See note 24 supra.

<sup>61</sup> SATC 241

<sup>62</sup> De Koker and Williams 25 – 3.

mean actually paid<sup>63</sup>. “Actually incurred” refers to the existence of an unconditional and absolute legal obligation to pay. It is immaterial when that payment is to be made. Accordingly, in order for a taxpayer to be eligible for a deduction under section 11 (a), a taxpayer need not have incurred the expenditure or loss in a sense that he must have parted money pursuant thereto, it is sufficient merely that there be an unconditional and absolute obligation to do so.

If a purchaser and a seller of a business agree that the purchaser of a business will assume the contingent liabilities of that business in consideration for an amount and they agree on the mechanism of how that will be implemented and, specifically, that, on a specific date, the purchaser will be liable to pay the purchaser the consideration payable for assuming the contingent liabilities, it seems to me that, when that date comes then the contingent liabilities have, vis a vis the seller, become actually incurred within the meaning of section 11(a) of the Act in that there then exists in respect of those an unconditional and absolute legal obligation to pay. On this basis, the author thinks, that the test for “actually incurred” would have been satisfied and, provided that all the other requirements of section 11(a) are met, the seller should be entitled to a deduction in respect of those expenses.

The third argument that can be made in favour of the deductibility of contingent liabilities is that they represent a diminution of the sellers patrimony and, as such constitute a “loss” within the meaning of section 11 (a) of the Act.<sup>64</sup> Contingent liabilities constitute a diminution of the seller’s patrimony in that, as part of the sale transaction, the seller forgoes part of the selling price in return for the purchaser assuming the contingent liabilities. It can be argued that the amount which has been forgone by the seller in this context (i.e. the amount of the contingent liabilities) constitute a loss “actually

---

<sup>63</sup> See Emslie *at e tal* 560.

<sup>64</sup> It is trite that where there had been a diminution in a taxpayer’s patrimony, such taxpayer has incurred a deductible loss. See *Joffe and Co (Pty) Ltd v CIR* 1946 AD 157.

incurred” by the seller within the meaning of section 11(a) of the Act. This is because the seller paid the purchaser a sum of money to take over the contingent liabilities.<sup>65</sup>

The fourth argument which could be made in favour of the deductibility of contingent liabilities is that of set-off i.e. that the seller sold its assets to the purchaser partly in consideration for the purchaser assuming the contingent liabilities. Because, from the seller’s perspective, the amount that it would have received in consideration for the business was less than the amount it would have received had it not paid the purchaser to assume the contingent liabilities, an expense or loss must have been incurred by the seller in the amount of the contingent liabilities.<sup>66</sup> This argument was accepted by the SCA in the *Ackerman’s Ltd v C: SARS*<sup>67</sup>, although on the facts of that case, the court held that set-off had not been established.<sup>68</sup>

A further argument to be made is that the inability of a seller to deduct contingent liabilities would result in inequity in that, when the contingent liabilities are eventually paid to the employees, there would be subject to income tax in the hands of employees, although not deductible in the hands of the employer, being, initially, the seller of the business and, eventually, the purchaser. The reason the contingent liabilities could possibly not be deductible in the hands of the purchaser is that there would be more associated to the acquisition of the business from the seller (which is a capital expenditure and therefore not deductible) than they would be associated with the income producing activities of the purchaser. Without considering the matter in any great detail, the court in *Ackermans* held, in *orbita*, that there will be nothing to prevent the purchaser of a business from deducting the

---

<sup>65</sup> Ger “Sale of Business Having Contingent liabilities Revisited January/February 2010 *De Rebus* 50.

<sup>66</sup> Clegg “Sale of Sorrows (ii)” 2010 24 *Tax Planning* 19.

<sup>67</sup> 2011 (1) SA (SCA).

<sup>68</sup> At par 8.

contingent liabilities as and when they become unconditional<sup>69</sup>. However, with respect, the issue is not as straight forward as the court appears to imply.<sup>70</sup>

It is entirely possible, based on, amongst other things, the capital argument set out above, that the purchaser, being the new employer, would not be allowed a deduction in respect of the contingent liabilities when they eventually become unconditional.

## 5.6 **Ackermans v SARS**

### 5.6.1 **Facts and Background**

As already discussed, until recently, there had been some uncertainty as to how contingent liabilities should be treated for tax deduction purposes, especially from the perspective of the seller. This uncertainty was resolved by the *Ackermans* case. This case therefore is a seminal case in this area of law.

In the *Ackermans* matter, the seller (Ackermans Limited) sold its retail business as a going concern to the buyer (Pepkor Limited). In terms of the sale agreement, the purchase price was defined as “the amount equal to sum of R 800 000.00 and the amount of the liabilities”. The purchase price was partly discharged by the assumption by the purchaser of all of the sellers contingent liabilities. It was common cause that, had the seller not disposed of its business in favour of the purchaser, all of the contingent liabilities of the seller would have been deductible as and when they became unconditional.

---

<sup>69</sup> At par 9.

<sup>70</sup> For a full discussion of the deductibility of contingent liabilities see Clegg (2010) 24 *Tax Planning* 71.

At issue in this matter, were three specific contingent liabilities being:

- (a) a contingent liability in respect of the seller's contractual obligation to fund post-retirement medical aid benefits for its employees;
- (b) a contingent liability in respect of the seller's obligations to its employees under a long term bonus scheme; and
- (c) a contingent liability in respect of repair obligations undertaken by the seller under property leases.

It was in respect of these three contingent liabilities that the seller wanted to obtain a deduction under the provisions of section 11(a) of the Act. In support of its contention that these three contingent liabilities are deductible under the provisions of section 11(a) of the Act, the seller advanced the following arguments<sup>71</sup>:

The first argument advanced by the seller was that expenditure incurred in order to rid oneself of contingent liabilities is itself of a revenue nature and, as such, qualify for a deduction.

The second argument advanced by the seller was that the contingent liabilities represented a diminution of the seller's patrimony. This "diminution in the seller's patrimony", it was argued, was equivalent to a "loss" within the context of section 11(a) of the Act.

The last argument raised by the seller was that, if the seller could not deduct the contingent liabilities, then none of the parties would be able to claim a deduction and this would result in an anomalous and undesirable situation. For its part, SARS argued that the expenditure in question:

---

<sup>71</sup> All of the sellers arguments are dealt with above accordingly, for purposes of the current discussion, the arguments are not dealt with in great detail.

- did not constitute 'expenditure' or 'expenditure actually incurred';
- was not incurred in the production of income;
- was of a capital nature;
- was not incurred for the purposes of Ackermans' trade as required by section 23(g) of the Act;
- was precluded from deduction by operation of section 23(e) of the Act (which refers to 'income carried to any reserve fund or capitalised in any way');
- was precluded from deduction by operation of section 23(f) of the Act (which refers to 'expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one').

#### 5.6.2 Court's Decision

Due to the conclusion reached by the court and the reasons thereof, it was necessary only for the court to deal with the first argument raised by SARS, namely that the expenditure claimed as a deduction by Ackermans did not constitute "expenditure actually incurred" within the meaning of section 11(a) of the Act. In substantiation of this argument, SARS argued that Ackermans had absolutely no obligation in terms of the sale agreement concluded between the two parties for sale of the business to pay Pepkor for assuming the liabilities. As such, SARS argued, the manner in which the purchase price was discharged between the parties (or put differently, the manner in which Ackermans assumed the contingent liabilities) did not involve any expenditure being incurred by Ackermans. It is against this argument that Ackermans raised its second argument i.e. that paying Pepkor to assume the contingent liabilities represent a diminution in its patrimony. As such, Ackermans argued, there is no need for there to be a legal obligation to make payment, that there has been diminution in its patrimony was sufficient to render the relevant expenditure as "actually incurred" within the meaning of section 11(a) of the Act.

The court rejected Ackerman's counter argument. In this regard it, per Cloete JA, held that:

“To my mind, 'expenditure incurred' means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability. No liability was incurred by Ackermans to Pepkor in terms of the sale agreement. The manner in which the purchase price was discharged by Pepkor did not result in the discharge of any obligation owed by Ackermans to Pepkor. Ackermans owed Pepkor nothing in terms of the sale agreement and one looks in vain for a clause in that agreement that has this effect. It is for this very reason that the appellant in its oral submissions abandoned any reliance on set-off, which would have been the inevitable effect if there had been these reciprocal obligations... The argument is untenable. It is trite that set-off comes into operation when two parties are mutually indebted to each other, and both debts are liquidated and fully due. That is not what happened here and the argument based on set-off was correctly abandoned.”<sup>72</sup>

The court further held that the journal entry which occurred as a result of the manner in which the purchase consideration was discharged does not constitute “expenditure actually incurred”. In this regard it said:

“It is clear that what occurred, as is usually the case in transactions of this nature, is that the net asset value of the business — the assets less the liabilities — was calculated and that this valuation dictated the purchase price. In the ordinary course of purchasing the business as a going concern on this basis it would follow that the liabilities would be discharged by the purchaser. The

---

<sup>72</sup> At par 8.

journal entries relied on by the appellants do not equate to expenditure actually incurred. On the contrary, the mechanism employed in the agreement of sale resulting in the journal entries was to facilitate the sale.”<sup>73</sup>

The court went on to say:

“The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date no expenditure was actually incurred by Ackermans.”<sup>74</sup>

The court found it unnecessary, for purposes of coming to a decision, to consider *Ackermans* seconding argument accordingly, that argument was not dealt with by the court.

The court rejected the third argument (i.e. that the inability of the seller to obtain a deduction in respect of the three contingent liabilities would mean that no deduction will be able to be obtained by either of the parties in respect of those liabilities). In the court’s view, the purchaser could claim a deduction in respect of those contingent liabilities as and when they become unconditional. In this regard, the court held:

“The argument is without foundation. There would be no bar to Pepkor deducting the liabilities as and when they became unconditional, as counsel representing the Commissioner rightly conceded.”<sup>75</sup>

---

<sup>73</sup> At par 10.

<sup>74</sup> At par 11.

<sup>75</sup> At par 9. As argued above, the situation with regard to the purchaser’s position may not be as straight forward as portrayed by the court.

### 5.6.3 Analysis

As one would expect, because of the groundbreaking nature of the judgment, it has received considerable attention from commentators. Naturally, some of the commentators agree with the judgement and some do not. Ger<sup>76</sup> has several criticisms to level against the judgment. Firstly, he criticises the court for the lack of detailed application to the various arguments raised by the parties. In his view, the court failed to deal with many of the substantive arguments that were raised by the parties but rather, dismissed them abruptly without providing substantial reasons.

In particular, Ger finds the court's view on "expenditure" problematic. This is because, he argues, in considering the seller's arguments, the court did not extend its reasoning to deal with "losses" within the meaning of section 11(a) of the Act. It only limited itself to dealing with "expenditure". This allowed the court, his argument continues, to dismiss the seller's argument simply on the basis that the seller did not incur expenditure because, in order to do so, the seller would have had a legal liability owed to the purchaser as at the date of transfer of the business. However, had the court considered the element of "loss" as well<sup>77</sup>, he argues, the court could have possibly come to the conclusion that the contingent liabilities constituted "losses" within the meaning of section 11 (a) of the Act and were thus deductible. This is because the existence of a legal liability is, for tax purposes, not a pre-requisite to the incurrance of a loss as is the case with the incurrance of an expenditure. Accordingly, had the court considered this element, the court could potentially have reached a differently conclusion. The court did not consider this element at all, safe for simply stating that it cannot accept it<sup>78</sup>.

---

<sup>76</sup> Ger "The problem of Paying With Share Resurfaces" January/February 2012 *De Rebus* 48.

<sup>77</sup> Section 11(a) of the Act provides for the deductibility of both "losses" and "expenditure".

<sup>78</sup> At par 8.

The other aspect of the judgment Ger has difficulty with is the statement by the court, via *obiter*, that although the seller may not be entitled to a deduction in respect of the contingent liabilities, there is nothing preventing the purchaser from claiming these deductions. Ger has difficulty with this statement because, from the purchaser's perspective, the contingent liabilities are more of a capital nature than they are of an income nature. Again, the court did not consider this aspect in any greater detail, save for stating that the purchaser could be entitled to these deductions.<sup>79</sup>

The decision also received attention from Kruger<sup>80</sup>. In his view, the primary argument of the seller in front of the court was mainly that a set-off had occurred. Although this was not explicit from the sale agreement, in Kruger's view, this was the net effect of the transaction. Although the set-off argument was rejected by the court<sup>81</sup>, in Kruger's view, to achieve set-off was the intention of the parties and the substance of the sale agreement.

Kruger also shares Ger's criticism that some of the material aspects of the judgement were only superficially dealt with by the court. Specifically, he points out that save for the "incurrence" of expenditure, the court did not deal with all the elements of section 11 (a) of the Act.

#### 5.6.4 Conclusion

In the *Ackermans* case, it appears that the position regarding the deductibility of contingent liabilities in the context of a sale of business is not, as is the general impression, that these are not deductible *per se* for purposes of section 11 (a) of the Act but, rather, that these may, depending on the sale agreement giving effect to the sale of business, be deductible. For example, it is clear that where the transaction is structured in such a way that set-off is

---

<sup>79</sup> For further discussions on this point, see Clegg 2010 *Tax Pplanning* 71.

<sup>80</sup> Kruger "The Sale of a Business" 2011 *BCTLQ* 17.

<sup>81</sup> At paragraph 8.

achieved between the purchase consideration and the contingent liabilities, the seller of the business will be able to deduct the contingent liabilities from its income. Accordingly, of significance in determining whether or not, in a sale of business context, the contingent liabilities are deductible are the provisions of the agreement giving effect to the transaction.

## 6 CHAPTER 6 - DEDUCTIBILITY OF SHARE-BASED PAYMENTS

### 6.1 Problem statement

It is fairly common in day to day commerce that a company which has either received services from a service provider or goods from a seller pursuant to a sale arrangement is, for whatever reason, unable to pay the service provider or seller the consideration payable for the services or the goods. Under those circumstances, some companies may choose to settle the liability towards the seller or service provider by issuing shares, from their own share capital, in favour of the seller or service provider. Ordinarily, the market value of the shares issued in consideration will be equal to the outstanding liability.

For tax purposes, the question that immediately arises is whether or not the company will be entitled to a tax deduction in respect of the shares issued i.e. whether or not the shares issued by the company in consideration for the services rendered by the service provider or in settlement of the purchase price of the goods acquired from the purchaser will be treated as an expense “actually incurred” for purposes of section 11(a) of the Act.

From the outset, the author must state that, rather unhelpfully, the Act discriminates in its treatment of shares issued as payment for services rendered, on the one hand, and shares issued as payment for an acquisition of assets, on the other hand. With regards to the latter, thanks to section 24B of the Act, which was inserted into the Act in 2004, the position is straight forward<sup>82</sup>.

Section 24B of the Income Tax Act reads as follows:

“Subject to subsection (2), if a company acquires any asset, as defined

---

<sup>82</sup> Section 24(B) of the Act was inserted by virtue of section 22 (1) of the Revenue Laws Amendment Act, 32 of 2004.

in paragraph 1 of the fifth schedule, from any person as consideration for shares issued by that company -

- (a) that company is for purposes of this Act deemed to have actually incurred an amount of expenditure in respect of the acquisition of that asset, which is equal to the lesser of the market value of that asset immediately after the acquisition or the market value of the shares immediately after the acquisition; and
- (b) that person is for purposes of this Act deemed to have disposed of that asset for an amount equal to the market value of the shares immediately prior to the acquisition.”

Clearly then, section 24B of the Act limits itself to expenditure incurred in respect of the acquisition of assets and does not deal at all with expenditure incurred in respect of acquisition of services. The position, therefore, is that in respect of expenditure incurred by issuing shares as settlement of the purchase consideration for a liability incurred by the company for the acquisition of assets, that expenditure will be deemed, by virtue of the provisions of section 24B of the Act, to be expenditure for purposes of section 11(a) of the Act.

Because the position in respect of amounts paid by a company in settlement of a liability resulting from services rendered is not addressed in the Act, this remains a ripe topic for analysis and consideration. What follows below is the author's analysis of what the position is (and) should be in this regard, based on case law and the principles of tax law.

## 6.2 **Relevant Case Law**

The body of case law which deals with this aspect of our tax law is unfortunately not comprehensive. In fact, much of the case law that exists deals not with shares issued in consideration for services, which, as indicated

above, is the remaining legal issue to be considered in this context but with shares issued in consideration for the acquisition of assets, which, as indicated above, has already been settled by section 24B of the Act.

Perhaps the most significant of the cases which deal with this matter, is the line of cases between SARS and Labat Africa Limited. These cases were heard in the Tax Court<sup>83</sup>, the High Court<sup>84</sup> and the SCA.<sup>85</sup>

The facts were briefly that Labat Africa Limited (“**Labat**”) acquired the business of another entity, which business included a trademark. The purchase price was R 120 000 000.00 (one hundred and twenty million Rand), R44 462 000.00 (forty four million four hundred and sixty two thousand Rand) of which was attributable to the trademark. Labat then sought to claim a deduction in respect of the portion of the purchase price relating to the trademark (i.e. R 44 462 000.00) on the basis of section 11 (gA) of the Act. As it read during the relevant year of assessment, the relevant portion of section 11 (gA) read as follows:

“For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived—

..

(gA) (iii) an allowance in respect of any expenditure... actually incurred by the taxpayer...in acquiring by assignment from any other person any...trademark...if such...trademark...is used by a taxpayer in the production of his income or income is derived by him therefrom...”<sup>86</sup>.

---

<sup>83</sup> ITC11024.

<sup>84</sup> *C: SARS v Labat Africa Ltd*, 72 SATC 75.

<sup>85</sup> *CSARS v Labat* (669/10) [2011] ZASCA57.

<sup>86</sup> Although the basis of a deduction in terms of section 11 (gA) of the Act is the acquisition of intellectual property right as with section 11 (a), it also requires that the relevant expenditure be “actually incurred”.

SARS disallowed the deduction claimed by Labat. The main ground for disallowing the deduction was that, in SARS view, no expenditure was “actually incurred” by Labat in acquiring the trademark as required by section 11 (gA) of the Act.

In the Income Tax Special Court, the court considered the matter in some detail. Significantly, in considering the matter, the court applied itself only to the question as to whether the expenditure was “actually incurred” for purposes of section 11 (gA) of the Act<sup>87</sup>. The court considered, in some detail, a comprehensive list of English case law dealing with this aspect. The entire body of cases considered by the court weighed in favour of the argument that shares issued by the company in settlement of a liability arising out of the purchase of an asset constitutes expenditure actually incurred. The principles deduced by the court from the English authorities were not identical however, each of their application resulted in the same conclusion, namely that shares issued in consideration for the acquisition of assets constitutes expenditure actually incurred by that company.

A noteworthy part of the court judgement, both in respect of its own decision and the later decision of the SCA, was the court’s attitude towards a decision handed down by Goldblatt J in the Johannesburg Tax Court in the context of an (at that stage) unreported decision dealing with similar facts.<sup>88</sup>

In that case, a company had bought a business of another company and settled the purchase price by issuing shares from its share capital. Part of the assets that were acquired was a license agreement. The taxpayer company then claimed the deduction in terms of section 11 (gA) of the Act in respect of the expenditure incurred to buy the license agreement. SARS disallowed the deduction on the basis that the company did not incur an expenditure

---

<sup>87</sup> As shall become clear from the author’s discussion relating to the SCA’s judgement, the SCA essentially held that the court misdirect itself as to the issue that fell to be considered.

<sup>88</sup> ITC10999.

because the issue and allotment of shares does not constitute expenditure by the company. Relying largely on academic literature as authority, Goldblatt J held that the issuing of shares could not be regarded as expenditure actually incurred. He further held that, “expenditure” should be given its ordinary meaning, which, according to Goldblatt J, is the spending of money or its equivalent in time or labour which must result in the diminution of the assets of the company incurring the expenditure. According to Goldblatt J, an issue of shares does not reduce the assets of the company and can therefore not constitute “expenditure actually incurred” within the meaning of the legislation. In this regard Goldblatt J held:

“Expenditure” in its ordinary dictionary meaning is 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. An allotment or issuing of shares by a company does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders. In these circumstances such issue or allotment of shares does not, in our view, constitute expenditure by the company. A share in a company consists of a bundle, complex or conglomerate of personal and hence incorporeal rights as against the company principally in regard to its assets and dividends when declared. Although a share is said to be “a share in the capital of the company”, this does not mean that the holders of the shares of a company are owners of its capital. Rather, it means that they have certain rights against the company to capital on winding up (the right to participate in a distribution on liquidation) and on reduction of capital; for the company itself is the owner of its capital. Thus the holder of a share does not own, but merely has a right to, a part of the share capital of the company...”<sup>89</sup>

---

<sup>89</sup> id at par 8.2 to 8.3.

In support of what is set out above, Goldblatt J quoted Silke as saying:

“It is submitted that the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. For example, if a merchant were required to pay for his goods by tendering land or shares in a company, the value of the land or shares would constitute expenditure in terms of s 11 (a) and would be deductible. If a merchant were to buy his goods in the United States at a price fixed in dollars, the liability so contracted would be 'expenditure' and would have to be brought to account at its equivalent in South African currency. An interesting point arises when a company discharges an obligation by the issue of its own shares. For example, a company may remunerate one of its employees for services rendered by the issue of its own shares. Since the company has not lost or parted with any asset, it is submitted that it has not expended anything, and that it is not entitled to claim as a deduction from income the nominal value of the shares issued to the employee. The position, it is submitted, would be different if the employee agrees to work for a salary payable in cash but subsequently decides to subscribe for shares and uses the remuneration owing to him to pay for the shares. In such a situation the company will have incurred expenditure comprising the salary due, notwithstanding the fact that its obligation is subsequently discharged by the issue of shares. But when a company is obliged to allot shares in return for services rendered to it, there is no laying out or expending of any of its moneys or assets which, it is submitted, is an essential requisite of the words 'expenditure actually incurred' in s 11 (a). A similar problem arises when a company allots shares in return for

trading stock. Whatever the strict legal position may be in relation to a company that discharges an obligation by the issue of its own shares, SARS is prepared in practice to allow as a deduction from the income of the company the nominal value of the shares it issues. While the recipient will be liable to tax on the value of the shares issued when they are issued in return for services rendered, the company will in practice be allowed a deduction of an amount equivalent to the nominal value of the shares issued.”<sup>90</sup>

This line of reasoning by Goldblatt J was entirely rejected by the Tax Court in the Labat matter<sup>91</sup>. Rejecting Goldblatt’s view on the matter and his reliance on Silke Jooste AJ held:

“The court found support for these views in paragraph 7.4 of Silke on South African Income Tax “*Memorial Edition*”. This paragraph was quoted in the judgment. A perusal of the passage makes it clear that the writer cites no authority for the statements made therein. It contains the contention that the reason why no expenditure has been incurred where the *quid pro quo* consist of an issue of shares, is that the “company ... has not lost or parted with any assets ...” Mr. Derksen, in my view correctly argued that this ignores the fact that the requirement is that the company should have incurred an unconditional legal obligation and that, if it has done so, the deductibility requirement is met and that the concept of “expenditure actually incurred” is not dependent upon the making of payment as was clearly stated in *Edgars Stores Limited v CIR, supra*. The contention also does not take cognisance of the weighty English and South African authority, to which Mr. Derksen referred to in his heads of argument and dealt

---

<sup>90</sup> Id at 8.4.

<sup>91</sup> See paragraphs 20-23.

with. As part of his comprehensive heads of argument, Mr. Derksen also attached the heads of argument filed on behalf of the Appellant and Respondent in the matter dealt with by Goldblatt, J. From these heads of argument it would appear that the court was not referred to any of the English authorities referred to above, nor the Lacey decision and consequently did not have the benefit of considering them. It would also appear that the matter was in any event not fully argued before the court. The Appellant's heads of argument contains no submissions or authority on the point, whilst the Respondent's heads of argument relies only on the above mentioned statement in *Silke*.<sup>92</sup>

Ironically, although one of the main reasons why the Tax Court rejected the judgement of Goldblatt J was because Goldblatt J relied on academic literature which was not founded on any authority, the Tax Court itself used academic literature to reject Goldblatt J's judgment. For example, amongst others, the court referred to an article which appeared in *De Rebus* and said:

“In the Tax Law Update section of *De Rebus*, September 2004 (at 61 to 62), Barry Ger, in an article “Income tax – The problem of paying with shares” also leveled some criticism at the decision in case 109999 (at 62). He stated it thus: “The judge's decision is not beyond criticism. His view of expenditure may be said to be exceedingly narrow and not necessarily correct. Indeed it could be argued that he confused the concept of ‘incurred of expenditure’ with the ‘settlement’ thereof. In this case, the taxpayer arguably incurred expenditure on the purchase of the license agreement – the fact that it chose to settle this expenditure in shares should not change this reality. Furthermore, by issuing shares in lieu of paying in cash for the license, it could be said that the taxpayer was indeed reducing its

---

<sup>92</sup> par 20 and 21.

assets. It was giving up the right it would otherwise have had to claim payment in cash for the shares it issued in exchange for the license. 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 Goldblat... The approach taken by the court in case 10999 is also inequitable in the sense that shares issued as consideration for the disposal of an asset or for services would generally be taxable as income or capital gain in the hands of the recipient of those shares. To disallow a corresponding deduction that would ordinarily have been claimed if cash had been paid in the hands of the company issuing these shares, is incongruous.”<sup>93</sup>

In light of the Tax Court decision, SARS appealed that decision to the High Court. The High Court sitting as a full bench and, in terms of a rather uninspiring judgment for its lack of detailed analysis, upheld the Tax Court’s decision. In upholding Jooste AJ’s decision, the court held that:

“The correctness of the view taken by the judge a quo is confirmed, on analysis made even on the criteria of Goldblatt J that the word "expenditure" must be given its ordinary meaning. If the agreement for the acquisition of the asset had been that the seller would purchase an agreed number of the unissued shares of the purchaser at an agreed price, and that the proceeds of such sale would be applied to payment of the purchase consideration of the asset, there could be no doubt that the transaction would constitute or involve an expenditure by the company of a portion of its share capital. It is difficult to see any distinction between this construction of the transaction and that provided for in the agreement with which we are concerned. It follows that the conclusion to which the judge a quo came is correct and that the issue of shares by a company for the

---

<sup>93</sup> par 22.

acquisition of an asset constitutes expenditure for the purposes of section 11 (gA) of the Income Tax Act. The appeal should therefore be dismissed with costs.”<sup>94</sup>

SARS then appealed to the SCA. The judgement of the SCA, to the extent that it was a rejection of the decision of the Tax Court and that of the High Court, was based entirely on the premise that the Tax Court (and therefore the High Court) completely misdirected itself as to the issues that fell to be considered<sup>95</sup>. In the view of the SCA, the question the court should have posed was whether the issuing of shares by a company amounts to “expenditure” and not whether to undertaking to issue shares amounts to an obligation. In this regard, the court held:

“The question the court should have posed was whether the issuing of shares by a company amounts to ‘expenditure’ and not whether the undertaking to issue shares amounts to an obligation, which it obviously does. The terms ‘obligation’ or ‘liability’ and ‘expenditure’ are not synonyms. This is apparent from what was said by Botha JA in *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* 1975 (1) SA 665 (A) at 674D-E, namely that the expression ‘any expenditure actually incurred’ means ‘all *expenditure* for which a *liability* has been incurred during the year, whether the liability has been discharged during that year or not’. In other words, the liability or obligation must be discharged by means of expenditure – timing is not the question. But the special court did seek to pose the correct question when it referred to some English judgments that dealt with the effect of a transaction in terms of which a company acquires assets ‘in consideration’ of the issue of fully-paid shares. The full court likewise asked whether the issue of a company’s own authorized share capital in exchange for a trade

---

<sup>94</sup> 89 at page 4.

<sup>95</sup> See paragraph 8-11.

mark ‘represents real consideration given by the company.’<sup>96</sup>  
(Emphasis added.)

The court went on to reject the body of English case law which the Tax Court relied on to reach its conclusion as irrelevant. The court then proceeded to agree with the views expressed by Goldblatt J and subsequently rejected by the Tax Court. In doing so, the court remarked that:

“As Goldblatt J said in *ITC 1783* (66) SATC 373, an allotment or issuing of shares does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders, and that it can therefore not qualify as an expenditure. It would have been more correct if he had said that it did not involve a shift of assets of the company even though it might, but not necessarily, dilute or reduce the value of the shares in the hands of the existing shareholders. If authority is needed for the self-evident statement of the learned judge that an allotment of shares does not diminish a company’s assets, one may refer to *Commissioner for Inland Revenue v Estate Kohler & others* 1953 (2) SA 584 (A) at 593H and 600F which was followed by *Estate Furman & others v Commissioner for Inland Revenue* 1962 (3) SA 517 (A).”<sup>97</sup>

In the circumstances, the SCA upheld the appeal. Ger levelled two specific criticisms against the judgement of the SCA<sup>98</sup>. Firstly, he used the analogy of purchasing goods or services in year 1 and not receiving payment in respect of the goods or services until year 2 in order to make the point that, in the context of a credit sale, there is indeed a diminution of assets because a liability arises in the purchaser’s hands and, in the same way, he argues that

---

<sup>96</sup> par 8 and 9.

<sup>97</sup> at par 14.

<sup>98</sup> Ger January/February 2012 *De Rebus* 48.

assets of a taxpayer in the *Labat* case also diminished. He explains that, on the acquisition of the trade mark, the taxpayer had an unconditional obligation to provide consideration to the seller. Even if that liability arose for a split second, he argues, it's still does diminish the assets of the taxpayer. He says:

“When goods and services are purchased on credit in year 1 and no payment is received until year 2, they also, on Harms AP’s understanding of expenditure, would seem not to give rise to any “diminution or movement of assets” in year one as no cash is passed to the creditor initially. Does this mean that deductions claimed for non-cash expenditure should be disallowed? Of course not, when a credit sale occurs, there is indeed a diminution of assets in the circumstances as a liability arises in the purchaser’s hands. It is this liability that diminishes the purchaser’s assets even though no cash passes between the parties initially.”<sup>99</sup>

Furthermore, he criticises the distinction made by the court between exchange transactions and sales transactions as artificial. He argues that in both transactions, a liability arises which results in a diminution of the assets of the seller. The only difference is the consideration used to settle that liability. He argues that “the fact that different consideration is used does not mean that a liability does not arise and a diminution of assets does not occur”<sup>100</sup>.

### 6.3 **Conclusion**

Accordingly, based on the *Labat* case (and specifically the SCA judgment) the position regarding deductibility of expenditure incurred as a result of issuing shares in settlement of a liability arising from an acquisition of an assets appears to be that because such a liability does not reduce the value of the

---

<sup>99</sup> *id* at page 49.

<sup>100</sup> 94 *id* at par 94.

shares of the company and does not reduce the assets of the company, it does not qualify as an expenditure and therefore does not give rise to a deduction under section 11 (a) of the Act.

## 7 CHAPTER 7 - DEDUCTIBILITY OF ILLEGAL EXPENDITURE

### 7.1 Introduction

The Act deals with various types of expenditure such as interest, legal expenses etc. In respect of some of these expenses, the Act contains comprehensive provisions dealing with their tax treatment. However, one type of expenditure which the Act neglects to deal with is expenditure incurred by a taxpayer during the course of conducting illegal activities. The question of the deductibility of this type of expenditure is a vexed (and even controversial) one. As it is set out below, the courts have demonstrated very little hesitation in holding that income derived by taxpayers from illegal activities is taxable however, it appears from the body of case law that has considered the question of the deductibility of expenses arising from such activities, that the courts have gone to some lengths to argue against the deductibility of expenditure arising from illegal activities<sup>101</sup>.

The Act, except for one specific provision which deals with a specific type of expenditure<sup>102</sup> does not specifically prohibit the deductibility of expenditure which arises from the conduct of illegal activities. Indeed, the Act does not even specifically provide for the taxation of income earned from these activities. As with most types of income and expenditure, the Act merely provides for general principles and criteria according to which the taxability and deductibility of those types of income and expenditure respectively should be determined. It is then up to the taxpayer, SARS and the courts to apply those general principles and criteria, on a case by case basis, to each specific set of facts to determine their taxability or otherwise, in the case of income, or their deductibility or otherwise, in the case of expenditure and losses. In the case of the courts, it is left to the wisdom of the judicial officer to make sure that the interpretation and application

---

<sup>101</sup> As will appear from what follows below, to the extent that the courts approach to these matters is based on some principle, that principle appears to be a public policy related principle.

<sup>102</sup> Section 23 (O) of the Act.

of the law is the correct and is not influenced by their religious or moral outlook, which, in the case of illegal receipts, is not an easy exercise.

The courts must consider each matter objectively and in line with the principles of interpretation discussed in chapter 2 above. Indeed, under the Constitution, all judges have an obligation to act freely, fairly, and without fear of favour<sup>103</sup>. However, when one considers the body of the cases dealing with the subject of the tax treatment of illegal receipt, it does appear that our courts have favoured the view that income earned from legal activities is inherently taxable and that the related expenditure (i.e. expenditure earned from illegal receipts) is inherently not deductible.

## 7.2 Taxability of Illegal Receipts

Before dealing with the deductibility of expenditure related to illegal activities, the author would first like to deal with the related topic of the taxability of illegal receipts. As the author indicated above, our courts view on this subject is rather emphatic.

The overall majority of the judgements that the author has encountered in its research (some of which are considered below) were in favour of the argument that such income is taxable. Many of the judgements which held that income earned by a taxpayer through illegal activities is taxable have turned on the question of whether or not such income has been “received” by the taxpayer. To contextualise this approach, in terms of section 1 of the Act, income can only be taxable in the hands of a taxpayer if that income has been “received” by a taxpayer or “accrued to or in favour of” the taxpayer.<sup>104</sup> Insofar as the meaning of “accrue” is concerned, the general principle, which was established in the *People’s Stores* case<sup>105</sup> is that an amount has accrued to a taxpayer if that

---

<sup>103</sup> Section 165 (2) of the Constitution.

<sup>104</sup> See *CIR vs Lategan* 1926 CPD 203; *CIR vs People’s Stores* 1990 (2) SA 353 (a); *CIR vs Delfos* 1936 AD2 42.

<sup>105</sup> *People’s Stores (Walvis Bay) (Pty) Ltd V CIR* 1990 (2) SA 353 (A).

taxpayer has become unconditionally entitled to that amount. The principle in respect of “received” for purposes of the gross income definition in section 1 of the Act is that an amount is only received by a taxpayer when it is received by a taxpayer for his/her own benefit and behalf.<sup>106</sup>

In terms of section 1 of the Act “gross income” is defined as follows:

“in relation to any year or period of assessment, means -

- (i) in the case of any resident, the total amount, in case or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person either than a resident, the total amount in cash or otherwise received by or accrue to or in favour of such person from a source within or deemed to be within the Republic”.

One of the first cases in South Africa which dealt with the taxability of illegal receipts is the case of *CIR vs Delagoa Bay Cigarettes Co.*<sup>107</sup> The illegal activity here was the conducting of an illegal lottery in that the taxpayer was selling cigarettes at an inflated price and placing a numbered coupon (the lottery ticket) in each of these packets. The actual price of the cigarettes was only a third of the price which the customers actually paid and the balance, being two thirds, was set aside for the lottery price money. In that case, the court, as per, Bristowe J, held as follows:

“I do not think that it is material for the purpose of this case whether the business carried on by the company is legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum, and after making the prescribed calculations and deducting the exemptions, abatements and deductions enumerated in the statute. The source of the income is immaterial. This was so held

---

<sup>106</sup> See *Geldenhys v CIR* 1947 (3) SA 256 (c).

<sup>107</sup> *CIR vs Delagoa Bay Cigarette Co* 1918 TPD 391.

in *Partridge v. Mallandaine* (18Q.B.D. 276), where the profits of a betting business was held to be taxable to income tax; Denman, J, saying that “even the fact of a vocation being unlawful could not be set up against the demand for income tax.” If the income itself is taxable it follows I think that if the prizes would have been a legitimate deduction, had the business been legal, they would equally be a legitimate deduction if the business is illegal. The deductions permitted by our statute are not made to depend on any question of legality or illegality; and in *Partridge v. Mallandaine* it was not suggested that betting losses could not be deducted. Indeed it seems common sense that if illegal profits are taxable they must be subject to the same deductions as if they were legal.”<sup>108</sup>

It appears that, in reaching its decision in this case, the court essentially took a public policy (and not purely legalistic) position. This conclusion is partly borne out by the fact that nowhere in the portion of the court’s judgment dealing with the taxability of the taxpayer’s income derived from the illegal activity does the court refer to the tax statute in force at the time. In fact, the portion of judgement dealing with the taxability of the illegal income of the taxpayer is only three quarters of a page long<sup>109</sup>. Admittedly, the court did refer to some authority, being the English case of *Partridge v Mallandaine*.<sup>110</sup> In that case, as in *the Delagoa* case, the subject of dispute was the taxability of profits earned from an illegal business.<sup>111</sup> In that case, the court held that even the fact of a vocation being unlawful could not be set up against the demand for income tax.

The *Delagoa* case is first of a long line of cases which appears to have been decided less on the basis of the legislative position than on the court’s moral outlook. Significantly, in *obita*, the court in *Delagoa* held that “if the income itself

---

<sup>108</sup> At 394

<sup>109</sup> There were a number of other issues which were at issue in this case, which made up the balance of the court’s judgement.

<sup>110</sup> *Partridge v Mallandaine* 18 QBD 276.

<sup>111</sup> At 394.

is taxable, it follows that if the prices would have been a legitimate deduction, had the business been legal, they would equally be a legitimate deduction if the business is illegal”<sup>112</sup>. The author shall consider this comment in greater detail below, suffice to say to say at this stage that it appears as if the court (or at least this specific court) would be prepared to rule in favour of taxpayer in a matter where the deductibility of expenditure incurred from a legal income is in question.

The next case the author would like to consider is *ITC 1624*.<sup>113</sup> In this case, the facts were briefly as follows:

“The taxpayer, a close corporation which conducted business as a customs clearing and freight forwarding agent, had fraudulently rendered inflated accounts in respect of certain fees to one of its customers, which fees it later recovered from the said customer. The taxpayer made provision in its books and budgeting for these illegally obtained profits, clearly in anticipation of the possibility that the defrauded customer could potentially pursue the taxpayer for these profits, save for the fact that the provision was made, as one would imagine, not in respect of “illegally obtained profits” but under the heading “accounts payable”.

The taxpayer argued that the illegally obtained profits had not been “received” by it and does not constitute “gross income” because the amount had not been received by the taxpayer “on its own behalf and for its own benefit”.

The taxpayer also argued that it was entitled to a tax deduction in respect of these profits as “expenditure actually incurred” in the production of income, although the taxpayer conceded that it was not entitled to the deduction to the extent that the disputed amount was only a provision.

---

<sup>112</sup> *Id.*

<sup>113</sup> *ITC 1624 (1996) 59 SATC 373.*

The court rejected the taxpayer's arguments and, in respect of the taxability of the illegal profits, held that those profits had indeed been received by the taxpayer and should therefore form part of the taxpayer's gross income. In aid of its argument, the court made the following example:

If a dishonest attorney recovered from his or her client, a sum for a witnesses fee and corruptly negotiated with the witness to accept a lesser sum than he or she had charged, so that he or she could retain the balance, it can surely not be suggested that the attorney had not received, in the tax sense, the overcharged amount. The same applies to the disputed sum obtained by the appellant by over charging its clients in this case<sup>114</sup>.

While the author cannot find any fault with the court's conclusion, once again, it does not appear as if the court based its conclusions on the Act. Whilst the author appreciates that the court considered a body of authority on this matter (most of the authority was, in fact, cases which were introduced by the appellant in aid of its own arguments, which arguments the court rejected) the author is still not satisfied that the courts ultimate conclusion was entirely free of moral influence.

The next case the author wishes to consider is *ITC 1545*<sup>115</sup>. In this case, the taxpayer had been convicted of theft and dealing in uncut diamonds. On the basis of evidence which was given in the taxpayer's criminal trial, in which a revenue inspector had set in and took notes, SARS issued additional assessments in respect of the taxpayer in which it included in the taxpayer's taxable income some money in respect of profit made from the taxpayers illegal activities.<sup>116</sup> The taxpayer also ran a scheme which was ostensibly a business relating to the sale of milk cultures. This was a type of a pyramid scheme which

---

<sup>114</sup> At page 580.

<sup>115</sup> ITC 1545 SATC 464.

<sup>116</sup> The case also dealt with the taxability of some amounts which SARS to contended constitute donations. In respect of these amounts, the court ruled in the taxpayers favour.

involved paying one set of investors from the deposit received from another set of investors although this was all done under the guise of a milk cultures business.

The taxability of the illegal profits received by the taxpayer turned on whether or not such profits could be regarded as having being “received” for purposes of section 11 (a) of the Act. In this regard, the court held that:

“Indeed, it could have never been intended that an amount received on behalf of another should fall within the gross income of the recipient. Where, however, an amount is received that taxpayer on his own behalf and for his own benefit but in pursuance of a void transaction there seems to be no reason for holding that such amount is not received within the meaning of the section, if that word is to be given its ordinary meaning. Not to do so, could lead to anomalies. It would mean, for example, that if a trader were to sell its goods on a Sunday in a breach of a local by-law, the price paid to him would not be received by him and would not form part of his gross income. The author can find nothing in the Act to justify such a construction: nor was any basis suggested for council for limiting of the word “received” in this way. The mere fact that the receipt was a consequence of a void transaction is no reason for ignoring it. Indeed, it does not follow that because a contract is prohibited by statute and therefore void *inter-partes*, it is to be totally disregarded and all the consequences flowing from it ignored.”<sup>117</sup>

The judgement of Scott J in this case, in the author’s view, stands out from the other judgements discussed under this heading for its reasoning. It is clear to me that, in coming to his conclusions, Scott J relied entirely (or to the fullest extent a judge can) on the provisions of the Act as opposed to any kind of public sentiment or morality. As with all the other previously discussed judgements, the author agrees with the conclusion reached by the court in this case, however, unlike the other judgements, the author will also agree with the

---

<sup>117</sup> At page 474.

reasoning of the court in this case. Indeed, the author does not see any reason why any income which has been earned through illegal activities cannot be regarded as having been “received” by the perpetrator. The author does think that the definition of “gross income” in section 1 of the Act is sufficiently wide to include such income. This, in the author’s view, makes it even more curious as to why, if the statute is allowing of this interpretation, our courts sometimes (in the author’s view) rely on reasoning based on a strand of morality to come to a conclusion which they can in any event had come to if they had relied on statute itself.

A common argument advanced by taxpayers in many of the cases which deal with the taxability of illegally received income is that the underlying agreements, because they are illegal, were null and void and thus whatever monies they would have received from those activities cannot be regarded as income because, if the agreement falls away, there is no nexus between the taxpayer and income. As with the courts, the author does not find any merit in this type of argument. As Scott J held in *ITC 1545*, it cannot be that the invalidity of such agreements necessarily implies that all the consequences flowing therefrom must be disregarded<sup>118</sup>. The law in respect of such agreements is that they are null and void *ab initio* and unenforceable. Without delving into the intricacies of the laws of contract, for that would be beyond this scope of this work, it appears to me that, whatever “*void ab initio*” may mean, it does not mean that the fact that there had been performance in terms of that agreement should be ignored.

### 7.3 **Deductibility of expenditure and losses arising from an illegally earned income**

Except in terms of section 23 (o) of the Act, the Act does not prohibit the deduction of losses and expenditure arising from illegal activities.<sup>119</sup> Indeed, one does not expect

---

<sup>118</sup> At page 473.

<sup>119</sup> Section 23 (o) of the Act, reads as follows:

23.No deductions shall in any case be made in respect of the following matters namely –

...

the Act to contain such prohibition. By in large, the issue of the deductibility of proceeds and expenditure arising from illegal income has been left to be to the courts to determine. Below, the author deals with a few cases which have dealt with this issue.

The first case which the author wishes to consider in this context is the *Delagoa* case. As already indicated above, the court in that case (although this was of *obiter dictum*) indicated that provided that all the other requirements for the deductibility are met, there is no reason why losses and expenditure incurred as a result of illegal commercial enterprise should not be deductible. The author agrees with the approach adopted by the court in matter however, as the author has already indicated, it appears as though the courts have sometimes been excessively eager to find reasons why such expenditure and losses should not be deductible.

In the case of *ITC 1624* the facts of which appear above, the taxpayer argued that it was entitled to a deduction in respect of the illegally received income as expenditure “actually incurred” in the production of income. This the taxpayer based on the argument that, on receiving the money, it was subject to a “simultaneous and corresponding liability to repay the victim of its fraud.”

In response to this argument, the court held that:

“It does not in my view follow from the fact that the appellant had an obligation to restore what it had unlawfully taken that it “actually incurred” “expenditure” for that sum. It may well be that if it paid the amount it would incur a loss which would be treated as having been incurred in the production of its income as a necessary concomitant of

---

(o) any expenditure incurred –

(i) where the payment of that expenditure or the agreement or offer to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act No. 12 of 2004): or

ii) which constitutes a fine charged or penalty imposed as a result of an unlawful activity carried out in the Republic or in any other country if that activity would be unlawful had it been carried out in the Republic.

the trade dishonestly carried on by it. But this has not happened.”<sup>120</sup>

It appears to me that the argument that is being advanced by the court in this case is, in essence, that the liability of the taxpayer in this case is a type of a contingent liability and as such is not ripe a deduction, this is because of the statement made by the court to the effect that “it may well be that if [the taxpayer] paid the amount it would incur a loss which would be treated as having been incurred in the production of its income as a necessary concomitant of the trade dishonestly carried on by it”<sup>121</sup>. If that is so i.e. if that is the argument that is being advanced by the court, then the author agrees with that argument. What, the author thinks, is significant about the reasoning of the court, is that the court accepts that the expenditure and losses arising from a illegal earned income may be deductible.

Although the author agrees with the principle advanced by the court (i.e. that if the liability is contingent, it is not deductible) on the facts, however, the author does not agree with the court that the expenditure was contingent. As discussed in chapter 2 above, expenditure is actually incurred (i.e. loses its contingency) upon the coming into existence of an unconditional legal obligation on the taxpayer to make payment in respect of that liability. In the author’s view, illegally earned income is a prime example of income in respect of which there is an unconditional obligation to make payment. The author agrees fully with the argument of the taxpayer to the effect that, on receiving the fraudulently obtained income, a reciprocal and immediate obligation on the taxpayer to repay that amount arose. It is indeed extremely difficult for me to imagine the conditionality or contingent nature illegally earned income. It seems to me that the obligation to restore such income to its rightful owner arises immediately when the owner is deprived thereof.

The issue of the deductibility of expenditure and losses arising from a illegal income was also considered in *ITC 1545*. In that case, the taxpayer also argued that because he stole the diamonds, he rendered himself immediately liable to the owner of the diamonds for the return of the diamonds or their value and thus the incurrence

---

<sup>120</sup> At page 381.

<sup>121</sup> *id*

of the relevant amount was unconditional. The taxpayer further argued that this liability was inseparable and necessary implication of the “trade” of dealing with stolen diamonds and that as it arose immediately, with each transaction, it had constituted deductible expenditure in terms of section 11 (a) of the Act.<sup>122</sup> In response to this argument, the court held that:

“On the basis of what is set out, above, however, it seems to me that the taxpayer’s liability is subject to a further perhaps more significant contingency, namely, that prior to the owner attempting to recover the value of the diamonds from the taxpayer it does not first succeed in recovering them from whoever possess them or for that matter recovering their value from some other person who may have dealt with them such as, for example, the person who sold them to the taxpayer in the first place. In the event of the owner succeeding in doing so, the taxpayer, of course will no longer be liable. This contingency is admittedly of a resolute nature, but that does not mean that the taxpayer’s liability to the owner is unconditional. What is clear therefore is that whether the taxpayer is ever made to compensate the owner or not depends in each case not only upon whether his crime is detected but also upon the non-happening of an uncertain future event...until at least, the owner institutes proceedings against the taxpayer to recover his loss from him rather than from any other party, the taxpayers liability does not, in the author’s view, amount to “expenditure... actually incurred” within the meaning of section 11 (a) of the Act.”<sup>123</sup>

Accordingly, the court essentially sets out a two stage test for the deductibility of expenditure incurred by a taxpayer in pursuing an illegal enterprise or, more accurately, for the unconditionality of an obligation to repay gains earned from such an enterprise. The stages are that, firstly, the crime must be detected and secondly, at the very least, the victim must institute action against the taxpayer for recovery of

---

<sup>122</sup> At page 471.

<sup>123</sup> Page 474.

the expenditure.

Once again, in the author's view, it is very difficult to understand this kind of reasoning. What the court is essentially saying is that if the crime of the taxpayer has not been detected and no legal proceedings have been instituted against the taxpayer by the victim to recover the amounts in question, then the taxpayer does not have an unconditional legal obligation to repay the illegally monies. This the author finds very difficult to accept. Surely, it cannot be that if A robs a bank, the obligation on A to return money to the bank is conditional upon A being detected and secondly the bank instituting proceedings against A for recovery of those amounts. The author accepts, that, in reality, in our bank example, A will not pay the money over to the bank until he is detected. However, in the author's view, that certainly does not mean that, before then, A's obligation to pay that money over to the bank was unconditional. As the court rightly points out, the possibility of there being legal proceedings instituted against the perpetrator taxpayer is remote. It may, in fact, never happen.

However, the fact that the taxpayer has not been detected by the authorities surely cannot mean that the taxpayer does not have an obligation to repay those amounts. Surely, both in law and in morality, the obligation on a thief to restore the stolen goods to the rightful owner arises immediately once the act of theft is committed. The author cannot agree with the argument advanced by the court in this case to the effect that that the obligation will only arise if, firstly, the thief is detected and, secondly, the rightful owner of the goods has not otherwise received the goods or the value thereof.

If one takes that kind of argument to its logical conclusion, then the only conclusion that one can reach is that, in the event that the rightful owner of goods that have been stolen is otherwise compensated for the value of those goods, the obligation on the perpetrator taxpayer to restore the goods is extinguished. Surely that cannot be correct.

## BIBLIOGRAPHY

### 1. Books

Botha C (2005) *Statutory Interpretation* Cape Town: Juta & Co

Currie & De Waal (2005) *The Bill of Rights Handbook* Cape Town: Juta & Co

De Koker *et al* (2009) *Silke on South Africa Income Tax* Cape Town: Lexisnexis

Emslie *et al* (1995) *Income Tax Cases and Materials* Cape Town: The Taxpayer

Hoexter (2006) *School of Law University of the Witwatersrand Introduction to South African Law* Johannesburg: Schreiner School of Law, University of the Witwatersrand

### 2. Cases

1995 (3) SA 391

1995 (2) 642 (CC)

2004 (5) SA 331

2002 (5) SA 721 (CC)

1942 CPD 509

1986 (3) SA 549

1995 (4) SA 877

1996 (4) SA 744 (CC)

1999 (2) SA 91

1975 (4) SA715 (A)

1931 AD 466

1911 AD 635

1997 (1) SA 710

1913 AS 250

1950 (4) SA 653 (A)

1995 (3) SA 391

21 LT 370

[1921] 1 KB 64

1985 (2) SA 935 (A)

1983 (4) SA935

1926 (AC) 37

45 SATC 241

1936 CPD 241

1975 (1) SA 665 (A)

1998 (3) SA 876 (A)

1946 AD 157

2011 (1) SA (SCA)

72 SATC 75

[2011] ZASCA 157

ITC10999

1926 CPD 203

1936 AD 242

1947 (3) SA 256 (C)

1918 TPD 391

ITC 1624 (1996) 59 SATC 373

### 3. Articles

Ger B (2011) “Sale of a business having contingent liabilities: revisited” *De Rebus* 50 – 51

Ger B (2012) “The problem of paying with shares resurfaces” *De Rebus* 48

Clegg D (2010) “Sale of business sorrows-ii” *Tax Planning* 71

Kruger D (2011) “The sale of a business” *Business and Company Law Quarterly* 17

**Word Count: 21 650 words.**