

THE TAX DEDUCTIBILITY OF SHARE-BASED PAYMENTS WHERE SERVICES ARE PROCURED OR DEBTS SETTLED

by

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SUMMARY

TAX DEDUCTIBILITY OF SHARE-BASED PAYMENTS WHERE SERVICES ARE PROCURED OR DEBTS SETTLED

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In the current economic climate, companies often use share-based payments to compensate suppliers/employees for services rendered or for the settlement of debt owing to suppliers. The Income Tax Act, No.58 of 1962, does not stipulate whether these share-based payments are allowed as a deduction for Income Tax purposes. As the Income Tax Act, No. 58 of 1962, is silent on this matter, to date, the various cases heard by South African courts resulted in conflicting judgments.

The question that motivated this study is whether share-based payments to compensate suppliers/employees for services rendered or to settle a debt owing to suppliers, constitute **‘expenditure actually incurred’**, as required by the Income Tax Act, No. 58 of 1962, and whether judgments made by the South African courts are in line with international practices. Tax legislation in the United Kingdom and Australia was evaluated for this purpose.

It was noted that the international tax legislation governing the deductibility of share-based payments is not very prescriptive and, thus, similar to the situation in South Africa. The decisions made by the South African courts are mostly in line with the judgments made abroad, except for the decision in *Sars v Labat Africa Limited* (2011), Zasca 157, made by South Africa’s highest court, which tends to favour the South African Revenue Services.

KEY WORDS

Share-based payments

Services

Debts

OPSOMMING

BELASTINGAFTREKBAARHEID VAN AANDEELGEBASEERDE BETALINGS WAAR DIENSTE BEKOM WORD OF SKULD VEREFFEN WORD

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In die huidige ekonomiese klimaat gebruik maatskappye dikwels aandeelgebaseerde betalings om hul verskaffers/werknemers te vergoed vir dienste gelewer, of om skuld te vereffen wat verskuldig is aan verskaffers. Die Inkomstebelastingwet, No.58 van 1962, stipuleer nie die aftrekbaarheid van hierdie tipe aandeelgebaseerde betalings vir inkomstebelastingdoeleindes nie. Aangesien die Inkomstebelastingwet, No.58 van 1962, geen voorsiening maak vir die belastinghantering van hierdie tipe betalings nie, het verskeie sake tot dusver voor die Suid-Afrikaanse howe voorgekom met weersprekende uitsprake.

Die navorsingsvraag wat hierdie studie gemotiveer het, was of maatskappye wat aandeelgebaseerde betalings maak om verskaffers/werknemers te vergoed vir dienste gelewer of om skuld te vereffen wat verskuldig was aan verskaffers, kwalifiseer as '**onkoste werklik aangegaan**', soos verlang deur die Inkomstebelastingwet, No.58 van 1962,, en of die uitsprake wat tot dusver gelewer was deur die Suid-Afrikaanse howe, in lyn is met internasionale praktyke. Die belastingwetgewing in die Verenigde Koninkryk en Australië is **geëvalueer** vir hierdie doeleindes.

Die studie het gevind dat internasionale belastingwetgewing wat die aftrekbaarheid van hierdie tipe aandeelgebaseerde betalings voorskryf, nie duidelik is nie en dus ooreenkom met die situasie in Suid Afrika. Die uitsprake gelewer deur die Suid-Afrikaanse hof is merendeels in lyn met internasionale uitsprake, behalwe vir die uitspraak in Sars v Labat Africa Limited (2011), Zasca 157, gelewer deur Suid-Afrika se hoogste hof, wat die Suid-Afrikaanse Inkomste Diens bevoordeel.

SLEUTELWOORDE

Aandeelgebaseerde betalings

Dienste

Skuld

CHAPTER 1

THE TAX DEDUCTIBILITY OF SHARE-BASED PAYMENTS WHERE SERVICES ARE PROCURED OR DEBTS SETTLED

INTRODUCTION

1.1 BACKGROUND

Apart from Broad-based Employee Share Plans, companies often grant shares to employees as a common feature of employee remuneration. Companies also issue shares to compensate suppliers who rendered professional services to the company. The International Financial Reporting Standards 2 (Share-based Payments), state that when goods or services received or acquired in a share-based payment transaction are not recognised as assets, they shall be recognised as expenses. The tax treatment of expenses so recognised are currently not prescribed by the Income Tax Act, No 58 of 1962, (hereafter referred to as 'the Act').

Section 24 B, of the Act, which prescribes the tax treatment of transactions where shares are issued as a consideration for the acquisition of an asset, was enacted in 2005. According to Section 24 B, where shares are issued as a consideration for the acquisition of an asset, expenditure would be actually incurred. The amount of the expenditure so incurred by acquiring the asset equates to the market value of the asset so acquired. Section 24 B is limited to assets acquired in a share-based payment transaction and does not address the tax treatment of shares issued in return for services rendered or for the settlement of a liability.

The limitations of Section 24B have been leading to contradicting outcomes in South African Tax Courts. In *Income Tax Case (ITC) 1783, 2004* (66 SATC 373), it was held that the issue of shares was not seen as expenditure, as contemplated in section 11(gA) of the Income Tax Act. In *ITC 1801, 2006* (68 SATC 57), it was held that the issue of shares signify expenditure, as contemplated in section 11(gA) of the Act. The ruling in *ITC 1801* was upheld by the High Court in the matter of *CSARS v Labat Africa Limited, 2010* (72

SATC 75). The Supreme Court of Appeal in *CSARS v Labat Africa Limited*, 2011(669/10) ZASCA 157, determined that the issue of shares as a consideration for the acquisition of assets does not constitute expenditure actually incurred.

This decision by the South African (SA) Supreme Court of Appeal is in contrast with decisions that stood for about 70 years in the United Kingdom (UK). These UK decisions allowed a deduction for consideration given in payment of the acquisition of assets.

Research submitted and comments provided on the SA Supreme Court of Appeal's judgment in the Labat case, indicates that uncertainty remains on whether equity-settled, share-based payments to employees and/or third parties for services rendered, constitute 'expenditure' for the company.

According to Williams (2011:4), as a result of the Labat judgment, an opportunity slipped by to align South African legal principles with current international commercial practice and with the principles applied in other jurisdictions. Tax payers in South Africa are left with a binding principle that counters the conventional thinking that a company parts with value when it issues shares, which are considered as an asset.

Previous research addressed several aspects of the question whether share-based payments for services rendered or payment of debt, constitute expenditure actually incurred:

- De Swardt, R. 2008. Do payments made for the procurement of services qualify as expenditure actually incurred?
- Bortz, J. 2007. Do share-based payments constitute expenditure, for tax purposes, in order to facilitate a deduction?
- Burger P.C. 2005. The tax deductibility of payments made as a consideration for services rendered.

1.2 PROBLEM STATEMENT

The Act does not stipulate whether payments made by a company, for services rendered or for the settlement of a debt, to its employees or another company, constitute

expenditure actually incurred, and whether these payments will be permitted as a deduction in terms of section 11 of the Act. To date, courts have been providing conflicting judgements and the only Supreme Court of Appeal judgment is in contrast with international practice. The following question therefore remains unanswered: Do payments for services rendered or for the payment of debt, constitute expenditure actually incurred?

1.3 PURPOSE STATEMENT

The main intention of this study is to determine whether share-based payments made by a company for services rendered or for the settlement of debt to another company, constitutes 'expenditure actually incurred' in terms of section 11(a) of the Act, and whether these payments warrant a deduction for income tax purposes.

1.4 RESEARCH OBJECTIVES

This study is guided by the following research objectives:

- To analyse the meaning of 'expenditure, and 'actually incurred' with the aid of local and international legislation and case law.
- To critically analyse South African case law judgments that, to date, dealt with the deductibility of share-based payments and to determine whether these payments constitute 'expenditure actually incurred'?
- To examine the treatment of share-based payments for services rendered, or as a settlement of debt in foreign jurisdictions, and to conclude on whether a deduction is permitted for income tax purposes in those jurisdictions.

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

Current tax legislation does not provide guidance on whether share-based payments for services rendered or for the settlement of debt, constitute 'expenditure actually incurred' for tax purposes. This research provides a detailed analysis of the terms 'expenditure' and 'actually incurred' in the context of share-based payments for services or for the settlement of debt. This study also depicts the treatment of share-based payments in foreign jurisdictions.

Theoretically, this research determined whether share-based payment for services rendered or for the settlement of debt, warrants a tax deduction. Practically, it should assist taxpayers in understanding the contradicting judgements by South African courts.

This research study has five main parts. The following section explicates the delimitations which will apply to the study. Thereafter a list of definitions of the key terms used in this study will follow. Next, the literature on the concepts 'expenditure' and 'actually incurred' are reviewed. International practices on the deduction of share-based payments are analysed, followed by an analysis of the South African case law judgments relating to the deduction of share-based payments.

1.6 DELIMITATIONS

The following is specifically excluded from the scope of this document:

- Taxation of directors and employees on vesting of equity instruments – Section 8C of the Act.
- Broad-based employee share plans – Section 8B of the Act.

1.7 DEFINITION OF KEY TERMS

This study includes a number of key terms. It is submitted that these key terms should be interpreted as follows:

Share-based payments: Payments made by a company by way of allotment and by issuing of its own shares to an employee or supplier as a consideration for services rendered or for the payment of debt.

Employee(s): Employee(s) receiving shares from his/her employment company in return for services rendered.

The following abbreviations are used in the body text of this dissertation:

Table 1: Abbreviations used in this document

| Abbreviation | Meaning |
|---------------------|---|
| Companies Act | Companies Act No 71 of 2008 |
| HMRC | Her Majesty's Revenue and Customs |
| IFRS | International Financial Reporting Standards |
| ITAA 1997 | Income Tax Assessment Act 1997 |
| ITC | Income Tax Court |
| SA | South African |
| SARS | South African Revenue Services |
| SATC | South African Table of Cases |
| The Act | Income Tax Act No 58 of 1962, as amended. |
| UK | United Kingdom |

1.8 STRUCTURE OF DISSERTATION

Chapter two provides an overview of the legal and accounting principles applicable to share-based payments, with specific reference to the definition of a 'share' as per the Companies Act, No.71 of 2008, and the definitions, and recognition criteria contained in the IFRS 2 Share-Based Payments.

In Chapter three, two requirements of the general deduction formula are analysed, as well as their applicability on share-based payments. Firstly, the terms 'expenditure' and 'losses' are analysed, followed by an analysis of the term 'actually incurred'.

Chapter four provides a critical analysis of existing South African case law dealing with the deductibility of share-based payments where services were procured or debts settled.

Chapter five provides an overview of the international treatment of transactions whereby shares are issued for the procurement of services or for the settlement of debt, focussing solely on tax legislation applicable in the United Kingdom and Australia, respectively.

In chapter six a conclusion is reached on whether share-based payments made for the procurement of services or for the settlement of debt, constitutes 'expenditure actually incurred' for income tax purposes.

CHAPTER 2

LEGAL AND ACCOUNTING PRINCIPLES APPLICABLE TO SHARE-BASED PAYMENTS

2.1 INTRODUCTION

Although this study is focused on the tax deductibility of share-based payments where services are procured or debts settled, it is important to understand the legal principles governing share-based payments as well as the prescribed accounting treatment

The first part of this chapter will briefly focus on key concepts relating to share-based payments as defined in the Companies Act, No.71 of 2008 followed by an overview of prescribed accounting treatment and relevant definitions as stipulated in the applicable accounting standards.

2.2 LEGAL PRINCIPLES

Companies often grant shares or share options to third parties or current employees as consideration for goods acquired or services rendered. These transactions are normally referred to as share-based payments.

In evaluating the legal nature of share-based payment, it is important to understand the following key concepts as defined in Section 5 (1) (a) of the Companies Act, No.71 of 2008, unless the context indicates otherwise:

- 'Share' is defined as one of the units into which the proprietary interest in a profit company is divided.
- 'Profit Company' is defined as a company incorporated for the purpose of financial gain for its shareholders.
- 'Consideration' includes anything of value given and accepted in exchange for any property, service, act, omission of forbearance, or any other thing of value, including money, labour, property, barter or similar exchange of one thing for another, or any

other thing, undertaking, or promise, irrespective of its apparent or intrinsic value or whether it is transferred directly or indirectly.

Blackman (Quoted by Burger PC, 2005:15) is of the opinion that holding a share in a company constitutes a collection of intricate individual and intangible rights in the hands of the shareholders of the company. Share has been described as “simply rights of action – *jura in personam* – entitling their owner to a certain interest in a company, its assets and dividends”.

A company could never own its own shares, be it before the issue of the shares or thereafter. This principle was stated in *Lowry v Consolidated African Selection Trust Ltd* (1940:648) and confirmed in *Etkind v Hicor Trading Ltd, 1999 (1) SA 111 (W)* as follows:

“...Unissued shares are not assets in any sense of the company; before allotment shares do not exist as a piece of property, what value they have comes when, and by the fact that, they are issued ...”.

According to Cilliers & Benade (In Burger PC, 2005:16) a shareholder can acquire shares in a company in one of two ways – by acquiring shares from a current shareholder, or from a company itself. It is understood that the same applies to potential shareholders of a company.

Section 40 of the Companies Act stipulates the consideration required for the issue of shares. Subsection (1)(a) states that the board of one company can issue authorised shares to another company, only for sufficient consideration, as determined by the board. Subsection 2 further states that the board of directors should determine the consideration for which, and the terms on which shares will be issued, before a company may issue any class of its own shares.

2.3 ACCOUNTING PRINCIPLES

The International Financial Reporting Standard 2: Share-Based Payment (IFRS 2, 2011:A95) prescribes the recognition and measurement criteria for an entity when the entity participates in a share-based payment transaction.

The first version of this IFRS was issued by the International Accounting Standards Board in February 2004 and is applicable to financial years beginning on or after 1 January 2005.

IFRS 2 stipulates that an entity shall account for share-based payment transactions in its financial statements, including transactions between the entity and its employees or other parties, which are settled in cash, other assets, or equity instruments of the entity (IFRS 2, 2011:A93).

IFRS 2 deals with the following three different types of transactions which should be accounted for in terms of this standard:

- (a) Equity settled share-based payment transactions.
- (b) Cash-settled share-based payment transactions.
- (c) Transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods and services, with a choice of whether the entity settles the transaction in cash or by issuing equity instruments (IFRS 2, 2011:A93).

The discussions in this research paper mainly focus on share-based payment transactions, which are settled by issuing the entity's own shares, commonly known as equity-settled share-based payments.

IFRS 2 defines an equity-settled, share-based payment as a share-based payment transaction in which the entity:

- (a) receives goods or services as consideration for its own equity instruments, including shares or share options, or

- (b) receives goods or services, but has no obligation to settle the transaction with the supplier (IFRS 2, Appendix A, Defined terms, 2011:A114).

In terms of IFRS 2 paragraph 7, an entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods, or when the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled, share-based payment transaction or a liability if the goods or services were acquired in a cash-settled, share-based payment transaction. IFRS 2 paragraph 8 further states that when the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses (IFRS 2, 2011:A95).

Paragraph 10 of IFRS 2 states that for equity-settled, share-based payment transactions, the entity shall directly measure the goods or services received and the corresponding increase in equity at the fair value of the goods or services received, unless that fair value cannot be reliably estimated. If the entity cannot reliably estimate the fair value of the goods or services received, the entity shall indirectly measure their value and the corresponding increase in equity, by reference to the fair value of the equity instruments granted (IFRS 2, 2011:A96).

2.4 SUMMARY

Issued shares represent an interest in the assets and liabilities of a company. Shares may only be issued in instances where adequate consideration was received for the issue of the shares.

Based on the previously stated definition of the word 'consideration', it can safely be assumed that shares can be issued where a company receives goods or services as a consideration for the issue of shares and the board of the company accepts the goods or services received as adequate consideration.

The applicable accounting statement requires the recognition of these transactions in the accounting records of a company. The goods or services should be recognised when received, with a resultant increase in the equity of the company.

The legal and accounting principles make provision for transactions where shares are issued as a consideration for the acquisition of goods or services received. However, to determine whether the goods or services so procured warrant a deduction for tax purposes, one needs to consider the tax principles analysed in Chapter 3.

CHAPTER 3

OVERVIEW OF THE REQUIREMENTS OF THE GENERAL DEDUCTION FORMULA

3.1 INTRODUCTION

In this section the study will focus on certain concepts and principles from the Act which prescribes the deductibility of expenses from taxable income.

Firstly and as base for the rest of the study the requirements of the general deduction formulae will be analysed followed by an in debt analysis of the terms “expenditure and losses” and “actually incurred”.

3.2 GENERAL DEDUCTION FORMULA

Section 11(a) of the Act contains the general deduction formula which permits certain expenditure as a deduction from income. The deductibility of share-based payments for services rendered or for the settlement of a debt, is considered under this paragraph only. The other specific deductions contained in the remaining sections of paragraph 11 do not specifically address the question so posed.

Section 11(a) permits a deduction for:

- expenditure and losses
- actually incurred
- during the year of assessment
- in the production of income
- not of a capital nature.

Huxham and Haupt (2011:99) submit that the accounting treatment of expenditure is, to a large extent, irrelevant in deciding whether or not it is deductible for tax purposes. They also state that an expense or loss will only be allowed as a deduction if it meets all the

above requirements. Should any of the requirements not be met the expenditure will not be permitted for income tax purposes, irrespective of how prudent its deduction may seem to be from an accounting point of view. With all due respect to the authors, it would however be advisable to consider the accounting treatment of transactions in instances where there is no prescriptive income tax legislation specifically relating to the transaction. The consideration of the accounting treatment may provide clarity on nature of the transaction which in turn can assist in deciding the tax treatment thereof.

For the purposes of this dissertation only, the first two requirements of the general deduction formula of section 11(a) are analysed, namely 'expenditure and losses' and 'actually incurred'. It is assumed that the remaining three requirements were met.

As these terms are not specifically defined in the Act, their interpretation needs to be considered with regards to existing case law.

Words should be given their literal meaning when interpreting the Act. In the British case, *Cape Brandy Syndicate v Inland Revenue Commissioners*, 1921 (1) K.B. 64, Rowlat J, at 71, indicated that when interpreting the Act, one should only consider what is obviously said, as there is no scope intendment. In his own words: "There is no equity about tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."

Based on the comments by Rowlat J above and taking cognisance of the general descriptions in various dictionaries, expenditure could be the act of spending money or consuming something. Actually incurred would mean that a person brings something upon himself.

3.3 EXPENDITURE AND LOSSES

The Act refers to expenditure and losses, but the terms thereof are not defined. Huxham and Haupt (2011:100) submit that it is not clear whether there is any difference between the two terms, although reference is made to a possible difference in two of the leading cases dealing with this section. In *Joffe and Co (Pty) Ltd v CIR*, 1946 (AD), the court

stated that losses were expenditure of an involuntary nature, and that the expenditure means a voluntary payment of money.

In the English case of *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co*, in the context of the difference between expenditure and losses, expenditure means something that a trader pays out, which comes out of his pocket, and a loss is not something he expends, but it affects him *ab extra*.

The Oxford English Dictionary (OED.com, 2012) defines the term 'expenditure' as "The action or practice of laying out, paying away, or spending (money), the expending or laying out (of energy, labour, time), the action or process of using up or consuming."

Huxham and Haupt (2011:100 paragraph 4) argue that expenditure and losses are not only cash outflows, but also liabilities, which may be settled in cash or otherwise. This view is supported by De Koker and Williams (2009:7-12 §7.5), who state that expenditure is not limited to pure cash lay outs, but includes lay outs of amounts which do not represent cash. It is important to note that expenditure does not have to be pure outlays of cash it could represent outlays of something else.

According to Meyerowitz (quoted by De Swardt, 2008:481) submits that expenditure may have various appearances that have a value in money or monetary value and, where expenditure does not take the form of cash, the expenditure is the cost to the taxpayer.

De Swardt (2008:479) submits that "It appears that a key requirement of expenditure is that something must have come from the taxpayers' pocket, or there must be an outgoing diminishment or deprivation of the taxpayers' patrimony; and that the deprivation should either be money or something that has a value in money."

From the above, it is clear that for a share-based payment for services rendered, or for the settlement of a liability to qualify as 'expenditure', there should be a decrease in the net worth of the company making the payment and that it is not a pre-requisite for the taxpayer to incur outlays of cash.

Huxham and Haupt (2011:100 paragraph 5) is of the opinion that expenditure is not incurred by a company when the company issues its own shares, as the company will not be financially worse off after the share issue. Thus, the company is not poorer after the share issue. This statement seems to be appropriate where cash is received for share issues but not in instances where services are received as a consideration for share issues or where a liability is settled.

An allotment of shares by a company as fully paid up implies that the company received the consideration for the subscription of shares as determined by the directors, resulting in an increase of cash/assets and issued share capital. In the case of a share-based payment, this right to receive the cash is forfeited. Should the shares be issued to employees for services rendered or as a consideration to settle a existing liability there would be no increase in cash/assets.

Meyerowitz on the other hand (in De Swardt, 2008:479) submits that the Act is not concerned with notional expenditure. De Swardt (De Jure, 2008:479 paragraph 5) argues that a possible reason for this is that an expense is an outlay of an asset, which is something to which the taxpayer has a legally enforceable right. It is clear from the excerpts above the an expense should be an outlay of an asset or legally enforceable right and that it should not be unreal or theoretical Consider for example a scenario where a taxpayer procures maintenance services and the service provider invoices the taxpayer for R 1000. Should all the other requirements of section 11(a) of the Act be met, the taxpayer recognises an expense of R 1000 and simultaneously recognises a liability of R 1000. We can therefore accept that an expense had been incurred for income tax purposes. Subsequently the taxpayer issues shares to the value of R 1000 to the supplier as a consideration for the services rendered. Inevitably the taxpayer forfeited his enforceable right to receive cash for the issue of shares to the supplier thus incurring an outlay of an asset and the expense on the other hand is not notional as it is real.

Burger (2005:37) submits that even if it is considered that the forfeiture of an economically favourable opportunity is considered to constitute an 'expense', it does not satisfy the 'actually incurred' requirement, and becomes academic. It is therefore important for the

purpose of this study to fully understand the concept of “actually incurred” which is dealt with in the next section.

3.4 ACTUALLY INCURRED

The Act refers to ‘actually incurred’, but the term is not defined therein.

Another requirement for expenditure to be permitted as an income tax deduction in terms of section 11(a) of the Act is that the expenditure should be ‘actually incurred’. It is not required to conclude on whether the expenditure was necessarily incurred – as long as it was actually incurred it will be allowed as a deduction.

Huxham and Haupt (2011:100 paragraph 6) submit that the deduction of an expense may be permitted for income tax purposes before the expense had actually been paid, thus the deductibility of expenditure is not determined on a cash basis only. As long as the liability was incurred, a claimable expenditure has arisen. This view is explained by the by the example provided in section 3.3 where the taxpayer incurred expenses of a R1000 and subsequently settled the liability.

In *Caltex Oil (SA) Ltd v SIR*, 1975 (AD), it was held that ‘expenditure actually incurred during a year’ does not mean that the expenditure should actually have been paid during the year. Expenditure actually incurred during a year is expenses for which a liability was incurred in that year, regardless of whether the liability was settled during the year. The “accrual” principle of accounting also states that transactions should be recorded in the period to which they relate and not when cash are paid or received in terms of the transaction.

De Swardt (2008:480) submits that the court, in the *Caltex Oil (SA) Ltd v SIR* case, drew a clear distinction between the expense and whether the expense had been paid, or whether a liability for the expense had been incurred.

Huxham and Haupt (2011:101 paragraph 1) submit that, whether or not an expense was incurred is often determined by examining the obligations arising from the contractual

agreement. It is assumed that from the excerpt mentioned above the obligation arising from the contractual agreement should be an actual obligation and not an obligation for future expenses. The activities which gave rise to the obligation should already have been incurred.

In *Nasionale Pers Bpk v KBI*, 1986 (3) SA 549 (A) (48 SATC 55), the court held that the requirement for expenditure to be 'actually incurred' consequently indicates that probable future expenditure would not be permitted as an income tax deduction in terms of section 11(a) of the Act. Only expenditure for which the taxpayer incurred an unconditional obligation may be deducted for income tax purposes in the relevant tax year.

In the *Edgars Stores Ltd v CIR*, 1988 (3) SA 876 (A) (50 SATC 81) case, it was held that expenditure for which an unconditional legal obligation had been incurred by the taxpayer during his/her year of assessment, should be allowed as a deduction in terms of section 11(a) of the Act.

Expenditure is actually incurred not only when it is paid, but when the taxpayer becomes legally liable to pay, even though no payment was made by the end of the year of assessment, or it is not due or payable by that date (Meyerowitz in De Swardt, 2008:481).

De Swardt (2008:481) submits that the determining factors are whether an expense exists and whether an unconditional liability was incurred during the year in respect of such expenditure, regardless of whether or not the liability was discharged.

From the above, it is clear that for a share-based payment for services rendered, or for the settlement of a debt to qualify for a deduction, an unconditional legal obligation with regard to an expense should have been incurred by the taxpayer.

Burger (page 39) argues that although the word 'expenditure' should be read in conjunction with 'actually incurred', an expenditure should first exist before it can be 'actually incurred' for purposes of section 11(a) of the Act. Burger (page 40) further submits, based on the excerpt from the *Caltex Oil (SA) Ltd v SIR* (1975:665), case that a

liability for something that is not an expense may not constitute ‘expenditure actually incurred’ and, may not be deductible.

Burt (in De Swardt: 2008:482) counter argues with reference to the same excerpt in the *Caltex Oil (SA) Ltd v SIR* case, that ‘expenditure’ would be ‘actually incurred’ if an unconditional legal obligation was incurred and the consideration due to settle the obligation has a monetary value.

De Swardt (2008:482) submits that if a company enters into an agreement for the procurement of services by means of share-based payment, it could generally be assumed that the company incurs an unconditional obligation to issue the shares. The question remains whether or not incurring this unconditional obligation qualifies as an ‘expense’, and not only whether some performance with monetary value is due. It therefore remains to be discussed whether a company that makes a share-based payment has, in fact incurred – valued in money – an outgoing diminishment or deprivation of its patrimony.

3.5 SUMMARY

It is clear from the above that an ‘expense’ is ‘actually incurred’ when a legal obligation arises that requires the taxpayer to pay. It is not required for the obligation to be settled before an expense is seen as ‘actually incurred’. Therefore, should an expense give rise to a liability in year one and be settled by the taxpayer in year two, it can be safely assumed that the expense was actually incurred in year one.

The uncertainty exists whether shares issued for the procurement of services or for the settlement of a debt, which originated as a consequence of the procurement of goods/services, constitutes and ‘expense’.

Both the terms, ‘expenditure or losses’ and ‘actually incurred’ are not defined in the Act, as stated above. Therefore, one would have to consider the literal meaning of the words.

Various courts attempted to clarify the literal meaning of ‘expenses or losses’ and ‘actually incurred’ and in Chapter 4 we critically analyse judgments made by these courts.

CHAPTER 4

CRITICAL ANALYSIS OF EXISTING CASE LAW IN SOUTH AFRICA

4.1 INTRODUCTION

In this section we critically analyse judgements made by South African courts in cases where the meaning of “expenditure” and “expenditure actually incurred” was considered.

We first consider the judgment made by the Income Tax Court in Income Tax Case 1783 in which the court expressed their view on the meaning of “expenditure”. There after we analyse the judgments made in Income Tax Case 1801, SARS v Labat Africa Limited (2010) 72 SATC and SARS v Labat Africa Limited (2011) ZASCA 157 which all relate to the same issue heard before different levels of South African courts and eventually led to the ground braking judgment by the South African Supreme Court of Appeal.

4.2 INCOME TAX CASE 1783

In this case, the taxpayer acquired a license agreement for the allotment of shares to the taxpayer. The taxpayer sought to deduct the amount relating to the agreement from its taxable income in terms of Section 11(A) of the Act. The Commissioner rejected the deduction, because the taxpayer had not incurred expenditure.

The court considered the general meaning of the word ‘expenditure’ to be the actual spending of money in cash or something similar, for example, a person’s time and effort and an ensuing decrease of the assets of the person incurring such expenditure. The court held that, although the allocation and issuing of shares by a company could diminish the value of the shares held by its current shareholders, the value of the total assets of the company that issues the shares is not reduced in any way (De Swardt, 2008:485).

The court held that a fascinating issue arises when a company settles its commitments by means of issuing its own shares as a consideration. To formulate their judgment, the court used an example where a company paid its employees for services the employees had

rendered to the company by the allotment and issuing of the company's own shares to these employees. As the company's assets did not decrease it was submitted that the company did not incur any expenses and, consequently, the value of the shares issued to the employees could not be claimed as an income tax deduction.

The court went on to indicate that the situation may be different in instances where employees who work for a salary payable in cash subscribe for shares in their employing company by agreeing upfront with their employer to apply their monthly salary to settle their debt owing to the employer for the subscription of the shares.

In the above scenario, the company would have actually incurred expenditure in the form of salaries due to its employees, despite this obligation being settled by the issuing of its own shares.

The court did, however, point out that in instances where companies are compelled to issue shares to its employees for services rendered to the company, there would be no disbursement of any cash or assets, which is a vital requisite of the phrase 'expenditure actually incurred' in Section 11(a) of the Act.

Meyerowitz is of the opinion that the decision in ITC 1783 is not correct (De Swardt, 2008:485). He submits that when a company remunerates a director or current employee by issuing the company's own shares, the expenditure should, at minimum, be the nominal value of the shares so issued.

Ger (2004:2) maintains that the judges' view of expenditure may have been exceedingly narrow and not necessarily correct. He submits that it is possible that the concept of 'incurred expenditure' was confused with the settlement thereof. According to him, expenditure was incurred by the taxpayer when the license agreement was purchased and that the way of settlement should not change this fact. He further argues that the taxpayer gave up his right to receive cash for the shares issued, thus reducing his assets. He also maintains that the concept of expenditure should not be restricted to pure cash outflows, but should include any economic forfeiture when items are acquired.

Clegg and Stretch (in De Swardt 2008:486) supports this view held by Ger. They argue that expenditure may be incurred in any form that has monetary value, such as shares, fixed property, or the rendering of services.

Burt, (in De Swardt, 2008:482) is of the opinion that when a company agrees to allot its own shares as consideration for the procurement of services, the company incurs a legal obligation to allot the shares. He submits that the company would be seen to have incurred expenditure by incurring a legal obligation. His arguments are based on the decisions in the *Caltex Oil (SA) Ltd v SIR* case and the *Edgars Stores Ltd v CIR* case.

De Swardt (2008:487) submits that “It may be true that the issue of shares does not per se reduce the assets of the company, but the forfeiture of the subscription price due to the company could be considered to reduce the assets of the company. It could be argued that, although the shares in the company do not constitute an asset of the company, the debt due by the subscriber to pay the issue price does constitute an asset of the company, as it is owed to the company itself. The expenditure therefore lies in the forfeiture of the subscription price due by the subscriber. This forfeiture may be affected as consideration for something different, such as the settlement of an amount due for the procurement of a service”.

4.3 INCOME TAX CASE 1801

In this case, the taxpayer acquired a trademark and allotted shares as a consideration for the trademark acquired. The taxpayer then claimed an income tax allowance in terms of Section 11(gA) of the Act. The Commissioner did not allow the deduction on the basis that no expenditure was incurred.

The taxpayer based its case on the fact that it had incurred an unconditional legal obligation to settle the purchase price for the trademark acquired, thus, by incurring the obligation; the taxpayer was of the opinion that it had incurred expenditure. The manner in which it discharged the obligation should not detract from the fact that the expense was incurred.

The court indicated that the view in *ITC 1783* was wrong and that income tax matters should not obscure any ordinary commercial transactions. Jooste, AJ said that the court, in *ITC 1783*, was not referred to and therefore did not consider any of the English authorities that was referred to in *ITC 1801*, nor to the decision made in the Lacey case and could therefore not benefit from it. The court assumed that ‘expenditure actually incurred’ means that an unconditional legal obligation should have been incurred by the taxpayer with regards to the amount concerned, and that it was not necessary for the obligation to have been settled or discharged. The court believed that where an unconditional legal obligation had been incurred by a taxpayer, the expenditure would become deductible, should it further comply with all the other requirements for deductibility stipulated in the Act.

In his judgement, Jooste, AJ referred to the following English cases that dealt with incurred expenses where shares were issued for the acquisition of assets. In the *Osborne v Steel Barrel Co. Limited*, 1942 (1) (All ER 634 (CA)), the court indicated that when a company credits shares as fully paid up as a consideration for an asset, it gives up the right to call on the allottee to pay the par value in cash. In *Craddock v Zevo Finance Co. Limited*, 1944 (1) (All ER 566 (CA)), the court held that the shares issued by the company as a consideration for the acquisition of assets was a real consideration and that any effort that attacks it, fails on the facts and on the law.

Jooste, AJ also refers to the *Lacey Proprietary Mines Limited v CIR*, 1938 (AD 267), case, in which the court said that the selling company should include in its income the value of the shares issued by the purchasing company. The actual value of the shares was the value the selling company included in its income. Jooste, AJ agreed that, based on this, where a company makes a share-based payment, it represents a genuine consideration provided by the issuing company.

Burt (in De Swardt, 2008: 490) submits that the decision in *ITC 1801* is legally sound, as it agrees with the highest authority in England, as well as with the highest authority in South Africa.

De Swardt (2008:491) submits that the decision in *ITC 1801* “... does not give authority for the argument that expenditure does not necessarily involve a resultant diminution of the

assets of the taxpayer”. De Swardt argues, with reference to the *Osborne* case, that the judgment in ITC 1801 proves that, where a company makes a share-based payment for the procurement of services, it surrenders the right to call on the allottee to pay for the issue price of the shares in cash. This right, according to De Swardt, constitutes an asset, as it presents monies owed to the company and because the expenditure lies in the forfeiture of this right and the ensuing decrease of the company’s assets.

4.4 SARS V LABAT AFRICA LIMITED (2010) 72 SATC

SARS was dissatisfied with the judgment passed in the tax court in ITC 1801, 2006 (68 SATC) and took the matter on appeal to the High Court. The High Court upheld the decision in ITC 1801,2006 (68 SATC) and a full bench confirmed the views then taken.

4.5 SARS V LABAT AFRICA LIMITED (2011) ZASCA 157

SARS successfully appealed the decision in *CSARS v Labat Africa Limited, 2010 (72 SATC 75)* in the Supreme Court of Appeal. The court indicated that the issue before them was the meaning of the term ‘expenditure’.

The court argued that the foreign and local decisions reached by the judges from the lower courts did not assist in interpreting the meaning of the word expenditure. The court rejected the previous decisions that established the meaning of ‘expenditure actually incurred’ on the grounds that they focused on *when* expenditure was incurred and not on *what* expenditure actually means.

According to the court, what needed to have been considered was not whether a liability had arisen, but whether the liability required expenditure.

Harms, AP, who delivered the judgment, indicated that the Act does not define the term ‘expenditure’. He submits that it is a common word used in the English language and, should the context in which it is used indicate otherwise, the ordinary meaning should be attributed to it. According to him, the ordinary meaning implies the act of spending and consuming money. He also referred to the meaning of the Afrikaans word ‘onkoste’ which,

according to him, supports his thoughts above. He explained that ,should one consider the meaning of the word 'expenditure' in the context of the Act, it would include the spending of any assets that has a monetary value. He concluded that the person who expends should experience a decrease or a movement in his/her asset portfolio.

Harms, AP agrees that, had the taxpayer issued the shares for cash to the seller of the trademark, and then used the proceeds to purchase the trademark, expenditure would have arisen from the taxpayers hands.

Ger (Ger: "Problem of paying with shares" Sept 2004.) submits: "... if this interpretation of expenditure is correct, the application of it in this case can be criticised." Ger reasons that, according to Harms' interpretation of expenditure, when goods or services are purchased on credit in year one, but payment only incurs in year two, no movement of assets occurred in year one. Thus, no deduction would be allowed in that year.

This means deduction claimed for non-cash expenditure would be disallowed. Ger further submits that "When a credit sale occurs, there is indeed a diminution of assets in these circumstances as a liability arises in the purchaser's hands to pay the creditor. It is this liability that diminishes the purchaser's assets even though no cash passes between the parties initially. Hence expenditure is incurred and should be successfully claimed as a deduction in year one." He argues that, in the case under consideration, the assets of the taxpayer diminished when the trademark was acquired, as a liability arose in the taxpayer's hands to provide a consideration to the seller. The liability that temporarily arose diminished the taxpayer's assets and, according to Harms' understanding, expenditure appeared to have been incurred.

4.6 SUMMARY

It is evident from the judgments made in the above court cases and from the criticism on these judgements, that conflicting views exist. The discrepancy is whether expenditure is actually incurred where goods or services are procured or liabilities settled by means of share issues.

As can be observed from the excerpts above expenditure is actually incurred where goods or services are procured or liabilities settled by means of share issues. It should be noted that one should not confuse the concept of the incurral of the expenditure with the settlement thereof. Expenditure may be incurred in one year and the liability which arises as a result of the incurred expenditure may only be settled in the next year. Should this expenditure meet all the requirements as per section 11(a) of the Act, the taxpayer should be allowed a deduction in the year in which the expenditure was incurred, not necessarily in the year in which the liability was settled.

Harmse's comments defy simple transacting in the modern era, namely that expenditure would have arisen in the taxpayers hands, had the taxpayer issued shares for cash to the seller of the trademark and applied the proceeds to purchase the trademark. The effects of a transaction where a movement of cash between the seller and the purchaser of the trademark occurred, and where no movement of cash between the two parties occurred, are one and the same.

This decision by South Africa's highest court may be open for further criticism and will, in all likelihood, be challenged in future. As discussed in Chapter 5, the practices applied by international revenue authorities regarding the deductibility of share-based payments differ from the current practices applied by SARS.

CHAPTER 5

OVERVIEW OF THE INTERNATIONAL TREATMENT OF SHARE-BASED PAYMENTS

5.1 INTRODUCTION

In both the United Kingdom and Australia, deductions are available to employers and employees for various qualifying options/shares issued under employee share schemes. Deductions relating to these schemes are not relevant for the purpose of this dissertation. The treatment of share-based payments as a consideration for services rendered, or for the settlement of a debt in the United Kingdom and Australia, is considered below.

5.2 UNITED KINGDOM

In terms of section 2(1) of the Corporations Tax Act, 2009, corporation tax is levied on profits of companies for any financial year for which the Act so provides. According to section 46(1) of the Corporations Tax Act, 2009 trade profits must be calculated in terms of the generally accepted accounting practice, taking into account deductions permitted by law.

In terms of current corporation tax applicable in the United Kingdom, normal business expenses incurred wholly or exclusively for trade purposes may be deducted from profits when computing the taxable income of a business, provided the expenses are not of a capital nature.

Measuring the profits (specific rules and practices) - receipts and deductions: deductions - scope of: summing up (HM Revenue and Customs Business Income Manual 42150, 2012) states that accounts drawn up according to an accepted accounting framework, provide the basis for determining the deductions against profits, subject to statute and case law. According to this manual, the broad test whether an expense is deductible, is whether it is a debit against trade receipts in calculating the profits of a company.

Tax legislation is written in a negative manner, in that it provides instances in which a deduction is prohibited, rather than instances in which a deduction is allowed.

Sections 74(1) and 74(2) of the Income and Corporations Tax Act, 1988, stipulates the prohibited deductions from taxable income. These deductions do not specifically address the situation where shares are issued to settle a liability that arose as a result of incurred expenses.

The requirements for certain expenses to be allowed as a deduction from trading profits are similar to the equivalent legislation in South Africa. Based on the aforementioned, it can safely be argued that, if a company incurs expenditure that is not prohibited and that results in a direct debit against trading profits related to the trading activities of a company, and subsequently settles the liability that arises as a result of the incurred expenditure, a deduction is permissible from the trading profits. Current corporate tax legislation in the United Kingdom does not make specific rules as to the manner in which the liabilities are settled.

Therefore, if a liability that arises as a result of the incurral of expenditure wholly and exclusively for trade purposes, is paid by means of the allotment of shares in the company, a deduction from taxable profits will be allowed.

Stock: trading transactions in: cost of acquisition of stock when there is a non-cash payment (HM Revenue and Customs Business Income Manual 33325, 2012) , prescribes the required tax treatment when stock is acquired in a barter transaction, i.e. when inventory is acquired and fully paid up shares are issued as a consideration for the inventory so purchased.

Inventory acquired by means of a barter transaction can be paid for by applying any of the acquiring company's assets, or by means of issuing a number of fully paid up shares in the acquiring company as a consideration for the inventory acquired.

The manual addresses the following three situations:

- Where inventory is purchased in a commercial transaction, the cost of the inventory equates to the value the transacting parties place on the consideration provided for the inventory.
- Where the company issues its own shares as a consideration for the inventory acquired, the cost of the inventory so acquired must at least be equal to the par value of the shares issued.
- If the transaction is deemed to be fraudulent, the cost of the inventory may be its current market value.

Where a company acquires inventory in a normal barter transaction and issues its own fully paid up shares as a consideration for the inventory so acquired, the minimum consideration paid for that inventory for income tax purposes, will equate to the par value of the shares issued by the company, or more, if the shares issued were issued at a premium.

Lord Greene, MR, in delivering his judgment in the *Osborne v Steel Barrel Co. Ltd*, 1942 (24 TC 293) case, stated that a company cannot issue its own shares at a markdown. Thus, where a company issues its own, fully paid up shares for a consideration other than money in cash, the consideration moving from the company that issued its shares must, at minimum, equate in value to the par value of the shares issued.

It should be noted that in the two leading cases dealing with the issue of shares for a consideration, *Osborne v Steel Barrel Co. Ltd* and *Craddock v Zevo Finance Co. Ltd*, 1946 (27 TC 267), the courts did not consider the expenditure actually incurred by the acquiring company, but focussed on what had passed from the acquiring company. This confirms the principle that the value of shares issued are acceptable as a consideration made for the acquisition of goods or services.

Consultation with various representatives of the Corporation Tax and Business Income Tax facet of Her Majesty's Revenue and Customs (HMRC) were undertaken to clarify whether the UK tax legislation is prescriptive on the tax treatment of share-based payments, where suppliers/employees are compensated for services delivered or for the settlement of debt owing to suppliers. Haria (2012) indicates that it was not be possible to

provide an opinion, as the technical analysis was very fact-dependent and that HMRC was not aware of the full circumstance surrounding these payments. Thus, HMRC could not determine whether a deduction would be allowed or not.

5.3 AUSTRALIA

For a company to deduct from its assessable income any amounts incurred in the gaining or generating of assessable income, it should comply with the requirements of section 8-1 of the Income Tax Assessment Act of 1997. This section addresses the general deduction allowable to taxpayers. It states that a company can deduct from its assessable income, any **loss** or **outgoing**:

- if the loss or outgoing is incurred in gaining or generating the company's assessable income, or
- if the loss or outgoing is essentially incurred in the carrying on of a business for the purpose of generating or producing a company's assessable income.

This section further prohibits deductions of losses or outgoings where:

- the loss or outgoing is of a capital nature;
- the loss or outgoing is of a private or domestic nature;
- the loss or outgoing is incurred in producing exempt income; and
- a provision of the Income Tax Assessment Act of 1997 prevents the deduction of the loss or the outgoing.

Losses or outgoings allowed as deductions under this section are regarded as general deductions.

If we assume that none of the prohibitions of section 8-1 of the Income Tax Assessment Act of 1997 is applicable, and that a company acquires goods/services to gain or produce its assessable income and subsequently settles the obligation so incurred by issuing of its own shares, we need to assess whether a **loss** or **outgoing** was incurred for the company to deduct from its assessable income the value of the goods/services acquired.

The Income Tax Assessment Act of 1997 does not define the terms of a loss or an outgoing. Consequently, case law and public rulings expressed by the Commissioner need to be consulted to determine whether shares issued by a company to settle an obligation will result in a loss or outgoing for the company.

In *Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd*, 1940 23 STC 235, where the company issued its own shares to its employees at a discount, the view of the majority bench was that when a company issues its shares, the process whereby the shares are issued do not constitute a trading transaction. Viscount Maugham, who summarised the view expressed by the majority of the bench, indicated that the company becomes larger when shares are issued. However, the receipts generated from trading activities and the expenditure incurred to generate these receipts, remain unchanged, and it is the difference between these receipts and expenditure that is taxable.

Viscount Maugham argues that the allotment and issue of shares by a company – at par value or not –does not have an effect on the profits of the company for income tax purposes. He continues that, after the issue of shares the capital was unchanged and no monies were expended. He also maintains that issuing shares at a discount does not equate to the company giving away moneys worth to its own financial detriment.

In *Pilmer v Duke Group Ltd (in liq)*, 2001 (207 CLR), {2001} HCA 31 (Kia Ora), the High Court believed no loss is incurred by the company when the company issues its shares for a consideration which is inadequate. The court concluded that the only outlay a company incurs in issuing its own shares is the clerical costs that accompany the share issue. Based on this, it seems the issue of shares issued by a company do not constitute a loss or outgoing for the company.

According to Bortz (2007:21), the Australian tax authority will not permit a deduction for expenses settled by issuing shares arising from the introduction of IFRS 2. In support of his view, he states that according to the Australian Treasury, no income tax deduction is permitted for these types of share-based payments, as a deduction is only permissible when a company has incurred an economic loss or outgoing. The view of the Australian Government then was that the present practice of not allowing a tax deduction should

remain intact and that no new income tax deduction for the issuing of options should be allowed.

To ensure clarity, the Commissioner issued Tax Ruling 2008/5 on Income Tax. It stipulates, in particular, if and in which circumstances there may be a loss or outgoing in purchasing assets or services for the purpose of section 8-1 of ITAA 1997, and what the amount of that loss or outgoing so incurred, should be.

The Commissioner issues public rulings to express his opinion about the manner in which tax provisions apply. These rulings apply to entities in general or apply to a particular scheme of transactions. Tax Ruling 2008/5 on Income Tax does not address the tax implication for tax payers receiving shares as consideration for assets sold or services rendered.

According to this ruling, a company does not incur a loss or an outgoing when the company issues its own shares as a settlement for assets or services acquired. As no loss or outgoing is incurred by the company, no deduction is permitted in terms of section 8-1 of the ITAA 1997, regardless of the nature of the assets, services or the intention for which it will be used. The shares issued to acquire the assets or services do not constitute expenses of the company. This rule applies to all cases where the income tax treatment is based on what would otherwise be deductions under section 8-1 of the Income Tax Assessment Act 1997.

The Commissioner is of the view that a company will be in a similar position after the company issued its own shares for a consideration which has no monetary value, i.e. for assets or services it would like to acquire, as when the shares are issued and paid for in cash. No loss, outgoing or expenditure is incurred by the issue of shares. In the Commissioner's view, the consideration the company receives for issuing its shares and the intention for which the company applies the consideration are irrelevant.

However, in this ruling the Commissioner makes provision for an instance where a company incurs a loss, outgoing or expenditure that is not a commitment to issue its own shares, for assets or services acquired. The Commissioner permits the **set-off** of the

liability incurred by the company to pay for the assets or services acquired from a supplier, against the commitment of the supplier of the assets or services to subscribe for shares in the company to which it had delivered the assets or rendered the services.

The Commissioner maintains the loss or outgoing incurred by the company in the acquisition of assets or services is not affected by the set-off against the loss or outgoing incurred by the supplier of the assets or services for the issue of shares. Thus, in the Commissioner's view, the set-off does not affect the deductions to which a company would otherwise be entitled under section 8-1 of the Income Tax Assessment Act 1997. The deductibility of the loss, outgoing or expenditure depends purely on its original character and the manner in which it is paid for or discharged should not affect its deductibility.

It is important to note that a price should be established for the assets or services acquired, as a company would not be seen to have incurred a loss or outgoing if no price or value is attributed to the assets or services other than the value of the stipulated shares.

The key requirement for loss, outgoing or expenditure settled by means of set-off, to be deductible under section 8-1 of the Income Tax Assessment Act 1997, is that the contract or arrangement entered into by the company and supplier of the assets or services should give rise to two existing cross obligations. It is evident from the Commissioner's views expressed in this public ruling, that a contract or agreement that gives rise to two different obligations should be concluded before the parties deliver in terms of the contract.

It is a requirement of the Australian courts that, before obligations can be recognised and paid by means of an agreed set-off, they should be payable immediately, i.e. as and when they arise.

This requirement is supported by Dixon who delivered the judgement in the case of *Federal Commissioner of Taxation v Steeves Agnew & Co. (Vict) Pty Ltd*, 1951 (82 CLR 408). He stated on pages 420 and 421 that, if cross-liabilities exist that are of equal amounts and are payable immediately and then set-off by mutual agreement, this set-off will generally be regarded as a payment in terms of most statutory and common-law principles. He emphasises that for the principles of set-off to be accepted, there must be

identifiable cross-liabilities, a formal agreement between the parties and the value of the cross-liabilities should be approximately equal. Where the values of the liabilities are not more or less equal, payment of the excess should be made in a different way.

It can be safely argued that it should be the **intention** of the company to settle the loss, outgoing or expenditure incurred in the acquisition of the assets or services, by the issuing of its own shares. It should also be the **intention** of the supplier of the assets or services to subscribe for shares in the company to whom it delivers the assets or services, and to settle this obligation by actually delivering assets or services.

The doctrine of payment by set-off has been applied since the statements by James, LJ on page 412 to 413 of the case between *Re Harmony and Montague Tin and Copper Mining Co. Ltd (Spargo)*, 1873 LR 8 Ch (App 407). James, LJ states that where a company is indebted to its shareholders to immediately pay them an amount of money, and the same shareholders are indebted to the company to immediately pay them an equal amount of money, and both parties agree that each debt will be accepted as settlement of the other, the company and the shareholders could respectively argue payment in cash, should an action be brought against any of the parties by the other. He further states that, should the transaction above be regarded a genuine business transaction, it would, in any court, be adequate proof in support of a claim of payment in cash

According to Baker (2012), the Australian Tax Office treats bartering transactions (exchanging goods/services for goods/services rather than for money) in the same way as a monetary transaction. She is of the view that Company A in the following example is entitled to a deduction from its assessable income.

Example: *Company A acquires goods (goods to use in the production of income if the requirements of section 8-1 of the Income Tax Assessment Act 1997 are met) from Company B to the value of \$100.*

Should Company A pay in cash for the goods, they would receive a \$100 tax deduction.

Company A settles the obligation so incurred by issuing shares in itself to Company B to the value of \$100.

5.4 SUMMARY

It seems the current tax legislation applicable in the United Kingdom, as in its equivalent counterpart in South Africa, is not prescriptive on the deductibility of certain share-based payments, i.e. where shares are issued to settle a liability, or where shares are issued to compensate employees for services rendered.

In the absence of prescriptive legislation, one needs to revert to case law to decide whether these types of payments would result in a deduction from profits for companies. Currently, there is no case law that specifically permits or prohibits these payments as a deduction. Thus, the onus is placed on the taxpayer to demonstrate that an expense was actually incurred in the normal course of business.

Based on the above analysis and views expressed, it seems that, under Australian tax legislation, a company is permitted to declare a deduction for income tax purposes where shares are issued for services procured or for the settlement of a liability.

It is evident that the practices followed by international revenue authorities are not standardised regarding the deductibility of share-based payments where services are procured or liabilities settled.

The practices followed above, existing case law and current South African tax legislation on this topic are concluded on in Chapter 6.

CHAPTER 6

CONCLUSION

6.1 BACKGROUND

The question that motivated this study was whether share-based payments made to compensate suppliers/employees for services rendered or for the settlement of a debt owing to suppliers, constituted 'expenditure actually incurred' as required by the Income Tax Act, and whether judgments made by South African courts are in line with practices followed internationally.

To address this question, a review of local and international tax legislation was performed and judgments made by South African courts were compared to judgements made and practices followed abroad. The international tax legislation reviewed focuses solely on the legislation in the United Kingdom and Australia.

6.2 SOUTH AFRICAN LEGISLATION

Based on the review of local tax legislation applicable to share-based payments, it is evident that the legislation does not specifically address the issue of deductibility of these payments where suppliers/employees are compensated for services rendered or for the settlement of debt owing to suppliers.

To assess whether such payments are deductible, the requirements of Section 11(a) of the Act should be considered, with specific reference to the concepts 'expenditure' and 'actually incurred'. Based on the overview of the two concepts, it is evident that conflicting opinions exist. The question still needs to be debated whether share-based payments made to compensate suppliers/employees for services rendered or for the settlement of debt, warrant a deduction for income tax purposes.

6.3 INTERNATIONAL LEGISLATION

From the review of the relevant tax legislation in the United Kingdom and Australia, it appears that the legislation in South Africa is similar to that of the United Kingdom, as the legislation in both countries is not prescriptive. The Australian tax legislation is similar to the judgement made in South Africa's Supreme Court of Appeal, which stipulates that share-based payments for services do not warrant a deduction, as no outgoing/expenditure is incurred.

6.4 IN CONCLUSION

The analysis of judgements made by South African courts also indicates there is no generally accepted conclusion on whether a deduction should be allowed for share-based payments made to compensate suppliers/employees for services rendered or for the settlement of debt owing to a supplier. A point to note is that, in the judgment by South Africa's Supreme Court of Appeal, judgments made by international courts, particularly those made in the United Kingdom, were not considered. .

Based on the judgment made by South Africa's highest court, and the interpretation of current tax legislation by SARS, it is clear that, currently, companies are entitled to claim a tax deduction where shares are issued to compensate suppliers/employees for services rendered or for the settlement of debt owing to a supplier.

It would be in the best interest of taxpayers and the Revenue Authority to include a section in the Act that specifically addresses the deductibility of share-based payments where shares are issued to compensate suppliers/employees for services rendered, or for the settlement of debt owing to a supplier. Until specific legislation is enacted to address this issue, the debate whether these payments are deductible, will continue.

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