THE ISSUE OF SHARES IS NOT 'EXPENDITURE' FOR THE PURPOSES OF THE INCOME TAX ACT: *COMMISSIONER, SOUTH AFRICAN REVENUE SERVICE v LABAT AFRICA LTD*

THABO LEGWAILA
Extraordinary Lecturer, Faculty of Law, University of Pretoria

INTRODUCTION

Section 11 of the Income Tax Act 58 of 1962 ('the Act') provides for deductions in the determination of a taxpayer's taxable income. Section 11*(g*A*)*, as it read during the 2000 tax year, provided for the amortisation of the cost of the acquisition of intellectual property rights at the rate of four per cent per annum. The salient provisions of the section provided (at the relevant period) that 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 an allowance in respect of any expenditure actually incurred by the taxpayer in acquiring by assignment from any other person any trade mark, if such trade mark is used by the taxpayer in the production of his income, or income is derived by him therefrom.

It should be mentioned at the outset that while the Act has undergone many and varied amendment since the 2000 tax year, the salient provisions of the Act remain unchanged in the 2013 tax year. In 2011 the Supreme Court of Appeal was called upon in the case of *Commissioner, South African Revenue Service v Labat Africa Ltd* 2013 (2) SA 33 (SCA) (hereinafter referred to as '*Labat*') to decide whether or not the issuing of shares by a company constitutes 'expenditure' for purposes of s 11 of the Act. In this analysis the Supreme Court of Appeal for the first time defines what the word 'expenditure' means for tax purposes.

Although in 2004 s 24B was introduced by the Revenue Laws Amendment Act 32 of 2004 specifically to deem a company that acquires an asset in consideration for shares issued to have incurred expenditure, the *Labat* case nevertheless remains important to the general interpretation of the term 'expenditure' in the Act. This note analyses the Supreme Court of Appeal's decision in the *Labat* case, explores the meaning of expenditure, and highlights the significance of the distinction between 'expenditure' and the incurral thereof. Furthermore, this note illustrates the impact of s 24B on the incurral of expenditure and the extent to which s 24B partially addresses the issue raised by the decision in the *Labat* case.

FACTUAL BACKGROUND

The taxpayer, Labat, under its former name of Acrem Holdings Ltd, purchased the entire business operations of Labat-Anderson (South Africa) (Pty) Ltd in terms of a contract concluded on 15 February 1999. The effective date of the contract was 1 June 1999. The business operations of Labat-Anderson were defined to include all its tangible and intangible assets including, more

particularly, Labat-Anderson's trade mark. In terms of the 'sale clause' of the agreement, the taxpayer purchased the business for a consideration of R120 million, discharged by the issue to Labat-Anderson of 133 333 333 Acrem shares at an issue price of 90 cents per share. The sale clause further provided that the purchase price was to be apportioned as to the net tangible assets at the values reflected in the accounts, then to the value of the trade mark and name in an amount as determined by an independent and suitably qualified valuator, and the balance was to be apportioned to goodwill.

In order to create the additional Acrem shares to be allocated to Labat-Anderson, it was necessary to increase and subdivide the authorised share capital of the taxpayer. The terms of the agreement were approved and the necessary special resolutions were taken to give effect to the transaction. The shares were issued and transferred in terms of the agreement. Their value, at the time of transfer, was in excess of the issue price. The trade mark was valued at R44 million and the allowance claimed was based on this valuation. The correctness of the valuation was not in dispute.

The taxpayer sought to claim a deductible allowance in terms of s 11*(g*A*)*(iii) for the expenditure incurred in acquiring by assignment the Labat-Anderson trade mark during the tax year.

THE JUDGMENTS

The appellant, the Commissioner for the South African Revenue Service ('the Commissioner'), disallowed the deduction. The taxpayer appealed to the Income Tax Special Court in Pretoria ('the Special Court'), which upheld the taxpayer's appeal, finding that the issuing of the shares with a value equal to the value of the trade mark meant that the taxpayer did actually incur expenditure in obtaining assignment of the trade mark (*ITC 1801* (68) SATC 57). The Commissioner appealed to the North Gauteng High Court. The full court of the North Gauteng High Court (*C: SARS v Labat Africa Ltd* 72 SATC 75) ruled in favour of the taxpayer by holding that the issue of shares constituted deductible expenditure actually incurred as long as the taxpayer has incurred an 'unconditional legal obligation'. The High Court affirmed the principle that once a taxpayer incurs a liability to pay, expenditure will have been 'incurred', and that it does not matter that the obligation to pay is subsequently settled by an issue of shares. The Commissioner then appealed to the Supreme Court of Appeal ('SCA').

The SCA focused on whether the issue of shares amounted to 'expenditure', as opposed to whether expenditure was incurred or not, or when it was incurred. The SCA, per Harms AP (with Lewis, Heher and Maya JJA and Plasket AJA concurring) elaborated on the meaning of expenditure and held as follows (para 12):

> 'The term "expenditure" is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term "onkoste", endorses this reading. In the

> context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.'

As to whether the taxpayer spent any money or assets in acquiring the trade mark the court stated as follows (para 14):

> 'Labat-Anderson assigned the trade mark as consideration for the shares and the taxpayer did not "expend" any money or assets in acquiring the trade mark. 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).'

CRITIQUE

Defining expenditure

The judge strove to find precedent on the definition of expenditure. The available South African case law dealing with the issue of the deductibility of expenditure addresses the question whether the expenditure was actually incurred, as opposed to whether what was incurred was indeed expenditure (see *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241; *Concentra (Pty) Ltd v CIR* 1942 CPD 509; *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A); *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A); *Edgars Stores Ltd v CIR* 1988 (3) SA 876; *CIR v Golden Dumps (Pty) Ltd* 1993 (4) SA 110 (A); *ITC 1444* 51 SATC 35). Some cases address whether the expenditure was incurred in the production of income (see inter alia *Port Elizabeth Electric Tramway*; *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A); *CIR v Nemojim* 1983 (4) SA 935 (A); *KBI v Van der Walt* 1986 (4) SA 303 (T)) and whether the expenditure is of a capital nature or not (see inter alia *CIR v George Forest Timber Co Ltd* 1924 AD 516; *New Estate Areas Ltd v CIR* 1946 AD 610; *Palabora Mining Co Ltd v SIR* 1973 (3) SA 819 (A)). Other cases distinguish losses from expenditure in the interpretation of the phrase 'expenditure or losses'.

As a point of departure in defining expenditure, it is important that one understands what constitutes 'expenditure' and what constitutes 'losses'. In *Joffe and Co (Pty) Ltd v CIR* 1946 AD 157 the taxpayer, a construction company, incurred liability for damages and legal costs as a result of the death of a plumber. The taxpayer argued that of the damages were not deductible as

expenditure; they were deductible as a loss. The court stated (at 166, emphasis supplied) that

> '[i]n relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an *involuntary deprivation*, whereas expenditure usually means a *voluntary payment* of money. When trading operations cause damage to third parties and this damage has to be made good, then the payment which is made of such damage (and possibly even the pre-existing liability to make such payment) may properly be called a loss, but when the *payment* has been made then it can also be properly called an expenditure.'

When the North Gauteng High Court in *Labat* ruled in favour of the taxpayer it held that the issue of shares constituted deductible expenditure actually incurred as long as the taxpayer has incurred an 'unconditional legal obligation'. In in its reasoning, the court erroneously focused on the 'incurral' of the expenditure and not whether what was incurred was expenditure.

The contrast between involuntary deprivation and voluntary payment, as well as a reference to the fact that when payment has been made then a loss can be called expenditure, suggests that the mere payment of the amount is expenditure, without any reference to the source of the amount paid. Thus payment, being a settlement of an obligation, is a determinant of whether there is expenditure. It is submitted that this distinction is merely pedantic as the loss would thus be incurred and hence be deductible at the time of incurral. The Act does not provide for a deduction of an expenditure or loss upon settlement thereof.

In *COT v Rendle* 1965 (1) SA 59 (SRAD), 26 SATC 326 the court outlined the difference between expenditure and loss as follows (26 SATC at 329):

> 'For the purposes of this case, expenditure incurred for the purpose of trade may be grouped broadly under two heads. First, money voluntarily and designedly spent by the taxpayer for the purpose of his trade; and second, money which is what I might call involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer. For the sake of convenience, I will refer to the first type of expenditure as "designed expenditure", and to the second as "fortuitous expenditure".'

Harms AP defined expenditure in *Labat* as follows (para 12, emphasis supplied): 'Its ordinary meaning refers to the action of spending funds; *disbursement* or consumption; and hence the amount of money spent.' In the English case of *Allen v Farquharson Brothers & Co* [1932] 17 TC 59 Finlay J, distinguishing between a disbursement and a loss, described a disbursement (at 64) as 'something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; *it is something which comes out of his pocket*' (emphasis supplied). Using Finlay J's analogy, the decision in *Labat* implies that when a company issues shares, nothing comes out of the company or its assets, or at least that if something does come out, then it does not come out of the company's pockets but those of its shareholders.

Incurral of an obligation differs from incurral of expenditure

The result of *Labat* is that a company can discharge an obligation (not expenditure) without spending money but by giving money's worth to the other party to the transaction (see also Lynette Olivier 'Law of taxation' 2004 *Annual Survey of South African Law* 764 at 787). This may seem to be an anomaly and an inconsistency both economically and from a tax point of view, since it is the shareholders (and not the company) that expends money or money's worth when the company discharges its obligations by diminishing the shareholder's assets in the company. The position is different from the incurral of expenditure, whereby a company incurs expenditure or loss in its trading operations that diminishes the value of the company. In the latter case the company is allowed a deduction of that expenditure or loss, and the shareholders are allowed capital losses upon the disposal of shares to the extent that their shares would have lost value pursuant to the expenditure or loss. When a company issues shares, according to *Labat*, it is the shareholders who incur expenditure; the pre-existing shares diminish in value and the person to whom the shares are issued receives a consideration of money's worth. This illustrates that the company does not incur expenditure, even if it might discharge an obligation, when the value of its shares diminish due to the issue of shares.

Commenting on *ITC 1783* and *ITC 1801*, Kevin Burt 'Issuing shares as consideration II' 2006 *Tax Planning* 47 at 48 states that

> 'Goldblatt J construed the expression "expenditure . . . actually incurred" too narrowly. There would appear to be nothing to suggest that the expression envisages anything more than the *incurral of a legal obligation* in terms of which some form of performance is due, provided that the performance due has a monetary value. The *incurral of a legal obligation* cannot, as a matter of fact, be affected by the means by which that obligation is discharged' (emphasis supplied).

Burt is correct in the interpretation of the words he uses. However, the Act makes no reference to the 'incurral of a legal obligation', but refers to the 'incurral of expenditure'. Incurral of a *legal obligation* is distinguishable from incurral of *expenditure*. If what is incurred by the taxpayer is a legal obligation, then it is true that the mode of performance would not matter. The question in *Labat*, and indeed in *ITC 1801*, was not whether a legal obligation was incurred, but whether what was incurred could be properly defined as 'expenditure'. Put differently: is what the taxpayer incurred an obligation 'to expend money or money's worth'? The nature of the obligation in this case is expressed by the mode of discharging that obligation by expenditure.

Tax symmetry

Counsel for Labat also raised the issue of tax symmetry to support the argument that the amount should be deductible in the hands of the company issuing shares. The argument was that, as the receipt of shares would constitute 'consideration' for the sale of an asset for purposes of determining

the seller's tax liability (i e taxable as gross income) it would be incongruous to not also regard those shares as being 'consideration' in the hands of the purchaser for the same purpose (i e deductible from income) (para 17). The SCA dismissed this argument, holding that 'tax laws notoriously contain many anomalies and inconsistencies' and refused to depart from the plain wording of the legislation merely to achieve the symmetry. The court stated that '[t]he taxable income is not the difference between gross income and expenditure; and gross income is not limited to the converse of expenditures' (ibid). This basically implies that the fact that an amount is taxable in the hands of one person does not on its own make that amount deductible in the hands of another (or even that the amount should be deductible at all). An amount is deductible if it satisfies the requirements for deductibility in terms of the Act. While this position could be considered unfair to taxpayers, the contra fiscum rule is not applicable to 'anomalies and inconsistencies' — it applies in cases of legislative ambiguity (see *Estate Reynolds & Others v CIR* 1937 AD 57 at 70; *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 727; *Hullet & Sons Ltd v Resident Magistrate, Lower Tugela* 1912 AD 760 at 764).

In contrast to the rejection of the tax symmetry argument in *Labat*, the court in *Lace Proprietary Mines Ltd v CIR* 1938 AD 267 held that when shares are issued to a vendor in discharge of the purchase price for an asset, the shares should be included in the gross income of the vendor (see also Burt op cit at 48). The court in *ITC 1801* took this to mean that if the amount constitutes gross income for the person receiving the shares, it must then constitute the consideration or expenditure for the person issuing shares. In this case, it is unclear whether tax synergy was intended to be achieved or it was a coincidence of the correct application of the law.

The impact of expenditure on assets

The court in *Labat* referred to the decision of Goldblatt J in *ITC 1783* (66) SATC 373. The facts in *ITC 1783* are similar to *Labat*, save for the fact that in *ITC 1783* the taxpayer acquired rights in terms of a licence agreement. In *ITC 1783* the judge commented that 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 expenditure. Harms AP went on to say that it would have been more correct if Goldblatt J had said that the issue of shares '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' (para 14).

The court in *Labat* expressed the view that the allotment of shares does not diminish a company's assets (see the similar logic in *Caltex Oil* (supra); C Divaris 'The Caltex case' (1975) 14 *Income Tax Reporter* 1 at 11). Equally, a payment of an amount to acquire goods and services does not result in the diminution of a company's assets, as the counter-performance restores the value of the assets. A transaction that reduces the assets of a company could

more appropriately be described as a loss rather than expenditure. It is submitted that, where the diminution of assets occurs, expenditure is a payment that is followed by a counter-performance that, but for the counter-performance, would diminish a company's assets.

It is important to determine who actually incurs expenditure, as an expenditure incurred by shareholders of a company cannot be attributable to the company itself, and vice versa. Furthermore, the identity of the person incurring expenditure can be varied by the transaction to which the expenditure relates. An allotment of shares reduces the company's existing shareholders' value in the company by subdividing the value and distributing it to the new shareholders. A dividend declaration would reduce the assets of a company in favour of the shareholders. The assets of the shareholders are not diminished, though, as there is a mere shift of the asset of the company to the shareholders. Therefore, such a shift of the assets does not necessarily result in expenditure in the hands of the shareholders.

It is submitted that a loss, in addition to its involuntary nature, should not be followed by any counter-performance. For example, if a company is legally bound to pay an amount that was contracted for by an employee, that company would be in the same position in relation to the actual performance as a company that is legally obliged to compensate an injured employee (see the *PE Tramway* case (supra)) or third party (the *Joffe* case (supra)). However, the company would not suffer a loss if the other party performs by delivering goods or services in terms of the contract. Hence, in addition to the involuntary attribute of a loss, the loss should be accompanied by no counter-performance.

Consideration v expenditure

Consideration and expenditure are not synonyms. Consideration can be anything given in return for goods or services, and this may not entail any expenditure (see *Collins Concise Dictionary* (3 ed) s v 'consideration'; see also IBFD *International Tax Glossary* (5 ed) s v 'consideration'). For that reason, the SCA in *Labat* correctly distinguished three cases in which the term 'consideration' was at issue, analysed and defined. These cases are all English cases: *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA); *Cradock v Zevo Financing Co Ltd* [1944] 1 All ER 566 (CA); and *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd* [1982] 2 All ER 942 (HL).

Barry Ger 'The problem of paying with shares resurfaces' (2012) January/February *De Rebus* 48 at 49 criticises the decision by Harms AP, stating that '[o]n acquisition of the trade mark, a liability arose in [the company's] hands to provide consideration to the seller of the trade mark'. There is no doubt that a liability arose or whether a consideration was given in return for the asset. The issue is that in discharging that liability by providing a consideration, the company did not expend anything — thus, there was no expenditure.

The method of discharging expenditure

Labat could be interpreted to imply that in a contract where the parties do not specify the mode of payment, expenditure cannot be incurred, as the

method of settling the liability may not qualify as expenditure. This might contradict the logic that the incurral of the expenditure without payment triggers the deductibility of the expenditure. Put differently, it might negate the deductibility of expenditure on the incurral thereof. At the very least it could also lead to anomalous results. For example, if a taxpayer incurs a liability in Year 1 and discharges that liability in a subsequent year, the expenditure is deductible in Year 1, the year in which the liability is incurred. If the parties subsequently decide that the liability will be discharged by the issue of shares, the deduction in the previous year will need to be reversed or otherwise corrected, for example by a recoupment when the company writes back the debt, because the company would have recovered the amounts that have previously been deducted (see s 8(4)*(a)* of the Act; see also *Omnia Fertilizer Ltd v C:SARS* 65 SATC 159). It is submitted that the two core requirements for deductibility — (i) expenditure; and (ii) the incurral thereof — should be separated and satisfied for the deduction to be allowable. If at the contract date there is incurral of an amount that qualifies as expenditure, then the deduction is allowable. If, on the other hand, the terms of the contract contain a consideration that does not constitute expenditure a deduction should not be allowed regardless of the incurral of the legal liability.

Aubrey S Silke *Silke on South African Income Tax* (2010) Service 42 para 7.4 says the following:

> '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 the 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 the obligation is subsequently discharged by the issue of shares. But when a company is obliged to allot shares in return for services rendered to it, there is no laying out or expending of any moneys or assets which, it is submitted, is an essential requisite of the words 'expenditure actually incurred' in s 11*(a)*. A similar problem arises when a company allots shares in return for trading stock.'

Silke is correct in stating that since the company has neither lost nor parted with any asset, it has not expended anything, and so it is not entitled to claim as a deduction from the income the nominal value of the shares issued to the employee. It is, however, submitted that by agreeing to compensate an employee by cash (and then subsequently issuing shares to the employee) this cannot change the company's position from not laying out or expending any moneys or assets to laying out such money or assets, merely because in the original arrangement the compensation qualified as expenditure. The change

in the form of compensation from cash to shares cannot have the effect of making the issue of shares expenditure. If Silke's position regarding the issue of shares in return for services rendered in lieu of remuneration is not accepted, s 8(4) of the Act may be applied to include a recoupment in the hands of the company where the deduction was claimed in a previous year of assessment. The recoupment provision in s 8(4) applies because the company would have recovered the amount previously deducted.

S P van Zyl ('The meaning of "expenditure" for purposes of section 11*(a)* and *(g*A*)* of the Income Tax Act 58 of 1962' (2012) 33 *Obiter* 186) argues that the reasoning by the court in *Labat* that the liability must be discharged by means of expenditure confuses expenditure with the discharge of an obligation or actual payment of the obligation. He further presents his view that 'while distinguishing between "expenditure" and "incurred" the court confused the meaning of expenditure to mean actual payment' (ibid at 188). In reaching his conclusion, Van Zyl assumes that the court implied that the expenditure should be discharged in the same year of assessment that it is incurred, or that the expenditure should be discharged before it is deducted. This, with respect, is not the correct representation of the court's decision. The basis of the court's assertion that the liability must be discharged by expenditure means that the taxpayer must, at the time of incurral, undertake to discharge that obligation by means of expenditure. This could be extended to say that when the liability is finally discharged, it should be discharged by means of expenditure; otherwise the amount previously deducted should be recouped. This is compatible with the meaning of 'incurred' as used in s 11*(a)* and *(g*A*)*.

Van Zyl further submits that 'Harms AP's additional requirement for "expenditure" — that assets should have changed hands — should, with respect, not be followed' (Van Zyl op cit at 190). Van Zyl correctly states that '[t]o include an additional requirement to "expenditure" — that assets mush have changed hands to satisfy the debt and so be regarded as expended — will have far reaching consequences for taxpayers who exchange services as full and final settlement of an obligation or liability' (ibid). As far as Van Zyl's view is concerned, it is submitted that while a transfer of assets is not a trigger for a debt to be satisfied, a transfer of value is required for a debt to be satisfied. Without such transfer of value, expenditure cannot exist.

A review of the decision

It is submitted that the decision in *Labat* is a correct one, based on the strict reading of the provisions of the Act. This conclusion finds support in foreign case law dealing with the nature of shares when issued. Foreign case law is relevant due to the fact that the *Labat* case is the first case in which the SCA considered the meaning of 'expenditure' separately from the question whether it has been incurred or not. In *St Helens Farm (ACT) Pty Ltd & others* 1981 ALR 23 the court held that until the allotment and issue of a share, there is no property in the unissued shares or right in or of the company in the unissued shares in its capital. Barwick CJ said (at 26) that

> 'of that capital, its nominal capital. But that capital is not the property of the company. Indeed, when allotted and issued the nominal amount of the issued share or shares constitutes in accounting terms a liability of the company. But it is not property which comes to the allotee from, or by transfer from, the company. It is property which comes into existence by the allotment and issue, or more precisely, which is the consequence of such allotment and issue.'

In *Ord Forest v FCT* (1973–1974) 2 ALR 403 Gibbs J stated (at 411) that '[m]oreover, the share does not pass from the company; before allotment the share does not exist as a piece of property; it is only when it is allotted and issued that the rights which it confers are created' (See also Kevin Burt 'Issuing shares as consideration: Expenditure actually incurred?' 2004 *Tax Planning* 133 at 134). Thus, a company cannot 'expend' without taking any asset 'out of its pocket'.

SARS'S DRAFT INTERPRETATION NOTE

Following the judgment in *ITC 1783*, the SARS issued Draft Interpretation Note 'Deductions: Expenditure actually incurred: Assets or services acquired in exchange for shares' dated 16 March 2004. Draft Interpretation Notes do not have any legal force. However, having said that, the abovementioned Draft Interpretation Note indicated the SARS position (at the time) on the incurral of expenditure where a company issues its own shares — a view that the SARS may still take on share issues under circumstances where s 24B of the Act (see below) does not apply. The Draft Interpretation Note re-emphasised the position adopted in *ITC 1783*: that where a company issues its own shares in exchange for an asset, the company will not have incurred any expenditure in respect of the acquisition of the asset, since it has not lost or expended anything. The Draft Interpretation Note has since been withdrawn, though, and is no longer available on the SARS website.

LEGISLATIVE INTERVENTION: SECTION 24B

The effect of the decision in *ITC 1783* was that when a company issues shares for no consideration in return for a capital asset, the company will not have incurred any expenditure. This results in the company having a zero base cost in the capital asset acquired, whilst the person transferring the asset would be subject to tax on the transfer of the asset. The zero base cost also implies that the company acquiring the asset will be taxed on the full consideration received on the subsequent disposal of the asset. The taxation of the base cost and the multiple taxation of the same gain is an anomaly in the tax system.

Because of this anomaly, which had been brought about by earlier decisions, the legislature introduced s 24B in 2004. This provision deems that a company that acquires an asset in consideration for shares issued to have incurred an amount of expenditure. In particular, s 24B was inserted to neutralise the decision by the Special Court in *ITC 1783* to the effect that when a company issues its own shares, it does not incur expenditure. Section

24B was introduced by the Revenue Laws Amendment Act 32 of 2004 with retrospective effect to 1 October 2001 (see also South African Revenue Service *Comprehensive Guide to Capital Gains Tax* (December 2011) 260).

Referring to the rule that the issue of shares for free does not amount to cost actually incurred and does creates a base cost of zero (the 'zero principle'), the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 stated that the reasons for the change were as follows:

> 'The zero principle for assets acquired in exchange for shares creates a significant hindrance to company formations and other forms of share financing. This zero principle also stands in contrast to widespread international practice, despite support for the principle found in case law. This zero principle is especially problematic if the party transferring assets to the company issuing shares is taxed on the transfer.'

In terms of s 24B, if a company acquires any asset from any person as consideration for shares issued by that company, that company is deemed to have actually incurred an amount of expenditure in respect of the acquisition of that asset (s 24B(1)*(a)*). The amount of expenditure incurred by the company is deemed to be equal to the lesser of the market value of the asset immediately after the acquisition of the asset, or the market value of the shares immediately after the acquisition (s 24B(1)*(a)*). It is important to note that s 24B applies only to situations where shares are issued in return for the acquisition of assets (see Ger op cit at 49). It is a common commercial practice to issue shares in return for the settlement of a liability, or as remuneration for services, or for the purchase of trading stock. However, s 24B does not apply to the issue of shares in return for services rendered. The issue of shares by a company would therefore not constitute 'expenditure' in terms of s 11*(a)* of the Act where the counter-performance involves services. A limited exception applies in terms of s 11*(lA)* where shares are issued in respect of qualifying equity shares issued pursuant to a so-called 'broad-based employee share plan,' as envisaged in s 8B of the Act.

Although *Labat* dealt the acquisition of an asset, being a trademark in terms of s 11*(gA)* of the Act, the reasoning adopted by the court should be equally applicable to transactions involving issue of shares in return for services rendered as expenditure incurred in terms of s 11*(a)* of the Act. This is because a service is an intangible commodity — an intangible equivalent of economic goods or assets (see P Hill 'Tangibles, intangibles and services: A new taxonomy for the classification of output' (1999) 32 *Canadian Journal of Economics* 426) and the acquisition of such service (where value is exchanged) constitutes expenditure in the hands of the company similar to the acquisition of an asset. This inequality of tax treatment could be resolved by an amendment of s 24B to include instances where services are rendered to a company in return for an issue of shares, or an introduction of a specific section dealing with instances where services are rendered to a company in return for an issue of shares.

The introduction of s 24B highlights the disconnection between the legislative intent and the court's interpretation of the laws. The introduction of s 24B effectively corrects the decision that supports a principle which is a

significant hindrance to company formations and other forms of share financing, and which stands in contrast to widespread international practice. The *Labat* decision did not take into account these considerations and applied a strict interpretation of the Act as it stood in 2000.

As I have stated above, s 24B was introduced in 2004 with retrospective effect to 1 October 2001, and therefore does not have any effect on the *Labat* case, since *Labat* had to be decided on the legal position as it stood in 2000. However, s 24B ensures that from its effective date of commencement, when a company issues shares in return for an asset, that company is deemed to have incurred expenditure. Thus, in effect s 24B overrides the decision in *Labat*: from 2001 *Labat* can no longer be relied on as precedent for the determination of whether a company issuing shares in return for a capital asset has incurred expenditure. However, *Labat* is still applicable for issues of shares in return for the settlement of a liability or the provision of services.

CONCLUSION

Labat governs what must be considered in determining whether there is an expense involved in a transaction. Although the judgment is not as elaborate as could have been expected from a case decided by the Supreme Court of Appeal, it does provide cardinal anchors for the definition of 'expenditure': that the definition does not take cognisance of either loss or whether expenditure was actually incurred. *Labat* provides a precedent for cases where different forms of consideration are given in return for contractual obligations.

The decision in *Labat* is a correct interpretation of the Act. It might result in undesirable consequences for companies and in the proper functioning of the tax system. These consequences could be rectified by legislative intervention, and this occurred with the introduction of s 24B. Section 24B clarified the tax policy attendant upon the issuing of shares as consideration for the acquisition of assets. The legislative amendment does not invalidate the importance of *Labat*, though. As mentioned earlier, s 24B does not apply to situations where shares are issued in return for the settlement of a liability or the provision of services. Legislative intervention may be necessary to cater for situations where shares are issued in return for the settlement of a pre-existing liability or as a form of remuneration for services, or even for the purchase of trading stock. In the absence of such intervention, *Labat* remains the authority for the view that such issue of shares would not constitute expenditure. Following *Labat*, the legal position is thus that the issue of shares does not constitute expenditure unless otherwise specifically deemed to be expenditure by the Act.