THE MEANING OF "EXPENDITURE" FOR PURPOSES OF SECTION 11(A) AND (GA) OF THE INCOME TAX ACT 58 OF 1962

CSARS v Labat Africa Ltd [2011] ZASCA 157

1 Introduction

It is trite that a taxpayer may deduct, from his/her gross income, any expenditure or losses that were actually incurred, in the year of assessment, in relation to the taxpayer's trade and in the production of income, provided that the expenditure is not of a capital nature (s 11(a), commonly known as the general-deduction formula). Section 11(a) does not require that the expenditure must have been incurred in the year of assessment. The courts have, however, interpreted this provision as restricting the deductibility of expenditure to expenses incurred in the year of assessment (see *Concentra (Pty) Ltd v CIR* 12 SATC 95; *Caltex Oil (SA) Limited v SIR* 1975 1 SA 665 (A) 674; *Burgess v CIR* 1993 4 SA 161 (A) 167; *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste* 1986 3 SA 549 (A) 561; and *Anglovaal Mining Ltd v CSARS* 2010 2 SA 299 (SCA) 313).

It often happens that a taxpayer will engage in a transaction where goods are exchanged for services, or services for other services, or goods for rights. Conversely, barter, or agreements akin thereto, are still a common phenomenon in modern-day business. The question often arises whether or not payment in kind satisfies the requirement of "expenditure" actually incurred to determine the deductibility of the "expense" in terms of the general-deduction formula. The term "expenditure" is not defined in the Act. The Supreme Court of Appeal was recently called on in *CSARS v Labat Africa Ltd* to interpret the meaning of "expenditure" and to determine whether or not the allotment and issuing of shares in a company in exchange for intellectual property rights, satisfies the "expenditure" requirement in terms of the general deduction formula (or in terms of s 11(gA)), and if so, what value would be attached to such expenditure. This case discussion will also critically discuss the application of the judgment on modern-day barter transactions or where substitutive performance is made to satisfy an obligation.

2 Facts

On 15 February 1999 Acrem Holdings Ltd purchased the business of Labat Anderson (South Africa) (Pty) Ltd as a going concern. The name "Acrem

Holdings Ltd" was changed to "Labat Africa Ltd" with effect from 11 June 1999. The agreement became unconditional on 1 June 1999. In terms of the agreement the purchase price was agreed upon as R120 million of which R44 462 000 constituted the purchase price for the "Labat" trademark. Labat Africa Ltd obtained the trademark on 1 June 1999 and on 15 June 1999 issued 49 402 222.20 shares at a value of 90c per share to Labat Anderson (South Africa) (Pty) Ltd to *inter alia* fulfil its obligation to pay the purchase price for the trademark. It was clear that on the date of transfer of the trademark and of the shares respectively the value of the shares was in excess of R44 462 000 being the value of the trademark. Labat Africa Ltd, after having acquired the trademark and after having issued the shares in full and final payment of the trademark, claimed an allowance in terms of section 11(gA) of the Income Tax Act. Section 11(gA), as it read during the 1999/2000 year of assessment when the allowance was claimed, provided for –

> "an allowance in respect of any expenditure (other than expenditure which has qualified in whole or part for deduction or allowance under any of the other provisions of this section or the corresponding provisions of any previous Income Tax Act) actually incurred by the taxpayer –
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> (iii) in acquiring by assignment from any other person any such patent, design, trademark or copyright or in acquiring any other property of a similar nature or any knowledge connected to the use of such patent, design, trade mark, copyright or such property or the right to have such knowledge imparted, if such invention, patent, design, trade mark, copyright, other property or knowledge, as the case may be, is used by the taxpayer in the production of income: Provided that –
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> (aa) where such expenditure exceeds R3 000, and was incurred –
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> (A) before 29 October 1999, the allowance shall not exceed for any one year such portion of the amount of the expenditure as is equal to such amount divided by the number of years, which in the opinion of the Commissioner, represents the probable duration of use of the invention, patent, design, trade mark, copyright, other property or knowledge, or four per cent of the said amount, whichever is the greater."

The Commissioner disallowed the claim for the allowance on the grounds that the issuing of a company's own shares does not constitute expenditure as contemplated in section 11(gA). In an appeal against the Commissioner's assessment (to the Income Tax Special Court), Jooste J ruled that the allotment and issuing of shares in full and final payment of the purchase price complied with the requirement in section 11(gA) that an amount was expended. This decision was confirmed on appeal in the High Court by Sapire AJ. The Commissioner then appealed to a full bench at the Supreme Court of Appeal.

3 Held

Harms AP ruled (Lewis, Heher, Maya JJA and Plasket AJA concurring) that the word "expenditure" as contemplated in the Income Tax Act means that the taxpayer's estate must have been impoverished or diminished to some

extent for an expenditure to have been expended. That means that the allotment and issuing of a company's own shares does not impoverish the company as such. Where the purchase price for a thing is settled by virtue of the allotment and issuing of a company's own shares, no amount was expended for income tax purposes, and it would subsequently not qualify for a deduction in terms of section 11(a) or for an allowance in terms of section 11(gA).

4 Discussion

In reaching its decision, the Income Tax Special Court ruled that the expression "expenditure actually incurred" means that the taxpayer must have incurred an unconditional legal obligation in respect of the agreed purchase price. On appeal the court quite rightly pointed out that, although the Income Tax Special Court correctly interpreted the meaning of "actually incurred" as it was laid down in *Edgars Stores Ltd v CIR* (1988 3 SA 876 (A)), it neglected to establish the meaning of the word "expenditure", which was the paramount issue in this case (par [6]-[7]). It is trite that the words "expenditure", "obligation" and "liability" are often incorrectly used as synonyms as Harms AP pointed out (par [8]). Despite the fact that the Income Tax Special Court ruled that the obligation need not be discharged to qualify as being incurred, it was clearly of the view that by extinguishing the obligation in terms of the contract, the taxpayer incurred expenditure (par [8]). On appeal it was held, in applying the judgment in *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* (1975 1 SA 665 (A) 674), that an obligation to pay will qualify as "expenditure" when a liability for the obligation has been incurred (par [8]). Conversely, the liability or obligation must be discharged by means of expenditure (par [8]). This reasoning, in my view, confuses expenditure with the discharge of an obligation or actual payment of the obligation. It is furthermore in clear contradiction to the judgments in *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste* (1986 3 SA 549 (A) 564); *Caltex Oil v SIR* (*supra* 674); and the judgment by Corbett JA in *Edgars Stores Ltd v CIR* (*supra* 888-889), where it was confirmed that an obligation need not be discharged for the "expenditure" to have been incurred. In my view, while distinguishing between "expenditure" and "incurred" the court confused the meaning of expenditure by interpreting it to mean actual payment. This results in the creation of two contradictory interpretations of the general-deduction formula. On the one hand, "actually incurred" means that an unconditional obligation must exist and that actual payment is not relevant for an expense to have been incurred. On the other hand, "expenditure" means the actual discharge (payment) of an obligation. This is an untenable situation. For example, where X incurred an unconditional liability in the 2009 year of assessment but pays the liability in the 2010 year of assessment, the amount is not deductible in 2010, because it was not actually incurred, although expended. The amount will not be deductible in 2009, because it was not expended, although it was actually incurred.

The court further criticised the Income Tax Special Court's application of the United Kingdom judgment in *Osborne v Steel Barrel Co Ltd* ([1942] 1 All ER 634 (CA)), where the court ruled that the issue of shares by the company amounted to consideration paid (par [10]). Harms AP ruled that this does not bear any relation to whether the issuing of shares equals expenditure (par [10]). The Oxford Dictionary (Soanes and Stevenson (eds) *Concise Oxford English Dictionary* 11ed) defines "expenditure" to mean "the action of spending funds" or "the amount of money spent" or "the use of energy or resources". It also defines "consideration" for purposes of law, "anything given or promised by one party in exchange for the promise or undertaking by another". Where expenditure relates to the spending of funds or money, "consideration" has a wider application to include the exchange of anything for something else. Although sections 11(a) and 11(gA) do not specifically require that the expenditure must have been incurred in cash, I doubt that the legislator intended to limit the deduction or allowance to cash or funds. Harms AP confirmed this view (par [12]). With this in mind the interpretation of "consideration" in *Osborne* (*supra*) fits well to determine the meaning of expenditure. The court correctly points out that some sort of diminution is required for expenditure to have been incurred (par [12]). A subsequent impoverishment test would, however, be very awkward and difficult to apply. In some cases, if not all, the taxpayer will, after expending the money or parting with assets, not be poorer as the assets or rights acquired will be worth more than the money paid or assets exchanged (par [12]). That said, the taxpayer might at the moment of parting with his money or assets be poorer, even if temporarily (par [12]). In applying the impoverishment test one should be very careful not to confuse "expenditure" with actual payment or parting with assets. By incurring a debt to obtain goods or services the taxpayer's estate will gain value when the goods or services are delivered but will also lose value when it becomes indebted to pay an amount and hence be impoverished.

The Tax Court did not apply Goldblatt J's application of the impoverishment test as applied on similar facts in *ITC 1783* ((66) SATC 373). Goldblatt J said that the allotment and issuing of shares do not reduce the assets of the company nor does it impoverish the company (par 8.2-8.3). He noted, however, that the value of the shares in the hands of the shareholders might decrease in value as a result of the allotment but that it does not qualify as an impoverishment in the hands of the company and can therefore not qualify as expenditure (par 8.2). Harms AP, although he agreed with the application of the impoverishment test by Goldblatt J, added that it would have been more correct if Goldblatt J said that the allotment and issuing of shares did not involve a shift of assets even though it might reduce the value of the shares in the hands of the shareholders (par [14]). Does the impoverishment test necessarily require that assets must have changed hands? For example: X, a physiotherapist, in exchange for services rendered by Y (an electrician), performs physiotherapy on Y in full and final payment of the obligation. Certainly X did not part with any assets. The fact that he could have charged another paying patient R500 per session surely

impoverished him to some extent. Can it be said that X expended R500? It has already been established that for expenditure to have actually been incurred, the debt need not be extinguished by actual payment. In a contract of sale the purchase price must be certain in money (*Inst* 3 140) and paid as such to be settled (*Inst* 3 141). That said, the seller may, if the price was agreed upon and certain in money, accept something other than money (*datio in solutum debiti*) to satisfy the debt (Joubert "Datio in Solutum" 1977 10 *De Jure* 29-30 and 35-36). If Harms AP's interpretation of "expenditure" is applied in the example above the expense was actually incurred when the electrician rendered the services and expended when the electrician accepted physiotherapy as *datio in solutum debiti.* No movement of assets is therefore required. It should, however, be stressed that section 11(*a*) does not require that the obligation must be extinguished for an expenditure to have been incurred to qualify for a deduction.

The allotment and issuing of shares might not impoverish the company as such but the shareholders (owners) of the company will be impoverished. For example, where X, the only shareholder in XYZ (Pty) Ltd who holds one share, allots and issues another share to Y in exchange for certain rights, X's share in the dividends of the company is effectively halved. Should the company be liquidated X's original claim against the company as single shareholder is now halved. Hence X is impoverished. That said, a company is a separate entity from its shareholders and although X is impoverished in the example, the company (XYZ (Pty) Ltd) as an entity and separate taxpayer is not impoverished. Goldblatt J and Harms AP therefore correctly ruled that the allotment and issuing of shares by a company do not impoverish the company as an entity and it can therefore, strictly speaking, not qualify as expenditure unless specifically provided for in the Act. That said, Harms AP's additional requirement for "expenditure" that assets should have changed hands should, with respect, not be followed. In a contract of sale (whether the price is paid in cash or by means of a *datio in solutum debiti*) the debt is satisfied by the mere transfer of ownership in the money or goods or the transfer of a right to a service or *res incorporales* (so received as payment) and no authority exists that assets must have changed hands for the debt to be satisfied (*Inst* 3 139; Gordon and Robinson *The Institutes of Gaius* (1988) 229-232; Joubert 1977 10 *De Jure* 29-30; Hawthorne "The Nature of Trade-in Agreements 1990 53 *THRHR* 116 121; and Christie *The Law of Contract in South Africa* 5ed (2006) 403). This is also the case in barter agreements. To include an additional requirement to "expenditure" that assets must 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. Taxpayers who incurred expenditure without parting with money or assets, but by parting with the right to charge money, should be entitled to a deduction just as a taxpayer is entitled to a deduction where the same obligation was settled by actual payment. The taxpayer would after all be impoverished because no payment was received where it could have been received and subsequently taxed. The value of the expenditure should be

the value of the original obligation certain in money. Labat contended (and quite rightly so) that serious anomalies would be created if the allotment of shares as payment for goods or services is not regarded as expenditure (par [17]). The value of the shares received by the seller would, subject to it not being of a capital nature, be taxable in his or her hands. The same value of the shares will not be allowed as expenditure in the purchaser's hand if Harms AP's interpretation of expenditure is correct. Harms AP is, however, of the opinion that the allowance for the intellectual property in this case is as a result of a special dispensation and that the anomaly is not as simple as Labat contended (par [17]). This anomaly is more evident in a simple example: Where X performs physiotherapy to the value of R500 on Y in exchange for services rendered (which was valued at R500), Y should include R500 in gross income as it was part of the total amount in cash or otherwise received by or accrued to him. Since assets were not exchanged, X would not be entitled to claim R500 as expenditure. But if X paid R500 in cash or by transferring an asset, it would qualify as expenditure. Such anomalies should not be allowed. Brincker points out that it is interesting to note that the court's approach to anomalies and inconsistencies in the Act, where the taxpayer is prejudiced, should be accepted as a fact of life, but where SARS is prejudiced a completely different stance is taken (see Brincker 2011 *The issue of shares does not constitute an expense for tax purposes* www.cliffedekkerhofmeyer.com/a_sndmsg/cdh_news_iten.asp?I=119346 (accessed 2011-10-31)).

Labat further contended that, due to subsequent changes in legislation (incorrectly referred to Sapire AJ in the High Court appeal (Case no A206/06) as s 84), the said transaction would have been treated differently and that the allotment and issuing of shares would now qualify as expenditure (par [18]). Harms AP correctly pointed out that the court should interpret the law as it stood when the facts unfolded and not when later legislation changed in the taxpayer's favour, especially when the amendments had no retrospective effect (par [18]).

5 Conclusion

Section 24B was introduced by section 22(1) of Act 32 of 2004 in terms of which a company is deemed to have actually incurred expenditure where a company has acquired an asset as defined in paragraph 1 of the Eighth Schedule and where the company has allotted and issued shares as consideration for such assets. The value of the assets or deemed expenditure is deemed to be the market value of the shares immediately after the acquisition (s 24B(1)(b)). This is a welcome amendment as the allotment and issuing of shares for services or goods are common commercial practice. Although the issue of the allotment and issuing of shares by a company in acquiring an asset such as intellectual property are now formally addressed in section 24B, a clear definition of "expenditure" is still lacking. Unfortunately the introduction of section 24B does not alter the stance taken by the SCA on the meaning of "expenditure". In the case of

barter agreements (or where a substitutive performance to money is accepted in a contract of sale) where services are exchanged for other services or goods, no expenditure would have been incurred, because there was no movement in assets irrespective of the fact that the taxpayer was impoverished (however briefly) by extinguishing the liability through services rendered. The court's confusion between "expenditure" and actual payment or extinguishment of debt should, with respect, not be followed. Only when the debt or obligation is waived by the creditor can it be said that no expenditure was incurred.

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