

POSSIBLE TAX TREATMENTS OF THE TRANSFER OF ACCOUNTING PROVISIONS DURING THE SALE OF A BUSINESS AND SUBSEQUENT TAX CONSIDERATIONS

By

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PREFACE

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

S Kroukamp

December 2006



SUMMARY

The potential buyer of a business evaluates the attractiveness of the transaction by considering the financial status of the business being sold. In determining the financial status of a business it is more important to determine the nature of the assets and liabilities recorded on the balance sheet rather than the mere existence thereof.

Included in the liabilities are accounting provisions recorded in terms of the Generally Accepted Accounting Practice (GAAP) to reflect a fair representation of the financial status. Although these provisions are made for accounting purposes, they cannot necessarily be deducted under the terms of the Income Tax Act, no 58 of 1962. The tax deductibility of accounting provisions has long been a potential contention when a business is sold.

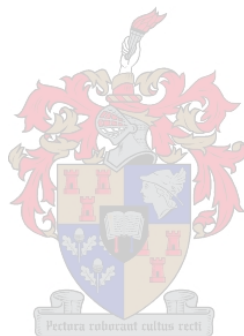
The Income Tax Act has specific sections that must be applied in determining the deductibility of accounting provisions, for example, section 11(a), which is the general deduction formula; section 23(g), which prohibits expenses not laid out for the purposes of trade; and section 23(e), which does not allow a deduction when a reserve fund is created (for example a leave pay provision).

In conducting this study, seven types of accounting provision generally recorded by businesses were identified: the bonus provision, leave pay provision, warranty provision, settlement discount and incentive-rebate provision, post employment provision, retrenchment cost provision and other provisions. These provisions are discussed in view of their possible income tax deductibility, and relevant case studies were identified to confirm the possible deductibility of these accounting provisions.

In this study, the transfer of accounting provisions during the sale of a business is considered for the purposes of both the buyer and seller. The tax implications for the buyer and seller are then evaluated, as well as the subsequent treatment of the

accounting provisions for the purposes of the buyer. Because the wording of the purchase contract is extremely important when a business is acquired, three examples of the wording of a purchase contract are discussed as well as the income tax implications thereof.

The extent of the advice given by a tax practitioner will depend on the allegiance of the practitioner (either for the buyer or seller) and will determine how the contract will be concluded. In conclusion a tax practitioner would want to assist his client to obtain the most effective tax position for the transaction and therefore each purchase contract must be reviewed on its own set of facts.



OPSOMMING

Die potensiële koper van 'n besigheid evalueer die aantreklikheid van 'n transaksie deur die finansiële status van die besigheid te ondersoek wat verkoop word. Om die bestaan van bates en laste van 'n besigheid wat geopenbaar word in die balansstaat te ondersoek is belangrik, maar die aard van die bates en laste moet ook ondersoek word, wat ook 'n invloed sal hê op die finansiële status van die besigheid.

Ingesluit in laste is rekeningkundige voorsienings wat in terme van Algemeen Aanvaarde Rekeningkundige Praktyk (AARP) geskep is om te sorg dat die finansiële state 'n redelike weergawe van die besigheid is. Die voorsienings wat vir rekeningkundige doeleindes geskep word kan nie noodwendig ingevolge die Inkomstebelastingwet nr 58 van 1962 afgetrek word nie. Die belastingaftrek-baarheid van rekeningkundige voorsienings is 'n potensiële omstrede onderwerp gedurende die verkoop van 'n besigheid.

Die Inkomstebelastingwet het spesifieke artikels wat gebruik word om die aftrekbaarheid van rekeningkundige voorsienings te bepaal soos byvoorbeeld artikel 11(a) wat die algemene aftrekkingsformule is, artikel 23(g) wat uitgawes beperk wat nie vir bedryfsdoeleindes aangegaan word nie en ook artikel 23(e) wat nie 'n aftrekking toelaat nie indien 'n reserwefonds geskep is en die uitgawes nog nie betaal of betaalbaar is nie (byvoorbeeld 'n verlofvoorsiening).

Sewe tipes rekeningkundige voorsienings is geïdentifiseer as voorsienings wat algemeen in 'n besigheid gebruik word soos byvoorbeeld bonusvoorsiening, verlofvoorsiening, waarborgvoorsiening, volumeverkope voorsiening, na-aftrede voordele voorsiening, afliggingskoste voorsiening en ander voorsienings. Hierdie voorsienings se aftrekbaarheid vir inkomstebelastingdoeleindes is bespreek en relevante hofsake is geïdentifiseer om die aftrekbaarheid van die voorsienings te bepaal.

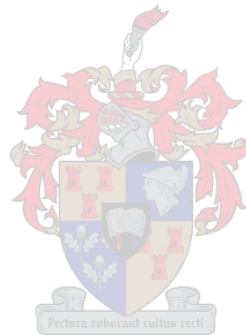
Die oordrag van rekeningkundige voorsienings gedurende die verkoop van 'n besigheid is oorweeg in die hande van die koper en verkoper. Die belastingimplikasie vir die koper en verkoper is geëvalueer asook die hantering van die rekeningkundige voorsienings by die koper in 'n latere tydperk. Die bewoording van die koopkontrak is baie belangrik wanneer 'n besigheid gekoop word. Voorbeelde van drie tipes bewoording wat mag voorkom in koopkontrakte is ondersoek asook die inkomstebelastinghantering van hierdie bewoording.

Die omvang van advies wat gegee word sal afhang van die betrokkenheid van die belastingadviseur, of hy advies gee vir die koper of verkoper en dit sal bepaal hoe die kontrak bewoord word. Die belastingadviseur sal graag sy kliënt met advies wil bedien sodat die beste belastinghantering bewerkstellig kan word en daarom moet elke koopkontrak op sy eie feitestel beoordeel word.



ACKNOWLEDGEMENTS

I could not have completed this assignment without the generous support and assistance of family, friends and colleagues. I am indebted to my husband, for all the long hours of encouragement and belief in me, and to my God, who makes all things possible.



QUOTE

The hardest thing in the world to understand is the Income Tax.

- Albert Einstein -



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1 INTRODUCTION

1.1 Relevance of the possible tax treatment of accounting provisions on the disposal or acquisition of a business

The buying and selling of businesses happens daily, but the processes leading to the conclusion of the deal are still not fine-tuned¹. The selling of a business may entail the sale of either the business's shares or its net asset value (gross assets less liabilities). When a business sells its shares, no transfer of the assets and liabilities occurs, only the shareholders change. However, when the net assets are sold, transfer of the assets and liabilities between the seller and buyer takes place²

Businesses reflect their assets and liabilities according to GAAP³ in their financial statements. Financial statements are drawn up on an annual basis for statutory purposes, for shareholders and for income tax purposes. At year-end businesses are required by GAAP to reflect the net financial status accurately by taking into account all possible expenses related to activities within that year. These types of expenses are recorded in the financial statements by means of accounting provisions permitted under IAS 37⁴. These accounting provisions

¹ Henry, D. Mergers: Why most big deals don't pay off, BusinessWeek October 14, 2002

² Macgregor, I. H. 1979: Mergers Acquisitions and Shareholders: Juta & Company Limited

³ Generally Accepted Accounting Practice

⁴ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board. This International Financial Reporting Standard (IFRS) was issued by the International Accounting Standards Board (IASB) and also issued in February 2004 by South Africa as a Statement of GAAP. Therefore the original text of IAS 37 has been adopted without any change.

The process to align the text of Statements of GAAP with that of IFRS is explained in Circular 5/2003 – Alignment of the Text of Statements of Generally Accepted Accounting Practice with that of International Financial Reporting Standards. (Before IAS 37 was issued in South Africa, the Statement of Generally Accepted Accounting Practice – AC 130 – Provisions, Contingent liabilities and contingent assets were used to recognise provisions.)

have been the source of numerous discussions, and there are differences of opinion in the treatment and deductibility for income tax purposes.

In the Tax Planning article, Keirby-Smith⁵ highlights some of the dilemmas that are usually associated with accounting provisions.

“The challenges facing the accountant in the form of provisions have extended to the offices of the Commissioner for Inland Revenue, with the result that numerous organisations have been on the receiving end of investigations by Inland Revenue, which have resulted in the add-back of provisions previously claimed and allowed for normal tax.”

These challenges are especially pronounced during the buying/selling of a business. The sales contract will stipulate the assets and liabilities (including provisions) to be sold; however, there is usually no reference as to how the buyer and seller should deal with accounting provisions for income tax purposes. Various contractual scenarios and permutations will be investigated and discussed in subsequent chapters.

The writer chose the tax treatment of accounting provisions for this study because this area is not clearly defined in the South African tax environment, a situation reflected in the sparse amount of literature, case law and legislation on the subject⁶. The writer aims to clarify some of the uncertainties that exist in the transfer of accounting provisions for the buyer and the seller. It is tempting to focus solely on the accounting practice of the phenomena of accounting

⁵ Keirby-Smith, B. 1996a. Deductibility of provisions, part 1, Tax planning page 2

⁶ Keirby-Smith, B. 1996a. Deductibility of provisions, part 1, Tax planning

provisions, but one must never lose sight of the fact that finalising the deal may depend its tax implications, as can be seen from the following statement.

“Taxes can play a large part in adding value to a deal if managed properly, and conversely, destroy a deal if not handled with care.”⁷

1.2 Reasons for the use of accounting provisions and taking over of accounting provisions

According to IAS 37, the definition of an accounting provision is: “a liability of uncertain timing or amount.”⁸ The determination of which liabilities are eligible for recording as accounting provisions are governed by three rules and will be discussed in more detail in Chapter 2. Because these liabilities are of uncertain timing or amount, they cannot be calculated exactly but are merely estimates based on circumstantial evidence at the time of finalising the financial statements.

Apart from the problems that may arise from interpreting the above-mentioned three rules are other criteria that govern the deductibility of these accounting provisions for income tax purposes. This means that a provision recorded for accounting purposes under IAS 37 will not necessarily meet the requirements for an income tax deduction. Care should therefore be taken to consult the general deduction formula stipulated in section 11(a) read together with section 23(g) of the Act⁹.

⁷ PricewaterhouseCoopers 2002: *Mergers and acquisitions Asian Taxation Guide*, page 2

⁸ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 10

⁹ Income Tax Act no 58 of 1962

The distinction between accounting and tax practice is summed up by Centlivres JA in *Sub-Nigel Ltd v CIR*¹⁰, who states:

“at the outset it must be pointed out that the court is not concerned with deductions which may be considered proper from an accountant’s point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act.”

In the normal course of business, the discrepancy between accounting provisions and the deductibility thereof for tax purposes does not cause much of a problem. When a business is sold at net asset value (which includes the effects of accounting provisions) the buyer assumes the liabilities of the business and the question arises whether the buyer can deduct these provisions, if at all. Another problematic scenario is whether the buyer can deduct the provision that has already been transferred to the buyer, but for which the expense occurs in a subsequent year.

The tax consequences for the buyer and seller are not dealt with explicitly in the legislation. For that reason the tax consequences for the transfer of accounting provisions were identified as the focus of this study, and it is the aim to clarify the income tax uncertainties in the area of selling of accounting provisions as part of the sale of a business.

1.3 Research methodology

The research methodology used was the historic method. A review of the literature was undertaken to determine the income tax implications of accounting provisions.

¹⁰ 1948 (4) SA 580 (A), 15 SATC 380 at 389

1.4 Course of study

This study starts with a review of the background of accounting provisions and the Income Tax implications of accounting provisions. The tax treatment of specific accounting provisions and more specifically their tax treatment as part of the sale of a business as a going concern will further be discussed.

The transfer of these accounting provisions during the sale of a business will be discussed for both the buyer and seller. The aim of the discussion is to clarify the treatment of accounting provisions for the buyer and seller during the sale of a business.

1.5 Limitation of scope of study

The tax treatment of the transfer of accounting provisions during the sale of a business will be dealt with. Accounting provisions form part of the net assets of a going concern.

The sale of the net assets of businesses outside South Africa, which includes accounting provisions, does not form part of the study. Capital Gains Tax implications also do not fall within the scope of this study.

1.6 Terminology

In this study, "seller" refers to a company/individual selling its business as a going concern to another party.

The other party is referred to as the buyer of the going concern. A going concern is defined as the net asset value (assets reduced by the liabilities) of the business.

Liabilities include any accounting provisions that are disclosed in the financial statements of a business.

2 BACKGROUND ON ACCOUNTING PROVISIONS

After the general introduction in chapter 1, chapter 2 will expound the fundamentals of accounting provisions in a more formal manner. The two areas that will be covered entail, firstly, accounting provisions in the financial environment and, secondly, the tax deductibility of these accounting provisions.

2.1 Provisions in the accounting profession

Accounting provisions are strictly guided by IAS 37¹, which forms part of GAAP² as clearly stated by the following paragraph:

“The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions...”

The reason for such strict governance is to establish a platform among the financial community for uniform treatment of these provisions. It will further minimise opportunities for abuse of the system.³

The criteria for the legitimacy of a provision (liability of uncertain timing or amount) are as follows:

“A provision should be recognised when:

¹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, Objective paragraph of IAS 37

² Generally Accepted Accounting Practice

³ Advanced International Financial Reporting Standards (“IFRS”) Training; PricewaterhouseCoopers, International Accounting Standard 37 (IAS 37)

an enterprise has a present obligation (legal or constructive) as a result of a past event;

it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and

a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.”⁴

The practical applications of the recognition of accounting provisions will be discussed in chapter 3 in more detail.

2.2 Tax implications of provisions

In general most expenditures are deductible from net income before tax under section 11(a) of the Act. Accounting provisions are considered a subset of the total expenses for a financial year and thus section 11(a) of the Act (or other applicable sections) must be considered in the determination of the deductibility thereof.

2.3 General deduction formula

Certain sections of the Act determine the deductibility of an expense. To be classified as deductible, an expenditure must comply with the requirements as laid down in section 11(a) of the Act and not be prohibited

⁴ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

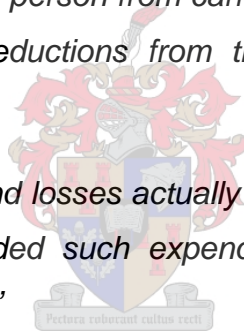
under section 23 of the Act. The combined working of these two sections of the Act is commonly known as the general deduction formula⁵.

Section 11(a) of the Act deals specifically with the treatment of expenses incurred, in the carrying on of any trade. "Trade"⁶ is defined in section 1 of the Act.

Section 11(a) of the Act lays down three requirements regarding expenses:

"11. General deductions allowed in determination of taxable income. — For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;"



To be deductible the expense must be actually incurred (in that specific tax year to qualify for a deduction) in the production of income and must not be of a capital nature. Only if all of the three requirements are complied with is the taxpayer entitled to a deduction for income tax purposes.

Section 23 of the Act in its entirety deals with deductions that are prohibited in the determination of taxable income. The two subsections pertinent to this study are section 23(g) and 23(e) of the Act because they specifically affect the accounting provisions and the deductibility thereof.

⁵ Keirby-Smith, B. 1996a. Deductibility of provisions, part 1, Tax planning

⁶ See Annexure A for an extract from the Act.

Section 23(g) of the Act reads as follows:

*“Deductions not allowed in determination of taxable income.—
No deductions shall in any case be made in respect of the
following matters, namely—*

*(g) any moneys, claimed as a deduction from income derived
from trade, to the extent to which such moneys were not laid out
or expended for the purposes of trade;”*

Section 23(e) of the Act prohibits the deduction of a reserve fund to meet contingent liabilities or anticipated liabilities, which have not actually been incurred.⁷

*“23. Deductions not allowed in determination of taxable
income.—No deductions shall in any case be made in respect of
the following matters, namely—*

income carried to any reserve fund or capitalized in any way;”

2.4 General deduction formula – actually incurred

In this section pertinent court cases will be discussed to clarify the concept of “actually incurred” as set out in section 11(a) of the Act.

Firstly, expenses actually incurred and paid in the same tax year are deductible under section 11(a) of the Act. However, expenses incurred in one financial year with payment due in the following financial year are also deductible in the first year. Two court cases confirm this deduction.

⁷ Pyott Ltd v CIR 1945 AD 128, 13 SATC 121

In *Port Elizabeth Tramway Co Ltd v CIR*⁸, it was found that an expense was actually incurred in one financial year, although no payment was made for this expense at the time.

The commentary from Watermeyer AJP in the above-mentioned case is:

“But expenses “actually incurred” cannot mean, “actually paid”. So long as the liability to pay them actually has been incurred they may be deductible.”

In the *Caltex Oil* case, it was held that ‘expenditure actually incurred’ does not necessitate the transfer of payment during the particular year of assessment. Botha JA commented during the case that:

“It is in the tax year in which the liability for the expenditure is incurred, and not in the tax year in which it is actually paid (if paid in a subsequent year), that the expenditure is actually incurred for the purposes of s 11(a).”⁹

What can be deducted from these two cases is that “actually incurred” therefore qualifies the expenditure to be due and payable. However, even when an expenditure is incurred within a particular assessment year, the payment can be made in a subsequent year.

Expenses that are conditional upon the outcome of future events cannot be deducted, as discussed in the following three court cases.

⁸ 1936 CPD 241 8 SATC 13 at 15

⁹ *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A); 37 SATC 1 at 12

In *Nasionale Pers Bpk v KBI*¹⁰, Hoexter JA expanded upon the term “actually incurred”:

“Die vereiste dat die onkoste “werklik aangegaan” moet wees, het egter tot gevolg dat moontlike toekomstige uitgawes wat bloot as waarskynlik geag word nie ingevolge art 11(a) aftrekbaar is nie. Alleen onkoste ten opsigte waarvan die belastingbetaler volstrekke en onvoorwaardelike aanspreeklikheid op die hals gehaal het, mag in die betrokke belastingjaar afgetrek word.”

In *Edgars Stores Ltd v CIR*¹¹, Corbett JA added:

“it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(a) from income returned for that year. The obligation may be unconditional ab initio or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied).”

¹⁰ 1986 (3) SA 549 (A) 48 SATC 55 at 69

¹¹ 1988 (3) SA 876 (A) , 50 SATC 81 at 90

In CIR v Golden Dumps (Pty) Ltd¹², similar conclusions were made:

“A liability is contingent where there is a claim which is disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay. ... The taxpayer could not properly claim the deduction in that tax year, and the Receiver of Revenue could not, in the light of the onus provision of s 82 of the Act, properly allow it.”

2.5 General deduction formula – in the production of income

Port Elizabeth Electric Tramways¹³ was one of the first cases in which the meaning “in the production of income” was considered. Expenditure must be closely linked to the business operation, and then the expense will be incurred “in the production of income” and deductible in terms of section 11(a) of the Act.

The principles laid down in Port Elizabeth Electric Tramways¹⁴ are frequently used in later cases that discuss the term “in the production of income”. Therefore only one later case will be discussed, as this is sufficient to identify the meaning of “in the production of income”.

In Port Elizabeth Electric Tramways, the judge held that¹⁵:

“all expenses attached to the performance of a business operation bona fide performed for the purposes of earning income are deductible whether they are necessary for its performance or attached to it by chance or are bona fide

¹² 1993 (4) SA 110 (A), 55 SATC 198 at 206 - 207

¹³ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13

¹⁴ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13

¹⁵ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13 at 13

incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.”

It is not necessary that each item of expenditure should directly or indirectly lead to the production of income as no expenditure, strictly speaking, actually produces income. This was observed in Port Elizabeth Electric Tramways¹⁶:

“Taking these in turn, the words of statute are “actually incurred” not “necessarily incurred”. The use of the word “actually” as contrasted with the word “necessarily” may widen the field of deductible expenditure.”

One needs to look at a business as a whole set of operations all directed towards producing the income when establishing whether an expense has been incurred in the production of income¹⁷.

If it were necessary to establish a strict causal nexus between the expenditure and the production of income, one would be investigating the business efficacy of the taxpayer, which is not the function of the Income Tax Act or the Commissioner. (ITC 1600¹⁸)

Income is produced by a series of actions, attendant upon which are expenses, which are deductible if they are so closely linked to such acts as to be regarded as part of the cost of performing them. The other two requirements of section 11(a) of the Act must have also been complied with for an expense to be deductible.

¹⁶ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13 at 15

¹⁷ W Neville & Co Ltd v F CoT (1957) 56 CLR 290

¹⁸ ITC 1600, 1995 58 SATC 131

In *Sub-Nigel Ltd v CIR*¹⁹, the court held that the fact that no income is actually earned is irrelevant as long as the expense is incurred for the purpose of earning income. The purpose of the expenditure must be considered to establish whether the expense is incurred to earn income, and if so, the requirement of “in the production of income” is complied with.

2.6 General deduction formula – not of a capital nature

To distinguish between a capital and a non-capital expenditure, the purpose of the expenditure must be considered. Case law lays down tests for distinguishing between capital and non-capital expenditures.

The true nature of the transaction should be examined to determine the capital or revenue nature of the attendant expenditure. In *New State Areas v CIR*²⁰, Watermeyer CJ summarised a test as:

“The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure even if it is paid in a lump sum.”

¹⁹ 1948 (4) SA 580 (A), 15 SATC 380

²⁰ 1946 AD 610 14 SATC 155 at 170

Several tests or guidelines have been enunciated by the courts to determine the revenue or capital nature of an expenditure. None of these tests is, however, absolutely conclusive, and each individual case should be considered on its own unique facts and circumstances.

If an expenditure incurred otherwise qualifies as a deduction but is capital in nature, the expenditure cannot be deducted in terms of section 11(a) of the Act. When an accounting provision is recognised in the balance sheet, then the expense will be included in the income statement. The terms “expense” and “accounting provision” will therefore be used interchangeably because the expense will be included in the income statement and it is the accounting provision’s transfer upon the sale of the business that will be discussed.

2.7 Conclusion

Accounting provisions may be created under IAS 37²¹, which forms part of GAAP. Because accounting provisions are usually expenses that are provided for, the general deduction formula²² as set out above must be utilised to determine if these accounting provisions are deductible for income tax purposes. In the next chapter some of the expenses that are often provided for in business and the income tax treatment thereof will be discussed.

²¹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, Objective paragraph of IAS 37

²² Keirby-Smith, B. 1996a. Deductibility of provisions, part 1, Tax planning

3 THE TAX TREATMENT OF ACCOUNTING PROVISIONS

3.1 Accounting and Tax

Accounting provisions are not always deductible for income tax purposes as discussed in the previous chapter. A provision is a charge against income, and the criteria for creating an accounting provision were discussed in the previous chapter.

The tax consequences of the recognition of accounting provisions are determined with reference to the Income Tax Act and not with reference to the accounting standards. *Caltex Oil (SA) Ltd v CIR*¹ made a distinction between accounting expenses in general and the income tax practice that is used for considering the deductibility of these accounting expenses:

"The Court is only concerned with deductions permissible according to the language of the Income Tax Act and not debits made in the taxpayer's books of account for deduction even though considered proper from an accountant's point of view..."

Accounting provisions are recognised in the balance sheet, and the corresponding accounting expenses are recognised in the income statement. An accounting provision must therefore be assessed in terms of the Income Tax Act to determine whether it is deductible for income tax purposes.

¹ 1975 1 SA 665 (A); 37 SATC 1 at 14

3.2 Provisions

The normal deduction principles for expenditure were discussed in the previous chapter. The following accounting provisions and their normal income tax treatment will be discussed²:

- Bonus provision;
- Leave pay provision;
- Warranty provision;
- Settlement discount and incentive-rebate provision;
- Post employment benefits;³
- Retrenchment costs⁴; and
- Other provisions.

The list is not exhaustive; however, the above-mentioned provisions are used in most businesses and therefore are useful for discussing how provisions are treated for Income Tax purposes.

3.3 Bonus provision

Bonus payments by businesses to their employees can be categorised as two types. The first is the thirteenth cheque bonus (similar to a monthly salary) and

² International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

³ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 19 Employee Benefits (IAS 19), International Accounting Standards Board
The process to align the text of Statements of GAAP with that of IFRS is explained Circular 5/2003 – Alignment of the Text of Statements of Generally Accepted Accounting Practice with that of International Financial Reporting Standards. (Before IAS 19 was issued in South Africa, the Statement of Generally Accepted Accounting Practice – AC 116 – Employee Benefits was used to recognise provisions.)

⁴ The other accounting provision that will be discussed in this chapter is retrenchment costs. These costs are usually associated with a business that is reorganised or a sale of a business.

the second is a performance bonus (based on employees' performance). The first bonus (set out in the employment contract) is usually a guaranteed bonus that is paid to the employee at the end of the year. The performance bonus is paid to the employee only when certain criteria are met.

In terms of IAS 37⁵

“A provision should be recognised when:

an enterprise has a present obligation (legal or constructive) as a result of a past event;

it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and

a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.”⁶

If the above-mentioned criteria are met, then the bonus provision should be provided for in the financial statements. Documentation⁷ such as the basic conditions of employment, the employment contract and the company's

IAS 37, paragraphs 70 to 83, set out the recognition of restructuring costs (which includes retrenchment costs).

⁵ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

⁶ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

⁷ Keirby-Smith, B. 1996b. Deductibility of provisions, part 2, Tax planning

employee and bonus policy will provide the necessary information to determine whether the bonus provision should be provided.

In *Nasionale Pers Bpk v KBI*⁸ it was held that if the taxpayer has an absolute and unconditional liability regarding bonus payments at year-end, the expenditure may be deducted. In this case the bonus provision was still conditional at year-end and the taxpayer could not claim a tax deduction equal to the bonus provision.

On analysis of the employment contracts in the case, the Court came to the conclusion that the taxpayer had no unconditional liability to pay the holiday bonuses at the end of the tax year. The bonuses were payable only to employees still in the service of the company on 31 October, which was after year-end, and accordingly, until it was certain that a particular employee would be in the service of the company on that date, there was no absolute and unconditional liability for his or her holiday bonus.

There can be situations where the employer has an absolute and unconditional liability for a proportion of the bonus payments, although payment takes place only later. If, under their employment contracts, the employees become entitled at year-end to a portion of the annual bonus, the provision can be deductible in terms of the general deduction criteria set out in the Act.

In *ITC 674*⁹, the employer was subject to certain obligations in the matter of holiday leave for its employees under the terms of an agreement, which contained provisions that holiday leave must be paid to the employees. The agreement stated that the employee has a proportionate right to holiday pay and

⁸ 1986 3 SA 549 (A), 48 SATC 55

⁹ 1949 16 SATC 234(U)

it cannot be withheld; therefore, the bonus provision was deductible in terms of section 11(a) of the Act. For bonus provisions to be deductible in terms of section 11(a) of the Act, the following requirements must be met; the expenditure must be actually incurred, in the production of income and not of a capital nature. The requirement that the expenditure actually be incurred was discussed previously. Bonus provision is part of the expenditure by the employer on the work force to produce income, and the Port Elizabeth Electric Tramway case¹⁰ set out that expenditure closely linked to the business is expenditure incurred in the production of income.

The other requirement for bonus provisions to be deductible under section 11(a) of the Act is that the expenditure must not be of a capital nature. The purpose of a bonus provision must be examined, and in the New State Areas case¹¹ a test was established to determine whether an expenditure was of a capital or revenue nature. If the expenditure is incidental to the performance of the business, then the expenditure is of a revenue nature. Bonus provisions are therefore not of a capital nature.

3.4 Leave pay provision

When leave pay is provided for in an employee's contract, then the employee is entitled to receive the value of the leave not taken. The employee's contract sets out whether the leave not taken can be paid out on a regular basis or only when the employee resigns or retires.

¹⁰ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13

¹¹ New State Areas v CIR 1946 AD 610, 14 SATC 155

The employer therefore incurs an obligation to the employee as the leave accumulates. The leave that accumulates can be reduced when the employee takes leave or the leave is paid to the employee¹².

The employer has a present obligation, and there will be an outflow of resources when the leave is paid and a reliable estimate can be made (the salary of the employee is used for the calculation of the leave days that accumulate). The criteria of IAS 37¹³ are met when leave is provided for in an employee's contract and the employee is entitled to any leave not taken. The accounting provision can therefore be recorded.

In ITC 1495¹⁴, deduction of the leave pay provision was disallowed. After this case and another¹⁵ in which the leave pay provision was allowed¹⁶, section 23E of the Act was promulgated to provide criteria as to when leave pay is deductible for Income Tax purposes.

Section 23E of the Act reads as follows:

"23E. Provisions relating to leave pay.—

(2) For the purposes of this Act, where in consequence of any leave to which an employee of the taxpayer became entitled during any year of assessment of the taxpayer ending on or

¹² Keirby-Smith, B. 1996e. Deductibility of provisions, part 4, Tax planning

¹³ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

¹⁴ 1990 53 SATC 216

¹⁵ ITC 1516, 1992 54 SATC 101

¹⁶ Keirby-Smith, B. 1996e. Deductibility of provisions, part 4, Tax planning

after 1 January 1994, the taxpayer has become liable to pay any amount of leave pay—

(a) the taxpayer shall be deemed not to have incurred expenditure in respect of such leave pay until it is actually paid by him or becomes due and payable by him; and

(b) such leave pay shall be deemed to accrue to the employee concerned on the date upon which such expenditure is deemed to have been incurred by the taxpayer.”

Leave pay can be deducted only when it is actually paid or has become due and payable by the employer, under this section of the Act. Section 23E of the Act came into effect during 1994, which ended the debate as to whether the provision is deductible or not¹⁷. There must be an absolute and unconditional liability, which is a question of fact, depending upon the terms of the relevant employment contract. There may be circumstances where the employee became entitled to the leave or the leave pay was paid by the employer or became due and payable by employer. The leave pay provision can then be deducted for income tax purposes in terms of section 23E of the Act.

Leave pay can only be deducted under section 23E of the Act, which sets out an additional test for this type of expenditure. If the leave pay is not due and payable, the expense cannot be deducted for income tax purposes.

3.5 Warranty provision

Warranty provisions are widely used and can be defined as follows:

¹⁷ Meyerowitz, D. 2001-2002: Meyerowitz on Income Tax 2001-2002 Edition. RSA: The Taxpayer

“A warranty is an undertaking given by the manufacturer to bear the cost of repairing or replacing certain parts of his product within a defined period subsequent to the sale of the product to the customer.”¹⁸

In terms of IAS 37¹⁹, a warranty provision can be recorded for accounting purposes when the business has a present obligation (goods were sold), there will be an outflow of resources (when the repairs are made) and a reliable estimate can be made (the estimate is usually made on past experience).

Firstly, when customers exercise their right to repair or replacement of a product they have bought, under section 11(a) of the Act, the expenditure is actually incurred, in the production of income and not of a capital nature and therefore deductible. The expenditure is closely linked²⁰ to the business and the expenditure is incidental²¹ to the performance of the business.

Under section 11(a) of the Act, this expenditure is not actually incurred (no unconditional legal liability exists²²) if the customer must still exercise its right to repair or replacement, and thus this provision cannot be deducted for income tax purposes.

Section 24C of the Act provides for an allowance in respect of future expenditure on contracts that is allowed at the discretion of the Commissioner. Future

¹⁸ Keirby-Smith, B. 1996c. Deductibility of provisions, part 3, Tax planning page 80

¹⁹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

²⁰ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13

²¹ New State Areas v CIR 1946 AD 610, 14 SATC 155

²² Keirby-Smith, B. 1996c. Deductibility of provisions, part 3, Tax planning

expenditure is now open to objection and appeal, and warranty provisions can be included as future expenditure.

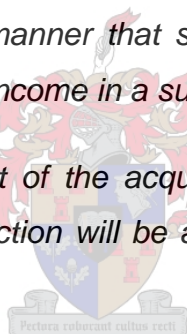
Section 24C of the Act states:

“24C. Allowance in respect of future expenditure on contracts.

(1) For the purposes of this section, “future expenditure” in relation to any year of assessment means an amount of expenditure which the Commissioner is satisfied will be incurred after the end of such year—

(a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or

(b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.



(2) If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilized in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the taxpayer’s taxable income for such year such allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount.

(3) The amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.”

In ITC 1527²³, Melamet J commented on section 24C:

“The section has been applied to building contracts and has been extended to other activities, but it is over to the taxpayer to convince the Commissioner that it should be applied in his particular activity. It has been applied to the motor industry and to publishers who print periodicals to be issued in the future. Section 24C is applied strictly, but there is no limitation on its application.”

In the above-mentioned case, the taxpayer did not satisfy the two requirements of section 24C of the Act, which is that there must be a causal link between the income included and the future expenditure that the taxpayer will incur²⁴ and that the future expenditure must be incurred by the taxpayer in the performance of its obligations under the contract giving rise to the income²⁵.

The court in ITC 1601²⁶ considered a further aspect, that of whether the nature of warranty provisions constitutes future expenditure as set out in section 24C(2) of the Act. The appellant in the case contended that the Commissioner did not request evidence for analysing the facts to this case. The court concluded that the appellant failed to provide additional information which could have played a

²³ 1992 54 SATC 227 at 239

²⁴ Section 24C(2) of the Act

²⁵ Section 24C(2) of the Act

²⁶ ITC 1601, 1995 58 SATC 172

role in the decision as to whether the warranty provision constituted future expenditure as set out in section 24C(2) of the Act. Therefore, this judgement does not create a precedent that warranty expenditure will never qualify as future expenditure under section 24C of the Act.²⁷

Van Niekerk J commented in ITC 1601²⁸:

“It was also, in my opinion, correctly submitted that section 24C was not enacted to provide a deductible reserve fund for possible “comebacks”, unforeseen contingencies or latent defects in the res vendita.”

The warranty provision must be seen to be an integral part of the contract and not as an expense incurred independently thereof. ITC1601²⁹ does not create a precedent governing the relationship between warranty expenditure and the section 24C deduction³⁰. The onus lies with the taxpayer to support the deductibility of the warranty provision³¹ under section 24C of the Act.

Where a section 24C allowance is deducted in a financial year, this allowance must be added back in the tax calculation the following year³².

3.6 Settlement discount and incentive-rebate provision

A settlement discount allows the buyer of goods to pay less than the invoiced amount if the buyer makes payment within a certain period of time. An incentive-

²⁷ Keirby-Smith, B. 1996c. Deductibility of provisions, part 3, Tax planning

²⁸ ITC 1601, 1995 58 SATC 172 at 175

²⁹ ITC 1601, 1995 58 SATC 172

³⁰ Keirby-Smith, B. 1996c. Deductibility of provisions, part 3, Tax planning

³¹ Keirby-Smith, B. 1996c. Deductibility of provisions, part 3, Tax planning

³² Section 24C(2) of the Act

rebate provision is based on the volume of goods purchased by the buyer. These terms and conditions are negotiated in advance of the purchase of goods.

In terms of IAS 37, a provision may be recognised when:

“a) an enterprise has a present obligation (legal or constructive) as a result of a past event;

b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and

a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.”³³

The settlement discount cannot be provided at year-end for goods sold within the specified period if payment has not yet been received. The seller of the goods does not have a present obligation to give this settlement discount, and the obligation will arise only when payment is actually received.

When payment is received, the settlement discount may be provided for under IAS 37³⁴. Under section 11(a) of the Act, this expense is actually incurred in the production of income and not of a capital nature and therefore deductible for income tax purposes.

³³ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

³⁴ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

The incentive-rebate provision may only be recorded if there is a present obligation. There are two types of incentive-rebate provisions, and the agreements and their underlying terms and conditions must be investigated before a decision can be made as to whether a provision can be recorded.

The first type of incentive-rebate is incurred regardless of how many units are purchased by the buyer of the goods. There is therefore a present obligation (when the sale contract is concluded), and the provision may be created if the other conditions of IAS 37³⁵ are also met.

An expense is deductible for income tax purposes if the requirements of section 11(a) of the Act are complied with. The expense must be actually incurred, in the production of income and must not be of a capital nature. The first type of incentive-rebate is therefore deductible for income tax purposes.

The second type of incentive-rebate is paid to the buyer of the goods only if a certain amount of units are bought within a certain time frame. If the number of units is less than the number set out in the agreement and not within a certain time frame, the rebate cannot be provided, as there is no present obligation under IAS 37³⁶.

³⁵ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

³⁶ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

For the second type of incentive-rebate, no rebate is provided and therefore section 11(a) of the Act does not apply. The expense is not actually incurred, although the other two requirements of section 11(a) of the Act are met, that is, the expense is in the production of income and not of a capital nature as the expenditure is closely linked³⁷ to the business and the expenditure is incidental³⁸ to the performance of the business.

3.7 Post employment benefits

IAS 19³⁹ prescribes the disclosure of post employment benefits. The post employment medical care benefit is discussed as this is typically used as an incentive for employees. Paragraph 35 of IAS 19⁴⁰ indicates that the statement on provisions⁴¹ is used to recognise a provision if there is an actuarial shortfall in the benefit plan.

An expense may be deductible for income tax purposes if the requirements of section 11(a) of the Act are complied with. The expense must be actually incurred, in the production of income and must not be of a capital nature.

A provision created for post employment benefits is therefore not deductible under section 11(a) of the Act as it usually represents actuarial risk, if the actuarial calculations indicate that the employer's obligation may have increased from the original calculations, and not an amount actually incurred.

³⁷ Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13

³⁸ New State Areas v CIR 1946 AD 610, 14 SATC 155

³⁹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 19 Employee Benefits (IAS 19), International Accounting Standards Board

⁴⁰ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 19 Employee Benefits (IAS 19), International Accounting Standards Board

⁴¹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

3.8 Retrenchment costs

Retrenchment costs are associated with the reorganisation, downsizing or sale of a business. Retrenchment costs that are not yet paid may be recorded as a provision when the conditions of IAS 37⁴² are met.

The board of directors usually makes a formal decision to reorganise, downsize, or sell the business and the employees are then informed of the decision. The employees either volunteer to resign, or a list of layoffs is set up and the employees are informed of the retrenchments. Retrenchment costs are usually recorded as a provision if the conditions for IAS 37⁴³ are met, although the actual payments to the employees are still outstanding.

In terms of paragraph 78 of IAS 37⁴⁴, an obligation arises for expenses pertinent to the sale of a business only if there is a binding sale agreement. This paragraph confirms further that the employer may provide for retrenchment costs if the employer has a present obligation (sales agreement), there will be an outflow of resources (actual payment), and a reliable estimate can be made of the amount (for example, the employees' retrenchment cost is calculated on years in service and formalised in the plan to sell the business).

The retrenchment provision is deductible for income tax purposes if the requirements of section 11(a) of the Act are complied with. The retrenchment

⁴² International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

⁴³ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

⁴⁴ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

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

In ITC 1716, the question arose as to whether retrenchment payments were in the production of income and of a revenue nature. The expenditure was held by the court to be in the production of income and of a revenue nature and therefore deductible under section 11(a) of the Act.

The court commented that:

“...employees are a necessary part of any business and they can never be a capital asset. They can terminate their employment at any time. That is why what is paid to employees is regarded as being inherently of a revenue nature and in the production of income.”⁴⁵

The last requirement for section 11(a) of the Act is whether the expense is actually incurred. If there is an unconditional legal obligation⁴⁶ for the retrenchment provision, then the expense is actually incurred and the provision is deductible for income tax purposes.

If a provision for retrenchment costs does not fulfil the requirements of section 11(a) of the Act, then the provision will not be deductible for income tax purposes.

⁴⁵ ITC 1716, 2000 64 SATC 27 at 31

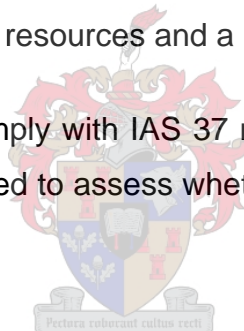
⁴⁶ Edgars Stores v CIR 1988 (3) SA 876 (A), 50 SATC 81

3.9 Other Provisions

Other provisions, which were previously recorded by businesses before the implementation of IAS 37⁴⁷, may not be provided for under the current IAS 37 because IAS 37 is part of the Alignment of the Text of Statement of Generally Accepted Accounting Practice with that of the International Financial Reporting Standards.

If the terms of IAS 37 are not met, the provision may not be provided for. In the past, businesses routinely provided for future expenses; however, these older provisions do not meet all of the terms of IAS 37. IAS 37 requires that a business must have a present obligation as a result of a past event, there will probably be an outflow of resources and a reliable estimate can be made.

Other provisions that comply with IAS 37 may be provided for. Section 11(a) of the Act can then be applied to assess whether the provision can be deducted for income tax purposes.



3.10 Conclusion

Accounting provisions that are recorded under IAS 37⁴⁸ that form part of the Statement of Generally Accepted Accounting Practice are not always deductible for income tax purposes. The nature of each accounting provision must be reviewed to evaluate whether the provision is deductible for income tax purposes.

⁴⁷ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board, paragraph 14

⁴⁸ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

4 CONTRACTS

4.1 Introduction

“In the case of each sale of a business it is necessary to analyse the agreement and to determine in substance what amounts are payable by the purchaser and receivable by the seller in respect of each of the assets making up the business.”¹

This extract emphasises that the wording in the purchase agreement is an important factor that must be considered before finalising the tax consequences² of an accounting provision. Before finalising a purchase agreement, the seller and buyer must decide on the tax consequences, as seen below.

“One of the major considerations in structuring a sales transaction is the tax consequences to both the Seller and the Buyer. Like other terms of the agreement, what may be good for the Buyer, may not necessarily be good for the Seller, or vice versa.

From a tax standpoint, the best strategy is to minimize the total taxes paid on the transaction, taking into consideration what the seller’s taxes may be now and what the Buyer will ultimately have to pay.”³

¹ Solomon, SC. Opinion on Tax treatment of sales of businesses: 1996, page 2

² Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

³ W.B. Grimes Co. Inc. 1999 Tax Implications on the Sale of A Business
www.mediamergers.com/taximplications.html

This chapter will discuss options in purchase agreements to transfer accounting provisions from a seller to a buyer or options for the seller to retain the obligation of an accounting provision.

4.2 Consideration

The consideration for the purchase of the net asset value should always form part of the agreement.⁴ In *CIR v Niko*⁵, it was held that the purchase price in a sale of business agreement must be allocated to the different assets; otherwise the Commissioner may allocate the purchase price to the different assets, a situation that can create problems for the seller and the buyer. The allocation made by the seller should be fair and reasonable and capable of being defended.

Inclusion of the description and amounts of the assets and liabilities of the companies involved in the sale agreement is mandatory when a company listed on the Johannesburg Stock Exchange is involved⁶ in selling or transferring its assets and liabilities.



The writer identified two options for the transfer of accounting provisions and one option for not transferring the accounting provisions from the seller to the buyer during the sale of a business. These options are discussed below.

4.3 Option 1 – Seller pays the buyer for taking over the liabilities

The sales agreement often provides only that the seller's assets and liabilities are taken over by the buyer and therefore the net amount is also the purchase

⁴ Macgregor, I. H. 1979: *Mergers Acquisitions and Shareholders: Juta & Company Limited*, page 51

⁵ 1940 AD 416 11 SATC 124

⁶ Macgregor, I. H. 1979: *Mergers Acquisitions and Shareholders: Juta & Company Limited*, page 58

price. The agreement often does not specify whether the assets will be paid for by the buyer or whether the liabilities will be paid by the seller.⁷

The option is then for the buyer to pay the seller for the assets at market value and the seller to pay the buyer for taking over the liabilities, which includes the accounting provisions. The reasoning for this option is the possibility that the seller may deduct the payment for the liabilities (including the accounting provisions) as an expenditure for income tax purposes. The writer is of the opinion that when payment was made by the seller to the buyer for taking over accounting provisions, the requirements of section 11(a) of the Act must be complied with by the seller for the seller to be entitled to a deduction.

The buyer would be taxed on these amounts received for taking over the liabilities.⁸ The payment would be included in the buyer's gross income. Gross income is defined in section 1 of the Act and reads as follows:

“...“gross income”, in relation to any year or period of assessment, means—

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or...

(ii)...

...during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way

⁷ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, ...“

A buyer who takes over a seller's liabilities, by receiving a payment for taking over the liabilities, could be entitled to claim a deduction when the liabilities and accounting provisions can fulfil the requirements of section 11(a) of the Act and that is if the expenditure is actually incurred, in the production of income and not of a capital nature. There can definitely be an argument for the tax deductibility of the accounting provisions and that is that the buyer took over the assets and liabilities and therefore the payment of the accounting provision (if not capital in nature) could be deductible for income tax purposes because it is closely linked to the business operation that was taken over.

Solomon SC argued in his opinion⁹ that the payment made by the seller is not incurred in the production of income. The payment is made to relieve the seller of future liabilities and not to produce income for the seller. A payment made by the seller for accounting provisions is therefore not deductible for income tax purposes.

The other argument for this option is that the amount is deductible by the seller for income tax purposes. The amount was actually incurred because the seller paid the buyer for taking over the accounting provisions¹⁰. For the expenditure to be in the production of income, it can be argued that the payment was made while the seller was still trading. The third requirement for the expenditure to be deductible under section 11(a) of the Act is that the expenditure must not be of a

⁸ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

⁹ Solomon, SC. Opinion on Tax treatment of sales of businesses: 1996

capital nature. The expenditure is not of a capital nature because the purpose of the payment is not of a capital nature.

The South African Receiver of Revenue (“SARS”) allows the deduction of the payment by the seller because the seller is still trading at the time the seller makes the payment. SARS is also of the opinion that the expenditure is incurred in the production of income and there is no argument that the payment is of a capital nature.¹¹

This option is not frequently used because the exchange of money (the seller paying the buyer to take over the liabilities and the buyer paying the seller for the assets) between the two parties is burdensome¹².

The next option that will be discussed below is frequently used when the agreement states that the assets and liabilities are taken over by the buyer and the net amount is the purchase price.¹³

4.4 Option 2 – The purchase consideration is the net asset value

Sales agreements usually state that the buyer will purchase the assets for a specified amount and assume the liabilities for another amount, the two amounts are then offset and the net purchase price is paid¹⁴. The provisions are then taken over by the buyer.

¹⁰ ITC 542, 13 SATC 116

¹¹ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

¹² Solomon, SC. Opinion on Tax treatment of sales of businesses: 1996

¹³ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

¹⁴ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

As this option is frequently used, the income tax consequences for the seller and buyer will be discussed in the next two chapters.

4.5 Option 3 – Seller retains obligation

Under the third option, when the seller ceases trading and sells the business, no further deductions can be claimed¹⁵ under section 11(a) of the Act because the expense will not be incurred in the production of income. However, if the expenditure is incurred due to an obligation assumed while trading, it is still deductible under section 11(a) of the Act even if it is paid after trading ceases¹⁶.

In ITC 729¹⁷, the following was held:

“An employer, as part of the wages to an employee, gives him an undertaking that when he retires he will be paid a pension. That undertaking amounts to a laying out of moneys for the purposes of trade. Nor does paragraph (g) state that the moneys must be laid out or expended for the purpose of trade during the year for which the assessment is being made. The paragraph is in wide terms and only requires that the payment must be one which was for the purposes of trade, so that once it is established that the obligation to make the payment was for the purpose of trade, then when that obligation is discharged it remains a payment for the purposes of trade.”

¹⁵ ITC 490, 12 SATC 72

¹⁶ ITC 729, 18 SATC 96 at 100 - 101

¹⁷ 18 SATC 96 at 100 -101

In ITC 490¹⁸ and ITC 729¹⁹, expenditures were judged deductible for income tax purposes even after trading ceased (for example, after the selling of the business). When the accounting provision is retained by the seller, the expense can be deducted for income tax purposes if the requirements of section 11(a) of the Act are met. Because the business has been sold, no income will be available from the business to be reduced by the expenditure and the seller will possibly incur a loss that cannot be used. If the seller has income from other businesses, the loss can be used to reduce the income from the other businesses.

The seller of the business would therefore not want to retain the obligation for accounting provisions.

The buyer in this option will not have taken over the accounting provisions and the buyer will therefore have no income tax implications for these provisions.

4.6 Conclusion

The wording of the sale agreement must be reviewed before finalising the tax consequences of the accounting provisions.

Two options were discussed for the transfer of accounting provisions and a third option was discussed for not transferring the accounting provisions from the seller to the buyer during the sale of a business. Two of the options discussed are not frequently used, so the focus of the next two chapters will be the transfer of accounting provisions to the buyer as a result of the payment of the net purchase price by the buyer.

¹⁸ ITC 490, 12 SATC 72

¹⁹ ITC 729, 18 SATC 96

5 THE TAX TREATMENT FOR THE SELLER OF THE TRANSFER OF ACCOUNTING PROVISIONS DURING THE SALE OF A BUSINESS

5.1 Introduction

There is little written by academic writers and no South African case law exists on the tax treatment of the transfer of accounting provisions during the sale of a business. There are two parties to this transaction, and whether the tax advisor is advising the seller or the buyer will determine how the contract is set up. It is assumed that the tax advisor wants to assist his or her client in obtaining the best tax implications for the transaction.¹

This chapter deals with the seller's income tax consequences of the transfer of accounting provisions. The subsequent treatment thereof in the hands of the buyer will be discussed in the next chapter. The accounting provisions and their treatment in the normal course of business and specifically the deductibility in terms of the general deduction formula were discussed in chapter 3.

5.2 Accounting provisions

The accounting provisions will be addressed as they were set out and discussed in chapter 3. Possible treatment of the accounting provisions in the seller's hands will be discussed under the headings below. As set out in the previous chapter, the following discussion will focus only on the transfer of accounting provisions from the seller to the buyer.

¹ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

5.3 Bonus provision

In Chapter 3 the tax consequences of bonus provisions were discussed. Two possible situations were identified: either the bonus provision was deductible under section 11(a) of the Act, or the bonus provision did not meet all of the requirements of section 11(a) of the Act and could not be deducted for income tax purposes.

There may be cases where an employer has an absolute and unconditional liability for a proportion of the bonus payments despite the fact that the date for payment of the bonuses has not yet arrived. For example, if under the employment contract, on completion of each month of service, employees becomes entitled to a pro rata portion of the annual bonus, then at the end of the employer's tax year the employer will have an absolute and unconditional liability for a portion of the bonus liabilities and will be entitled to deduct those amounts for income tax purposes.

The seller is allowed to deduct this expense, if there was an unconditional liability to pay, because the expense was incurred during the period when the business was trading.

There cannot be a tax deduction of an amount equal to the bonus provision if it is conditional and therefore not actually incurred or expensed in the production of income. When the actual expense is incurred, a deduction is available under section 11(a) of the Act. In *Nasionale Pers Bpk v KBI*², it was held that only expenditure in respect of which the taxpayer has an absolute and unconditional liability can be deducted in that particular year.

² 1986 (3) SA 549 (A), 48 SATC 55

The seller cannot deduct this expense if there was not an unconditional liability to pay, as the expense was not incurred during the period when the business was trading.

5.4 Leave pay provision

Under sections 11(a) and 23E(2) of the Act, leave pay can only be deducted for income tax purposes when the requirements of section 11(a) of the Act are met and the amount is actually paid or has become due and payable by the employer. There must be an absolute and unconditional liability, which is a question of fact, depending upon the terms of the relevant employment contract.

In Chapter 3 the tax consequences of leave pay provisions were discussed. Two possible situations were identified: either the leave pay provision was deductible under section 23E(2) of the Act, or the leave pay provision that the employer provided for has not become due and payable and therefore is not deductible for income tax purposes.

If the employment contract stipulates that the employees are entitled to a pro rata portion of the annual payment on completion of each month's service, then the provision is absolute and unconditional and can be deducted³. Reference to pro rata entitlement is not the normal wording in most employment contracts, and only in certain industries this wording is used⁴.

The seller can deduct this expense if the requirements of section 23E(2) of the Act are met, as discussed in chapter 3.

³ ITC 674, 1949 16 SATC 235

⁴ Keirby-Smith, B. 1996d. Deductibility of provisions, part 4, Tax planning

Leave pay can only be deducted under section 23E of the Act, which sets out an additional test for this type of expenditure (The other tests are set out in section 11(a) of the Act). If the leave pay is not due and payable, the expense cannot be deducted for income tax purposes.

The seller cannot deduct this expense for income tax purposes if the leave pay provision has not become due and payable and the requirements of section 11(a) of the Act are not met.

5.5 Warranty provision

When customers exercise their right to repair or replacement of a product they bought, then under section 11(a) of the Act, the expenditure is actually incurred, in the production of income and not of a capital nature and therefore deductible. When customers exercise this right before the sale of the business, the seller may deduct the expense under section 11(a) of the Act.

The question of whether the seller may claim a tax deduction for the amount of the warranty provision or part thereof under the general deduction provisions will depend on the facts, including the terms of the warranties. A taxpayer may claim a deduction in respect of expenditure for which there is an absolute and unconditional liability in the tax year in question. In the *Edgars Stores*⁵ case, D Corbett CJ commented the following:

“It is, of course, important in this context to distinguish between expenditure in respect of which the obligation is conditional and remains so during the year of assessment, and expenditure in respect of which the obligation is or during the year of

⁵ *Edgars Stores v CIR* 1988 (3) SA 876 (A) 50 SATC 81 at 90

assessment becomes unconditional, but cannot be quantified until after the termination of the year of assessment.”

The Court held that the former category of expenditure (conditional) is not deductible during that year of assessment, while the latter category of expenditure (unconditional) is deductible for income tax purposes.

The same principles were applied in the Australian case involving RACV Insurance⁶. In this case the taxpayer, a short-term insurer, claimed a deduction of losses resulting from insured events which had occurred during the tax year but for which it had not yet received claims during that year. Based upon past history it was able to make a reliable estimate of the amounts of those claims. The Court held that the company was entitled to claim the deduction. Australia has a provision similar to section 11(a) in regard to the deduction of expenditure incurred (section 51 of the Australian Income Tax Act).⁷

Applying the previous court case principles to the seller, the seller may be entitled to claim the deduction if it is able to show that, although it had not yet received claims under the warranties, events giving rise to unconditional liability under the warranties had occurred before the end of the tax year in question, and if it is able to provide a reliable estimate of its liability or loss resulting from those events. If the provision is still conditional, the seller cannot deduct the expense under section 11(a) of the Act.

Another possibility for the deductibility of the warranty provision in the hands of the seller is if section 24C of the Act can be applied. Under this section, the

⁶ RACV Insurance (Pty) Ltd v FCOT (1974(4)), ATR 610

⁷ Meyerowitz, D, Emslie, TS and Davis, DM (eds) Income Tax – Deduction – Provision for leave pay – Whether absolute liability incurred in year of assessment. Volume 40 no 10 The Taxpayer 1991

seller is obliged to add back the amount of the deduction in the following year of assessment.

In effect, the amount deducted under section 24C of the Act in the year prior to the sale of the business is added back in the year that the business is sold (that is the following year of the deduction of the warranty provision under section 24C of the Act). Clearly, the seller will not be allowed a further deduction under section 24C of the Act in the year the business is sold, as the buyer assumed the accounting provisions in question. The Commissioner of SARS will not be satisfied that such amount will be utilised in whole or in part by the seller to finance future expenditure as required by section 24C(2) of the Act, after the business is sold.

5.6 Settlement discount and incentive-rebate provision

As discussed in Chapter 3, if the seller recognises a provision for a settlement discount, the provision will be deductible under section 11(a) of the Act if all of the requirements of section 11(a) of the Act are met.

The settlement discount may not be provided for by the seller if the buyer of the goods did not pay for goods bought at the time of the sale of the business. Settlement discounts that are provided for under IAS 37⁸ will therefore also be deductible for the seller if the requirements of section 11(a) of the Act are met.

As was set out in chapter 3, two types of incentive-rebate provisions were identified. The first type of incentive-rebate provision is payable regardless of how many units are bought by the buyer of the goods. This incentive-rebate may

⁸ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

be provided for under IAS 37⁹. If the requirements of section 11(a) of the Act are met, the seller may deduct this provision.

The second type will only be paid to the buyer of the goods if a certain quantity of units is bought. This type of incentive-rebate may not be provided for under IAS 37¹⁰ until the required quantity of goods is bought. There is no present obligation for the payment of the said incentive-rebate; therefore, this provision may not be included in the net assets of the seller, and no transfer of provision may be concluded.

5.7 Post employment benefits

The seller may not deduct a provision for post employment benefits if the amount is still conditional and the expense is not actually incurred or expensed in the production of income. When the actual expense is incurred, a deduction is available under section 11(a) of the Act. In *Nasionale Pers Bpk v KBI*¹¹, it was held that only expenditure in respect of which the taxpayer has an absolute and unconditional liability may be deducted in that particular year.

The seller may deduct this expense if there was an unconditional liability to pay, as the expense was incurred during the period when the seller was trading and it is also an expense incurred in the production of income. The requirements for a deduction under section 11(a) of the Act are discussed in chapter 3.

⁹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

¹⁰ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

¹¹ *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55

5.8 Retrenchment costs

The provision of retrenchment costs was discussed in chapter 3. If the requirements of section 11(a) of the Act are complied with, the seller may deduct the retrenchment costs that were provided for when the sale of the business occurred.

ITC 1716¹² and Edgars Stores¹³ confirm that the provision for retrenchment costs is deductible if the requirements of section 11(a) of the Act are met. The seller may therefore deduct the retrenchment cost provision for income tax purposes if the requirements are met.

If the provided retrenchment costs do not satisfy the requirements of section 11(a) of the Act, then the provision may not be deducted by the seller for income tax purposes.

5.9 Other provisions

As discussed in chapter 3, if the requirements of IAS 37¹⁴ are not met, the accounting provisions may not be provided. The seller can transfer only the accounting provisions recorded in the financial statements at the date of sale of the business.

5.10 Conclusion

This chapter discussed the seller's income tax consequences of the transfer of accounting provisions to the buyer. The seller of the business should identify all

¹² ITC 1716, 2000 64 SATC 27

¹³ Edgars Stores v CIR 1988 (3) SA 876 (A), 50 SATC 81

¹⁴ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

of the accounting provisions that were recognized under IAS 37¹⁵ in the financial statements. The requirements of section 11(a) of the Act (or other sections of the Act that have been identified in this study) must be met in order for the accounting provisions to be deductible for income tax purposes. The requirements are that the expense must be actually incurred, in the production of income and not be of a capital nature.

After evaluating the accounting provision's income tax deductibility, the relevant deductions can be made for the tax calculation of the seller.



¹⁵ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

6 THE TAX TREATMENT FOR THE BUYER OF THE TRANSFER OF ACCOUNTING PROVISIONS DURING THE SALE OF A BUSINESS

6.1 Introduction

This chapter will deal only with the tax consequences of the buyer of the business, when there is a transfer of accounting provisions. The tax treatment for the transfer of accounting provisions for the seller of the business was discussed in the previous chapter. The accounting provisions and their income tax treatment in the normal course of business and specifically deductibility in terms of the general deduction formula were discussed in chapter 3.

6.2 Accounting provisions

The accounting provisions will be addressed as they were set out and discussed in chapter 3. The possible income tax treatment of the transfer of accounting provisions in the buyer's hands will be discussed under the headings below.

6.3 Bonus provision

The nature of the bonus provision that has been transferred from the seller to the buyer during a sale of a business must be examined to determine whether the bonus provision is deductible in the buyer's hands, as well as when this deduction for income tax purposes may occur.

The first possibility from the perspective of the buyer that of the bonus provision not being deductible, is when the seller had an absolute and unconditional liability for a proportion of the bonus payments¹ despite the fact that the date for payment of the bonuses is after the sale of the business.

¹ ITC 674, 1949 16 SATC 235

The buyer who assumes the bonus provision may not deduct the expenditure when the business is bought or if this type of provision is actually paid because not all the requirements of section 11(a) of the Act will be met. The requirement that the expense must be incurred in the production of the buyer's income is not met. In *Port Elizabeth Electric Tramway*², it was found that the expense must be closely linked to the production of income for the expense to be deductible. The expense was not incurred for the production of the buyer's income; therefore, the buyer will not be permitted to deduct this provision for income tax purposes.

Prior to the sale of the business, bonus provisions are estimated based on circumstantial evidence. If the bonus provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income.

The second possibility is when the buyer takes over the employment contracts and the contracts stipulate that bonus provisions are conditional upon a future date (which is after the sale of the business).

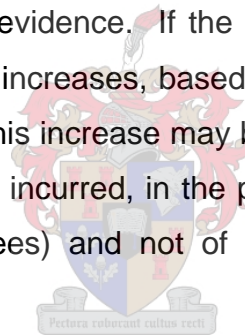
The buyer who assumes the provision is permitted to deduct the expenditure as soon as the expense is actually incurred and in the production of income under the terms of section 11(a) of the Act. When the expense is actually incurred, a deduction is available under section 11(a) of the Act. In *Nasionale Pers Bpk v KBI*³, it was held that only expenditure in respect of which the taxpayer has an absolute and unconditional liability can be deducted in that particular year. The buyer would therefore be able to deduct this provision under section 11(a) of the

² *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13

Act. The expense was conditional only for the seller of the business. It can be argued that this provision incentivises the employees when they receive bonus payments and that the expense is made in the production of the buyer's income.⁴

The buyer that assumes the bonus provision that is conditional upon a future date will be able to deduct the expense on the future date as the expenditure will be incurred for the buyer's production of income and the other requirements of section 11(a) of the Act are met.

Prior to the sale of the business, conditional bonus provisions are estimated based on circumstantial evidence. If the conditional bonus provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase may be deductible for income tax purposes if the expense is actually incurred, in the production of income (as the payment incentivises the employees) and not of a capital nature under the terms of section 11(a) of the Act.



6.4 Leave pay provision

Under section 23E(2) of the Act, leave pay may be deducted for income tax purposes only when the amount is actually paid or has become due and payable by the employer. There must be an absolute and unconditional liability, which is a question of fact depending upon the terms of the relevant employment contract. The requirements of section 11(a) of the Act must also be met for the leave pay provision to be deductible for income tax purposes.

³ 1986 (3) SA 549 (A), 48 SATC 55

⁴ Port Elizabeth Electric Tramways Co v CIR 1936 CPD 241, 8 SATC 13 and CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A), 20 SATC 113

The first possible situation when the buyer takes over the leave pay provision is that this provision is not deductible under section 23E, read in conjunction with section 11(a), of the Act. The requirement that the expense be incurred in the production of the buyer's income cannot be met. In *Port Elizabeth Electric Tramway*⁵ it was found that the expense must be closely linked to the production of income in order for the expense to be deductible. The expense was not incurred by the buyer in the production of the buyer's income; therefore, the buyer will not be permitted to deduct this provision for income tax purposes. Whether the buyer actually pays the leave pay provision or not is irrelevant because the expense may not be deducted for income tax purposes because the expense was not incurred in the production of the buyer's income.

Prior to the sale of the business, leave pay provisions are estimated based on circumstantial evidence. If the leave pay provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income.

The second situation is when the leave pay becomes due and payable in the hands of the buyer and the requirements of section 11(a) and section 23E of the Act are met. The leave pay provision will be deductible by the buyer for income tax purposes when all of the requirements are met and not necessarily when the accounting provisions are transferred or paid.

The one requirement of section 11(a) of the Act that needs further discussion is whether the expense is incurred in the production of income if the leave pay becomes due and payable in the hands of the buyer. The expense was

⁵ *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13

conditional only for the seller of the business. It can be argued that this provision incentivises the employees when they receive leave pay and it then can be argued that the expense is made in the production of the buyer's income.⁶

Prior to the sale of the business, conditional leave pay provisions are estimated based on circumstantial evidence. If the conditional leave pay provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase may be deductible for income tax purposes if the expense is actually incurred, in the production of income (as the payment incentivises the employees) and not of a capital nature under the terms of section 11(a) of the Act.

6.5 Warranty provision

When the buyer takes over a warranty provision from the seller, the warranty provision is deductible under section 11(a) of the Act only if the expenditure is actually incurred, in the production of income and not of a capital nature. Chapter 3 provides a detailed discussion of this tax provision's deductibility.

No income tax deduction may be claimed by the buyer when the provision is taken over and the actual warranty expense is incurred after the purchase of the business. The expense will not be incurred in the production of income because the seller received the income prior to the sale of the business for work that must be performed by the buyer as a result of the warranty claim. The other requirements of section 11(a) of the Act will be met because the expense will be actually incurred by the buyer and the expense will not be of a capital nature because the expense will not be borne to create a capital asset.

⁶ Port Elizabeth Electric Tramways Co v CIR 1936 CPD 241, 8 SATC 13 and CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A), 20 SATC 113

Prior to the sale of the business, warranty provisions are estimated based on circumstantial evidence. If the warranty provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income.

6.6 Settlement discount and incentive-rebate provision

A buyer who takes over a seller's provision to pay a settlement discount will not be entitled to claim a deduction for the amount in question, even if the buyer actually gives the discount to the customers. The expenditure by the buyer will not be incurred in the production of income as required by section 11(a) of the Act because the seller received the income for the transactions that the settlement discount relates to.

Prior to the sale of the business, settlement discounts are estimated based on circumstantial evidence. If the settlement discount (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income.

As set out in chapter 3, there are two types of incentive-rebate provisions. The first type is payable regardless of how many units are bought by the buyer of the goods. The second type is paid to the buyer of the goods only if a certain number of units are bought. A provision for the first type of incentive-rebate may be recognised for accounting purposes under IAS 37⁷, however the second type

⁷ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

of incentive-rebate may not be recognised as a provision under IAS 37⁸ because there is no present obligation for the payment of this incentive-rebate.

When the first type of incentive-rebate provision is taken over by the buyer, the buyer cannot deduct this expense. The buyer did not incur the expense in the production of income because the seller received the income for the incentive-rebate that was created by the seller. Not all of the requirements of section 11(a) of the Act are met for an income tax deduction for the buyer.

Prior to the sale of the business, the first type of incentive-rebate provisions are estimated based on circumstantial evidence. If the incentive-rebate provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income.

When the second type of incentive-rebate provision is taken over by the buyer, the buyer cannot deduct this expense. The buyer did not incur the expense in the production of income because the seller received the income for the incentive-rebate that will be paid to the buyer of the goods. Not all of the requirements of section 11(a) of the Act are met for an income tax deduction for the buyer.

Prior to the sale of the business, the second type of incentive-rebate provisions are estimated based on circumstantial evidence. This incentive-rebate provision (that was not transferred to the buyer) increases, based on additional evidence

⁸ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income. The seller received the income for the incentive-rebate that will be paid to the buyer of the goods.

The possibility exists that the expenditure incurred for the first type of incentive-rebate, recognised by the seller as a provision, may be in the production of income if the buyer can prove that the expense is closely related to the buyer's income producing activities. Customers are incentivised to make further purchases when they receive discounts, and as a result this incentive-rebate can be argued as a deductible expense⁹. Refer to *Port Elizabeth Electric Tramways Co v CIR*¹⁰ and *CIR v Genn & Co (Pty) Ltd*¹¹ for more information on this principle.

6.7 Post employment benefits

The buyer who takes over the seller's provision to pay post employment benefits will not be entitled to claim a deduction of the provision for income tax purposes, even if the buyer actually pays the post employment benefits. The expenditure by the buyer will not be incurred in the production of income as required by section 11(a) of the Act.

Prior to the sale of the business, the post employment benefits provisions are estimated based on circumstantial evidence. If the post employment benefits provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the

⁹ Internal opinion by PricewaterhouseCoopers tax department Cape Town. Tax treatment of the transfer of contingent liabilities on the sale of a business: 1997

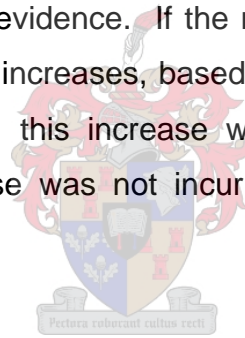
¹⁰ 1936 CPD 241, 8 SATC 13

production of the buyer's income and represents the actuarial risk and not an amount actually incurred.

6.8 Retrenchment costs

A buyer who takes over a seller's provision to pay retrenchment costs will not be entitled to claim a deduction of the amount in question, even if the buyer actually makes payments to the employees, because the expenditure by the buyer will not be incurred in the production of income as required by section 11(a) of the Act.

Prior to the sale of the business, the retrenchment cost provisions are estimated based on circumstantial evidence. If the retrenchment cost provision (that was transferred to the buyer) increases, based on additional evidence after the date of sale of the business, this increase will not be deductible for income tax purposes as the expense was not incurred in the production of the buyer's income.



6.9 Other provisions

As discussed in chapter 3, if the requirements of IAS 37¹² are not met, accounting provisions cannot be recognised in the financial statements. There will not be any income tax consequences, as these amounts are not provided for in the financial statements and these provisions are not part of the purchase price where the buyer assumes the liabilities.

¹¹ 1955 (3) SA 293 (A), 20 SATC 113

¹² International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

If accounting provisions meet all of the requirements of section 11(a) of the Act after the business is bought, the buyer can deduct these accounting provisions for income tax purposes.

6.10 Conclusion

The chapter dealt with the buyer's income tax consequences of the transfer of accounting provisions from the seller. The buyer of the business must identify all of the accounting provisions that were transferred and recognised under IAS 37¹³ in the financial statements. The requirements of section 11(a) of the Act (or other sections of the Act that have been identified in this study) must be met for the accounting provisions to be deductible for income tax purposes. The requirements are that the expense must be actually incurred, in the production of income and not of a capital nature.

The one requirement of section 11(a) of the Act that predominantly prohibits a deduction for the buyer of the transferred accounting provisions is for the expense to be incurred in the production of the buyer's income. This requirement, as well as the other two requirements of section 11(a) of the Act, must be met for the expense to be deductible for income tax purposes.

After evaluating the income tax deductibility of the accounting provisions, the relevant deductions may be made in the tax calculation of the buyer.

¹³ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

7 CONCLUSION

This study focused on the transfer of accounting provisions when the net assets of a business are sold with the concomitant transfer of the assets as well as the liabilities from the seller to the buyer. Accounting provisions are included in the liabilities of the business and are recognised under IAS 37¹, which forms part of GAAP. The accounting provisions that are created under GAAP are not always deductible for income tax purposes. The nature of each accounting provision must be reviewed carefully to evaluate whether the provision is deductible for income tax purposes.

The recognition criteria for accounting provisions can be found in paragraph 14 of IAS 37. An accounting provision should be recognised when the taxpayer has 1) a present obligation as a result of a past event, 2) there is a probable outflow of resources of the taxpayer to settle the obligation and 3) a reliable estimate can be made of the amount of the obligation². All three of the criteria must be met before the accounting provision can be provided for in the taxpayer's accounting records.

The wording of the purchase agreement must be reviewed in order to assess the income tax consequences of the accounting provisions. Three options were discussed: the seller pays the buyer for taking over the liabilities, the purchase consideration is the net asset value, and the seller retains the obligation after the sale of the business. This study considers the income tax consequences of the

¹ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

² International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

transfer of accounting provisions when the net assets of a business are sold. The other two alternatives for the wording of contracts were only briefly discussed.

Seven generally occurring types of accounting provision were identified and discussed in detail: bonus provision, leave pay provision, warranty provision, settlement discount and incentive-rebate provision, post employment provision, retrenchment cost provision and other provisions. These provisions were discussed in view of their possible income tax deductibility. Relevant court cases were identified to confirm the possible deductibility of these accounting provisions.

The seller of the business must identify all of the accounting provisions that were recognized under IAS 37³ in the financial statements. The requirements of section 11(a) of the Act (or other sections of the Act that have been identified in this study) must be met for the accounting provisions to be deductible for income tax purposes. The requirements are that the expense must be actually incurred, in the production of income and not be of a capital nature.

After evaluating the accounting provision's income tax deductibility, the relevant deductions can be made in the tax calculation of the seller.

The buyer of the business must identify all of the accounting provisions that were transferred and recognized under IAS 37⁴ in the financial statements. The

³ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

⁴ International Financial Reporting Standards on CD-ROM, 2005, International Accounting Standard 37 Provisions, Contingent Liabilities and Contingent Assets (IAS 37), International Accounting Standards Board

requirements of section 11(a) of the Act (or other sections of the Act that have been identified in this study) must be met for the accounting provisions to be deductible for income tax purposes. The requirements are that the expense must be actually incurred, in the production of income and not be of a capital nature.

The requirement of section 11(a) of the Act that predominantly prohibits a deduction of the transferred accounting provisions for the buyer is that the expense must be incurred in the production of the buyer's income. This requirement, as well as the other two in section 11(a) of the Act, must be met for the expense to be deductible for income tax purposes.

After evaluating the accounting provision's income tax deductibility, the relevant deductions can be made in the tax calculation of the buyer.

This study is not meant to be an exhaustive analysis of the accounting provisions that can be recorded under IAS 37 or the income tax consequences of the transfer of accounting provisions. Rather, this study gives typical examples of the possible income tax consequences relevant to the treatment of accounting provisions for the seller and the buyer.

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ANNEXURE A - EXTRACTS FROM THE INCOME TAX ACT NO 58 OF 1962

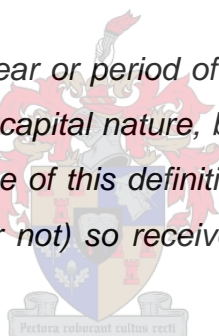
Section 1

“...“gross income”, in relation to any year or period of assessment, means—

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii)...

...during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder,...“



“...“trade” includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any other property which is of a similar nature;”

Section 11(a)

“11. General deductions allowed in determination of taxable income.—For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;”

Section 23(e)

“23. Deductions not allowed in determination of taxable income.—No deductions shall in any case be made in respect of the following matters, namely—

income carried to any reserve fund or capitalized in any way;”

Section 23(g)

“23. Deductions not allowed in determination of taxable income.—No deductions shall in any case be made in respect of the following matters, namely—

(g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;”

Section 23(E)

“23E. Provisions relating to leave pay.—(1) For the purposes of this section—

“employee” includes the holder of any office;

“leave pay” means any amount which a taxpayer has during any year of assessment become liable to pay to his employee in consequence of the employee having during such year become entitled to any period of leave which had not been taken by him during that year;

“leave pay provision” means an amount equal to the lesser of—

(a) the amount included in the taxpayer’s income in terms of the provisions of subsection (5); and

(b) an amount determined in relation to all periods of leave to which the taxpayer’s employees were entitled as at the end of the last year of assessment of the taxpayer ending before 1 January 1994, and calculated by applying, in the case of each such employee, the employee’s rate of earnings as at the end of such year to the period of leave to which such employee was so entitled.



(2) For the purposes of this Act, where in consequence of any leave to which an employee of the taxpayer became entitled during any year of assessment of the taxpayer ending on or after 1 January 1994, the taxpayer has become liable to pay any amount of leave pay—

(a) the taxpayer shall be deemed not to have incurred expenditure in respect of such leave pay until it is actually paid by him or becomes due and payable by him; and

(b) such leave pay shall be deemed to accrue to the employee concerned on the date upon which such expenditure is deemed to have been incurred by the taxpayer.

(3) Where any taxpayer has in any return of income submitted by him to the Commissioner before 1 March 1993 claimed a deduction of an amount determined in accordance with a practice consistently applied by him and in the bona fide belief that such amount constituted leave pay which was lawfully allowable as a deduction in the determination of his taxable income (whether such amount exceeds or is less than the amount which was lawfully deductible), there shall be allowed as a deduction in the determination of his taxable income for such year and for each subsequent year of assessment ending before 1 January 1994 an amount determined in accordance with the said practice: Provided that where in his return of income for any year of assessment ending before 1 January 1994 the taxpayer has amended such practice and the deduction determined in accordance with such amended practice is less than the deduction which would have been determined in accordance with his previous practice, the amount to be allowed as a deduction under this subsection in that year of assessment and in each subsequent year of assessment ending before 1 January 1994 shall be determined in accordance with such amended practice.

(4) Where in respect of any year of assessment of a taxpayer ending before 1 January 1994, the Commissioner has not prior to the date of commencement of the Income Tax Act, 1993,

issued an assessment, a deduction in respect of leave pay shall not be granted for such year otherwise than as may be permitted under the provisions of subsection (3).

(5) There shall be included in the income of any taxpayer in his first year of assessment ending on or after 1 January 1994 the sum of all amounts allowed to be deducted in the determination of his taxable income in all years of assessment ending before that date in respect of leave pay relating to all periods of leave to which his employees were entitled at the end of the last year of assessment ending before the said date.

(6) Where an amount has under the provisions of subsection (5) been included in the income of any taxpayer, any amount of leave pay which becomes due and payable by him to an employee in respect of any period of leave taken into account in the determination of such amount shall, notwithstanding the provisions of subsection (3), be allowed to be deducted from his income in the year of assessment during which such leave pay becomes due and payable.

(7) There shall in the case of any taxpayer to whom the provisions of subsection (5) are applicable, be allowed to be deducted in the determination of his taxable income for his first year of assessment ending on or after 1 January 1994 and for each of the four succeeding years of assessment (such succeeding years of assessment hereinafter being referred to as the second to fifth years, in chronological order) a deduction equal to—

- (a) *in the said first year, 100 per cent;*
- (b) *in the second year, 85 per cent;*
- (c) *in the third year, 70 per cent;*
- (d) *in the fourth year, 50 per cent; and*
- (e) *in the fifth year, 25 per cent,*

of the amount of the leave pay provision determined in relation to the taxpayer: Provided that—

- (i) *the deduction so allowed in any year of assessment shall be included in the taxpayer's taxable income in the following year of assessment; and*
- (ii) *no deduction shall be allowed under this subsection if the taxpayer has during the current or any previous year of assessment commencing on or after 1 January 1994 ceased to carry on trade.*

(8) Where—

- (a) *any commercial or industrial undertaking has been acquired by one company from another company;*
- (b) *both such companies are managed, controlled or owned by substantially the same persons; and*
- (c) *the last-mentioned company contemplated in paragraph (a) is entitled to a deduction as contemplated in subsection (7),*

the Commissioner may direct that, subject to such conditions as he may impose, the said two companies shall for the purposes of subsections (1), (3), (4), (5), (6) and (7) be regarded as being one company.

Section 24C

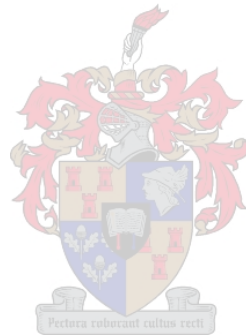
“24C. Allowance in respect of future expenditure on contracts.—*(1) For the purposes of this section, “future expenditure” in relation to any year of assessment means an amount of expenditure which the Commissioner is satisfied will be incurred after the end of such year—*

(a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or

(b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.

(2) If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilized in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the taxpayer’s taxable income for such year such allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount.

The amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.”



PREFACE

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

S Kroukamp

S Kroukamp

December 2006

