lawfulness of comments on the basis of good taste, one falls into a quagmire of uncertainty. Allow me to repeat the principle voiced by the majority of the court in this regard, which would hopefully become a mantra: "The courts cannot prescribe what people may or should say" (par 86).

Postcript

The author of this note acted as the attorney of record for the Citizen and related parties in the court *a quo*, the Supreme Court of Appeal and the Constitutional Court. However, this note is not based on privileged knowledge of the case or documents made available to the author, nor does it represent the views of any of the parties or their legal advisors, nor should the views set out in this note be attributed to anybody but the author. It is nothing more than an academic discussion of the case by an individual commentator.

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Ackermans Ltd v Commissioner for South African Revenue Service, Pep Store (SA) Ltd v Commissioner for South African Revenue Service 2011 1 SA 1 (SCA)

The deductibility of contingent liabilities taken over in the sale of a going concern

1 Introduction

It is prudent to appreciate the accounting practices employed by an entity where commercial agreements are drafted for and on behalf of that entity. The financial reports of an entity are commonly used in the determination of the purchase price of a sale agreement but the subsequent tax liability resulting from the agreement must be independently evaluated and anticipated.

This note aims to provide an analysis of the judgments of the Tax Court and the Supreme Court of Appeal in the matters of *Ackermans / Pep Stores v CSARS* (Reported as *A Co Limited v Commissioner for the South African Revenue Service* 12323 [2009] ZATC 5; 12324) [2009] ZATC 3 and *Ackermans Ltd v Commissioner for South African Revenue Service, Pep Store (SA) Ltd v Commissioner for South African Revenue Service* 2011 1 SA 1 (SCA) respectively). The focus of the analysis relates to the meaning and treatment of contingent liabilities in accounting practice as compared with the deductibility of those liabilities in terms of

section 11(a) read with section 23(g) (the general deductions formula) of the Income Tax Act 58 of 1962 ("the ITA"). Accounting practice dictates that a future obligation be recorded at its present value in financial reports but an anticipated obligation will not qualify as a deduction in terms of the general deductions formula due to the specific requirements therefore in the ITA.

2 The Factual Background and Salient Features of the Case

2 1 The Tax Court Judgment

Willis, J delivered judgment on 14 May 2009 in the South Gauteng Tax Court on two connected matters with analogous issues. Both cases focused on the tax-deductibility of particular amounts following upon the sale of businesses as going concerns (*A Co Limited v CSARS supra* par 1). On 1 March 2004, the appellants, which were referred to as A Co Limited and B Co Limited (together referred to as "the taxpayers"), sold their retail clothing businesses as going concerns to X Co, being Pepkor Limited ("Pepkor") (*A Co Limited v CSARS supra* par 1). The businesses were sold by way of substantially the same written sale agreement and principles. The two companies formed part of the same group of companies and the facts relating to Ackermans were argued by agreement with the order subsequently applying to both matters (*A Co Limited v CSARS supra* par 1).

This sale included the business assets, the liabilities and the contracts at the effective date for an amount equal to the sum of R800,000,000 together with the rand value of the liabilities ("the purchase price"). "Liabilities" were defined in the agreement to mean "all of the liabilities arising in connection with the business, in respect of any period prior to the effective date, ..." (*A Co Limited v CSARS supra* par [2]). The purchase price was allocated to the business assets with reference to immovable property, plant, machinery, equipment, vehicles, trade debtors, intercompany loans, other loans and inventory valued at "the net book value as reflected in the Effective Date Management Accounts", cash and cash equivalents valued at "the face value as reflected in the Effective Date Management accounts"; trademarks valued at "the market value determined by the seller as at the effective date and goodwill comprised 'the balance'". Pepkor was substituted in all employment contracts in existence immediately before the effective date. (See s 197 Labour Relations Act 66 of 1995). Pepkor discharged its contractual obligations in terms of the agreement and took transfer of the businesses.

Ackermans initially claimed a deduction in the amount of R23,017,959 from its taxable income in terms of the general deductions formula of the ITA (*A Co Limited v CSARS supra* par 17). The claimed deduction, comprising of three underlying contingent liabilities, was later amended to reflect long-term bonuses, post-retirement medical aid liabilities and a full repairing lease comprising approximately R17,000,000 (*A Co Limited v CSARS supra* par 18). Ackermans claimed

that the purchase price was effectively reduced by "expenditure ... incurred" within the meaning of section 11(a) of the ITA, as it removed the anticipated or contingent revenue expenses and was therefore generally of a revenue nature (*Ackermans v CSARS supra* parr 5 & 21).

The Commissioner issued an additional assessment for the 2004 year of assessment of Ackermans in which the deductions claimed were disallowed on the basis that they did not constitute expenditure; expenditure actually incurred or expenditure incurred in the production of income. The deductions, if they were expenditures, were also disallowed as being of a capital nature and not incurred for the purpose of trade. The Commissioner further regarded the deductions as prohibited in terms of section 23(e), (f) and (g) of the ITA (*A Co Limited v CSARS supra* par 19).

Ackermans, in response, argued that it had not claimed the contingent liabilities as a deduction but rather that it "paid" Pepkor R311,692,717 to be relieved of its liabilities and to generate income of R1,1 billion and not R800 million (*A Co Limited v CSARS supra* parr 29 & 31). Ackermans alleged that it made certain accounting provisions upon the sale of its business, which comprised the aggregate of the provisions for the three underlying contingent liabilities (*A Co Limited v CSARS supra* par 18). It is not in dispute that these contingent liabilities would have ordinarily been deductible, in terms of the general deductions formula, at the time when they were incurred by the taxpayers and thus became unconditional, had the amalgamation not happened (*Nasionale Pers Bpk v KBI* 1986 3 SA 549 (A) 564B-D). The contingent liabilities were eventually paid by Pepkor after the liabilities were assumed by Pepkor in terms of the sale agreement (*Ackermans v CSARS supra* par 4).

The Tax Court held that as "the amount claimed by the taxpayer as a deduction consisted of merely conditional liabilities in respect of which there was no obligation to effect payment ... [and] therefore no expenditure relating thereto could possibly have been incurred" (*A Co Limited v CSARS supra* par 30). The court accordingly confirmed the assessment of the Commissioner under appeal (*A Co Limited v CSARS supra* par 40).

2 2 The Supreme Court of Appeal Judgment

Cloete JA delivered the unanimous judgment (Navsa, Cachalia, Mhlantla And Bosielo JJA concurring) in the Supreme Court of Appeal (on 2010-10-01) in an appeal by the taxpayers, now referred to as Ackermans Limited ("Ackermans") and Pep Stores SA Limited ("Pep Stores") (together referred to as "the taxpayers"), against the decision of the South Gauteng Tax Court. The court confirmed the facts as set out by the Tax Court (*Ackermans v CSARS supra* par 1 to 6).

This court found that "expenditure incurred" means the undertaking of an obligation to pay or the actual incurring of a liability (*Ackermans v CSARS supra* par [7]). The valuation of the net asset value of the business

(the assets less the liabilities) dictated the purchase price (*Ackermans v CSARS supra* par [10]). This mechanism employed in the agreement of sale, resulting in the journal entries, was intended to facilitate the sale, as the purchaser would normally discharge the liabilities, in these kinds of transactions. The journal entries relied on by the appellants therefore do not equate to expenditure actually incurred (*Ackermans v CSARS supra* par [10]). The result is thus that Ackermans merely freed itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities (*Ackermans v CSARS supra* par 11). The court also noted that Ackermans had decided to abandon any reliance on set-off, as set-off comes into operation when two parties are mutually indebted to each other, and both debts are liquidated and fully due (*Ackermans v CSARS supra* par 8).

The Supreme Court further found that Ackermans incurred no actual liability to Pepkor in terms of the sale agreement and the manner in which the purchase price was discharged by Pepkor did not result in the discharge of any obligation owed by Ackermans to Pepkor. The argument of the taxpayers accordingly failed (see in general Rudnicki "Salient Features of a Sale-of-Business Transaction" 2010 *Business Tax & Company Law Quarterly* 24). There was, as a result, no need for the SCA to consider the further requirements of the general deductions formula. The appeals were dismissed, with costs, including the costs of two counsel (*Ackermans v CSARS supra* par 12).

3 The True Effect of the Transaction and the Analysis of Its Consequences

The true nature and effect of the sale agreement, however, in reality amounted to the transfer of the businesses of the taxpayers to Pepkor as going concerns in accordance with the amalgamation provisions of the ITA (s 44(1)(a) & (b) ITA). The sale agreement provided for a purchase price in "the amount equal to the sum of R800 million" and "the rand amount of the liabilities" (*Ackermans v CSARS supra* par 3). This purchase price, as a result, amounted to R1,111,692,717, being the R800 million plus the liabilities of R311,692,717. The purchase price was, based on this formulation, reduced to provide for Pepkor assuming the liabilities of Ackermans. No actual amount was therefore physically paid for Pepkor to assume the liabilities.

Ackermans, as a result, only received approximately R800 million from the transaction with the balance of the purchase price being deducted from the amount due to Ackermans for Pepkor assuming the contingent liabilities. The agreement could have been structured for Ackermans to receive the full purchase price and only thereafter would Ackermans have been obliged to pay an amount equal to the amount of the contingent liabilities to Pepkor. It was, however, practical and convenient to structure the sale agreement to incorporate set-off as the requisite reciprocal obligations existed between the parties in terms of the sale agreement (see Kruger "The Sale of a Business, The Assumption

of Liabilities in Part Settlement of the Purchase Price and the VAT Implications where the Corporate Rules Apply" 2010 *Business Tax & Company Law Quarterly* 21). The substance of the agreements accordingly intended for the taxpayers to pay to Pepkor an amount in consideration for its assuming the contingent liabilities. This was, however, not explicitly stated and the Supreme Court found that set-off did not apply and it was held that the taxpayers did not incur the amount for purposes of the general deductions formula.

The legal effect of set-off is that it takes the place of payment of a debt and the debt is *ipso jure* lessened on both parties proportionally (See in general *Joint Municipal Pension Fund (Transvaal) v Pretoria Municipal Pension Fund* [1969] 2 All SA 121 (T) and *Harrismith Board of Executors* v *Odendaal* 1923 AD 530 539). The structure of payment of the purchase price in the sale agreement was therefore intended to achieve the effect of set-off and was drafted in a practical manner and in accordance with the generally accepted accounting practice of valuing a business. Set-off can therefore be said to have occurred as Ackermans received a release from its future contingent liabilities.

4 The Conflicting Purpose of Tax Law and Accounting Practice

Accounting practice informs the drafting of financial reports and this is not always congruent with the objectives of tax law. Ackermans was registered as a limited company in terms of the Companies Act 61 of 1973 applicable at the time and which, inter alia, required (s 285A) the preparation of annual financial statements in accordance with South African Generally Accepted Accounting Practice ("SA GAAP"). The current Companies Act 71 of 2008 now require that certain categories of profit companies prepare their financial statements to be consistent with International Financial Reporting Standards ("IFRS") (s 29 (1) & (5)).

Financial statements are, in general, intended to show the true and fair view of, or present fairly information regarding the financial position, performance and changes in financial position of an entity (par 46 of the Framework for the Preparation and Presentation of Financial Statements; Steinbank *et al A Students Guide to International Financial Reporting* (2009) 6). The principal qualitative characteristics and appropriate accounting standards normally result in financial statements that convey, what is generally understood, as a true and fair view of, or as presenting fairly such information. Tax law, however, focuses only on those transactions for which provision is made in tax legislation (*Caltex Oil (SA) Ltd v Commissioner for Inland Revenue* 37 SACT 1 14). The calculation of taxable income is, as a result, an artificial concept based on tax legislation and the calculation of accounting profit will differ from taxable income as the basis for their calculations, definitions and objects thereof often vary.

4 1 Financial Statements from an Accounting Perspective

SA GAAP is approved and adopted by the International Accounting Standards Committee Board (http://www.ifrs.com/ accessed on 2011-11-17). SA GAAP includes both a Framework for the Preparation and Presentation of Financial Statements ("the Framework") as well as individual accounting standards, which provide specific guidance on accounting practice. IFRS are published by the International Accounting Standards Board. The IFRS Framework provides an overriding requirement for information that is useful in making economic decisions. SA GAAP recommends the accounting treatment to be applied to material account balances and classes of transactions contained in the accounting records of an entity and ultimately reported in financial statements (par 30 of the Framework).

The Framework, as approved for issue by the Accounting Practices Board, inter alia, "sets out the concepts that underlie the preparation and presentation of financial statements for external users" (par 1(f) Framework). It defines the components of financial statements, and contains a definition of a liability (par 49(b) Framework). A liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. An essential characteristic of a liability is that the enterprise has a present obligation (par 60 Framework). An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable because of a binding contract or statutory requirement but may also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. A distinction must be drawn between a present obligation and a future commitment. A decision by an enterprise to acquire assets in the future alone does amount to a present obligation. An obligation typically arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire that asset (par 61 Framework).

In casu, the liabilities recorded in the Annexures to the Sale Agreement include Bonus, Long-term Medical Expenses and Lease. The accounting standards included in SA GAAP applicable in this matter are *IAS 19 (AC 116) Employee Benefits* and *IAS 37 (AC 130) Provisions, Contingent Liabilities and Contingent Assets*. These meet the criteria for definition as liability as each represents a present obligation arising from a past event that will result in the outflow of future economic benefits. The bonus represents the present value of a future obligation, discounted for the time value of money, of an amount payable to current employees at a date in the future further than 12 months, the obligation for which arises out of a constructive obligation (the past event) set by the expectation created in the minds of such employees based on precedent of historical payments of such amounts, or by the inclusion of the obligation in a contract of employment. The provision for post-retirement medical benefits represents the present value of a future obligation, determined

with reference to actuarial calculations, discounted for the time value of money, of an amount payable in respect of post-retirement medical benefits of current employees. The outflow of future economic benefits relates to the bonus occurring at the time that such bonuses are paid or at a time when the obligation to pay these bonuses are passed to another and the outflow for provision for post-retirement medical benefits resulting at the time that such bonuses are paid or at a time when the obligation to pay these bonuses is passed to another.

4 2 The Income Tax Act Provisions

A deduction in terms of South African tax legislation is determined with reference to section 11(a) of the ITA, which stipulate that there shall be allowed as deductions from the income of a person expenditure (an outflow resulting from a voluntary action of the taxpayer (*Port Elizabeth Electric Tramway supra)* and losses (an involuntary deprivation suffered by the loser (*Joffe & Co (Pty) Ltd supra* 360)) actually incurred in the production of the income for the purpose of determining the taxable income derived by any person from carrying on any trade as defined in section 1 of the ITA, provided such expenditure and losses are not of a capital nature (See *Port Elizabeth Electric Tramway Co Ltd v CIR supra).* Actually incurred requires an "undertaking of an obligation to pay" or the "actual incurring of a liability". (See in general van Coller "The Premier, the Member of Cabinet and the Commissioner: An Evaluation of Income Tax Case No 1873" 2011 *SA Merc LJ* 116). The expenditure or loss must have been actually incurred between a taxpayer and a third party, in the year of assessment under consideration (See *Sub-Nigel Ltd v CIR* 1948 4 SA 580 (A)) and must be deducted in the year in which it is incurred (unless provided for elsewhere in the ITA). The expenditure or loss does not have to be necessarily incurred but has to be actually incurred for the purposes of trade (*Port Elizabeth Electric Tramway supra; Caltex Oil (SA) Ltd v SIR* 1975 1 SA 665 (A)*)*. The actual payment date of the expense or loss so incurred has no bearing on the deductibility thereof as this would be determined by the date on which the expense or loss arises or at the time that the taxpayer becomes liable for payment thereof (*Caltex Oil (SA) Ltd v SIR supra and Edgars Stores Ltd v CIR* 1988 3 SA 876 A). A deductible liability must thus be "actual in the sense that it is real, it exists, it is not contingent" (*ITC 1587* 1995 57 SATC 97).

Section 1(a) must be read and interpreted with the provisions of section 23(g) of the ITA, which prohibits the deduction of 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 (See *Oosthuizen v Standard Credit Corporation Limited* 1993 3 SA 891 (A)). This limits the application of the general deduction formula by prohibiting the deduction of any amounts claimed as a deduction from income not incurred for the purpose of or in connection with profit-making activities (*ITC 1466* 1990 52 SATC 25).

4 3 Binding Class Ruling

SARS has subsequently issued a Binding Class Ruling (029 issued on 2011-05-10 in accordance with s 76R ITA, valid for five years as from 2010-12-24) regarding sections 11(a), 23(a) and 23E relating to the deductibility of contingent liabilities disposed of and taken over when buying the assets and liabilities of another entity within the same group of companies. This ruling is intended to promote consistency and certainty in the interpretation and application of questions regarding the deductibility of contingent liabilities taken over, when buying the assets and liabilities of another company within the same group of companies under section 44 of the ITA. The ruling confirms that the purchasing party will be entitled to deduct expenditure actually incurred which relates to contingent obligations under the general deductions formula, provided that section 23E is complied with in respect of leave pay. The seller will not, however, be entitled to a deduction of the contingent obligations transferred to the buyer, notwithstanding any reduction of the purchase price, arising from the purchaser assuming such contingent obligations.

5 Conclusion

The parties to this sale agreement in reality determined the purchase price with reference to the financial reports of the taxpayers. For the purposes of compliance with the accounting standards and the true and fair presentation of the financial statements of the entity, liabilities are therefore raised, and related expenditure is accounted for. This valuation of a going concern makes the assumption that the business will continue as a going concern for the foreseeable future. The accounting standards thus seek to fairly present this assumption by recording and accounting for the present value of these future obligations where the future payment of these obligations is probable and measurable, and where the economic resources from which the obligation will be settled are funded by the growth in the resources in the current reporting period, thus matching the portion of the future expenditure incurred in the current year with the resources created in the current year. The resulting charge against net accounting profit is a fair presentation of this transaction, and the resulting liability is a fair presentation of the amount that will need to be settled at a future date.

The accounting treatment of a contingent liability will accordingly reflect the present value, at the end of a reporting period, of an obligation arising from a past event that will result in the outflow of economic benefits. A deduction claimed in terms of the general deductions formula in the ITA must, however, meet the requirements in the general deductions formula of the ITA. This will specifically require the expense or loss to have been actually incurred in the year of assessment in which it is claimed. A purchaser will therefore only be entitled to deduct expenditure actually incurred in respect of any contingent liabilities assumed. A seller will, likewise, not be entitled to a deduction of the contingent liabilities transferred to the purchaser despite any reduction in the purchase price of the business arising from the purchaser's

assumption of the contingent liabilities. The expenditure must first be actually incurred in order to qualify for the deduction of those liabilities. This requires an undertaking of an obligation to pay or an actual incurring of a liability before a taxpayer will be able to claim any deduction of any contingent liabilities in terms of the general deductions formula.

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Wesbank v Deon Winston Papier and the National Credit Regulator

(unreported Western Cape High Court case no 14256/10 (WCC))
Termination of debt review in terms of section 86(10) of the National Credit Act 34 of 2005

1 Introduction

The National Credit Act 34 of 2005 (NCA) comes to the rescue of consumers who are over-indebted (s 79) and/or to whom reckless credit (s 80) has been granted by affording them the opportunity to obtain debt relief *inter alia* by voluntarily applying for debt review in terms of section 86 of the NCA with a view to eventually obtain restructuring of their credit agreement debt by agreement (s 86(8)(a)) or court order (s 86(7)(c)). The debt review procedure, which is conducted by a debt counsellor, is set out in section 86 of the NCA read with regulation 24 made thereunder. Provision is made in section 86(10) of the NCA for termination of a debt review in the following terms:

> If a consumer is in default under a credit agreement that is being reviewed in terms of this section, the credit provider in respect of that credit agreement may give notice to terminate the review in the prescribed manner to -
>
> (a) the consumer;
>
> (b) the debt counsellor; and
>
> (c) the National Credit Regulator,
>
> at any time at least 60 business days after the date on which the consumer applied for the debt review.

As remarked by Blignaut J in *Mercedes Benz South Africa v Dunga* (2011 1 SA 374 (WCC)hereafter "the *Dunga* matter") the NCA is by now notorious for its lack of clarity (17) and this is especially so on the topic of termination of debt review in terms of section 86(10) of the NCA. A considerable number of dissenting judgments on the topic were delivered during 2010 adding to the confusion. Two main views are discernable from these judgments: View one, as espoused by Kathree-