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South African Revenue Service
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SUBMISSION: DISCUSSION PAPER ON THE TAX IMPLICATIONS FOR THE SELLER AND PURCHASER IN RELATION TO THE ASSUMPTION OF CONTINGENT LIABILITIES IN PART SETTLEMENT OF THE PURCHASE PRICE OF ASSETS ACQUIRED AS PART OF A GOING CONCERN

Dear Sir/Madam

The South African Revenue Service’s abovementioned Discussion Paper (hereinafter referred to as the discussion paper) refers. We hereby present the SAICA National Tax Committee’s response to your request for comments.

General

Limitation of discussion paper to sales of going concerns

While it is acknowledged that the vast majority of disposal and acquisition transactions involving the assumption of contingent liabilities involve the disposal of a going concern, this is not always the case.
It is, therefore, unfortunate that the discussion paper is limited to the disposal of going concerns. While the tax implications of the assumption of contingent liabilities as part of a disposal of a business or assets that do not comprise the sale of a going concern are potentially more complex and fact dependent, the same general principles for deductibility apply equally to such transactions.

It is therefore recommended that any interpretation note that follows from the discussion paper should not be limited to sales of going concerns.

Valuation provisions
The discussion paper draws a distinction between contingent liabilities and “valuation provisions”.
While the distinction is acknowledged, the terminology is not in line with accounting terminology.

For this reason, it is recommended that the terminology that should be used is an “impairment provision” rather than a “valuation provision”. Furthermore, it should be clarified that what is referred to here is an impairment of the value of an asset. See IAS 36 for further detail in this regard.

Complexity in claiming deductions
Complex practical issues arise from the treatment proposed in the discussion paper.

There is clearly a timing difference between the date when the seller includes the value allocated to the free-standing contingent liability in the proceeds on disposal and the date when the purchaser actually incurs the expense and either claims a deduction under section 11(a) or under the various capital allowance provisions. Particularly, in the case of allowances that are spread over a number of years of assessment, if the asset would have qualified for an allowance in an earlier year had the free-standing contingent liability been treated as expenditure incurred in that earlier year, then the allowance which is claimed in the year the
expenditure is incurred must be adjusted to take into account the allowance which would have been claimable in those earlier years. This would result in a significant administrative burden for the purchaser and separate records of the assets acquired in this transaction would have to be maintained.

Furthermore, should the contingent liability never realise, there is no expenditure actually incurred and therefore no deduction for the purchaser, while the proceeds of the seller included the value of the contingent liability at the date of sale. There is no recourse to either the seller or the purchaser to rectify this mismatch.

This type of mismatch or non-claiming of a deduction would also arise in circumstances where a wide range of assets are acquired upon the assumption of several contingent liabilities, some of which are only realised several years subsequent to the sale.

For example, a purchaser who acquires a business as a going concern and assumes say a bonus provision, will be required to account for that provision separately from any provision which it may raise going forward so as to be able to distinguish between the assumed non-employment related provision and the ongoing employment related provision. Not only must the purchaser in terms of the proposed treatment separate the assumed provisions from any ongoing employment related provisions, but the purchaser would be required to keep track of how the contingent liabilities assumed were allocated originally among the assets acquired in the sale, as well as keeping track of when the provisions are realised and the impact thereof on the tax cost of the assets.

In addition to the difficulty in tracking the costs for purposes of the correct tax treatment, there could conceivably be absurd results. For example, a scenario could arise where trading stock acquired as part of a business has been disposed of, but the provision assumed in payment for the trading stock, has not been realised. Proceeds on disposal of the trading stock would be subject to tax with no concomitant tax cost to serve as an income tax deduction.
**Embedded contingent liabilities**

We cautiously welcome the recognition by SARS of the distinction between embedded contingent liabilities that depress the value of an asset and other contingent liabilities that are distinct and separate from an asset – i.e. free-standing liabilities. However, a few comments need to be made in this regard:

- The discussion paper states that “SARS accepts that a distinction must be drawn between an embedded statutory obligation that depresses the value of an asset and a separately identifiable contingent liability.” Caution should be exercised with regard to the limitation of this principle to only statutory obligations. It is possible for obligations to be embedded in an asset without a statutory obligation. For example, a lessee may have a contractual obligation to restore a leased property to its original condition upon termination of the lease, in which case the obligation is embedded in the right of occupation. See paragraph 36 of the judgment in the *Daishowa-Marubeni International Ltd v The Queen (DMI)* case (heard in the Supreme Court of Canada) where the court expressed the view that an obligation associated with a property right could be embedded in that property right without there being a statutory obligation. The discussion document also refers to the transfer of obligations under section 197 of the Labour Relations Act as an example of a “free-standing liability”. We submit that in practice these obligations are almost inevitably transferred as part of the sale of the business as a going concern. For these reasons, SARS’s reference to an embedded statutory obligation is misplaced and the same principle should apply to obligations that are embedded in an asset contractually or otherwise.

- It is stated in the discussion paper that a distinction must be drawn between contingent liabilities embedded in an asset and those which are distinct from an asset. However, this principle also extends to absolute liabilities. See paragraph 40 of the *Daishowa-Marubeni* judgment in this regard.

- The discussion paper provides no guidance on when an obligation will be considered as being embedded in an asset; nor was such guidance provided in the *Daishowa-Marubeni*
judgment. Guidance is required in this regard, including the application of the principle in the South African context.

**Corporate rollover relief**

It is noted that the discussion paper is intended to apply only to transactions falling outside of the provisions of sections 41 to 47. No reasons for excluding the application of the principles to such transactions are provided. Sections 41 to 47 do not, as a general proposition, apply to the transfer of liabilities, contingent or absolute. Rather, these provisions address only the tax implications of the transfer of assets.

There is no apparent reason why the discussion paper should not also address such transactions. Rather, there are several compelling reasons why such transactions should also be covered by any future interpretation note to be issued by SARS:

- The general principles for deductibility of expenditure are equally applicable to the transfer of contingent liabilities in the context of such transactions;
- Transactions may only be partially subject to rollover relief, e.g. the parties to a section 45 intra-group transaction may elect that the provisions do not apply to certain assets or a section 2 asset-for-share transaction may include consideration in the form of cash in addition to shares;
- Sections 42 and 44 provide that rollover relief does not apply to the extent that any consideration is given in a form other than equity shares or the assumption of qualifying debts; however, a contingent liability is arguably not a debt as contemplated in those sections (a debt seemingly being a reference to an absolute liability) and the assumption thereof could result in a denial of rollover relief, a situation which is seemingly not intended, but which has not been remedied by the legislature.

The discussion paper should therefore also address transactions undertaken in terms of sections 41 to 47.
Asymmetrical tax treatment of seller and purchaser

The proposed application of the law by SARS set out in the discussion paper will lead to the asymmetrical tax treatment of the seller and purchaser noted in the Daishowa-Marubeni case. As noted in that judgment, an interpretation that promotes symmetry and fairness through a harmonious taxation scheme is to be preferred over an interpretation which promotes neither value.

The asymmetry in the proposed treatment by SARS can be demonstrated through a simple example.

Assume A sells a business comprising of an asset with a market value of R1 000. As consideration for the asset, the purchaser, B, pays an amount of R800 in cash and assumes a contingent liability of A on which the parties place a value of R200. In this instance, A has received consideration on the disposal of the asset of R1 000 and is taxed as such. B will initially only have a tax cost in the asset of R800, being the amount in respect of which it has an unconditional obligation (the balance of R200 being conditional). Should B in turn sell the business (together with contingent liability) the next day, it will have consideration of R1 000, but will only have a tax cost against the asset of R800. This asymmetry should be avoided.

Another way of looking at the asymmetry is that the seller of the business will suffer an economic cost in relation to the contingent liability (as a result of a reduced purchase price for the business as a whole were the contingent liability not to be assumed). If the seller would have been entitled to a deduction had the contingent liability been actually incurred in the ordinary course, then either the seller or the purchaser (but not both) should be entitled to a deduction in respect thereof. On the proposed interpretation, the seller will not be entitled to a deduction (despite carrying an economic cost). Furthermore, the purchaser will not be entitled to a deduction until such time as actual expenditure is incurred and then only if the assumption of the contingent liability was consideration for an asset of a revenue nature. If the purchaser assumes a contingent liability in payment for an allowance asset, the purchaser will be considered as having incurred a cost only when the liability becomes unconditional.
That is, the quantum of the expenditure incurred, would form part of the cost of acquisition of the allowance asset in the purchaser’s hands. The purchaser is then entitled to claim the relevant capital allowance (e.g. wear and tear) in respect of the cost of the asset. Further, the purchaser would not be entitled to, in addition to the relevant capital allowance, claim any deduction in respect of the liability itself (e.g. the purchaser will not be entitled to also claim a deduction for employment costs incurred, should a contingent liability, in respect of, say, a bonus provision that had been assumed as payment for the allowance asset, become unconditional). Thus, in this example, the employment costs incurred in respect of the bonus provision will be deductible by neither the seller nor the purchaser, regardless of the fact that the contingent liability incurred in respect of the bonus provision has become unconditional.

In contrast, if the purchaser pays cash to the seller for the acquisition of the allowance asset and the seller, in turn, pays cash to the purchaser for the assumption of the contingent liability (e.g. the bonus provision), the seller would be entitled to claim a deduction in respect of the employment costs so incurred (i.e. in respect of the contingent liability, which has become unconditional by virtue of the sale agreement), and the purchaser would be entitled to claim the relevant capital allowance (e.g. wear and tear) in respect of the cost of the asset. Based on this comparison, in our view, the treatment proposed in the discussion paper has an inequitable result.

The seller

Amount received or accrued

We are generally in agreement with the principle stated in the discussion paper that the assumption by the purchaser of a contingent liability on the sale of a business will generally give rise to the receipt or accrual of an amount for the seller. However, we have some concerns with certain of the statements made.

The statement is made that no present value adjustment is made to account for the fact that the actual payment is only expected to be made in the future. We agree with this statement to the
extent that it relates to an agreed value placed on the assumption of the contingent liabilities by the parties.

However, it should be noted that an arm’s length value may differ from the face value of the contingent liability for a number of reasons, including due to the time value of money. For example, in a cash settled share scheme, the seller may have raised a contingent liability based on the current share price.

However, such contingent liability may only be expected to crystallise in 3 to 5 years’ time. It would be realistic to assume that the parties would agree to a reduced value for the assumption of the contingent liability taking into consideration the time value of money. It is therefore important to draw a distinction between valuation principles and the so-called Lategan principle which is no longer of application in our law.

It is stated that if a value is placed on the assumption of the contingent liabilities but the agreement does not reflect that value or understates the value there would be an additional amount of consideration. Caution should be exercised with this statement. The mere fact that a contingent liability objectively may have a value associated with the assumption thereof does not in itself permit the agreement between the parties to be disregarded if that agreement reflects the true intentions of the parties and the true consideration that is placed on the assumption by them. The only way in which such an agreement can be impeached is if it is a sham or simulates an agreement that does not reflect the true agreement between the parties.

Availability of deduction

The discussion paper states that “the seller will not have incurred any expenditure on assumption of the free-standing contingent liability by the purchaser.” We respectfully disagree with this conclusion for the reasons set out below.

The discussion paper cites various cases dealing with the distinction between expenditure and losses.
We are not sure of the relevance of that distinction in the case at hand, save to say that what we are concerned with in this instance is whether there is expenditure and not whether there is a loss.

The discussion paper suggests that the reason why there is no expenditure is that the contingent liability itself would not have materialised in the seller's hands and that accordingly the seller does not incur any expenditure in relation to the contingent liability assumed by the purchaser. With respect, this reasoning completely misses the point, seemingly because the discussion paper misapplies the passage cited from the *Labat Africa* judgment where Harms AP in turn cited the passage from the *Caltex Oil* case referring to expenditure for which a liability has been incurred. What was being referred to here was simply to draw a distinction between the terms ‘liability’ and ‘expenditure’.

Although the judgment in the *Labat Africa* case was, with respect, unfortunate in concluding that an issue of shares does not constitute expenditure, it did lay down the test for what does constitute expenditure. In this regard, Harms AP sets out the test for expenditure (at paragraph 12) as “a diminution (even if only temporary) or at the very least movement of assets of the person who expends.” In the same paragraph, he also makes it clear that expenditure would also include the disbursement of assets with a monetary value.

Applying this to the assumption of contingent liabilities in the sale of a going concern, if a seller disposes of an asset with a monetary value to a purchaser as consideration for the purchaser assuming a contingent liability, the seller has incurred expenditure in that regard. Assume, for example, that a seller disposes of a business consisting of a single asset with a market value of R1 000. As consideration for the asset, the purchaser pays an amount of R800 in cash and assumes a contingent liability of the seller on which the parties place a value of R200. In this instance, the seller has received consideration on the disposal of the asset of R1000. By the same token, the seller has expended an amount of R1000 by transferring an asset to that value to the purchaser in consideration for acquiring cash of R800 and being
indemnified for its contingent liability, the effect being that the seller has incurred expenditure of R200 in respect of such indemnification.

The issue is not whether expenditure has been incurred in relation to the contingent liability or whether the contingent liability has materialised, but rather whether expenditure has been incurred in order for the seller to rid itself of the contingent liability (see paragraph 5 of the Ackermans judgment in this regard). In other words, the issue at hand is in many respects analogous to an insurance arrangement where an insured pays a premium to an insurer in order to indemnify the insured against losses arising from uncertain future events. There can be no question that the insured incurs expenditure in that regard, the expenditure being in respect of the indemnification rather than the actual loss in respect of which the insured is indemnified.

Insofar as the question of the incurral of expenditure is concerned, the fact that the contingent liability has not materialised and the nature of the contingent liability is irrelevant (although the latter may be relevant in determining whether other requirements of the general deduction formula are met).

Therefore, if the contingent liability in question is, say, in relation to warranty claims, the expenditure incurred is not in respect of warranty claims, but in respect of the purchaser indemnifying the seller against warranty claims.

In our view, the Ackermans judgment is unfortunate and questionable as to its correctness. In this regard, the court adopted a perhaps overly formulistic approach to the matter by suggesting that Ackermans had simply accepted a lesser purchase price for the assets than it would have received had it retained the liabilities instead of considering the substance of the arrangement and the true intentions of the parties, being that Ackermans transferred the assets partly as consideration for the purchaser assuming the liabilities. After all, while it is common that a sale of a business if often done on the basis of a sale of the net assets for a net price, as a general rule, the true agreement is that the purchaser is acquiring the gross assets partly for a
monetary consideration and partly for a consideration in the form of the assumption of liabilities (contingent or absolute) and the seller is compensating the purchaser for the assumption of such liabilities by providing assets with a value equal to the agreed value of such liabilities.

It should be noted that this case directly contradicts the position adopted in the discussion paper in relation to amounts received or accrued where it is argued that the assumption of liabilities constitutes consideration for the disposal of the assets. See paragraph 11 of the judgment in this regard.

In any event, the Ackermans judgment left the question open as to whether the court would have arrived at a different conclusion had the agreement been to the effect that the assets would be acquired for their full value and Ackermans would be obliged to pay to the purchaser an amount for the assumption of the liabilities. Had the agreement been structured in that manner, the court may well have concluded that Ackermans had indeed incurred expenditure in relation to the assumption of the contingent liabilities. This point is recognised in the discussion paper at 5.2.3. However, SARS suggests that one has to look at the specific facts that apply to the particular case. While this statement cannot be disputed, it is submitted that the only question at stake is whether, in substance (and here we refer to the legal substance or intention of the parties rather than the economic substance), the seller has been impoverished as a consequence of the purchaser assuming the contingent liability when compared to the situation had the seller retained the contingent liability. If the seller has been so impoverished, it has incurred expenditure in relation to the assumption of the contingent liability.

It should be noted that the position adopted by SARS in the discussion paper and in the Ackermans case is at odds with the position adopted in an unreported case in the tax court of 11 May 2005 where, in arguing against a purchaser of a business being entitled to a deduction in respect of an assumed contingent liability, SARS expressed the view that the expenditure had been incurred by the seller.
Given our views above, we disagree with the statement that the other requirements of the general deduction formula need not be discussed. In any event, we believe that any interpretation note should comprehensively address all requirements of the general deduction formula and not simply disregard these on the basis that SARS is of the view that one of the requirements is not met. We briefly set out our views on each of the further requirements below.

**Actually incurred**
The test as to whether an expenditure or loss has been incurred is well established as being an unconditional legal obligation\(^1\). Where a seller has an obligation to compensate a purchaser for the assumption of a contingent liability, the seller would have incurred an unconditional legal obligation to the purchaser in that regard on the agreement in question becoming unconditional. It matters not whether the obligation to compensate the purchaser is in money or in kind.

To this end, where a seller compensates a purchaser for the assumption of a contingent liability it would have incurred an expense in that regard. As is noted above, the expense incurred is not in the nature of the contingent liability itself, but rather in the nature of compensation for the purchaser assuming such liability.

**In the production of the income**
The tests as to whether expenditure is incurred in the production of the income are also well established. In the *PE Electric Tramway*\(^2\) case it was held that:

“The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.”

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\(^1\) See for example *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A), 37 SATC 1, *Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A), 50 SATC 81

\(^2\) *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13
It was further held that:
“… all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide 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.”

This test was cited with approval in the Genn case\(^3\) and expanded on as follows:
“In deciding how the expenditure should properly be regarded the court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects.”

In the Sub-Nigel case\(^4\) it was established that it is not necessary that the expenditure produce any part of the income in the particular year of assessment. The income may be earned in a subsequent year or, indeed, in a previous year.\(^5\)

In Tornado Transport (Edms) Bpk v KBI,\(^6\) it was held that an ex post facto payment of an existing debt was made in the production of income and this did not change if the payment was not made to the creditor directly. This case could be seen as authority for the situation where a person compensates another person to settle a liability on its behalf, as would be the case where a seller of a business incurs an expense in consideration for a purchaser assuming a liability.

On the authority of the above cases and others, it is submitted that where a seller of a business compensates the purchaser for assuming a contingent liability that is closely connected to the

\(^3\) CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A), 20 SATC 113
\(^4\) Sub-Nigel Ltd v CIR 1948 (4) SA 580 (A), 15 SATC 381
\(^5\) Commissioner for Inland Revenue v Pick ‘n Pay Wholesalers(Pty) Ltd 1987(3) SA 453 (A)
\(^6\) 1997 (T), 62 SATC 373
income-earning operations of that business, such compensation would be incurred in the production of the income.

While the tax court decision in the Ackermans case\(^7\) held that any expenditure incurred in relation to the assumption of the contingent liabilities was not incurred in the production of income, it is submitted that this decision was incorrect and not in accordance with the tests laid down and referred to above. In that decision, the court placed emphasis on the purpose of the expenditure being to induce the purchaser to assume the liabilities. However, this ignores the purpose of the contingent liabilities which, it is submitted, was the relevant consideration. The tax court cited no authorities in support of its conclusion in this regard.

**Which are not of a capital nature**

The tax court in *ITC 1839* held that such expenditure was of a capital nature on the grounds that it was more closely connected to the taxpayer’s income-earning structure than to its income-earning operations. No reasoning is provided for this conclusion, but it would appear that the tax court reached this decision on the basis that the taxpayer had not discharged its onus in this regard.

With respect, the reason applied by the tax court in this regard is flawed. The test is not whether the expenditure is more closely connected to the taxpayer’s income-earning structure or to its income-earning operations. Rather, the test as laid down in *New State Areas*\(^8\) is “whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery” (our emphasis).

The court in *New State Areas* went on to state that: “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

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\(^7\) *ITC 1839* 72 SATC 61

\(^8\) *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155
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.”

Expenditure incurred to compensate a purchaser of a business for assuming liabilities on the sale of a business is not expenditure incurred for the acquisition of a capital asset. Furthermore, it is not expenditure incurred in order for the seller to rid itself of its income-earning structure. Rather, it is expenditure incurred to rid one of a liability which, if such liability arose in the ordinary course of operations, is nothing more than part of the cost of performing those income-earning operations. On that basis, it is expenditure of a revenue nature and not expenditure of a capital nature.

Carrying on a trade
The decisions of the courts have not been consistent on the question whether expenditure incurred on or after the cessation of a business is deductible. However, the general principle appears to be that an expenditure incurred in respect of an obligation assumed during the course of its existence will continue to be deductible despite the cessation of that business.9

In ITC 1627 the court cited a number of decisions of the English courts in support of the view that trading only ceases when all the debts of the businesses have been paid and all sums due to it have been collected.10

In ITC 1839 the tax court ruled that any such expenditure was not laid out or expended for the purposes of the taxpayer’s trade. The ratio for this ruling was on the basis that the transactions in question were undertaken with a view to enabling the taxpayer to sell its business as a going concern and, in particular, for the purpose of bringing an end to the appellant’s trading activities. With respect, this reasoning is flawed when regard is had to the decisions of the courts referred to above.

9 ITC 1029 26 SATC 54; ITC 729 18 SATC 96; ITC 1627 60 SATC 26
10 See for example Theophile vs Solicitor-General (1950) 1 All ER 405(HL)
The Purchaser

Consideration for assumption of contingent liabilities

The discussion paper does not address at all the tax implications for the purchaser of the compensation given by the seller for the assumption of the liabilities (both absolute and contingent).

As a general proposition, where a purchaser assumes liabilities of a seller of a going-concern and is compensated in that regard, either in money or in kind, the purchaser will have a receipt or accrual as contemplated in the Act. However, we are of the view that such receipt or accrual will, generally, be of a capital nature and accordingly not constitute gross income for the purchaser on the grounds that it is not received in terms of a scheme of profit-making.\(^{11}\)

Insofar as CGT is concerned, we hold the view that there would be no disposal of an asset from the point of view of the purchaser insofar as payment for the assumption of the contingent liabilities is concerned. While the right to claim payment of the compensation is a personal right of the purchaser and that right is extinguished through performance, the right to claim payment is not an asset within the meaning of the term as defined in paragraph 1\(^{12}\). In this instance, there is no disposal of an asset as contemplated in the CGT legislation, but rather the acquisition of a contingent liability.

As such, our view is that, as a general proposition, there are no tax implications for a purchaser in respect of any compensation for the assumption of liabilities as part of the acquisition of a business.

Expenditure actually incurred at date of sale

\(^{11}\) 11 CIR v Stott in 1928 AD 252 at 264, 3 SATC 253; CIR v Pick ’n Pay Employee Share Purchase Trust, 1992 (4) SA 39 (A), 54 SATC 271

\(^{12}\) See SARS Comprehensive Guide to CGT Issue 4 pages 39 - 40
We agree that the position in the discussion paper to the effect that the purchaser would not have incurred expenditure until such time as the contingent liability becomes unconditional is probably a correct application of the law.

_Free-standing contingent liability becomes unconditional_

We generally agree with the view expressed that the nature of any expenditure incurred in relation to the contingent liability will depend on the nature of the particular asset acquired and in respect of which the assumption of the contingent liability was consideration. However, it should be noted that this position is at odds with the decision of the tax court in the unreported judgment of 11 May 2005 referred to earlier in this document.

**Concluding remarks**

The issues which the discussion paper attempts to address are age-old, having been around since the introduction of income tax more than 100 years ago. Following the decision of the SCA in the Ackermans case we lobbied National Treasury to introduce legislation to eliminate the uncertainties, potential asymmetries and possibility for double taxation. This led to draft legislation in 2011.

However, the proposed legislation was subsequently withdrawn as agreement could not be reached on whether the seller or the purchaser should be entitled to the deduction. Instead, it was proposed that a general binding ruling or interpretation note be issued to clarify the tax treatment of contingent liabilities assumed. Presumably, that is what has prompted the issue of the discussion paper.

The purpose behind the draft legislation was to eliminate the uncertainties and ensure that one of the seller or the purchaser is entitled to a deduction in relation to assumed contingent liabilities, the proposed approach adopted in the discussion paper does not achieve those objectives. Unfortunately, SARS has tended to take the approach of denying the deduction in both the hands of the seller and the purchaser, even going to the extent of using conflicting
arguments. The courts have not assisted in this process by issuing numerous conflicting, confusing and, in a number of instances, questionable decisions.

The proposed treatment in the discussion paper is, with respect, inequitable and the complexity of the proposed treatment may impede the sale of businesses as going concerns – for example, purchasers may be reluctant to take on employees of a business if employee-related contingent liabilities are not freely deductible. From a macro-economic perspective, it is important that businesses are freely transferable and more critically that where businesses are transferred that there is minimal impact on the employees of those businesses. It is submitted that the principles set out in the discussion paper are not aligned with this objective.

While it is acknowledged that SARS may have concerns with regard to opportunities for avoidance, particularly insofar as transactions undertaken under the corporate rollover relief rules are concerned, that should not derogate from a principled approach to interpretation being taken. Any residual concerns can and should be addressed through legislative intervention where necessary. For example, the corporate rollover relief rules do not address the assumption of contingent liabilities. In principle, there is no reason why these rules should not be extended to the assumption of contingent liabilities such that the parties are treated as one and the same person for purposes of determining any deductions with regards to such liabilities.

We recommend that legislation be enacted, as proposed in the Draft Taxation Laws Amendment Bill 2011, which clarifies that where a purchaser assumes a contingent liability in payment of an allowance asset:

- the value of the contingent liability so assumed is to be taken into account when determining the total consideration paid for the asset, in both the seller and the purchaser’s hands;
• the seller is entitled to claim a deduction in respect of the expenditure incurred, when the contingent liability became unconditional in the seller’s hands by virtue of the sale agreement; and
• the purchaser is not also entitled to claim a deduction in respect of the same expenditure.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

Piet Nel CA(SA)

PROJECT DIRECTOR: TAX