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Legal and Policy Division
South African Revenue Service
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Dear Sirs

SECTION 24B OF THE INCOME TAX ACT NO. 58 OF 1962: TRANSACTIONS WHERE ASSETS ARE ACQUIRED IN EXCHANGE FOR SHARES ISSUED

The current version of section 24B of the Income Tax Act No. 58 of 1962 (the Act) provides for the tax deductibility or otherwise of the acquisition of any asset settled through the issue of shares by a company.

The section was inserted into the Act in terms of section 22(1) of the Revenue Laws Amendment Act No. 32 of 2004. It was deemed to have come into operation on 1 October 2001 and applies in respect of any asset acquired on or after that date for purposes of determining any capital gain or loss from the disposal of any asset (other than trading stock), i.e. it is effective from 1 October 2001 for the purpose of the Eighth Schedule to the Act. The effective date of the section is 24 January 2004 in respect of any asset acquired on or after that date for purposes of determining any other tax liability levied in terms of the Act.

This would, in our view, include the determination of the value of any tax deduction determined in terms of the Act, amongst others,

- the general deduction formula (section 11(a) read with section 23(g));
- valuation of trading stock (section 22);
- wear and tear allowances (section 11(e));
- capital allowances (sections 12C);
- the inclusion of the value in gross income (as defined in section 1).
However, section 24B of the Act does not apply where a company acquires services and settles the acquisition of the services through the issue of shares in the company.

1. **Background**

   1.1. The reasons for the exclusion of services from the provisions of section 24B of the Act are unknown. This exclusion however creates an anomaly in the application of the provisions of the Act as the provider of the services, and therefore the recipient of the shares, would have to bring the value of the shares into account in the determination of his/her gross income whilst the recipient of the services, i.e. the issuer of the shares, is denied a deduction of the value of the services acquired where such services were incurred in the production of income.

   1.2. This is due to the fact that gross income is defined as, amongst other, “the total amount, in cash or otherwise, received by accrued to or in favour of such resident ...”. Therefore, once it has been established that a receipt has been enjoyed in the form of shares, it is necessary to value those shares.

   1.3. Where the recipient of the shares is an employee of the company or of an associated institution, the valuation of the shares is governed by the provisions of the Seventh Schedule to the Act.

   1.4. The Act therefore acknowledges to a limited extent the fact that shares may be issued as compensation for services rendered.

2. **South African case law**

   2.1. The status of the South African case law has not changed since the previous submission nor has any applicable judgments been delivered on the matter since the previous submission was made.

   2.2. It is, however, clear from the limited South African case law available that the expenditure incurred in respect of the acquisition of a service may be settled by means of the issue of shares.

   2.3. South African companies are often advised to enter into agreements in terms of which provision for specific amounts are made, which amounts can only be paid through the issue of shares on the basis that these amounts will be deductible.

   2.4. However, it is widely accepted that the South African business environment has changed over the last decade as more “unsophisticated” or entrepreneurs with limited (if any) tax knowledge enter the market. Emphasized by the need for the SARS to introduce measures such as the Small Business Tax Amnesty and other initiatives such as taxpayer education/information programmes.
2.5. The provision of services in exchange for shares are becoming more prevalent and these entrepreneurs are often not aware of the need to structure these service agreements in order to provide for specific amounts which can only be paid through the issue of shares. The inclusion of services in section 24B of the Act will ensure that all companies are entitled to the same deductions irrespective of the level of sophistication of the shareholders and/or executive management of these companies.

2.6. As stated in our submission dated 3 March 2004, the practice of issuing shares in the settlement of an obligation has been a common method employed by companies to settle expenditure or obligations arising on the acquisition of trading stock, capital assets and especially in merger and acquisition transactions. Although not specifically highlighted in that submission, the expenditure or obligations arising from the acquisition of the trading stock, capital asset and even more so in merger and acquisition transactions often include a service component.

2.7. However, in the absence of any specific provisions dealing with this issue in the Act, the treatment of the expenditure incurred in respect of services rendered and settled by means of the issue of shares in the company, cannot be predicted with reasonable certainty.

2.8. We are further of the opinion that the principles to determine the value of the “expenditure actually incurred” when services are acquired should be no different to the principles applied when an asset is acquired.

3. Application of the Companies Act No 61 of 1973

As noted in the previous submission, section 92(1) of the Companies Act No. 61 of 1973 (the Companies Act) provides that a company may not allot or issue any shares unless the full issue price of or other consideration for the shares has been paid to and received by the company. The principle still applies, irrespective of the amendment to section 38 of the Companies Act which will enable companies to provide financial assistance for the purchase of their own shares.

4. United Kingdom case law

As stated in the previous submission, an analysis of the decisions of the courts of the United Kingdom resulted in the following conclusions:

4.1. The amount of the expenditure for tax purposes would depend on the circumstances;

4.2. Where the purchase price for the asset that is being purchased is contractually quantified and shares are issued in discharge of that amount, the expenditure would be that amount. In such a case the company would have to take care that the issue of shares complies with sections 77(2), 82(1) and 92(1) of the Companies Act;
4.3. Where the contract does not quantify the purchase price, it seems that the amount deductible as expenditure would depend on whether the shares were issued by the company at par or at a premium. This would represent the value, which the company itself, for purposes of the transaction, placed on its shares.

5. **Recommendation**

5.1. It is recommended that consideration be given to the amendment of section 24B of the Act and paragraph 20 of the Eighth Schedule to the Act to include as expenditure, shares issued by a company in settlement of an obligation arising from the acquisition of services.

5.2. The implementation of the suggestion would create certainty in regards to the claiming of such expenditure incurred as well as create equity as the receipt of the shares given in consideration of the provision of the services would be taxable in the hands of the recipient.

Please do not hesitate to contact me should you require further information.

Yours faithfully

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