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How to cite this thesis
THE TAX IMPLICATIONS OF TAKE-OVERS,
MERGERS AND ACQUISITIONS

BY

RODNEY MORRIS

NAVORSINGSESSAY
VOORGELE TER GEGEELTELIKE VERVULING VAN
DIE VEREISTES VIR DIE GRAAD
M COM (ONDERNEMINGSBESTUUR)
IN DIE
FAKULTEIT EKONOMIESE EN BESTUURSWETENSKAPPE
AAN DIE
RANDSE AFRIKAANSE UNIVERSITEIT

STUDIELEIER: MEV D.D. VORSTER
DECEMBER 1987
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1. INTRODUCTION

1.1 Background to Mergers and Acquisitions

Mergers and acquisitions are as old as business itself; however, the number and size of mergers and acquisitions has increased dramatically over the last twenty years.

History has shown that a boom in listings as is presently being experienced sows the seeds for a massive growth in mergers and acquisitions in the years to come. It is very difficult to assemble the historical data which would show the extent of mergers and acquisitions. However, MacGregor (1979:18) showed that the delistings experienced on the Johannesburg Stock Exchange are mainly caused by mergers, as illustrated in Table 1 below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Transfer at Request of Company</th>
<th>Suspended or Terminated</th>
<th>Transfer to Secondary Company</th>
<th>Merged with or Acquired by another Company</th>
<th>Total</th>
<th>1 - 2 Percentage Delistings because of Merger or Acquisition</th>
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<tr>
<td>1961</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>4</td>
<td>6</td>
<td>66.7</td>
</tr>
<tr>
<td>1962</td>
<td>2</td>
<td>4</td>
<td>0</td>
<td>8</td>
<td>14</td>
<td>57.1</td>
</tr>
<tr>
<td>1963</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>8</td>
<td>10</td>
<td>80.0</td>
</tr>
<tr>
<td>1964</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>6</td>
<td>6</td>
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<tr>
<td>1965</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>9</td>
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</tr>
<tr>
<td>1966</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>7</td>
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<td>1967</td>
<td>1</td>
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<td>0</td>
<td>5</td>
<td>6</td>
<td>83.3</td>
</tr>
<tr>
<td>1968</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>10</td>
<td>90.0</td>
</tr>
<tr>
<td>1969</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>37</td>
<td>38</td>
<td>97.4</td>
</tr>
<tr>
<td>1970</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>21</td>
<td>21</td>
<td>100.0</td>
</tr>
<tr>
<td>1971</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>9</td>
<td>10</td>
<td>90.0</td>
</tr>
<tr>
<td>1972</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>20</td>
<td>22</td>
<td>90.9</td>
</tr>
<tr>
<td>1973</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>31</td>
<td>33</td>
<td>93.9</td>
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<tr>
<td>1974</td>
<td>1</td>
<td>3</td>
<td>0</td>
<td>24</td>
<td>28</td>
<td>85.7</td>
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<tr>
<td>1975</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>30</td>
<td>32</td>
<td>93.8</td>
</tr>
<tr>
<td>Total</td>
<td>11</td>
<td>12</td>
<td>1</td>
<td>228</td>
<td>252</td>
<td>90.5</td>
</tr>
</tbody>
</table>

- 1 -
The number of listings and delistings is a factor of a number of interdependent variables. What is evident is that after a listings boom comes the next stage, being a rapid increase in the number of delistings (refer to Table 2 below). The listings boom appears to have reached its peak in 1987 with an estimate of 253 new companies being listed. Since October 1987, when the stock market had a major correction, the number of listings has dropped sharply.

Table 2 - Companies Listed and Delisted on the Johannesburg Stock Exchange (1969 - 1986) - Floquet (1987:1)

1.2 Definition of Terminology Used

In South Africa, the terms "merger", "acquisition" and "take-overs" are used synonymously; however, there is a subtle difference between merger and "acquisition" or "take-over". MacGregor (1979:6) explains these terms as follows:
"Merger" is an arrangement whereby the assets of two companies become vested in, or under the control of, one company which has as its shareholders all, or substantially all, the shareholders of the two companies.

"Take-over" or "acquisition" is a transaction or series of transactions whereby a person acquires control over the assets of a company.

The distinction between a merger and an acquisition will have little effect on the use of this paper as it has been written in such a way as to identify tax problems in either instance.

1.3 The Need for Research into Mergers and Acquisitions

It has been shown that the chances of success when merging or acquiring a company are much greater through the proper planning of an acquisition process which is integrated with a sound pre-transaction investigation. The pre-transaction investigation is primarily focused on the financial books and records of the company being acquired, one of these areas being tax planning.

In the past, purchasing companies have not spent much time on the tax implications of a purchase, some even relying on a clause inserted in the purchase agreement whereby the seller agrees that he will be responsible for paying the tax and/or penalties on events prior to the purchase of the company. It is vital that the purchaser be aware that it is the company that
will be liable for any taxes, and that it would then have to proceed to negotiate with the seller. This may cause substantial cash flow problems for the company until the seller reimburses the tax, or even worse the seller might not be able to pay the taxes or not be traced at all.

A proper pre-transaction tax investigation will not only limit the risk of extra taxes and/or penalties being levied, but it could also identify areas where the company is not utilising the allowances and deductions provided for in the Income Tax Act No. 58 of 1962 as amended. For convenience, this will be referred to as "the Act" in this paper.

The purpose of this paper is to provide the prospective purchaser with a methodical view to approach and value the tax risk of a company. Furthermore, it should enable the prospective purchaser not only to identify possible tax problems, but also provide suggestions on what tax planning should be made to avoid or reduce the tax problem.

The fact that this paper solely deals with tax issues should not, however, allow tax to distort a sound business decision. However, it is the writer's intention that the prospective purchaser become aware of the tax problems, and thus be able to make a sound and more informed business decision.
The prospective purchaser has two options available when acquiring an interest in a company. The prospective purchaser can either purchase the shares or assets of that company. The factors which influence the decision to purchase shares or assets in a company are discussed in Section 2 of this paper.
2. THE DECISION TO PURCHASE SHARES OR ASSETS IN THE COMPANY

The decision of whether to buy the assets in the company or its shares is primarily a business one. Some of these business factors would be:

- How the seller wants the sale to be structured.
- Whether the purchaser can afford the shares instead of one or two specific assets.
- How the purchase will fit into the buyer's existing business.

Tax should, however, play a part in the decision-making process as each of the purchase options has specific tax implications. For example, if the company being purchased owns property as its sole asset then it would probably be cheaper to purchase the shares of the company rather than the property. The reason for this is that the duty payable on transfer of shares is lower than the transfer duty on property. The exception to this would be if the land was purchased for speculatative purposes.

If the majority of the assets in the company are for sale in the same contract, general sales tax will not have any effect. The reason being that no sales tax is paid on the sale of shares nor will any sales tax be paid where all the assets are purchased as a going concern. General sales tax would only be levied if
the company sold its assets in terms of a number of small sales. If this is the situation, it would be advisable to obtain specific advice on the potential sales tax liability.

The result of the findings from the investigation of the balance sheet (as discussed in Section 3 hereafter) and what the purchaser intends to do with the acquired company are factors which may determine whether or not the purchaser buys the assets or the shares of the company. Take for example the situation of the purchaser buying a company where the only asset in the company was some form of trading stock such as land or goods. Should he purchase the shares, having valued the trading stock above its original cost price, then in spite of him paying the premium for the shares, he will not be allowed any tax relief for the premium. However, if he were to purchase the underlying trading stock, then he will get relief on the premium he pays for the trading stock. Further complications in purchasing the shares are that he will have to discount the revenue reserves because of the fact that dividends are taxed in the hands of an individual shareholder or close corporation.

The purchaser, when purchasing the shares of the company, will then be taking over the liabilities of the company. Some of these are specifically tax related; for example, unpaid general sales tax, Pay-As-You-Earn tax, and even company tax. These will all be discussed in Section 4.
Another consideration which may determine whether or not the purchaser buys the assets or the shares of the company is the method of financing and the tax deduction of the interest expense on money borrowed to finance the acquisition. In general, the interest expense on any money borrowed by a company to purchase the shares in another company will not be allowed as a tax deduction. The reason being that normally the only income that the purchasing company will earn is dividend income, which if received by a company, is exempt from tax in terms of section 10(k) of the Act. As a company can only deduct an expense in terms of section 11(a) of the Act if it is, among other things, in the production of income, this effectively means that the interest incurred in purchasing the shares will normally not be deductible for income tax purposes. A more detailed discussion follows in Section 5 of this paper where the various methods of financing the purchase of a company will be discussed.

A final consideration is that when purchasing the shares, the buyer is effectively taking over the company as a going concern including all the staff and the reputation of the company. These features are intrinsic to a company and will be an important factor in the decision. For example, take a purchasing company that acquires another company specifically because of its management team. The purchasing company would probably have to purchase the shares and tie in the management to the purchase.
3. EXAMINATION OF THE BALANCE SHEET

The purchaser should always carefully analyse the balance sheet to ensure that his valuation of the company has fully discounted all the tax implications of the balance sheet items before deciding whether to purchase the shares or the assets of the company.

An analytical review of the amounts making up the balance sheet will normally reveal the areas where the greater risks lie and naturally more time and care should be taken in such areas. Certain tax implications are very intricate and complicated, and expert help should be sought. The purchaser should evaluate the cost of this advice against the benefits he will receive in return.

The approach adopted by the writer is to discuss each major item in the balance sheet separately.

3.1 Share Capital and Stated Capital Accounts

The purchaser should ensure that no part of the issued share capital could be classified as a capitalisation share in terms of clause (i) of the second proviso to the definition of dividends in section 1 of the Act. Share capital would qualify as such if the company had made a capitalisation issue on or after 1 January 1974 out of profits or reserves.

If the purchaser identified a capitalisation issue, the next step would be to ascertain what taxes, if any, would be paid.

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The profits available for distribution should then be classified into two groups: capitalised capital profits and capitalised revenue profits. The classification should identify each change as either capitalised capital profits or capitalised revenue profits. Each change increasing the capital reserves should be identified as such, and the company should have proof thereof in the form of a director's resolution, or even disclosure in Part 8 of the Company Tax Return. Where a company reduced its share capital subsequent to a capitalisation issue, then it is practise that any reduction first utilises the available revenue reserves and only then will it utilise the capital reserves.

When the capitalised reserves have been identified, then capitalised capital profits should be valued as normal capital profits whilst capitalised revenue profits should be valued as normal revenue reserves.

The purchaser must deduct from the capitalised reserves all capitalisation issues on or before 1 January 1974 as a period of ten years has now passed since the date of first issue. The reason for this is that section 8(2) of the Act deals with a reduction of a capitalisation issue prior to 1 January 1974 within ten years of such issue.

Example 1

The balance sheet of XYZ (Pty) Limited was as follows on 1 January 1987:
Share capital: 25 000 ordinary shares at R1

Net assets (at cost)

The share capital includes 15 000 R1 shares issued as capitalisation shares in 1970 and 10 000 R1 shares which were issued after 1 January 1974 using R3 000 capital profits and R7 000 revenue profits.

If the company were to be put into liquidation, only the R7 000 capitalised revenue profits would be taxed as a dividend as neither the capitalised capital profits nor the shares issued in 1970 will constitute a dividend.

If, on the other hand, it was a partial reduction of share capital, then that part of the reduction that related to both capitalised capital profits and capitalised revenue profits would be deemed to be a dividend and taxed accordingly. Naturally, if the shareholder is a company, there will be no normal tax on the dividend in its hands, but the valuation will still have to take into account the possibilities of undistributed profits tax and the impact of the tax on dividends levied on the individual shareholders of the holding company.

3.2 Share Premium

The same principles apply to share premium as apply to paid up share capital as it originates from a share issue at a premium to the par value of the shares being issued.
Non-distributable reserves can originate either because of statutory obligations or as a result of the policy of the directors to set aside some of the after-tax profit of the company for some specific purpose. In the latter situation, the reserve could be as a result of realised or unrealised profits. An example of a non-distributable reserve consisting of unrealised profits would be a reserve arising from the revaluation of land and buildings, and this will have no tax implications.

The non-distributable reserves that have been created out of realised profits can either be of a revenue or capital nature for tax purposes. If they are of a revenue nature, then they must be valued the same way a distributable reserve is valued and which is discussed under that heading.

The implication of capital reserves is that these reserves would normally be a capital receipt when distributed to the new shareholders unless, of course, the company distributed these reserves as a "going concern". If the capital reserves are distributed when the company is being wound-up or liquidated, then section 1, paragraph (a) of the Act, to the definition of a dividend excludes the distribution as being a dividend, and individual shareholders will be exempt from paying dividend tax on any such distribution. The Act unfortunately does not define a receipt or accrual "of a capital nature", and where there is doubt the prior court cases should be able to guide one to the correct conclusion.
The prospective purchaser should not base his opinion on whether a reserve is declared as capital or revenue in the tax return, even if it is not questioned by the Commissioner. The reason being that the Commissioner, subject to prescription, is allowed at any time to deem a receipt or accrual to be of a revenue nature, the result being that the company will have to pay tax on the receipt at the ruling tax rate for the year that the additional income is levied.

The purchaser must therefore request an analysis of all the movements in the account together with a detailed explanation of all increases. He should then proceed to make a decision as to whether the receipts are of a capital nature. A full analysis of court cases ruling whether an amount is of a capital or revenue nature lies beyond the scope of this research report, but in view of the possible effects of an incorrect conclusion, a brief summary of some of the court cases is described below.

An analogy that is often used to illustrate the principle is that of the tree and its fruit (Huxham, 1987:22). The tree would be the capital asset which is used to generate the fruit. If the tree or part of it were realised, it would normally be a capital receipt whilst the fruit would be realised as revenue profit. The courts have laid down a number of tests over the years which can be applied in deciding whether a receipt is of a capital or revenue nature. The dominant case is that of intention. Other considerations are the manner in which the acquisition or
disposal was made and the period for which the asset was held. The purchaser of the company must first determine if the intention of the company when originally acquiring the asset was to hold it as an income producing machine, i.e. as an investment, or whether it was acquired for the purpose of later selling the asset at a profit. The intention to invest would normally result in a capital profit unless there was a change of intention prior to selling the asset. Such a change occurred in CIR v Lydenberg Platinum Ltd. 1929 AD where Stratford J.A. used these words: "... even though it was assumed that these properties were originally acquired for the purpose of carrying on the business of mining, the subsequent events to which I have referred point to a clear change of policy in regard to the use to which they were put". A change in intention requires something more than a decision to sell, even if the realisation was done in order to give the company the best advantage. The degree to which the company pursued a scheme of profit-making is very important. In Natal Estates Ltd. v SIR 1975(4) SA217 (AD), it was held that the company, in realising its land by development and sale, "... had crossed the Rubicon and gone over to the business, or embarked upon a scheme of selling such land for profit, using the land as his stock in trade".

In a situation where the company has mixed intentions, the courts have taken the view that the receipt is revenue as the taxpayer was not able to discharge the onus of proof resting on him that he is not subject to tax (Meyerowitz, 1987:99).
The prospective purchaser could do well to base his initial enquiries and examinations on the following aspects (Meyerowitz, paragraph 339):

"(1) The name of the company;

(2) its objects;

(3) its activities;

(4) its policy;

(5) the circumstances of acquisition of the asset in question;

(6) the circumstances of its realisation."

3.4 Distributable Reserves

The purchaser should always be aware of the tax implications of distributable reserves. Naturally if it is a company, then the dividend income will be exempt from normal tax in its hands, but the ultimate shareholder, if he is an individual or close corporation, would have to pay tax on the dividend when he ultimately accrues or receives it. Furthermore, any expenses incurred by the company in collecting the dividend would not be allowed as a deduction as it was not in the production of taxable income. Some discount is therefore applied to the revenue in order to recognise the tax implications on the dividend being distributed.
If the purchaser is an individual or close corporation, he would be granted relief of one third of the dividend received, assuming for the individual that he had taxable income of more than R4 600. The remaining two thirds would be included in taxable income and taxed accordingly.

An individual has a further two options available which will reduce his tax liability:

- Firstly, he could convert the company to a Close Corporation (C.C.) in terms of section 40A of the Act. Once conversion has taken place, any dividend distributed after six months of the financial year end prior to conversion, will be exempt from tax in the hands of the members in terms of section 10(1)(KA) of the Act. The only tax that will be paid will be ten percent of the distributable reserve, i.e. not including any profits of a capital nature, and this will be paid by the company.

- Secondly, he could use section 40B of the Act. In order for this to apply, the purchaser would have to wind-up or deregister the newly acquired company, and the company would then pay a tax on ten percent of the dividend. It should be noted that the winding up or deregistration of the company would not prohibit the purchaser taking over the assets and carrying on trading in either his personal capacity or some entity owned or controlled by him.
Should the purchaser intend to follow this route, then it is recommended that he records and preferably minutes his reasons ensuring that he is not open to attack under section 103(1) of the Act. Furthermore, section 40B of the Act will only apply to dividends.

The following example will illustrate the tax implications of the distributable reserves, and also that use of section 40B of the Act is the optional way of distributing the reserves. However, it is not normal for someone to buy a company with the sole objective of winding it up.

Example 2

X (Pty) Limited has recently been purchased by an individual who has taxable income of R80 000 per annum. At the end of its latest year of assessment the company had a distributable reserve of R100 000. What are the tax implications of this reserve?

(a) Declares a dividend of R100 000. Individual will pay tax at his marginal rate of, say 45% on the dividend less one third allowance:

\[ R100\ 000 \times (1 - \frac{1}{3}) \times 45\% = R30\ 000,00 \]

(b) Follows the route of Section 40A. Company will pay a conversion tax of 10% of the revenue reserves:

\[ R100\ 000 \times 10\% = R10\ 000 \]
(c) Follows the route of Section 40B of the Act. Company will pay tax equivalent to 10% of the amount of the tax-free dividend:

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve</td>
<td>R100 000</td>
<td>R100 000</td>
<td>R100 000</td>
</tr>
<tr>
<td>Dividend</td>
<td>R909 901</td>
<td>R909 901</td>
<td>R909 901</td>
</tr>
<tr>
<td>Tax Payable</td>
<td>R909 091 X 10% = R9 091</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Summary

<table>
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<th></th>
<th>(1)</th>
<th>(2)</th>
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<tbody>
<tr>
<td>Distributable reserve</td>
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<td>R 100 000</td>
<td>R 100 000</td>
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<tr>
<td>Tax levied:</td>
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<td></td>
<td></td>
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<tr>
<td>Tax on dividend</td>
<td>R 30 000</td>
<td>R 10 000</td>
<td>R 9 091</td>
</tr>
<tr>
<td>Conversion tax</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>After-tax benefit to</td>
<td>R 70 000</td>
<td>R 90 000</td>
<td>R 90 909</td>
</tr>
<tr>
<td>shareholder</td>
<td></td>
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</tbody>
</table>

3.5 Preference Share Capital

The prospective purchaser should ascertain what terms apply to the redemption of the shares as this will affect the valuation of the preference shares.

The risk would apply if the shares are to be redeemed in the future at a premium. Take a 7% preference share whose nominal value is R1 which will be redeemed at R2,50 in ten years' time. One might assume that this premium of R1,50 was really the result of the share only having a 7% nominal return. However, for tax purposes the discount or premium on redemption of preference shares would normally be a receipt or expense that is capital in nature and therefore not taxable or deductible. The owner whose shares are not being redeemed would receive income, in the case of a redemption at a premium, that under normal circumstances
would be capital and not fall into the definition of gross income.

Preference shares that had originally been issued as part of a capitalisation issue would normally be taxed as a dividend on their issue. The exemption, to the issue, would not normally be granted as in terms of the definition of a dividend (h)(ii) according to the Act it only applies to equity share capital. Only in circumstances where there was a right for the preference shares to participate beyond a specified amount in the distribution of capital or profit could such a share be defined as equity share capital. If this is the case, then the same rules would apply to any reduction in preference shares as to a reduction in ordinary shares.

Finally, when valuing the preference share any dividend paid is not deductible for tax purposes. The rule would apply to both standard and/or participating dividends. The result is that the effective cost of financing is higher than it appears to be. Assuming that the tax rate is 50%, then the nominal cost of a 7% preference share would be the same as a 14% debenture or other loan as long as the company was in a tax profit situation. Should the company to be acquired be in a large assessed loss position which will only be used up in many years' time, then it would normally be cheaper for the company to rather use the 7% redeemable preference share rather than the 14% debenture because of the time value of money.
Example 3

This example will illustrate the effective costs of preference shares and debentures when companies are either in a profit or loss situation. Both Companies A and B had taxable income of R100 000 for the year before taking into account the "financing charges". Both companies had raised finance of R60 000 at the beginning of the year; Company A via the issue of 7% redeemable preference shares, and Company B by way of 14% debentures. Companies C and D had a loss before tax with "financing charges" of R100 000 for the year. The financing charges being R60 000 7% redeemable preference shares for Company C and R60 000 14% debentures for Company D.

Assume all the companies paid either the preference share dividend or debenture interest at the end of the year. Show the effects on the companies' profits or losses for the year (tax rate is 50%).

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit/(loss) before tax</td>
<td>R100 000</td>
<td>R100 000</td>
<td>R-100 000</td>
<td>R-100 000</td>
</tr>
<tr>
<td>and &quot;finance charges&quot;</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debenture charges</td>
<td></td>
<td>8 400</td>
<td></td>
<td>8 400</td>
</tr>
<tr>
<td>Profit/(loss) after debenture interest</td>
<td>R100 000</td>
<td>R 91 600</td>
<td>R-100 000</td>
<td>R-108 400</td>
</tr>
<tr>
<td>Tax charge</td>
<td>50 000</td>
<td>45 800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profits after tax</td>
<td>R 50 000</td>
<td>R 45 800</td>
<td>R-100 000</td>
<td>R-108 400</td>
</tr>
<tr>
<td>Preference share dividends</td>
<td>4 200</td>
<td></td>
<td>4 200</td>
<td></td>
</tr>
<tr>
<td>Net profit/(loss) after &quot;finance charges&quot;</td>
<td>R 45 800</td>
<td>R 45 800</td>
<td>R-104 200</td>
<td>R-108 400</td>
</tr>
</tbody>
</table>
3.6 Long-Term Loans

There are many types of long-term loans which a company might have. Examples are mortgage bonds, convertible or redeemable debentures, secured loans, etc. For income tax purposes, the type of the loan is not normally decisive on whether or not the interest paid on the loan is to be deductible. The valuation placed on these loans by the prospective purchaser would materially differ on whether or not the interest was tax deductible as it has a direct effect on the after-tax cost of the loans.

In Financier v COT (17 SATC 34), Tredgold J.A. stated the following principles:

1) Where a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income-earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.

2) Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested money in an investment which does not produce taxable income, the income will be deductible for income purposes.
The above principles show that the ultimate use of the borrowed money is not necessarily the decisive factor, but rather the question of whether the expenditure was incurred for the purpose of earning income. There is a difference between where an amount is borrowed and specifically applied to an identifiable purpose and the situation where the borrowings went into a large pool of funds. In the former, the situation and related tax implications are clear cut, whereas in the latter further clarification would be needed to assess the situation and even then there would be some risk of the Revenue Department disallowing the interest under section 11(a) of the Act.

It is important that the purchaser analyses the reasons for borrowings increasing as this is one of the main indicators that show whether the expense is tax deductible or not. Should any of the borrowings not be deductible, then he should not only put a premium on these loans because of the tax implications in future years, but he should also provide for possible adjustments to taxable income in prior years that have not yet prescribed.

The purchaser must also bear in mind the principles which were discussed under preference shares above where the loan is redeemed at a premium or discount.

3.7 Deferred Taxation

A company provides for deferred tax in terms of AC 102 which is a statement of Generally Accepted Accounting Practice. The provision for deferred tax is used to match the income or expense
which is included in the income statement for a particular period but not included in the taxable income calculation. The match is only done for timing differences, that is for those items which affect accounting profits and taxable income in different periods. A timing difference is one that originates in one period and reverses in one or more subsequent periods. Adjustments are not normally made for permanent differences as once these have been included in the accounts or taxation computation, then there will never be a reversing affect.

The analysis of the deferred taxation account is important not for any direct implications but rather because it will highlight those items where deferred tax has been provided and then those items where no deferred tax had been provided for but should have been. Any change in the deferred tax provision will have a direct effect on the balance sheet and possibly the income statement as well. Finally, the analysis should bear in mind the manner in which deferred tax has been provided, i.e. on the deferred method or the liability method (Everingham & Hopkins, 1987:13).

The following example should help to clarify deferred tax. Better Bay Furnishers sells furniture on Hire Purchase (H.P.) terms only. They account for sales in the normal manner of taking profit when the sale is made (selling price minus cost of goods sold), and then accounting for the finance charged to the buyers of the furniture over the period of the hire purchase agreement. For tax, however, they are entitled to a credit agreement allow—
ance in terms of section 24 of the Act. Assume now that the company had made a decision, which was in conflict with Generally Accepted Accounting Practice, not to provide any deferred tax as they believed the business would carry on growing and that the allowance claimed would grow from year to year. The lack of provision for deferred tax effectively increased the earnings by what the provision should have been. The higher earnings per share might persuade management to recommend a higher dividend per share. While times are good, everyone is happy - especially the shareholder who is getting bigger dividends and higher earnings. As the new purchaser of the company complies with Generally Accepted Accounting Practice, he would have to make a provision in his valuation for the effect of the decreased earnings per share because of the provision for deferred tax.

3.8 Fixed Assets

The fixed assets of the company will include everything from land and buildings to office furniture that the company owns. Most companies depreciate their assets on the same basis, and at the same rate as for tax. If the shares of the company are bought then the wear and tear for tax will remain the same. However, if the assets are purchased, then wear and tear will be granted on the purchase price of the assets, and it is important that these prices are clearly specified in the sales agreement. For convenience, the discussion will be broken down into the different types of assets.
3.8.1 Land and Buildings

If the company owns land and/or buildings, it is of critical importance to establish why they were purchased, when they were purchased, and what they will be used for. The reason for this is that you must be able to satisfy both yourself and the Revenue Department, if and when the time comes, that any profits on sale of these assets are either capital or revenue. The intention of the company at the date of acquisition of the asset is critical to the decision of capital or revenue; for instance, was the asset purchased for investment or for speculation? It would, therefore, be much more difficult to convince Revenue authorities that a profit on a vacant stand that was purchased one year ago is capital than in the case of land and buildings purchased and used in the operations of the company. A full discussion of capital versus revenue is beyond the scope of this report.

In order to qualify for allowances in terms of section 13(1) and 13(7) of the Act, should the company carry on a process of manufacture or similar process, then the purchaser should look at what could be called the "pedigree" of the building. This would indicate whether the company could claim the two percent building annual allowance in terms of section 13(1) of the Act. The allowance is dependent on the date of erection of the building, and is based on the cost less initial allowances, and the total of the building and initial allowances must not exceed the cost of the building.
The following table provides a guideline to claiming the allowance:

**Table 3 - Building Allowances**

<table>
<thead>
<tr>
<th></th>
<th>Date of Erection</th>
<th>Process</th>
<th>Similar</th>
<th>Qualification</th>
<th>Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original cost</td>
<td>Before 25-3-59</td>
<td>N/A</td>
<td>N/A</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Between 25-3-59</td>
<td>X</td>
<td>X</td>
<td>Must be used by owner and previous owner must have qualified</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>14-3-61</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>After 14-3-61</td>
<td>X</td>
<td>X</td>
<td>Used by owner or leased to tenant and previous owner must have qualified</td>
<td>2</td>
</tr>
<tr>
<td>Improve-ments</td>
<td>Before 31-3-71</td>
<td>X</td>
<td>X</td>
<td>Must qualify for allowance on original building</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>After 11-4-71</td>
<td>X</td>
<td>X</td>
<td>Original building need not qualify</td>
<td>2</td>
</tr>
</tbody>
</table>

The building initial allowance is of little concern when purchasing a company except that it is important to see that the company had, subject to prescription, claimed the allowance correctly in the past. It should be noted that the allowance is only granted if the building is used in the process of manufacturing, and only in the year the building is first brought into use. If the building is erected on leasehold property, then the company must be entitled to occupy the property for at least ten years from the commencement of the erection.

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Whilst the buyer could qualify for the allowance, it must be noted that it is based on the actual original cost. Therefore, the buyer is not entitled to use the value placed on the land and buildings for purposes of establishing a selling price for the shares in the company.

If the purchaser is buying the assets rather than the shares, then he must ensure that the agreement specifies the price for the land and buildings separately. In establishing the price, he should bear in mind that no allowances are granted on the cost of the land.

Finally, the purchaser should take into account the potential recoupment of any building allowances previously granted. The method used for valuation of the land and buildings for accounting purposes should also be reviewed for any tax implications; for example, are the buildings valued at historical cost or in terms of a policy of regular fixed asset revaluation.

3.8.2 Plant and Machinery

The purchaser does not normally have to worry about capital versus revenue considerations for plant as the general rule is that the plant is purchased for use by the company, and any recovery on sale over and above the original cost will be capital. The high inflation rates in South Africa and the devaluation of our currency in the past years has often lead to imported plant being worth a lot more than the original cost.
The only factor to take into account is that there will once again be a recoupment of initial, and wear and tear allowances previously granted. It should be noted that any investment allowance is not subject to any recoupment. The investment allowances are claimed in the year the plant and machinery is brought into the process of manufacture, and the purchaser need only ensure that the allowances have been correctly claimed in the years that have not yet prescribed. The investment allowance only applies to plant and machinery brought into use on or before 30 June 1985. This has now been replaced by an accelerated wear and tear allowance.

A recoupment is taxed in terms of section 8(4)(a) of the Act, and it applies to specific amounts claimed under sections 11 to 20; 24D, 27(2)(b), and 27(2)(c) of the Act.

There is once again a difference in tax treatment if the purchaser were to buy the shares or the fixed assets of the company, especially if the company is in a process of manufacture or a similar one. In most circumstances, it would probably be better to buy the assets rather than the shares, the pros and cons of which are discussed above.

The purchaser should always examine the rates that are being claimed for tax to ensure that where the rates claimed are high, the local Receiver has given written consent to them. However, he should also see if the company could perhaps claim
higher rates or perhaps the company might qualify for special
allowances which it has not claimed to date; for example, the
accelerated rates, granted to taxpayers who carry on certain
trading activities in an economic development area. Any
acceleration in wear and tear and other allowances will have a
direct impact on the cash flow as the company will have reduced
taxable income, thereby reducing company tax payments.

3.8.3 Leasehold Improvements

A company could have an amount in the balance sheet for
leasehold improvements already incurred or being planned for the
future. The former is easier to identify, but the tax conse-
quences of both can be material if no tax planning has taken
place.

The lessee can only claim an allowance, in terms of section
11(g) of the Act, provided that there was an obligation for him
to effect the improvements or erect the buildings on the land.
There are a number of conditions included in the section which
should be studied if there is such an expenditure. The most
important criteria are that the lessee has an obligation and
that the lessor will have included such improvements in his gross
income.

The obligation must be specific either as to the value of
the improvements or that the lessee erects a building of certain
laid down specifications.
Where the target company has land and/or buildings which it leases out, there is always a potential latent tax problem for any leasehold improvements that have been or will be made to the property. The reason is that whilst the lessee receives the benefit of deducting the cost of the improvements or the stipulated cost, whichever is the lower, the lessor on the other hand is taxed on the benefit in a manner that could be detrimental to the lessor. The lessor is first taxed on the amount stipulated in the agreement as the value of the improvements. If, however, the value of the improvements is less than the stipulated sum, he will still be taxed on the amount specified in the lease. The prospective purchaser should carefully scrutinise any lease agreements. The leasehold improvements would be taxed in the hands of the lessor when the agreement is concluded, and in this situation the purchaser would merely have to adjust for the tax effect of the conclusion of any such future agreements. Some relief can be granted at the discretion of the Commissioner in terms of section 11(h) of the Act, but the section specifically makes provision that no allowance will be granted where the lessor or lessee holds more than fifty percent of any class of shares issued by the other company, or where a third party owns more than fifty percent of any class of shares in both the lessor and lessee. In practice, the lessor would receive an allowance of the difference between the amount of the improvements included in his gross income and the amount of those improvements discounted at say 6% over the period of the lease, but he should bear in mind that every case is considered on its facts.
Leased Property

It is common for companies to use off balance sheet finance for certain assets used by them; for example, motor cars, plant and machinery, computer equipment, etc., all of which could be used by the company. In return the company will pay a monthly rental in terms of a lease agreement. The lease payments are so calculated that the lessee has effectively paid for the asset plus interest charges by the end of the lease agreement. It is therefore able to acquire the asset for no consideration. The seller of the company will no doubt put the proper market value on the asset when valuing his company. The buyer, on the other hand, should be aware of the provisions of section 8(5) of the Act which states that if a person acquires leased or rented movable or immovable property and has the lease rentals deducted from his taxable income, and subsequently acquires the property for no consideration or for a consideration which is less than its market value from the lessor, then he will be taxed on the difference between the market value and the amount paid for the asset. Furthermore, section 8(5)(6A) of the Act, effective for leases entered into on or after 1 September 1983, now deems the lessee to have had a recoupment where he continues the lease at a nominal rental or where the lessor has abandoned his claim to the asset. The purchaser must also remember to take into account the General Sales Tax that he will pay when there is a change of ownership in the leased asset. The lessee who now has
taken ownership of the old leased asset will pay General Sales Tax on the market value of the article he has acquired, the rate presently being twelve percent.

3.8.5 Other Fixed Assets

Other fixed assets are not normally material in relation to all the assets and liabilities of the target company.

The principles established above also apply here; for example, recoupments included in taxable income and what would be a capital profit on a sale of fixed assets.

Furthermore, most companies tend to write-off these assets on the same basis for both book and tax purposes. Finally, the purchaser must ensure that all assets that might need to be scrapped have already been brought into use by the company as he is only entitled to claim a scrapping allowance if the company had previously used the assets.

3.9 Investments in Subsidiaries and Associated Companies

The fact that a company has built up a share in another company to the level where it is either an associate company or a subsidiary generally indicates that the investment is for long term growth and that profits, if any, realised on the sale of these investments would be capital in nature. The main exception to the rule is where the holding company is classified as a sharedealer, in this case the profits or losses on sale of
shares will be of a revenue nature. If the target company has any investments, the purchaser should first ascertain whether or not the company should be or is classified as a sharedealer and whether or not any profit on sale of the investment will be revenue or capital in nature. The purchaser should also keep in mind the decision held in Elandsheuwel Farming (Edms) Bpk v SBI 1978 (1) SA 101 A. In this case, on a majority decision, it was held that the advent of new shareholders with the object of them making a profit on the sale of land amounted to a new factor sufficient to indicate that the company had changed its intention (Meyerowitz, 1987:92(A1)).

Some of the basic principles which can be used are discussed in 3.3 above. Further discussion is beyond the scope of this report. It is further advised that where there is any doubt, tax expertise should be obtained to identify any tax problems.

The purchaser should ascertain whether or not the company is a sharedealer and that there are no hidden hazards as a result of section 24A of the Act. This section was introduced because of liquidity problems that a person who had "sold" his trading stock consisting of fixed property, or shares for shares in the purchasing company. The problem being that the "sale" or exchange of the trading stock for shares yields a profit that falls into the definition of gross income on the date of the sale. The seller, however, has merely realised a paper profit, and there will be no resultant cash flow to pay the tax on the profit.
Section 24A of the Act gives the seller the option of deferring payment on tax until the tainted shares are sold. The purchaser should note that he might need to delve deeply into the past as it is unlikely that there would be any obvious warning signs. Should he decide to purchase the target company, it would also be advisable to insert a warranty that the shares held by the company have not been tainted in any way by the company having exercised an option in terms of section 24A of the Act in the past.

The investment being discussed here comprises not only of the shares in the company, but also any inter-company loans. In the case of the company not being a sharedealer, the profit or loss from the sale of shares would normally be capital in nature. The debit balance inter-company loan requires further discussion. When managing a subsidiary or associate company, the holding company will for convenience often make payments for them; for example, to pay the rent, purchase of stock, debtors, etc. For the service provided, he might charge an administration fee, interest on debit balances, and could even sell its own products to the subsidiary company. The prospective purchaser needs to carefully analyse the constituents of the loan if there is any possibility of the subsidiary company not being able to pay its debts. The company would only be able to claim a loss for tax, on a loan becoming irrecoverable, if he was conducting a business of a money lender.
The courts are reluctant to classify a taxpayer as a money lender. A recent case was Solaglass where a group specially set up a new company to act as an intermediary in the group borrowing funds from group companies with surplus cash and lending funds to group companies with shortages; the court held that the company was not conducting a money lending operation. Losses in these circumstances would be capital. However, the company was able to obtain relief and a tax deduction for amounts that it wrote-off which had previously been included in its gross income. The courts adopted a principle, which is contrary to common and/or commercial law, of first-in, first-out. This means that the write-off will relate to the last debit entries making up the irrecoverable debt.

Finally, if the subsidiary or associated companies have recently been acquired, the purchaser should investigate the method that was used to finance the investment. The reason being that, with the exclusion of the company being a sharedealer, the only income that the purchaser could realise is dividend income, and because the dividends are exempt from income, any expenditure including interest spent to derive the income would not be deductible for tax purposes. There have been a few exceptions to the rule; for instance, CIR v Drakensberg Garden Hotel (Pty) Ltd., 1960 2 SA 475(A) where the taxpayer managed to convince the court that the shares were not acquired to earn dividend income but rather to secure for the company income in the form of rental and trading profits from business activities conducted by him on the property owned by the acquired company.
3.10 Other Investments

The prospective purchaser must once again investigate the background to the investments in order to ascertain the intention of the company when the investment was originally made. He should then proceed to see if there was any change in intention. Once complete, he should ascertain whether a sale of the investment would yield a capital or revenue profit and adjust his valuation for his conclusion. The purchaser should also refer to investments in subsidiary or associated companies for further clarification.

3.11 Loans

The rules explained in 3.9 above for the tax implications on loans being written off once again apply here. The purchaser should consider it very unlikely that an irrecoverable loan may be written off for tax unless it had previously been included in its gross income. The terms of the loans should also be examined to see if they are earning a market related interest rate. If the interest rate is either nil or below the market rate, then the purchaser should trace the source of the existing loans. If the loans were funded by reducing working capital requirements, using surplus cash or even if the shareholders were to make interest-free loans to the company, there will be no problem. However, should the loans be funded by interest-bearing debt, the interest charge incurred for this funding will not be deductible for tax purposes.
A discussion of long-term loans made to shareholders of the company who are individuals is set forth in Paragraph 3.9.

3.12 Goodwill

The payment of goodwill refers to the excess price that the purchaser is willing to pay over and above net asset value. The prospective purchaser must never, in his eagerness to purchase the company, forget that he will not be able to claim a deduction in respect of the payment of goodwill. This rule would even apply where the payment was made over a number of years in the future and dependent on the profit of the company. In this situation, although there is no relief for the purchaser, there is a good chance that the seller might be taxed on these receipts. A costly mistake for both parties because of a badly drafted sales agreement. It could be costly for the purchaser as he will effectively be paying up to double for goodwill in order to compensate the seller for the tax which could be avoided.

3.13 Stock

Stock can be basically broken up into two categories, trading stock and consumable stock, each being differently treated for tax.

3.13.1 Trading Stock

"Trading stock" includes anything produced, manufactured, purchased or in any other manner acquired by the taxpayer for the
purpose of manufacture, sale or exchange by him. It also includes anything that is sold whose proceeds would form part of his gross income (Silke, 1982:613).

The purchaser, having valued the trading stock for the purpose of establishing a purchase price for the shares in the company, must then see what the tax value of the stock is. This is important as stock has a direct revenue impact on its owner. To illustrate the effect, let us take the situation where "A" buys a company whose sole asset is trading stock valued for tax purposes at R1 million. "A", being aware of the replacement value for the stock being close to R5 million and that he can sell it for R8 million, thinks he is getting a bargain price of R4 million. His intention is to sell off all the stock and wind up the company making a nice healthy profit of R4 million. The real effect is:

<table>
<thead>
<tr>
<th></th>
<th>&quot;A&quot; Perception</th>
<th>For Tax</th>
<th>Real Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock sold</td>
<td>R 8 000 000</td>
<td></td>
<td>R 8 000 000</td>
</tr>
<tr>
<td>Cost of stock</td>
<td>4 000 000 *</td>
<td>1 000 000</td>
<td>4 000 000</td>
</tr>
<tr>
<td>Profit</td>
<td>R 4 000 000</td>
<td>R 7 000 000</td>
<td>R 4 000 000</td>
</tr>
<tr>
<td>Tax at 50%</td>
<td>2 000 000</td>
<td>3 500 000</td>
<td>3 500 000</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>R 2 000 000</td>
<td>R 3 500 000</td>
<td>R 500 000</td>
</tr>
</tbody>
</table>

* Stock was reduced to purchase price.

"A" has not made the after-tax profit of R2 million, but instead will have to be content with a mere R500 000, a costly
mistake indeed. In this example, "A" obviously should have purchased the stock instead of the shares. The original seller of the stock would then have been liable for tax on the difference between the cost of the stock and the selling price to "A".

The cost of trading stock for tax purposes is the original cost to the taxpayer in the current or any previous year plus any further costs incurred to get the stock into its existing condition. The taxpayer can make an adjustment to the cost of the stock, because the net realisable value of the stock is less than its cost. This adjustment is made with the Commissioner's actual or implied consent so unless he considers the adjustments to be reasonable, he is able to withdraw part or all of the concession.

Trading stock will include raw materials, work in progress, finished goods and merchandise for sale. The valuation of this stock has been discussed above, but it is interesting to note that over the last few years the tax value has been so structured that many of the standards of Generally Accepted Accounting Practice now apply. The latest has been the acceptance of AC 108, the Generally Accepted Accounting Guideline for stock for years of assessment ending after 1 June 1984. Any prospective purchaser should familiarise himself with AC 108 so that he is able to ascertain that the target company complies with accounting practice. He should also be aware that a company can directly affect the tax that it pays by playing around with its stock figure. Many a small company has either put fictitious low stock figures
in its balance sheet or merely written off costs that should be added to the cost of stock.

Apart from the observations above, there are two specific items that the purchaser should be aware of:

(i) The amendment to section 22(3)(d) of the Act in 1984 ruled that the cost price of stock should be calculated in terms of AC 108 for the years of assessment ending on or after 1 June 1984. This section allowed the taxpayer who had, in good faith, not included the further costs into the cost of the trading stock to get some relief by way of the increase in value being phased in over four years. The taxpayer would, therefore, now include the full cost in his financial statements, but would claim relief in the tax computation. A review of the computation should show if relief has been claimed, and if so the purchaser should adjust his valuation for the future tax liability. He need only be concerned about the relief adjustment to the financial year ending on or before 31 May 1988, this being the end of the four year period.

(ii) A most important area of concern dealing with the 1984 Income Tax amendment is section 22(5) of the Act. This refers to the fact that a company whose financial year end is after 1 April 1984 is no longer permitted to value its stock on the last-in, first-out basis (LIFO). This has no effect on the company being purchased only if the company had never used LIFO for tax purposes in the past.
However, if the company had used LIFO in the past, there is a hidden tax hazard that should be compensated for. Companies who used LIFO were able to charge cost of sales with the most recently incurred costs. LIFO partially eliminated the stock profits which arose from holding stock during periods of inflation (Everingham & Hopkins, 1987:89). For practical purposes, an index or link chain method is often used. The use of LIFO will, therefore, increase cost of sales in each year as these costs will be represented by the costs of the latest rather than the earliest purchases, and the closing stock will be substantially lower than on a FIFO basis. The difference in costs on the two methods is aggravated by the number of years LIFO has been used and by the rate of price increases.

The amendment would have had a great impact on companies who were using LIFO, and the Minister of Finance, feeling no doubt benevolent, ruled that on or after 1 April 1984, closing stock must be valued on a cost basis, not using LIFO, but the taxpayer would be permitted to reduce the cost by the LIFO reserve. This is effectively a permanent allowance that has been granted as the only time the reserve will be lost is if the company has a reduction of stock levels. In order to be able to claim the LIFO reserve for tax, the company must use the same basis for its financial statements. Although it reduces the earnings, the company has the benefit of reducing the tax charge in each year.
The withdrawal of the LIFO method of stock valuation left many companies finding it incompatible to continue using LIFO as a stock accounting policy. The result was that many companies changed to FIFO or the average method of stock valuation for both tax and accounting purposes. The profits made on conversion were included in the income statement for that year. Few companies, if any, made any provision for the tax implications of the LIFO reserve as there was no intention to liquidate the companies. The companies that made the conversion will only have a note in the financial statements in the year of conversion and in the subsequent year. Prospective purchasers should review the financial statements for a number of years prior to the purchase, especially the 1983, 1984, 1985 and 1986 years. These should show if LIFO was used and how the conversion from LIFO was made. From this information, the tax implications can be quantified.

3.13.2 Consumable Stores

The issue of whether stock is trading stock or consumable stores is a recent but important tax issue, the reason being that a taxpayer is not required to value consumable stores held by him at the beginning and end of every year for the purposes of determining his taxable income in terms of section 22 of the Act. The result is that the consumable stores are effectively written off for tax purposes when purchased. The prospective purchaser of a company should, therefore, identify whether or not certain stock has been correctly or incorrectly classified. The case of
Commissioner for Inland Revenue versus De Beers Holdings (Pty) Ltd. 1984(3) SA286(T) clarified the whole issue. In essence, it defined consumable stores as being articles and materials acquired by the taxpayer not for the purpose of resale at a profit, but acquired instead with the intention that they will be used or consumed in the ordinary course of the taxpayer carrying on his trade.

The effect of any reclassification of stock would be a cash outflow or inflow on the taxpayer's next tax return being assessed on the tax rate times the rand amount of the reclassification.

**Example 4**

A manufacturer has stock of two million rand consisting of spare parts, fuel, felts and sieves which are used in the process of manufacturing the final product, but which never form any part of the finished product produced by him. He classifies this stock as being trading stock, and his tax rate is 45%. The tax benefit and resultant cash outflow of the correct classification of this stock is detailed below:

<table>
<thead>
<tr>
<th>Consumable stores conversion</th>
<th>R 2 000 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate</td>
<td>45%</td>
</tr>
<tr>
<td>Net tax savings</td>
<td>R 900 000</td>
</tr>
</tbody>
</table>
3.14 Debtors

Debtors can broadly be classified as normal trade debtors and suspensive sale debtors. Trade debtors for the purpose of this report are all debtors excluding suspensive sale debtors.

When a purchaser looks at the debtors, the first thing he must do is to ascertain the origin of the debts. The reason for this is that the valuation of the debts will fluctuate according to whether or not any bad debts will be allowed to be written off for tax. One of the main criteria used to establish this is whether or not the debt was included in the taxpayer's income for the current or any previous year of assessment. Examples of debtors that would not qualify are:

- Staff loans
- Debts that the company acquired from another company even if the debtor was included in the income of the other company.

Suspensive sale debtors are given a special allowance under section 24 of the Act. This is because the taxpayer must include the full sale price of a suspensive sale in his taxable income for the year even though he might only receive payment over the next few years. In a business with a large debtors balance, any change in the allowance claimed will have a substantial effect on the tax paid.
The prospective purchaser should therefore, for tax purposes, be interested in two aspects of the suspensive sale. Firstly, he should see if the debtor has or has not been classified correctly as a suspensive sale. The most important criteria here is that ownership must pass after a period of at least 12 months after the date the contract was entered into and at least twenty-five percent of the contract is payable on or after the 12 month period. Secondly, he should ascertain whether the allowance has been claimed correctly. The allowance is basically the gross profit percentage multiplied by the outstanding debtors balance.

Trade debtors have in the past not been entitled to many allowances except for bad and doubtful debt provisions. However, recently an unpublished court case became general knowledge. The taxpayer in this instance sold his merchandise on what is referred to as "a six-months-to-pay revolving credit scheme". The judgement of the case stated that the taxpayer was entitled to establish a "present worth" of the right to future instalments. Kriegler J held that the "present worth" is equal to the market value of the merchant's outstanding book debts as at the last day of his year of assessment. The prospective purchaser should, therefore, see whether the target company has applied the above principle, and should review the related tax exposure on the matter as, although the company could try to claim the allowance, the Commissioner intends to take the decision to appeal.
3.15 Payments in Advance

Companies, particularly those in the construction industry, receive payments in advance. Normally, a taxpayer would have to pay tax on the advance payment received; however, when the amount has been received in terms of a contract and is to be used to finance future expenditures in terms of the contract, then the Commissioner is permitted to grant an allowance in terms of section 24 C(2) of the Act for such future expenditures.

The prospective purchaser should, therefore, review the accounts to identify such payments, and then ensure that they have been correctly accounted for in the tax schedule.

3.16 Provisions

In terms of section 23(3) of the Act, no deduction will be allowed for any income carried to a reserve fund. The prospective purchaser should, therefore, review the financial statements and the tax assessments of the company to ensure that the provisions have been correctly treated.

Companies tend to disclose all their provisions as a lump sum, some of which might be tax deductible. For example, a company that provides for accumulated leave owing to their employees would probably be allowed to deduct the provision provided the company was obliged to pay out the accumulated leave to any employee upon his resignation from the company. On the other
hand, a company whose financial year is in June would not be entitled to claim an allowance on the provision for a Christmas bonus paid to employees, as at the end of June there was no liability to pay any such amount. The expense will only be deductible when it is finally paid out in December, unless they could prove that there is a definite liability to make such a payment, for instance, in respect of past services.
4. OTHER CONSIDERATIONS

4.1 Assessed Losses

An assessed loss in a company is of significant value to a prospective purchaser as it represents the amount of tax-free, taxable income he can earn. The value that he can place on it is dependent on a number of items such as the tax rate, the period over which the loss will be used, and whether the company will be eligible for the assessed loss in terms of sections 20 and 103(2) of the Act.

In terms of section 20(1) of the Act, any loss incurred by a company, in any year of carrying on a trade, can be carried forward to the next year of assessment, and can then be set off against the income derived in that year. In order to be eligible to carry the loss forward, it was decided in S A Bazaars (Pty) Ltd. v CIR 1952(4) SA 505 AD that a company had to carry on a trade in that year even if no income was earned. The prospective purchaser must, therefore, ensure that not only has the company carried on trading in the last few years, but also that it will be able to continue to trade in the future. A review of activity on the balance sheet and income statement should provide satisfactory proof on the company's past trading activity.

The prospective purchaser should then consider section 103(2) of the Act in order to see whether or not the company might lose the assessed loss. This section allows the Commissioner to disallow the assessed loss where:
there has been a change in shareholding; and

- the company directly or indirectly receives or accrues any income; and

- the agreement was solely or mainly for the purpose of utilising any assessed loss.

Therefore, if a company is purchased for the sole purpose of utilising an assessed loss by the injection of assets into the company, the prospective purchaser would leave the company open to losing its assessed loss.

The final point to bear in mind is that a company's assessed loss must be reduced by the amount of any benefit received resulting from a compromise made with the creditors in terms of section 20(1) (a) proviso (ii) of the Act.

4.2 The Tax Computation

The tax computation is a schedule that starts with the company's income before tax, which has been extracted from the audited income statement, and then has a number of adjustments which will end with the taxable income of the company.

It is vital that the prospective purchaser carefully reviews this schedule to ensure that all the necessary adjustments have been made whether they increase or decrease the company's taxable income. Once the amendments to the adjustments that should be
made have been identified, the prospective purchaser will be able to amend the valuation of the company to take into account the effect of the adjustments to be made.

The purchaser's next step is to reconcile the tax computation to the "I.T. 34", that the company has received from the Commissioner, which will show the taxable income levied on the company for each of the years. Where the two do not agree, the purchaser must establish the reconciling item and also the reason for its omission or inclusion. He will then be able to make any further adjustments to the company's valuation.

4.3 The Tax Assessment

It is important for the prospective purchaser to inspect the tax assessments because of the following reasons:

i) A company normally has in terms of section 66(1) of the Act sixty days from the end of its financial year in which to render a return. Application for the extension to submit a return is usually given within certain limits. Where no extension has been granted and a return is late, a penalty is likely to be levied by the Commissioner which is normally a nominal amount for first offenders, but in some cases could be material.

ii) The tax assessments will indicate two dates, a due date and a second date. The due date is very important as it shows the date that will be used to calculate prescription of a
tax assessment, that is the "date of assessment". The reason for this is that in terms of Section 79(1)(c) of the Act, the Commissioner is prohibited from raising an additional assessment unless, of course, there was fraud, misrepresentation or non-disclosure of material facts, after expiration of three years from the date of assessment. Where an amount claimed for tax is at the discretion of the Commissioner, for instance, exporter's allowance, the prescription for such amounts is two years in terms of section 3(2) of the Act. It is, therefore, important to identify when the tax assessments prescribe as there could be adjustments claimed for tax purposes which although contentious would no longer be open to attack as prescription has set in.

iii) Thirdly, it is important to reconcile the tax assessment to the tax return submitted by the company, thus not only ensuring that the company has been properly assessed, but also the tax returns which had not yet prescribed would be identified for review by the buyer. The relevance of this review is discussed in section 4.2 above.

4.4 Undistributed Profits Tax

The aim of undistributed profits tax is to encourage companies to distribute their profits. This tax will only be a concern of the purchaser, subject to a change in the income tax rates, to the extent that a company does not distribute the dividend income that it earns. If the purchaser identifies a
possible undistributed profits tax problem, it is suggested that he obtain tax advice in order to ascertain the potential liability to the company.

4.5 Pay-As-You-Earn and Fringe Benefits Tax

The prospective purchaser of a company should pay careful attention to the Pay-As-You-Earn deduction system that the company employs. He should bear in mind that the company will be liable for any taxes which they should have deducted. The risk is further compounded by the fact that a ten percent penalty plus interest at fifteen percent per annum is automatically levied, not to mention the fact that the Commissioner can go back for as many years as the incorrect deductions were made.

It is important to ensure that not only the correct deductions are made for salary paid to the employee, but also that the benefits or advantages derived by reason of employment or the holding of any office are correctly valued in terms of the seventh schedule of the Act.

The purchaser must also be aware that the company will not be relieved from the tax even if it was ignorant of the fact that it should have levied the tax. An example of this is where a South African company contracted with an overseas company to complete certain work in South Africa. After the negotiations were concluded, the South African company agreed to pay a stipulated amount to the employees of the overseas company on behalf
of that company. The South African company would deduct these payments from payments due to the overseas company. The result of this was that the South African company was found by the Commissioner to have been responsible for taxes being deducted from the payments made to the employees in question. The company was unfortunately unaware that it should have adopted this procedure. The Commissioner, as part of its check up procedure, identified the error and the company was taxed on all the taxes that it should have deducted and which were not recoverable, as the employees could not be taxed, costing the company many millions of rands.

4.6 General Sales Tax

Once again, a prospective purchaser must ensure that the system for levying and paying general sales tax is sound. Where a company has not complied with the Act correctly, he will be liable for the shortage of general sales tax. Furthermore, an automatic penalty of ten percent per month is levied, but is limited to one hundred percent. If there is any doubt, it would be advisable to consult an expert in this field.
5. FINANCING THE ACQUISITION

5.1 Introduction

The purchaser must carefully evaluate the various methods of financing the acquisition of the shares or assets of the target company. The method of financing the acquisition will have a direct impact on the effective cost of the acquisition. The structure of the acquisition and the finance raised will not only have a bearing on the actual cost of the financing, but also whether or not it is tax deductable.

Obviously, the method of financing is not only dependent on the requirements of the buyer, but also that of the seller. A detailed exposition of the implications of the various financing schemes is beyond the scope of this report. Furthermore, it is suggested that the purchaser of the company obtains tax advice in order for a scheme to be structured for the benefit of the buyer and the seller. A review of the Financial Press in 1987 has shown that companies listed on the Johannesburg Stock Exchange have a preference for issuing ordinary shares which are sometimes supplemented by cash and/or preference shares.

5.2 Interest Incurred in the Production of Income

Should the purchaser want to deduct the interest on the acquisition of a company, he must show that it was in the production of his income. Therefore, if the purchaser was a company, it would need to be a sharedealer in order to claim the interest
expense for tax. As discussed in Section 2 above, no deduction of interest will be allowed if the shares were purchased as an investment for capital growth and/or dividend income. If the purchaser is an individual, he will be allowed to deduct a part of the interest expense in the same ratio as the dividends he earns are included in his taxable income.

The ultimate destination of the funds borrowed is not necessarily the decisive factor, nor whether the borrowed money earned any income, but rather if the funds were borrowed in order to produce income. Producer v Commissioner of Taxes (4) SA 230 (SR) illustrates this principle. The appellant company borrowed money which it lent to its subsidiary in order to facilitate the sale of its products. Subsequently, the subsidiary company issued new shares to the appellant. The cost of these new shares was set off against the debt. The appellant carried on claiming the deduction for interest, but the Commissioner sought to disallow some of the interest as it was incurred in the holding of shares. The court, however, held that there was no direct connection between the borrowing of the money in the ordinary course of the appellant’s business and the purchase of the shares.

Income Tax Case Number 953 has put some limitations on the application of Producer as it developed the principle that if the money is applied to a fresh purpose, then it would compel a re-examination of the borrowing. Therefore, if one had to use the circumstances in Producer, except that the debt was first
repaid and then the funds used to purchase the shares, it would appear that the interest would not be deductible.

The CIR v Standard Bank of SA Ltd. 1985 (4) SA 495 (AD) highlighted the fact that the purchaser must be careful of funding an acquisition from a general pool of funds. The reason for this is that if the purchaser cannot identify the connection between specific borrowings and the investment, he might have a problem in proving what portion of interest charge is tax deductible. More importantly, he would obviously want to use his future surplus funds to pay back the borrowings used for the investment, specifically where the interest is not tax deductible. If a pool of funds were used, once again there will be no clarity of what the surplus funds are actually being apportioned to the borrowings for the investment.

5.3 The Closeness of the Connection

The taxpayer, in order to be allowed to claim an expense, must link the expenditure to the income earning operations. It is always preferable to plan the funding so that there is no controversy in the matter. Sometimes, there might be a dispute with the Commissioner, and then the purchaser must look at the Act in conjunction with decided case law.

In CIR v Drakensberg Gardens Hotel (Pty) Ltd. 1960 (2) SA 475, a company acquired the shares of another company who owned the hotel premises and stores on which the former carried
on his business. The acquiring company had purchased the shares as it was essential for the conducting of his business that he secure control over the property which he had previously leased. The court held that there was a sufficiently close link between the interest paid and the income earnings operations of the taxpayer.

The above case does contrast somewhat with CIR v Shapiro 1928 NPD 436 where the managing director of a company purchased shares, out of borrowings, in order to buy out the controlling shareholder of a company. He then appointed himself a managing director and gave himself a salary. He claimed the interest expense as he believed that it was closely related to his salary and the earning of his director's fees. The court held that his salary was as a result of the efforts he put into the company, and not because of the purchase of the shares. The interest was, therefore, not allowed as it related to the purchase of shares, and the link between the interest and the salary was not sufficiently closely connected.

5.4 The Finance Used

The financing of an acquisition can be done in a number of ways, some of which are:

- Use of surplus cash

- Borrowings

- Issue of Ordinary or Preference Shares
The purchaser should carefully plan the financing of the purchase so that he not only considers his desired financial structure, but also the after-tax cost of the various forms of financing.

5.4.1 The Funding of the Acquisition with Surplus Cash

The payment via the use of surplus cash should not cause any tax problems for the purchaser even if the cash was once as a result of past borrowings. Reference should, however, be made to decisions made in the cases of Producer and Financier as discussed above.

A method that has been used in the past by companies wishing to generate the cash surplus is the depositing of all sales and debtor receipts into a special bank account, and subsequently funding the purchase through this account. If this reduction of working capital was because of excess stock and/or debtors in the past, then it is unlikely that it is open to attack. However, if the purchasing company had merely reduced the working capital as a scheme to fund the acquisition out of cash, and subsequently had to borrow funds in order to build up the working capital once again, then it is suggested that there could be a tax problem. The reason for this would be that although the interest qualified as a deduction in terms of section 11(a) of the Act, the purchaser could be open to attack under section 103(1) of the Act. The Commissioner might be able to argue that all of the following exist:
- There was an avoidance, or postponement, of a liability to pay tax.
- The avoidance was as a result of a transaction operation or scheme.
- There was abnormality.
- The scheme was solely or mainly to avoid any levy imposed by any Act administered by the Commissioner.

In spite of the fact that the Commissioner has not been successful in the application of section 103(1) of the Act, it would be prudent to avoid financing schemes that are open to attack.

5.4.2 The Funding of the Acquisition via Borrowings

The factors that affect the deduction of the interest under section 11(a) of the Act have been discussed above. Briefly, it is unlikely that a company will be entitled to deduct interest expense incurred in acquiring a company. If it is the purchaser's intention to fund the acquisition by way of borrowings and if the interest is not tax deductible, then it is suggested that the borrowings be clearly identifiable. Ideally, a separate account should be used for the borrowings. This will then allow the purchaser to divert future surplus funds to reduce these borrowings. If this is not done, then the purchaser would have difficulty in proving what the surplus funds were used for.
The purchaser should also be careful to avoid the principles established in ITC 1117. In this case, funds were borrowed at a rate, between five and twelve percent, which were at the discretion of the directors. The directors having determined the rate at eight percent for the year, were only permitted a deduction of five percent by the Commissioner. The court held that because expenditure was only incurred where there was a legal obligation to pay the expenditure, the company could only claim a deduction for the five percent, being the minimum amount it was obliged to pay.

Finally, the principle established in ITC 1121 must also be considered. In this case, a property company that had previously issued debentures for 115 000 pounds sterling went into liquidation. The debenture holders, not wanting to lose their money, formed a new company buying the property for 70 000 pounds sterling, and then issued debenture holders with debentures worth 115 000 pounds sterling. Interest was paid on the 115 000 pounds sterling which was disallowed. The court held that only 70 000 pounds sterling of the loan was incurred in the production of income, and interest on this amount only would be deductible, not on the 115 000 pounds sterling.

5.4.3 The Funding of the Acquisition by the Issue of Ordinary or Preference Shares

During the 1987 calendar year, most listed companies chose to fund the acquisition of a company by way of issuing shares in
itself to the seller. This was sometimes supplemented with issuing preference shares and/or surplus cash funds.

The funding of the acquisition in this manner for unlisted companies is both expensive for the purchaser and often unacceptable to the buyer because of the seller having greater difficulty in realising the shares.

The purchaser should analyse the cost of issuing shares instead of borrowings taking into account that there is no normal tax relief on preference or ordinary dividends paid by a company. The purchaser should remember that the costs relating to the issue, including any stamp duties paid, are not deductible for tax purposes.

The purchaser might be able to use the principles established in the Standard Bank case (see 5.3 above) to convince his bank to reduce the prescribed dividend rate on any preference shares issued by the purchasing company to the bank to assist in funding the target company. The reason for this is that the bank would be allowed to deduct the interest on funds that are deposited with it whilst it will receive the preference share dividends free of any tax.
6. CONCLUSION

"It is unlikely that management will ever abandon the objective of growth, and one must expect to see them continuing to achieve this objective by means of mergers and acquisitions as an alternative to internal growth." MacGregor (1979:125).

Once management has identified the need to acquire a company then it should carefully evaluate all candidates in order to identify the best one. The evaluation must cover all aspects, including tax as mentioned in this report. The business environment is a highly competitive one, and the purchaser will only succeed if he follows a disciplined and systematic procedure of evaluating all the available alternatives before the selection is made.

This paper has endeavoured to set out the broad principles and other tax considerations that apply to the purchaser. The purchaser should use the text and the Income Tax Act to establish a value on the identified target company.

The contract of purchase and sale is only arrived at after a lengthy process of negotiations between the purchaser and seller, and this will determine both the nature and terms of the transaction. The purchaser should ideally design a plan that will be advantageous to both parties, which will give him an edge if other parties are also competing for the acquisition.
Ultimately, the purchaser will make the purchase decision after carefully evaluating his business strategy and an analysis of the target company. He should always remember that the tax computations can, if ignored, lead to great losses, and should be thoroughly investigated before beginning the negotiations.
7. BIBLIOGRAPHY


