THE TAX IMPLICATIONS OF TAX CONCESSIONS, COMPROMISES AND ASSESSED LOSSES

by

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DIE BELASTING IMPLIKASIES VAN BELASTINGVERGUNNINGS, SKIKKINGS EN AANGESLANE VERLIESE

Dit gebeur soms dat 'n maatskappy met 'n aangeslane verlies nie in 'n posisie is om sy krediteure ten volle te betaal nie. In hierdie omstandighede sal die krediteure van die maatskappy waarskynlik 'n aanbod van 'n verminderde uitbetaling van hulle eise aanvaar. Hulle word oorgehaal deur die feit dat indien 'n likwikasie sy dikwels uitgerekte verloop neem, saam met die kostes daaraan verbonde en die genadelose stroping van inflasie, hulle selfs nog minder sal ontvang as wat hulle aangebied word ingevolge 'n verkryging.

In baie gevalle is 'n groot deel van die motivering agter die verkryging van 'n maatskappy in finansiële moeilikheid of likwidasie die feit dat die maatskappy 'n aansienlike aangeslane verlies het wat van ooglopende waarde kan wees vanuit 'n inkomstebelastingoogpunt indien die maatskappy se finansiële nood verlig kan word.

Ten einde al die krediteure tot die verkryging te verbind, word die voorstel normaalweg geïmplementeer deur die meganisme van artikel 311 van die Maatskappyewet (Wet 61 van 1973) (hierna verwys as die Maatskappywet). Artikel 311 van die Maatskappyewet handel oor skikkings of reëlings wat gemaak word tussen 'n maatskappy en sy krediteure. As dit eers gesanksioneer is deur 'n hofbevel, bind die reëling alle krediteure.

Die gewildheid van hierdie praktyk het tot 'n einde gekom toe die fundamentele beginsels onderliggend aan wat die "standaard skema" genoem kan word, bevraagteken is in die Hoë Hof in die saak *Ex parte* Kaplan: *In re* Robin Consolidated Industries Ltd (1987 (3) SA 413 [W]) (hierna verwys as die Robin-saak).

As gevolg van die Robin-saak is talle van hierdie reëlingskemas deur die jare ontwikkel en gesanksioneer deur die howe, insluitend die sogenaamde "voorkeuraandeelskema". Nieteenstaande hierdie alternatiewe, het die sakesektor egter groot huiwering getoon om betrokke te raak by skikkings of reëlings ingevolge artikel 311 van die Maatskappyewet en gevolglik het die gewildheid daarvan om hierdie transaksies aan te gaan getaan sedert 1987. Verder ontstaan probleme oor die manier waarop die uitbetaling van krediteure gestruktureer is ingevolge die reëlingskema as gevolg van die bepalings van artikel 20(1)(a)(ii) van die Inkomstebelastingwet (Wet 58 van 1962) (hierna verwys na as die Wet) en artikel 103(2) van die Wet. Die Kommissaris vir die Suid-Afrikaanse Inkomstediens (hierna verwys na as die Kommissaris) het hierdie twee artikels geïnkorporeer by die Wet om die handel in aangeslaneverliesmaatskappye teen te werk (De Koker, 2000: 17.17).

Dit blyk egter dat die minderheidsbeslissing in Namex (Edms) Bpk v KBI (1994 (2) SA 265 [A]) (hierna na verwys as die Namex-saak) die belangstelling in artikel 311-skikkings en –reëlings weer aangewakker het, aangesien twee van die vyf appèlregters bevind het dat die standaard skema in werklikheid tussen die maatskappy en sy krediteure was en artikel 311 van die Maatskappyewet gevolglik toegepas kan word.

Een van die alternatiewe skemas wat gebruik word na die Robin-saak is die voorkeuraandeelskema. Die doeltreffendheid van hierdie skema lyk egter twyfelagtig in die lig van die beslissing in CIR v Datakor Engineering (Pty) Ltd 1998 CLR 574 (A) (hierna verwys na as die Datakor-saak) met verwysing na die bepalings van artikel 20(1)(a)(ii) van die Wet.

Artikel 20(1)(a) van die Wet bepaal dat, in die berekening van die belasbare inkomste wat verkry word uit die beoefening van 'n bedryf, 'n aangeslane verlies wat oorgebring word verreken kan word teen sodanige inkomste. Ingevolge artikel 20(1)(a)(ii) van die Wet word egter voorsiening gemaak vir 'n beperking van sodanige verrekening, aangesien die balans van die aangeslane verlies verminder sal word met die bedrag of waarde van enige voordeel wat ontvang word deur of toeval aan die belastingpligtige as gevolg van 'n vergunning toegestaan deur of skikkings aangegaan met sy krediteure waardeur sy verpligtinge teenoor hulle verminder of uit die weg geruim is. Dit sal uiteraard die aantrekkingskrag van die verkryging verminder. Om hierdie probleem te systap, behoort 'n ander roete dus gevolg te word om enige skikking te vermy. Indien daar egter geen skikking tussen die maatskappy en sy krediteure is nie, kan artikel 311 van die Maatskappyewet nie gebruik word nie.

As gevolg van die implementering van die verkryging van sodanige maatskappy volg daar normaalweg 'n verandering in aandeelhouding van die maatskappy met die aangeslane verlies. In so 'n geval het die Kommissaris die mag ingevolge artikel 103(2) van die Wet om die verrekening van die aangeslane verlies teen enige inkomste wat ontstaan (regstreeks of onregstreeks) as gevolg van die verandering in aandeelhouding af te wys, mits daar aan sekere vereistes voldoen word.

Die navorsing en gevolgtrekkings word uiteengesit in drie breë afdelings. Die eerste afdeling, bestaande uit hoofstuk twee, handel oor bepalings en vereistes van artikel 311 van die Maatskappyewet met 'n spesifieke bespreking van die standaard skema en die voorkeuraandeelskema. Die tweede afdeling, bestaande uit hoofstuk drie, is gemik op 'n ontleding van die bepalings van artikel 20(1)(a)(ii) van die Wet en die beslissing van die Datakor-saak. Die derde afdeling, bestaande uit hoofstuk vier, is gemik op 'n ontleding van die bepalings van artikel 103(2) van die Wet.

In hoofstuk twee word die bepalings en vereistes van artikel 311 van die Maatskappyewet bespreek en die standaard skema en voorkeuraandeelskema word ondersoek, ontleed en bespreek in die lig van die vereistes van artikel 311 van die Maatskappyewet.

In hoofstuk drie word die bepalings van artikel 20(1)(a)(ii) van die Wet onderverdeel in sy vereistes soos geïdentifiseer deur die Datakor-saak en in besonderhede bespreek en krities ontleed met verwysing na tersaaklike gerapporteerde sake. Die Datakor-saak word ook bespreek en krities ontleed met spesifieke verwysing na die bedrag of waarde van die voordeel wat ontstaan uit 'n vergunning wat toegestaan of skikking wat aangegaan word deur die maatskappy se krediteure.

In hoofstuk vier word die bepalings van artikel 103(2) van die Wet onderverdeel in sy vereistes en in besonderhede bespreek en ontleed met verwysing na tersaaklike gerapporteerde sake.

Die gevolgtrekking van die studie en aanbevelings word gemaak in hoofstuk vyf.

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CHAPTER 1
INTRODUCTION

1.1 The topic of the study

The objective of this study is to examine the preference share scheme devised in practice to acquire a company (with the assessed loss of the acquired company still intact) in terms of the procedures as provided for in section 311 of the Companies Act (Act 61 of 1973; hereafter referred to as the Companies Act).

The study mainly aims at discussing and analysing the standard scheme, the preference share scheme and the future of the preference share scheme in light of the recent decision of the Supreme Court of Appeal in CIR v Datakor Engineering (Pty) Ltd 1998 CLR 574 (A) (hereafter referred to as the Datakor case) which has thrown the proverbial cat amongst the pigeons with reference to schemes of arrangements.

In order to properly focus this study it is limited to an analysis of the provisions of section 20(1)(a)(ii) of the Income Tax Act (Act 58 of 1962) (hereafter referred to as the Act) with reference to the Datakor case, and the anti-avoidance provisions contained in section 103(2) of the Act.

1.2 Background and purpose of the study

It sometimes happens that a company with an assessed loss is not in a position to pay creditors in full. In these circumstances the creditors of the company are likely to accept an offer of a reduced pay-out of their claims. They are persuaded by the fact that should a liquidation run its often lengthy course, together with the costs involved and the merciless ravages of inflation, they will receive even less than what is offered to them in terms of an acquisition.

In many instances a larger part of the motivation behind the acquisition of a company in financial difficulty or liquidation is the fact that the company has a sizeable assessed loss that can be of obvious use from an income tax point of view if the company's financial woes can be alleviated.

In order to bind all the creditors to the acquisition, the proposal is normally implemented through the mechanism of section 311 of the Companies Act. Section 311 of the Companies Act deals with compromises or arrangements made between a company and its creditors. Once sanctioned by an order of the court, the arrangement binds all creditors.

The popularity of this practice came to an end when the fundamental principles underlying what may be termed the "standard scheme" were questioned in the High Court in the case of *Ex parte* Kaplan: *In re* Robin Consolidated Industries Ltd (1987 (3) SA 413 [W]) (hereafter referred to as the Robin case).

As a result of the Robin case numerous of these schemes of arrangement were developed through the years and sanctioned by the courts, including the so-called "preference share scheme". Notwithstanding these alternatives, the business sector, however, has displayed a great reluctance to become involved in section 311 of the Companies Act compromises or arrangements and accordingly the popularity of entering into these transactions waned since 1987.

Furthermore, problems arise in the way the payout of the creditors in terms of the scheme of arrangement is structured due to the provisions of section 20(1)(a)(ii) of the Act and section 103(2) of the Act. The Commissioner incorporated these two sections in the Act to counter the trafficking in assessed loss companies (De Koker, 2000: 17.17).

However, it appears that the minority decision of Namex (Edms) Bpk v KBI (1994 (2) SA 265 [A]) (hereafter referred to as the Namex case) has re-ignited the interest in section 311 compromises and arrangements as two of the five Appellate judges found that the standard scheme was in fact one between the company and its creditors and as a result section 311 of the Companies Act may be applied.

One of the alternative schemes adopted subsequent to the Robin case is the preference share scheme. The efficiency of this scheme however, appears questionable in light of the Datakor case with reference to the provisions of section 20(1)(a)(ii) of the Act.

Section 20(1)(a) of the Act provides that, in calculating the taxable income derived from carrying on any trade, an assessed loss brought forward may be set-off against such income. However, in terms of section 20(1)(a)(ii) of the Act a limitation of such a set-off is provided for, as the balance of the assessed loss shall be reduced by the amount or value of any benefit received by or accruing to the taxpayer resulting from a concession granted by or compromises made with its creditors whereby its liabilities to them have been reduced or extinguished. This would obviously reduce the appeal of the acquisition. Therefore, in order to side-step this problem, a different route should be followed to avoid any compromise. However, if there is no compromise between the company and its creditors, section 311 of the Companies Act can not be used.

Furthermore, as a result of the implementation of the acquisition of such a company there normally follows a change in shareholding of the company with the assessed loss. In such an instance the Commissioner for the South African Revenue Service (hereafter the Commissioner) has the power in terms of section 103(2) of the Act, to disallow the set-off of the assessed loss against any income arising (directly or indirectly) as a result of the change in shareholding provided certain requirements are met.

1.3 Motivation for the study

The company acquiring a company with an assessed loss therefore has, from an income tax perspective, two main hurdles to overcome if it intends to preserve the assessed loss in the company acquired.

Accordingly, it is necessary to investigate the preference share scheme in light of the provisions of section 20(1)(a)(ii) of the Act and section 103(2) of the Act. The Supreme Court of Appeal has handed down a decision in the Datakor case in terms of section 20(1)(a)(ii) of the Act. It is therefore necessary to determine the effect of the decision in the Datakor case on the preference share scheme.

1.4 The programme and sources of the study

The research and conclusions are recorded in three broad sections. The first section, consisting of chapter two, deals with provisions and requirements of section 311 of the Companies Act with a specific discussion of the standard scheme and the preference share scheme. The second section, consisting of chapter three, is aimed at analysing the provisions of section 20(1)(a)(ii) of the Act and the decision of the Datakor case. The third section, consisting of chapter four, is aimed at analysing the provisions of section 103(2) of the Act.

In chapter two the provisions and requirements of section 311 of the Companies Act are discussed and the standard scheme and preference share scheme are investigated, analysed and discussed in light of the requirements of section 311 of the Companies Act.

In chapter three, the provisions of section 20(1)(a)(ii) of the Act are broken down into its requirements as identified by the Datakor case and are discussed and critically analysed in detail with reference to relevant case law. The Datakor case is also discussed and critically analysed with specific reference to the amount or value of the benefit arising from a concession granted or compromise made by the company's creditors.

In chapter four, the provisions of section 103(2) of the Act are broken down into its requirements and are analysed and discussed in detail with reference to relevant case law.

The conclusion of the study is reached and some recommendations are made in chapter five.

The main sources of this study are the Companies Act, the Act and the Datakor case.

CHAPTER 2
SECTION 311 OF THE COMPANIES ACT: COMPROMISES AND ARRANGEMENTS

2.1 Introduction

A variety of circumstances may make it desirable to reorganise or reconstruct the existing share capital structure of a company.

The Companies Act provides for various ways to effect this reorganisation or reconstruction in the capital structure of the company. The procedures for reorganisation provided for by the Companies Act range from resolutions for alterations of share capital, including increases, reductions and other changes of capital, and from variation of shareholders' rights to arrangements and compromises (Cilliers, Benade, Henning, Du Plessis & Delport, 1992: 447); Pretorius, Delport, Havenga & Vermaas, 1999: 491). The choice of the reorganisation or reconstruction mechanism may depend on various factors. The mechanism could range from an increase in the share capital of the company, as a result of the growth of its business undertaking to a reduction of the company's share capital or the reorganisation of its equity structure by entering into a compromise with its creditors or an arrangement with its shareholders and/or its creditors as a result of unfavourable trading results or other losses (Cilliers, et al. 1992: 447; Pretorius, et al. 1999: 491).

As a result of the last-mentioned circumstances, and in most instances because the company experiences financial difficulties, a company may need to negotiate with persons who have claims against it, such as its creditors or shareholders, with a view to modifying their claims in their common interest (Cilliers, et al. 1992: 447).

In most instances, an insolvent company would historically have accumulated an assessed loss. For this reason, an insolvent company will often be a prime target for an acquisition. The possibility exists that, if it can be acquired with its assessed loss intact, or substantially intact, and it can generate income, a substantial tax saving can be gained through the set-off of the assessed loss against income (Getz & Jooste, 1995: 56).

Furthermore, where the company experiences financial difficulty or is in the process of liquidation, the creditors of the company are very likely to accept an offer of a reduced payout of their claims. They will be persuaded that if liquidation runs its often lengthy course, accompanied by its attendant costs and the ravages of inflation, they will receive even less than what is offered to them (Getz & Jooste, 1995: 56).

However, the rights to claim something from a company often rest in large groups or classes of persons with whom it would be impossible for the company to negotiate individually. Accordingly, the necessity arises not only for a procedure whereby a company can negotiate with the shareholders and/or creditors of such a group collectively, but also for machinery which enable the company to bind all the shareholders and/or creditors of that group to the bargain agreed and decided upon by a majority of persons in that group. As a failure to reach consensus with one individual shareholder or creditor could frustrate a compromise or arrangement, a statutory procedure was thus necessary to allow for collective negotiations with various groups. Section 311 of the Companies Act provided this machinery (Cilliers, et al. 1992: 447-448).

The rationale behind a provision like section 311 of the Companies Act was succinctly described by Paterson and Ednie in Australian Company Law 2nd edition and subsequently approved of by Coetzee DJP in the Transvaal Provincial Division case of *Ex parte* NBSA Centre Ltd 1987(2) SA 783 (TPD) at 787 (See also Jooste, 1987: 323) as follows:

> "The section is intended to provide machinery (i) for overcoming the impossibility or impracticability of obtaining the individual consent of every member of the class intended to be bound thereby; (ii) to prevent in appropriate circumstances a minority of class members frustrating a beneficial scheme."

The quote only refers to members of a company but it is submitted that what is said is clearly applicable to creditors of a company as well (Levin, 1992a: 126-127).

It is therefore necessary to consider in more detail the elements and requirements of section 311 of the Companies Act.

2.2 The mechanics of section 311 of the Companies Act

Section 311 of the Companies Act reads as follows:

> "(1) Where any compromise or arrangement is proposed between a company and its creditors or any class of them or between a company and its members or any class of them, the Court may, on the application of the company or any creditor or member of the

company or, in the case of a company being wound up, of the liquidator, or if the company is subject to a judicial management order, of the judicial manager, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the Court may direct.

(2) If the compromise or arrangement is agreed to by-

(a) a majority in number representing three-fourths in value of the creditors or class of creditors; or

(b) a majority representing three-fourths of the votes exercisable by the members or class of members,

(as the case may be) present and voting either in person or by proxy at the meeting, such compromise or arrangement shall, if sanctioned by the Court, be binding on all the creditors or the class of creditors, or on the members or class of members (as the case may be) and also on the company or on the liquidator if the company is being wound up or on the judicial manager if the company is subject to a judicial management order."

From the above, it is clear that, for a proposed scheme to fall within the ambit of section 311 of the Companies Act, it must constitute a compromise or arrangement between the company and its creditors or members, or a class of them. In light of this, the definitions of a compromise and an arrangement deserve closer attention. These concepts are discussed under paragraphs 2.3 and 2.4 respectively.

The requirement that the compromise or arrangement must be between the company and its creditors will be discussed under paragraphs 2.6 and 2.7.

2.3 The meaning of compromise

The meaning of compromise has been held to include an agreement entered into between a company and its creditors and/or members which terminates a dispute regarding the rights of parties or some difficulty in enforcing these rights (*Ex parte* Cyrildene Heights (Pty) Ltd 1966 (1) SA 307 (W) 308).

The essential characteristics of compromises and arrangements were crisply highlighted by Brightman J, in the English case of *re* NFU Development Trust Ltd (1973 (1) ALL ER 135 (Ch) 140).

> "The word 'compromise' implies some element of accommodation on each side, It is not apt to describe total surrender. A claimant who abandons his claim is not compromising it. Similarly, I think that the word 'arrangement' in this section implies some element of give and take."

Accordingly, the compromises and arrangements contemplated by section 311 of the Companies Act:

> "are of the widest character and the only limitations are that an arrangement must not authorize something contrary to the general law or *ultra vires* the company and, that if capital is to be reduced, the formalities of subsection 83 *et seq*. must be observed."

This statement was approved of in the case of *Ex parte* Federale Nywerhede 1975 (1) SA 826 (W) and Sher, 1982: 49 and indexes the flexibility of section 311 of the Companies Act.

2.4 The meaning of arrangement

An arrangement on the other hand, is a far wider concept yet still similar to a compromise. The only restriction placed upon implementing an arrangement is that it cannot be contrary to general law or *ultra vires* or if the parties could achieve the same result through a contract (Cilliers, et al. 1992: 450).

Arrangement was found by Berman J in *Ex parte* Millman: *In re* Multibou (Pty) Ltd 1987 (4) SA 405 (C) (hereafter referred to as the Multibou case) not to bear a meaning in any way restricted by its association with the word compromise in the section.

Consequently, the words compromise or arrangement connotes some form of give and take or a compensating advantage to the members or creditors concerned (Cilliers, et al. 1992: 451; *Ex Parte* Federale Nywerhede 1975 (1) SA 826 (W) 830). In the case of *Ex parte* Satbel (Edms) Bpk: *In re* Meyer v Satbel (Edms) Bpk 1984 (4) SA 347 (W) the court found that the scheme in question amounted to an expropriation of the shareholders' rights and thus did not amount to an arrangement between the company and its members. It held that the essential meaning of the word arrangement envisaged some form of continued existence but in a different form.

2.5 Procedure in terms of section 311 of the Companies Act

Section 311 of the Companies Act provides that where any compromise or arrangement is proposed between a company and its members or creditors, the court may order a meeting on application by either the company, any member or creditor of the company, the liquidator or the judicial manager of the company.

Once sanctioned by the court, the compromise or arrangement will be binding for all creditors and members provided it was agreed to by:

- a majority in number representing 75% in value of the creditors; or
- a majority in number representing 75% of the votes exercisable by the members (section 311(2) of the Companies Act).

What has been set out above is a brief explanation of the mechanics and procedure of section 311 of the Companies Act. One must not, however, lose sight of the fact that the sanction merely awards a compromise or arrangement as a contractual force between the company and its creditors or members. The court has no greater power over it than any other sort of contract (Parker v WGB Kinsey & Co (Pvt) Ltd 1988 (1) SA 42 (ZS) at 47-48). Accordingly, the effect of the compromise or arrangement is to bind by recourse to section 311 of the Companies Act, the dissenting individual members or creditors to the proposed scheme.

In light of the above, it is clear that companies have substantial scope in designing schemes of compromises or arrangements to suit their particular needs.

The acquisition of a company without the concomitant reduction of its assessed loss for set-off purposes against future income is, for obvious reasons, an attractive proposition.

From an income tax perspective, section 311 of the Companies Act provides machinery to acquire companies with assessed losses which, if section 20(1)(a)(ii) of the Act (see discussion in chapter three) or section 103(2) of the Act (see discussion in chapter four) is not applied successfully, may be used to shelter taxable income. It also, as stated above, ensures that the offerer acquires a company without the fear of meeting unknown claims in the future. In the last decade or so, a veritable industry arose around the judicially controlled section 311 of the Companies Act procedure. As time progressed, the schemes to effect compromises and arrangements became increasingly sophisticated, culminating in what one might term the standard scheme.

2.6 The standard scheme

2.6.1 Introduction

Fuelling the growth of this industry was the courts' indulgent attitude towards the standard scheme when called upon to sanction it. The standard scheme used to achieve compromises and arrangements, and which was sanctioned throughout the Republic of South Africa, may be described as having certain elements discussed below (Larkin 1987a: 30).

2.6.2 The elements of the standard scheme

The standard scheme relates to a company under provisional liquidation, in terms whereof a third party (the offerer) proposes to make available a sum of money to the company under provisional liquidation, who is required to distribute it, as a dividend, to its creditors. Generally secured and preferent creditors are paid in full, while concurrent creditors receive a reduced claim.

In return for the dividend payment, the creditors lose all further rights against the company under provisional liquidation. The creditors' claims, however, persist and the creditors agree that, upon sanction of the scheme by a court under section 311 of the Companies Act, their claims are ceded or deemed to be ceded to the offerer.

Generally, compromises or arrangements contain a provision, namely, that the deemed cession will take place after the company has reduced the creditors claims by say, one cent in the Rand. Furthermore, the standard scheme was usually conditional upon the acquisition by the offerer of the entire issued share capital of the company and the release of the company from provisional or final liquidation (Jooste, 1988: 199).

The net effect of an offer of compromise or arrangement is that the offerer acquires control of a company, with an assessed loss, of which he is now the sole creditor. The success of the scheme was obviously dependent upon the unsuccessful application of section 103(2) of the Act (see discussions in chapter four), in which event all taxable income would be sheltered from tax to the extent of the assessed loss.

Regarding the standard scheme, two issues must be considered, namely, what was the advantage of having the court sanction the scheme and why were the ceded claims reduced by a nominal amount (which equally applies to the preference share scheme)?

Firstly, the sanctioning of a compromise or arrangement by the court ensures that it will be binding for all creditors and members, despite the lack of unanimous consent. Sanction obviously depends upon the achievement of a certain majority in favour of the scheme, provided that all formalities necessary under section 311 of the Companies Act have been complied with. The fact that the compromise is now binding on all creditors or members is a distinct advantage as the offerer will be safeguarded against unknown creditors bringing claims against the company in the future.

Secondly, the reason why the ceded claims were reduced by a nominal amount was to bring the scheme within the ambit of section 311 of the Companies Act and with it, all the safeguards. The success of the scheme however, was dependent upon the scheme being one between the company and its creditors or members and not only the offerer and the company's creditors or members.

It was this aspect which came under fire in the Robin case. Section 311 of the Companies Act requires that a compromise must be effected between the company and its creditors. In devising these schemes it was generally believed that the involvement of the company in the reduction of the creditors' claims, would satisfy the requirement set out in section 311 of the Companies Act. The subsequent cession of the balance of the creditors' claims to the offerer was then seen as ancillary to what had already transpired (Larkin, 1987b: 59).

Over a period of time and given the courts' acceptance of the standard scheme, the issue as to whether the scheme could in reality be said to be one between the company and its creditors was forgotten. In the Robin case the court resurrected this issue and found that no amount of cession or reduction of claims could bring the scheme under section 311 of the Companies Act, as it did not amount to a scheme between the company and its creditors.

While accepting that a compromise or arrangement was still possible where a third party was involved, the court held that this would only be the case where the true parties to the scheme were the company and creditors (Jooste, 1988: 199-200).

In addition to the above, the court in the Robin case rejected the argument that by reducing the creditors' claims by a nominal amount, the company played a role in the scheme. The cession of the claims was not necessary to give effect to the reduction of the claims but was totally independent thereof.

The court also found that if it sanctioned such a scheme, it would be permitting a hopelessly insolvent company to continue trading. Furthermore, Coetzee DJP held that the company's debts would now be concentrated in the hands of the controlling party of the company. The court believed that this would have a negative impact upon the interests of the public.

The court concluded that the standard scheme was one in terms of which the offerer rather than the company intended to acquire the creditors' claims. Accordingly, the company played no role and thus section 311 of the Companies Act would not be applied.

2.6.3 Criticism of the Robin decision

The judgement directed by Coetzee DJP was premised on the fact that judges had for some time felt uneasy about the realities of the standard scheme and the propriety of the terms and conditions and their effect upon the creditors.

The Robin case was of particular importance as it involved a considerable deficit and was more elaborate than most standard schemes.

Coetzee DJP found that the fact that the judiciary had ruled in favour of the standard scheme over the years had not validated these schemes. In an effort to substantiate his reasoning, Coetzee DJP stated that judges frequently fail, as do all humans, and that the fact that they had tacitly held in favour such schemes cannot bar an investigation into the validity of compromises and arrangements in the future (Larkin, 1987b: 59).

With regard to the court's concern about the propriety of the standard terms and conditions, it is submitted that Coetzee DJP in the Robin case acted as a participant rather than an objective bystander in the judicial proceedings. Previously, courts have relied upon the fact that as section 311 of the Companies Act, once sanctioned, becomes binding on all creditors as well as on the company liquidator and judicial manager, the court was entitled to redraft certain terms and conditions. Coetzee DJP took this patronising approach one step further by stating that creditors were not capable of looking after their own self-interests and accordingly should not be allowed to enter into such schemes.

One might argue however that the creditors are in the best position to judge what is in their own interests. Furthermore, the court's role should be limited to ensuring that all the procedural requirements and formalities have been properly complied with. If what had developed had not been fair to the creditors, it is submitted that they would not have accepted the offer. In addition, creditors should be entitled to elect to accept an offer on the basis that a reduction in their claim in terms of a compromise or arrangement may be better than having a worthless claim at face value upon liquidation of the company.

Another criticism of the Robin case may be said to be the death of a company that has a chance to survive and trade profitably. Generally, the reason for the standard scheme's popularity rests on the fact that claims against the company are essentially preserved, thus also preserving the assessed loss of the company (Larkin, 1987b: 59). On a practical level, it can be argued that an assessed loss is in fact an asset of a company and that the creditors should be entitled to take advantage of this remaining asset. Perhaps the court should have let commercial realities take over on the assumption that from an income tax point of view, there was nothing undesirable in the scheme. This approach would obviously ensure that a company, if it has a viable prospect to survive, could commence trading and ultimately trade itself out of its financial difficulties.

Furthermore, certain academic writers believe that the intention of the legislature in drafting section 311 of the Companies Act was to allow the tax loss of a company to play a role in compromises. If so, then one should surely interpret section 311 of the Companies Act to make it possible to retain the tax loss arrangements (Larkin 1987a: 32). The assessed loss, which now constitutes an asset, could then be used to entice the offerer to pay enough to its existing creditors to secure it. From this perspective, the cession of claims becomes a purely functional step ancillary to the compromise or arrangement.

Finally, the court in the Robin case justified its decision by concluding that the compromise was not legal for the following reasons: There was no compromise with the company and its creditors for its liabilities remained in tact. The standard scheme merely substituted one creditor for another, because the offerer and accordingly the company were in the same insolvent situation as they were when in liquidation.

Coetzee DJP found (Robin case: 426):

> "When discharging the winding-up order, the court now sends back into the business world the same hopelessly insolvent company to trade and incur

debts as before. Per se this is not illegal but a greater potential for harm and prejudice to the public than before lurks in this state of affairs."

The court's rationale was based on the fact that once sanctioned all the debts were consolidated in the hands of the controller of the company.

It is submitted that this line of argument is weak as it not only involves speculation but also represents a deviation from the court's traditional approach to company law, namely that new creditors should deal open-eyed with such a company.

2.6.4 The effect of the Robin decision and subsequent developments

Consequent to the judgement of the Robin case, there have been massive obstacles in obtaining sanctions to offers of compromise and other schemes of arrangements in terms of section 311 of the Companies Act in their standard form.

In short, the judgement raised the following problems (Robin case: 423-426):

- Company as a party

  The court was not satisfied in the Robin case that the company itself was a material party to the compromise or arrangement. The central characteristic of section 311 of the Companies Act is a contractual one. Accordingly, where a company is not in fact a material party to the arrangement it cannot be said to be part of the scheme. Since the Robin case, a number of test cases have come before the courts in an effort to overcome this obstacle.

- Solvency of a company

  It had become customary before the Robin case to discharge a company from its status of provisional liquidation. The court did not generally apply its mind to the question as to whether the company was now in fact solvent and whether it should be discharged from liquidation. As a result of the Robin case, an alternative approach developed, namely to subordinate the offerer's claim against the company or to convert the claims to preference shares.

Shortly after the Robin case, the Cape Provincial Division of the Supreme Court was called upon to comment upon a revised version of the standard scheme in the Multibou case. The principal feature of the revised scheme was that the offerer would acquire by way of cession 99% of each creditor's claim against payment by the offerer of a certain sum in money. The company would then borrow the balance from the offerer on a loan account in order to pay the creditors the 1 % of their claim.

Counsel argued that the scheme in the Multibou case was distinguishable from the Robin case on the basis that the company now played a material part, as the partial cession required the consent of the company.

Berman J in the Multibou case rejected this submission and held that the scheme fell outside the ambit of section 311 of the Companies Act on the basis that the cession did not amount to a partial cession. What was to be ceded was the entire balance of each creditor's claim and not only a part thereof. The consent of the company was thus not necessary to render the cession legally valid and enforceable. In addition to this, the scheme could not be regarded as a single transaction but was in fact a number of separate transactions independent of each other (Jooste, 1988: 199).

The court in the Multibou case, basing its decision on the reasoning of the Robin case, found that the scheme was nothing more than a sham, a disguised and simulated transaction.

The case of *Ex parte* Strydom NO: *In re* Central Plumbing Works (Natal) (Pty) Ltd 1988 (1) SA 616 came before the Natal Provincial Division of the Supreme Court. In upholding the standard scheme it came to a contrary decision to Coetzee DJP and Berman J in the Robin and Multibou cases by finding that the cession amounted to a deemed cession. In these circumstances, it required the company to consent to the cession of the creditors' claims and accordingly constituted an agreement between the company and its creditors or members. The court found both Coetzee DJP and Berman J had erred by looking merely at the final result and not at the scheme as a whole.

Two out of five Appellate Division Judges in the Appellate Division decision of the Namex case came to the conclusion that the standard scheme as decided upon in the Robin case, was in fact an arrangement between the company and its creditors and accordingly fell within the ambit of section 311 of the Companies Act. This, however, is a minority decision as the remaining judges found it unnecessary to comment on this issue, thus should a similar case come before another court, that court will not be bound to follow it. The finding, however, still remains a highly persuasive authority and will carry weight in future decisions.

In the Namex case, as with the Robin case, the two judges agreed that the mere reduction of creditor claims did not transform the standard scheme into an arrangement between a company and its creditors. They believed however, that the standard scheme (as opposed to Coetzee DJP in the Robin case) was in any event, without such reduction, an arrangement between the company and its creditors.

The two judges based their decision on the following reason, namely that an essential element of the standard scheme was the eventual release of the company from provisional liquidation. They found that the release from liquidation was in both the company and the creditors' interests as, if the company was in fact finally wound-up, the creditors would receive a lower dividend as opposed to that allowed by the offered. From the company's point of view, release from liquidation meant that it could act and trade freely once again.

The minority decision in Namex case accordingly found that the proposed resurrection of the company was indicative of an arrangement between it and its creditors. It has been argued that this line of reasoning, although not binding on other courts, will benefit future offers should another court be persuaded to decide on this issue, as the need for reducing the creditors' claims to bring the compromise within the ambit of section 311 of the Companies Act will consequently fall away. This apparently will also result in a preservation of the assessed loss in its entirety, which is obviously an inducement to the tax conscious offerers.

It is important to bear in mind however, that courts will be reluctant to sanction compromises or arrangements if there is any danger of future creditors being prejudiced. This approach is based on the fact that once the court has sanctioned an offer of compromise or arrangement, it effectively allows an insolvent company to enter into the business community and to contract with unsuspecting creditors, as was found in the Robin case. The only difference is that upon sanctioning, all the claims have been consolidated in the offerer's hands.

As an alternative to the standard scheme subsequent to the Robin case, there evolved an arrangement between a company and its creditors which is now generally known as the "preference share scheme".

2.7 The preference share scheme

The essence of this scheme is that the claims of the creditors, as reduced by a capital amount paid to them in terms of this scheme, are converted into preference share capital and the creditors are then deemed to have renounced their entitlement to the issue and allotment of such preference shares in favour of a person (usually the offerer) nominated by the company. The rights of all the creditors under such arrangement are confined to the right to claim payment of the dividends receivable by them under the arrangement.

Most, if not all, of the preference share route schemes utilise the method of redeemable preference shares but the terms and conditions thereof tend to vary. Certain schemes provide an actual redemption date whilst other schemes provide that the redemption date is to he determined at the discretion of the directors of the company. The value of the redemption is equivalent to the issue price of the shares. Certain schemes provide for a dividend (usually non-cumulative) to be declared at the discretion of the directors. Most schemes entitle the preference shareholder to priority for repayment of capital in the event of the company being wound up (Getz & Jooste, 1995: 56).

The question that arises is whether the scheme amounted to a compromise or arrangement between the company and its creditors so as to overcome the obstacles set up in the Robin case. It is clear that the company now plays a role in issuing the shares and paying the dividend but the difficulty lies in the fact that the company does not, in effect, issue the shares to its creditors. In substance, they are issued directly to the offerer. In these circumstances, one questions whether the company has any involvement, directly, with the creditors at all? In effect, it appears to be a compromise or arrangement between the company and its creditors in respect of the dividend and one between the company and its offerer in respect of the shares.

The test case which came before the courts dealing with the conversion of creditors' claims into redeemable preference shares was Sackstein NO v Boltstone (Free State) (Pty) Ltd 1988 (4) SA 556(O).

In Sackstein NO v Boltstone (Free State) (Pty) Ltd 1988 (4) SA 556 (O), Oliver J held that the arrangement was indeed one between the company and its creditors. He found the creditors to be directly involved as they had to agree to the conversion of their claims into capital and renounce all their rights and entitlement thereto. The company was also found to be directly involved for the following reasons:

- it presumably had to pass a resolution authorising the transfer of its entire share capital to the offerer;

- it had to pass a resolution to capitalise the creditors claims on the basis of converting their claims into preference shares and allocating them to the creditors *pro rata* their claims;

- the company had to actively issue the shares and transfer the shares to the offerer; and

- the company ultimately had to pay the creditors the agreed sum as reduced by a nominal amount.

In his judgement, Oliver J commented on the decision of Friedman J in the Central Plumbing Works case. He disagreed with Friedman J's reasoning relating to the capitalisation of the shareholders loan accounts and held that what should be considered is not whether the arrangement can be undone in the future but whether it was a genuine arrangement at the present time.

2.8 Conclusion

Whilst the preference share scheme clearly satisfies the requirements of section 311 of the Companies Act, what is of material importance is whether it is able to preserve the company's assessed loss pursuant to the provisions of section 20(1)(a)(ii) of the Act and section 103(2) of the Act. The issue pertaining to section 20(1)(a)(ii) of the Act was decided in the recent judgement of the Datakor case.

Therefore, in chapter three the provisions of section 20(1)(a)(ii) of the Act and the judgement of the Datakor case are considered and in chapter four the provisions of section 103(2) of the Act are considered.

CHAPTER 3

SECTION 20(1)(a)(ii) OF THE ACT: CONSESSIONS AND COMPROMISES

3.1 Introduction

In this chapter the provisions of section 20(1)(a)(ii) of the Act are broken down into its requirements as identified by the Datakor case and are discussed and critically analysed in detail with reference to relevant case law. The Datakor case is also discussed and critically analysed with specific reference to the amount or value of the benefit arising from a concession granted or compromise made by the company's creditors.

Section 20(1)(a)(ii) of the Act (as amended by the Revenue Laws Amendment Act, 59 of 2000) provides that:

> "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be set off against the income so derived by such person –

(a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment: Provided that –

(i) …

(ii) the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade."

From the above, it is clear that a company must first of all continue to trade in the relevant year of assessment if it wishes to preserve the assessed loss and to avoid the application of section 20(1)(a)(ii) of the Act. This requirement will be discussed in paragraph 3.2.

Furthermore, it is clear from the wording of section 20(1)(a)(ii) of the Act that the section may be broken down into a number of requirements, which must all be met for the section to be applicable in reducing the taxpayer's assessed loss. If the taxpayer succeeds in establishing the absence of one of the requirements, the commissioner will be unable to invoke section 20(1)(a)(ii) of the Act (ITC 1613: 193).

It is interesting to note that the Supreme Court of Appeal in the Datakor case (1998 CLR 574 (A) 577) held that a breakdown of section 20(1)(a)(ii) of the Act, into its so-called elements, is useful. However, it warned that caution should be used in this regard, since the interrelationship between the elements could be disguised as a result of the isolation of the elements, which in turn could lead to failure when considering the provision as a whole.

The requirements for section 20(1)(a)(ii) of the Act as set out by the court in the Datakor case (1998 CLR 574 (A) 577) will for purposes of this chapter be discussed as follows:

- "...the balance of assessed loss shall be reduced by the amount or value of any benefit..."
  - there must be a "benefit" (discussed in paragraph 3.3); and
  - the amount of the benefit should be measurable in money or have some value (discussed in paragraph 3.4);

- "...received by or accruing to a person..."
  - the benefit must be received by or accrued to a person (discussed in paragraph 3.5);

- "...resulting from a concession granted or a compromise made..."
  - a "concession or compromise" must have been made or granted (discussed in paragraph 3.6); and
  - the benefit should "result" from the concession or compromise (discussed in paragraph 3.7);

- "...with his creditors..."
  - the concession or compromise should have taken place between the taxpayer that has the assessed loss and his creditors (discussed in paragraph 3.8);

- "...whereby his liabilities to them have been reduced or extinguished..."
  - the taxpayer with the assessed loss' liabilities should be reduced or extinguished due to the concession or compromise between the company with the assessed loss and his creditors (discussed in paragraph 3.9);

- "...provided such liabilities arose in the ordinary course of trade..."
  - the liabilities referred to above should have arisen in the ordinary course of trade (discussed in paragraph 3.10).

3.2 Carrying on of a trade

Before considering the requirements of section 20(1)(a)(ii) of the Act as set out above, a further and important prerequisite for the maintenance of an assessed loss must be considered.

The preamble to section 20(1)(a)(ii) of the Act provides that an assessed loss can only be carried forward (i.e. to a following tax year) if the company with the assessed loss carried on a trade during the year from which the assessed loss is carried forward. With regard to section 20(1)(a) of the Act it was held in the case of SA Bazaars (Pty) Ltd v CIR 1952 (4) SA 505 (A), 18 SATC 175 (hereafter referred to as the SA Bazaars case) that it was not competent for a company which had not carried on any trade within a particular year, to set-off in its income tax return for that year the balance of assessed loss incurred by it in previous years. In this regard Centlivres CJ in the SA Bazaars case (1952 (4) SA 505 (A), 18 SATC 175) held:

> "As the appellant carried on no trade during the year under consideration it was not competent for it to set-off in its income tax return for that year the balance of assessed loss incurred by it in previous years."

This principle, with regard to companies, was confirmed in the case of Robin Consolidated Industries v CIR 1997 2 All SA 195 (A), 59 SATC 199: 210. Accordingly, section 20(1)(a) of the Act envisages a continuity of trade in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each succeeding year a balance can be struck which can then be carried forward from year to year until it is exhausted.

If, for any reason the assessed loss cannot so be set off and balanced in any particular year, there will be no balance of assessed loss for that year that can be carried forward to the succeeding year. In other words the essential continuity has been fatally interrupted. In the SA Bazaars case that interruption occurred because the taxpayer ceased trade in a particular year.

De Koker (2000: 8.127) states that a company failing to carry on a trade for an entire year of assessment will be prohibited from carrying forward any balance of assessed loss to the following year. De Koker (2000: 8.127), however, also states that it is not essential for a company to have carried on a trade during the whole year, but that any sufficient period of trading during the year should suffice. It was stated in the SA Bazaars case (1952 (4) SA 505 (A), 18 SATC 175) that the mere fact that a company keeps itself alive during the year of assessment without trading is not enough to entitle it to carry forward an assessed loss into the next year.

The SA Bazaars case left open the question whether an assessed loss can be deducted when a trade is carried on but no income is earned during the year of assessment. In ITC 777, 19 SATC 320 a company had unsuccessfully endeavoured to let property during the tax year in question. The court held that it was carrying on trade and was therefore entitled to carry forward an assessed loss. It was not contended by the Commissioner in that case that the company was not entitled to utilise the assessed loss merely because it had no income in that year. Accordingly, a deduction or determination of an assessed loss is not precluded where the taxpayer has in fact carried on a trade during the year of assessment, although it has derived no income from that trade (Coetzee, 1998: 37).

In light of the above, the essential question is what exactly constitutes trade. In other words, the question could be raised whether the assessed loss would be precluded where there had been no income derived from trade, although the taxpayer has in fact carried on a trade during the year of assessment. Meyerowitz (2000: 12.134) contends that a set-off of an assessed loss should not be precluded where there had been no income derived from the trade, even though the taxpayers had in fact carried on a trade.

The most important issue therefore, is what constitutes a "trade" and when will the trade be "carried on" for purposes of section 20(1)(a)(ii) of the Act. "Trade" as defined in section 1 of the Act includes-

> " ... every profession, trade, business, employment, calling, occupation or venture ..."

Meyerowitz (2000: 11.24) comments on this definition:

> "not only is this definition very wide, but it is not necessarily exhaustive."

In ITC 770 19 SATC 216, Dowling J referred to the definition of "trade" and stated that:

> " ... the words "trade", "business", "occupation", or "venture" used in the definition of trade, ... obviously intended to embrace every profitable activity and ... I think should be given the <u>widest possible interpretation</u>." (Emphasis added.)

The fact that the definition includes a reference to "venture" is evidence that it is the actual endeavour to carry on a trade that is material as to whether or not a taxpayer was carrying on a trade as set out in section 20(1) of the Act and not the fact that a taxpayer derived income from the trade. The basis for this contention is to be found in the dictionary definition of "venture". In this regard, the Oxford English Dictionary (Oxford University Press. 1993: Compact Edition) defines the word as follows:

> "An act or occasion of trying one's chance or fortune: a course or proceeding the outcome of which is uncertain but which is attended by the danger of risk or loss: an enterprise, operation or undertaking of a hazardous or risky nature"

McKechnie (1977) defines the noun "venture" as –

> "A risky or dangerous undertaking; a business enterprise in which there is danger of loss as well as chance for profit."

As a verb McKechnie (1977) quotes –

> "To do or go at some risk - to dare."

In ITC 1476, 52 SATC 141, Kirk-Cohen J, in considering whether or not a taxpayer had carried on a trade during a particular year of assessment, stated that:

> "It is a question of fact, depending on the circumstances in each case, whether a taxpayer carried on a trade for the period in question. In my view the carrying on of a trade involves an active step - something far more than merely watching over existing investments which are not, and are not intended or expected to be, income producing during the year in question."

In ITC 777, 19 SATC 320, Neser J held that:

> "... a mere intention to let property would not amount to the carrying on of a trade but I do not agree that to constitute carrying on trade there had to be an actual letting. It was the intention of the company if possible to let the property and though its efforts to do so were not sustained or strenuous it did endeavour to let it to and through associated companies"

It has been held that in many businesses long intervals of inactivity occur, and the decision of Rowlatt, J in Kirk & Randall Ltd v Dunn 8 TC 663 is very much in point. The learned judge said (669):

> "Here the question seems to be, is what this company is doing, carrying on a trade or business, or nothing at all? There is no question about it being anything else but a trade or business if it is carrying on anything."

The judge further said (669):

> "Because in the middle of a great career a company, might have a year when (it) was holding itself out for business, but nothing came, yet that would not effect a break in the life of the company for income tax purposes."

De Koker (2000: 8.127) refers to the practice of the Commissioner and states that the taxpayer must actually carry on trading activities and that the Commissioner does not accept that the mere receipt of interest or dividends constitutes the carrying on of a trade. In view of this practice it will further not suffice if there is a mere intention to earn income from the carrying on of a trade.

In this regard, it is submitted that the issue of whether trading activities are actually being carried on would depend on the specific trade that the taxpayer carries on. De Koker (2000: 8.127), for example, states that the receipt of interest should in the case of a "moneylender", be regarded as income derived from the carrying on of a trade.

3.3 Benefit

In order for the South African Revenue Service to be able to apply section 20(1)(ii)(a) it must be clear that the compromise or concession with the taxpayer's creditor(s) resulted in some sort of benefit to the taxpayer.

The term "benefit" is not defined in the Act. Regard must therefore be had for the meaning assigned to this term in case law in the context of section 20(1)(a)(ii) of the Act. Reliance may also be placed on the ordinary meaning of the term as given by a dictionary.

In ITC 1613 the court was faced with a variation on the section 311 of the Companies Act compromise which involved the issue of preference shares by the target company in consideration for capitalisation of the remaining undischarged loan accounts or trade debts owed to the creditors of the company. The question to be determined was whether a benefit existed as a result of the change from debt to equity. In ITC 1613, Wunsh J addressed the question as to whether a benefit is received by a company when debt is converted into equity and held that (ITC 1613: 194):

> "Any arrangement or dispensation by which a company is protected from action by its creditors so as to enable it to continue with its business, whether by means of a subordination agreement or the capitalisation of the claims, that is converting them into permanent or long-term capital, must redound to its benefit. It enables the company to be discharged from liquidation, to continue with its business under its directors and to have to deal with a single well-disposed shareholder in stead of the existing creditors, who could once again seek the company's liquidation."

Regarding the use of redeemable preference shares to alleviate a company's debt the court held as follows (ITC1613: 194):

> "Holders of redeemable preference shares cannot sue the company as creditors for the repayment of the capital when redemption becomes due, although they can, as shareholders apply for the winding-up of the company (*Re Holders Investment Trust Ltd* [1971] 2 All ER 289 (ChD). Although, as I have said, the terms of redemption of the preference shares were not proved, I must assume, the *onus* on this part of the case being on the appellant, that they were not immediately redeemable (that would have been most unusual bearing in mind also the provisions of s 8E of the Income Tax Act) so that any steps by the holders of those shares would not have posed an immediate or even a short-term threat. I have no doubt that the company derived a benefit from the arrangement and the conversion of the creditors' claims to share capital, relieving it of the need to find external funds to pay these claims which were due and payable."

ITC 1613 was taken on appeal, after Wunsh J had found that the Commissioner failed to prove the value of the benefit resulting from the compromise or concession, and was reported as the Datakor case. In the Datakor case (1998 CLR 574 (A) 581) the Appeal Court approved Wunsh J's findings in the court *a quo* regarding the existence of a benefit and made the following remarks in respect of this element of section 20(1)(a)(ii) of the Act, by stating that:

> "The provision in question concerns itself with 'any benefit', words of a wide and indeterminate meaning. Whether the benefit is effected or reduced by other factors is, for this part of the investigation at least, of no consequence. The benefit in the words of the Act, is to be found in the reduction of the debt, something which and the extent of which, as said before, is common cause. Indeed, the cession by the creditors (to waive the balance of their exigible claims against the taxpayer in return for a nebulous 'right' to redemption of redeemable preference shares) must of necessity translate into a benefit"

It is clear from the above that a court is willing to give a very wide meaning to the term benefit. How wide a court would interpret the term, is uncertain.

Onions (1973) defines "benefit" to mean –

> "to be of advantage of profit, to improve, help forward".

It is submitted that this dictionary meaning is in line with the wide meaning that a court will assign to the term.

Based on the above, it is suggested that a court would consider a capitalisation of loans into shares or a subordination of loans as constituting a benefit for purposes of section 20(1)(a)(ii) of the Act. In *Ex Parte* de Villiers and Another NO: *In re* Carbon Developments (Pty) Ltd 1993 (1) SA 493 (A) and Namex (Edms) Bpk v KBI 1994 (2) SA 265 (A), the courts also determined that a subordination agreement between the company and its creditors constitute a benefit due to the fact that the company would be discharged from liquidation.

Other aspects resulting from a section 311 of the Companies Act scheme of arrangement that could constitute a benefit for purposes of section 20(1)(a) (ii) of the Act could include the following (ITC 1613: 194):

- the taxpayer not having to be liquidated;

- the taxpayer will be put in a position to become a profitable company again; and
- the taxpayer can restore its solvency.

Based on the above and the fact that the term benefit could be interpreted in a wide manner, it is submitted that it would not be too difficult for the South African Revenue Service to argue and prove a benefit resulting from a Section 311 of the Companies Act scheme of arrangement.

3.4 The amount or value of the benefit

3.4.1 Determination of the amount or value of the benefit

The court in ITC 1613: 195, determined that the trigger for section 20(1)(a)(ii) of the Act is the "amount or value" of any benefit. This, according to the Special Income Tax Court, implied that a benefit will have an "amount" or a "value" if it has money's worth or can be turned into money. The court proceeded to state that, to be an "amount", something must have an ascertainable money value. The same criteria were laid down in respect of the "value" of a benefit. The court then held that a benefit will have a money value or a worth in money if it compensates the recipient of the benefit, or saves the recipient from expenditure, or can be realised in money. Based on these principles the court held that it was not able to quantify the benefit received by the taxpayer on the facts before it. On appeal, however, the court in the Datakor case held differently. In the Datakor case, the court considered the facts and overruled the court a quo's judgement by holding that the benefit was a fixed and ascertainable amount i.e. the share premium amount resulting from the issue of shares to settle the liabilities of the creditors.

It is important to note that the appeal court in Datakor's case did not overrule the principle to determine the amount or value of a benefit, but only the finding on the facts.

A further issue raised by the Datakor case is that the onus to prove the quantum of the amount or value of the benefit is not on the Commissioner, as determined by Wunsh in ITC 1613. In this regard see discussion below under paragraph 3.4.2.

If a court finds that a benefit has arisen, e.g. if a court holds that a subordination constitutes a benefit, it is submitted that the amount by which a claim has been subordinated will constitute the value of the benefit.

It may be difficult if at all possible to quantify the value of such a benefit. In ITC 1613: 194, Wunsh J discussed the amount or value of the benefit received by the company. The facts of the case were briefly that the company had entered into a scheme of arrangement with its creditors. The features of the scheme of arrangement were that the Appellant had been discharged from liquidation, and a company D acquired the existing share capital of the Appellant company. In terms of the scheme, D would provide capital to A by subscribing for shares at an allotment price equal to the capital sum. The capital sum was to be applied to discharge costs and to pay the net amounts due to secured creditors, the claims of preference creditors and to concurrent creditors the balance remaining to be discharged among them on a pro rata basis as if payment towards the concurrent claims against the company.

The concurrent creditors received a dividend of 43,48 cents in the Rand. The effect was that in terms of the scheme, each creditor received the right to redeemable preference shares at an allotment price of 56,52 cents for each 56,52 cents owing. In fact for each 100 cents of the claims not paid, the creditors were entitled to a share with a nominal value of 1 cent issued at a premium of 99 cents, carrying a "coupon rate", of 10% per annum on presumably the issue price. Consequently 100 additional shares were issued at an allotment price of R5 736 100, while 18 997 499 cumulative redeemable preference shares were issued at an allotment price of R18 997 499 (the nominal amount being R189 975 and the share premium being R18 807 524). The Appellant company had an assessed loss carried forward from the prior year of R8 540 219.

The company had net deductions of R15 090 168 and this resulted in the company carrying forward an assessed loss of R23 630 387. The Commissioner then sought to reduce the loss by the value of the share premium account.

The court dealing with the amount or value to be placed on the benefit received by the company found that the value of the benefit could only be quantified where the amount or value of the benefit is equivalent to the nominal amount of the claims that were converted (ITC 1613: 187-191). On this aspect Wunsh J held that (ITC 1613 194-195):

> "If a creditor foregoes a part of its claim against a company, the amount abandoned is the amount of the benefit. Where a creditor accepts as a substitute for a part of its claim a stake in the company's capital, it is not immediately clear whether this is so. The trigger for the application of section 20(1)(a)(ii) is the amount or value of a benefit. A benefit has an amount or a value if it has money's worth or can be turned into money."

The meaning of amount has been the subject of a number of decisions by our courts. In CIR v Butcher Brothers (Pty) Ltd (1945 AD 301), the Appellate Division held that it was essential for the Commissioner, in order to support his assessment, to show that some amount had accrued to or been received by the company. The consideration passing from lessee to the lessor, whether in cash or otherwise, distinct from and in addition to or in lieu of rent, *had to have an ascertainable money value*, and not merely a conjectural value (CIR v Butcher Brothers (Pty) Ltd 1945 AD 318-321).

Feetham JA held (CIR v Butcher Brothers (Pty) Ltd 1945 AD 301 322):

> "As appears from what I have said above, the terms of paragraph (*d*), according to my understanding of them, are such as to be capable of applying to the benefits to which a lessor becomes entitled by virtue of clauses, such as this lease contains, which provide that buildings are to be erected on the leased property by the lessee, and that such buildings are to become the absolute property of the lessor on the termination of the lease without payment of compensation to the lessee. As stated above, however, the consideration represented by such benefits must, in my opinion, in order that it may be either an 'amount' or 'a premium or like consideration' within the meaning of paragraph (*d*), be consideration having an ascertainable money value."

In Lategan v CIR 1926 CPD 203 208, Watermeyer J held that unless the word "amount" meant something more than amount of money, the definition given in the Act (the Income Tax Act 41 of 1917) would not seem to be wide enough to include the "value" of property or rights earned by the taxpayer, unless they were benefits granted in respect of employment. According to Watermeyer J (Lategan v CIR 1926 CPD 203 208-209):

> "The Legislator could hardly, however, have intended such a result, because then it would be open to any taxpayer (who did not earn his income by employment) to receive payment in some form other than money, and thus escape taxation. In my opinion, the word "amount" must be given a wider meaning, and must include not only money, but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value."

In ITC 1613: 195, the court concluded that the definition of amount should be extended to include the criteria for determining the value of the benefit received. A benefit has a money value or a worth in money to the extent that it compensates the recipient or saves it from expenditure or can be realised for money. The court then considered the situation where there is no method to quantify the value of the benefit received in terms of the principles applied in determining the amount by referring to the authorities and similar case law.

In this regard De Koker (2000: 2.2) asks the question whether a person necessarily needs to receive a benefit from a receipt or accrual of money's worth before it can be included in his gross income. In Ochberg v CIR 1931 AD 215, the court held that the value of shares issued by a company to a person for services rendered was taxable even though the recipient held nearly all the shares in the company and may not have benefited from the transaction, since the shares did not increase his percentage holding, except fractionally. The majority found that the question whether the taxpayer had benefited from the transaction was not the test (De Koker, 2000: 2.2). Emslie, Davis & Hutton (1995: 62) comment on the court's finding, stating that it was the substance and not merely the form of the transaction that should prevail, although the majority and the minority, with the minority placing great reliance on the substance argument, differed as to the true nature of the transaction. A major point of descent seems to have been the extent to which the benefit to the taxpayer ought to be taken into account in deciding whether or not he received an amount. The Ochberg approach is generally referred to as the objective approach. In Stander v CIR 1997 3 SA 617 (C), the court followed a subjective approach, developing the finding of Wessels CJ in CIR v Delfos 1933 AD, 6 SATC 92, where he held that tax is to be assessed in money on all receipts and accruals having a money value and that if it is something which is not money's worth or cannot be turned into money, it is not to be regarded as income. In order to constitute an amount a benefit must constitute property with a money value or a right that can be turned into money (CIR v Delfos 1933 AD, 6 SATC 92).

In CIR v Genn (Pty) Ltd 1955 3 SA 293 (A) 301G-H, the court held that the transaction in Ochberg's case

> "was of a type in which benefit was notionally possible, to the extent at least that what before the transaction did not belong to [the taxpayer] became as a result of it, his property absolutely".

De Koker (2000: 2.2) finds no fault with the reasoning that despite the irrelevance of the question whether a person (company) had enjoyed a benefit, a receipt or accrual in a form other than money must still be valued. If the receipt or accrual's ascertainable money value cannot be determined, it cannot form part of the 'gross income' (De Koker, 2000: 2.2). Meyerowitz (2000: 6.42-6.43 and further in general 6.44-6.48) states that where a receipt or accrual is not money but money's worth, it must be valued.

The question arises as to the method to be used in valuing such an illusive item as a receipt or accrual of money's worth.

According to De Koker (2000: 2.13) the value to be placed upon assets other than cash received or accrued as income is the amount that could be obtained for it on the open market if it were to be sold under some reasonable method of sale. The author continues by stating that:

> "[o]n the principle that if the thing received by or accruing to the taxpayer cannot be turned into money he cannot be subjected to tax, it is submitted that the benefit derived by a borrower from an interest-free loan or that derived by a taxpayer enjoying the free use of a house or other asset, for example, in terms of a will, is not taxable."

It is arguable that a value is required for the benefit. Wunsh J held in ITC 1613: 195 that the trigger for section 20(1)(a)(ii) of the Act is the value of the benefit. Accordingly, the failure to determine the value of the benefit would result in the non-reduction of the taxpayer's assessed loss in terms of section 20(1)(a)(ii) of the Act. Although the views expressed are in relation to the gross income definition, Wunsh J held in ITC 1613 and later in Income Tax Case *9818* (Transvaal Income Tax Special Court) 1998 4 JTLR 84 that the principles in valuing a benefit as discussed above should apply equally to the valuation of the benefit, if any, in terms of section 20(1)(a)(ii) of the Act.

To this extent Wunsh J held that (ITC 1613: 195):

> "Obviously the same criteria applies in determining the value of a benefit. A benefit has a money value or a worth in money to the extent that it compensates the recipient or saves it from expenditure or can be realised for money."

The special court for hearing income tax cases continued and held that the principle laid down in CIR v Butcher Bros (Pty) Ltd 1945 AD 103 should apply to a benefit or amount which is to be brought into the tax net by the application of section 20(1)(a)(ii) of the Act. The court furthermore referred to the Appellate Division case of CIR v Peoples Stores (Walvis Bay) (Pty) Ltd (1990 2 SA 353 (A). Briefly, the facts of the case were that the taxpayer carried on its business as a subsidiary in the Edgars group of companies as a retailer of clothing, footwear, household textiles and related goods, selling its wares to customers for cash and on credit. The bulk of its credit sales were made under a so-called six-months-to-pay revolving credit scheme. Basically this entailed that the amounts charged to a customer's account were payable in six equal monthly instalments. At or soon after every month end, a statement of account was rendered to each customer. The instalment reflected on the statement as payable, had to be paid before the next statement date. In other words, a purchase made in January would be reflected on the statement rendered at or soon after the end of that month. One-sixth of the purchase price would be reflected on the statement as payable. The customer was required to pay the amount due before the date of the next statement or soon after the end of February. During the 1983 tax year the taxpayer sold goods under the scheme for a total amount of some R1.3 million. At year-end an amount of R341 281 representing instalments not yet payable was still outstanding. The Commissioner included the latter amount in the taxable income on which the taxpayer was assessed for normal tax for the year in question (Emslie, Davis & Hutton, 1995: 35-36). The taxpayer, unsuccessfully, objected to the assessment, and appealed to the Special Court on the grounds that (CIR v Peoples Stores (Walvis Bay) (Pty) Ltd (1990 2 SA 353 (A) 360F-361D):

"13.1 The instalments not yet payable nor paid of R341 218 did not constitute an "amount, in cash or otherwise, received by or accrued to or in favour of" the taxpayer within the meaning of "gross income" as defined in s 1, and ought therefore not to have been treated as such.

13.2 Alternatively to 13.1:

13.2.2 The instalments not yet payable nor paid ... ought not to have been included in the taxpayer's gross income at their face value. They should have been included at no more than the present value of the right to receive those instalments in future."

The two relevant questions that the court had to decide on were firstly whether the value of the instalments not yet paid or payable were to be included in the taxpayer's gross income. The second question related to the method of determining the value of the instalments (CIR v Peoples Stores (Walvis Bay) (Pty) Ltd (1990 2 SA 353 (A) 361E-F).

Referring to Lategan v CIR 1926 CPD 203, the court (CIR v Peoples Stores (Walvis Bay) (Pty) Ltd (1990 2 SA 353 (A) 363I-364A) held that:

"The first and basic proposition is that income, although expressed as an *amount* in the definition, need not be an actual amount of money but may be "every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value... including debts and rights of action"(*per* Watermeyer J at 209).

This proposition is obviously correct so that very little need to be added to what Watermeyer J himself said in support thereof. It is hardly conceivable that the Legislature could not have been aware of, or would have turned a blind eye to, the handsome profits often reaped from commercial transactions in which money is not the medium of exchange."

Hefer JA (CIR v Peoples Stores [Walvis Bay] [Pty] Ltd 1990 2 SA 353 [A]) furthermore confirmed the findings of the Appellate Division in cases such as Lace Proprietary Mines Ltd v CIR 1938 AD 267, where it was confirmed that income in a form other than money may be taxable.

In Mooi v Secretary for Inland Revenue 1972 (1) SA 675 (A), it was decided that a right (*in casu* an option to purchase shares) may indeed constitute an "amount... accrued to" the taxpayer.

Ogilvie Thompson CJ held:

> "'The object of para *(c)* of the definition is of course to bring into the category of 'gross income' all 'amounts', whether of a capital nature or not, accrued in respect of services. Linguistically inappropriate though the word 'amount' may be in this context, when a taxpayer becomes entitled to a right 'in respect of services' a money value must be assigned to that right in order to determine the relevant 'amount' to be incorporated as 'gross income'." (Mooi v Secretary for Inland Revenue 1972 (1) SA 675 (A) 684).

From the above it is clear that income in a form other than money must be of such a nature that a money value can be attached to it. The majority of decisions were aimed at qualifying receipts and or accruals in a form other than money for the purpose of including the "amounts" in the "gross income'" of the taxpayer (CIR v People's Stores (Pty) Ltd 1990 2 SA 353 (A) 364F-H; Mooi v SIR 1972 1 SA 675 (A) 682H; ITC 1613 59 SATC 187 195.)

The principles discussed above could be useful guidelines in determining whether a benefit exists.

3.4.2 Onus to proof the amount or value of the benefit

As mentioned Harms J in the Datakor case decided that the onus to prove the quantum of the amount or value of the benefit is not on the Commissioner, as determined by Wunsh in ITC 1613. In this regard it is submitted that Bricout & Emslie's criticism in this regard is well-founded. They (Bricout & Emslie, 1999: 226-236) state as follows:

> "The Supreme Court of Appeal held that the court a quo had erred in finding that the burden of proof lay on the Commissioner to establish the existence

of the 'amount or value' of the benefit to the taxpayer. Harms JA said (at 1059C) that:

> 'The Court below relied upon Commissioner for Inland Revenue v Butcher Bros (Pty) Ltd 1945 AD 301 at 319 (although I think that 322-3 were intended) and De Koker Silke on South African Income Tax para 18.27 for its conclusion summarised in para [16] above. The latter work does not support the finding and appears to the contrary:
>
> > '*It would seem that the Commissioner is entitled to tax any receipt or disallow any claim for deduction, set-off or exemption and leave it to the taxpayer to prove that he is wrong'.*' "

They (Bricout & Emslie, 1999: 226-236) continued their criticism as follows:

> "Harms JA is perfectly correct in his citation of the above passage from Silke, but it is nevertheless misleading because on the facing page of para 18.27 of Silke is the following passage relied on by Wunsh J:
>
> > 'It is submitted, therefore, that although the onus is on the taxpayer to show that any 'amount' (ascertainable money value) is not subject to tax, it is not he who is put to the burden of proving that there is an amount representing money value: that burden falls on the Commissioner.' "

Bricout & Emslie (1999: 226-236) concluded their criticism with regard to the onus to proof the amount or value of the benefit as follows:

> "These two extracts from Silke are easily harmonised: the Commissioner bears the burden of establishing the existence of an 'amount' having an ascertainable money value, and once he has done so the taxpayer must prove that such amount is not taxable. In the context of section 20(1)(a)(ii), the equivalent construction would be that it is for the Commissioner to establish the existence of the 'amount or value' of the benefit to the taxpayer, and it is then for the taxpayer to prove that his balance of assessed loss does not fall to be reduced by such amount or value. It is therefore respectfully submitted that the finding of Wunsh J is supported by Silke.
>
> In a subsequently reported judgement (ITC 1654 61 SATC 131), Van Reenen J, relying on Butcher Bros., held that the onus of showing that an amount had accrued rested on the Commissioner.

Harms JA's finding that the Butcher Bros. decision was of no assistance, because in that case one was concerned with a right to the return, after 50 years, of land and buildings, whereas on the present facts there was a fixed amount—the share premium account—and not an assessed amount, is difficult to understand. The share premium account seems an arbitrary amount latched onto by the Commissioner, for if the finding of the Supreme Court of Appeal were correct, why not reduce the balance of the assessed loss by the nominal value of the preference shares issued—a further R189 975—as well? Wherever the burden of proof lay, the challenge presented by the facts of Datakor Engineering was to quantify the 'amount or value' of the benefit to the taxpayer. And, with respect, the real point was not whether there was a fixed amount which was being argued about, but what the true amount or value of the benefit to the taxpayer was. This is the issue that was, with respect, avoided by the Supreme Court of Appeal; and on this issue it is submitted that the authority of the Butcher Bros. case on the question of the burden of proof was in point."

3.5 Received by or accrued to a person

A benefit must be received by or accrued to a person. Our courts have considered the phrase "received by or accrued to" on numerous occasions from a "gross income" definition perspective. In this regard the court in CIR v People's Stores (Walvis Bay Ltd 1990 [2] SA 353 [A]) settled a long standing dispute and found that this phrase "accrued to" means, "to be unconditionally entitled to".

While the applicability of this requirement could be resisted on theoretical grounds, it is submitted that they are too obscure to provide sufficient certainty. There is for instance, the Special Income Tax Court authority that for example indicates that forgiveness of a debt does not constitute a receipt or accrual (the court a quo in CIR v Louis Zinn Organisation (1958 [4] SA 477 [AD]). However, it is submitted that such an argument, in this instance, would render section 20(1)(a)(ii) of the Act nonsensical.

More importantly though, for the purposes of this requirement, is the meaning of the phrase "a person". The first impression is that the legislature may have used this word to refer to "any person" i.e. even a third party that may or may not be part to a particular transaction that is relevant to section 20(1)(a)(ii) of the Act. It is however submitted that this could not have been the intention of the legislature, since this will create total absurdity. The term "person" should therefore be read with the preamble of section 20(1)(a)(ii) of the Act. In the preamble of section 20(1)(a)(ii) of the Act, reference is made to

> "determining the taxable income derived by any person ... there shall be set off against the income so derived by such person any balance of assessed loss incurred by the taxpayer".

It is submitted that in order for the section to be without ambiguity, the legislature could not have intended to refer to any person other than the same person i.e. the taxpayer with the assessed loss. In other words, it is submitted that in order to reflect the true and correct intention of the legislature the references to any "*person*" and "*such person*" refers to the company that has the assessed or assessable loss. Therefore, the required benefit should be received by or accrued to the taxpayer having the assessed loss.

3.6 Concession or compromise

This requirement states that a "concession" must be granted or a "compromise" must be made with the creditors of the person who has the assessed loss. These two terms are not defined in the Act.

The ordinary meaning of these terms can be established from a dictionary. In this regard McKechnie (1977) defines "compromise" to mean:

> "a settlement in which each side gives up some demands or make concession. An adjustment of opposing principles in which part of which is given up".

Onions (1973), in turn, defines it to mean:

> "to settle by mutual concession, to adjust or settle, partial surrender of one's position...."

McKechnie (1977) defines "concession" to mean:

> "a conceding granting, giving in, yielding".

The terms "concession" and "compromise" have been considered by our courts in the context of a section 311 of the Companies Act scheme of arrangement (see discussions in chapter two). Although the meaning given to these terms in this context is not necessarily authoritative for purposes of section 20(1)(a)(ii) of the Act, it could be used as guidelines to determine the nature and context in which they can apply.

In Ex parte Cyrildene Heights (Pty) Ltd 1996 (1) SA 307 (W) for instance, it was held by Stegmann J that the word "compromise" in the context of section 103 of Companies Act of 1926 (which corresponds with the current section 311 of the Companies Act), the section that regulates schemes of arrangements, means the following:

> "A compromise there presupposes some dispute about rights to be compromised or some difficulty in enforcing them ... The petition does not say there is any dispute about rights of creditors or any difficulties in enforcing them against the company because the creditors other than the Botbyls are to be paid in full, and the Botbyls have agreed to accept some lesser amount in settlement of their claim. Consequently the offer cannot be said to constitute a compromise". (Emphasis added).

The question that arises is whether a transaction in terms of section 311 of the Companies Act inevitably concludes that a concession or compromise exists? Therefore, does an "arrangement" in terms of section 311 of the Companies Act also lead to a concession or compromise? It has been suggested that any qualifying "arrangement" (for purposes of section 311 of the Companies Act) must involve "some element of give and take" (*Re* Savoy Hotel Ltd, (1981) 3 ALL ER 646). However, does this mean that such a transaction necessarily involves a "concession" or "compromise"? In other words, the enquiry would turn on whether a section 311 of the Companies Act scheme of arrangement *per se* involves a "concession " or "compromise" and hence potentially fall within section 20 (subject to the section's other requirements)?

In this regard, Cilliers *et al* (1992: 448-449), define a "compromise", for purposes of section 311 of the Companies Act, as being an agreement between a company and its creditors and/or members which terminates a dispute about:

- the rights of the parties which are to be compromised, or
- there is some difficulty in enforcing them, but it does not imply a confiscation of rights.

Cilliers *et al* (1992: 450-451) determine in turn that the meaning of an "arrangement" is a much wider concept than a compromise and includes a reorganisation of the capital of the company by the consolidation of shares or by the dividing of shares into different classes or by both these methods. Arrangement denotes

> "some element of give and take some compensating advantage to the members or creditors concerned".

Case law on section 311 of the Companies Act generally also recognises that "arrangement" is a word of wide import. Judge AR van Heerden comments on this issue in the Namex case, although a minority judgement has, it is submitted, strong persuasive value:

> "Tweedens is dit eintlik vanselfsprekend dat 'n 'reeling' nie sinoniem met 'n 'skikking' is nie, want anders sou die Wetgewer twee woorde met dieselfde betekenis gebruik het. In hierdie verband dien daarop gewys te word dat in Multi-Bou met blykbare goedkeuring verwys is dat 'n

> opvatting dan vir die doeleindes van art 311(1) 'n 'reeling' 'n skikkings-element ('an element of compromise') moet bevat. Dit kan nie juis wees nie omdat 'n skikking 'n geskil voorveronderstel, en 'n reeling klaarblylik nie die oplossing van 'n geskil ten doel hoef te hê nie." (Emphasis added)

From the above it is clear that an "arrangement" is not necessarily a compromise or concession for purposes of section 20(1)(a)(ii) of the Act. The meaning of "arrangement" is something different from that of a concession or compromise and should, it is submitted, be interpreted as such, if a section 311 of the Companies Act scheme is truly an "arrangement" and not a concession or compromise. In such circumstances it is submitted that a true arrangement (in terms of section 311 of the Companies Act) should also not be regarded as a concession or compromise for purposes of section 20(1)(a)(ii) of the Act.

Besides the consideration of these terms in the context of section 311 of the Companies Act scheme of arrangement, they have also, to some extent, been referred to or considered in the context of section 20(1)(a)(ii) of the Act.

Anon. (1989: 29) formulates it in the following manner:

> "Section 20(1)(a)(ii) we consider, envisages a situation in which the creditors have agreed to accept something less than they originally entitled to insist upon. The question is whether by converting their claims into share capital, the erstwhile creditors have granted a concession to or made a compromise with the company.
>
> A persuasive approach, we feel, is to examine the quid pro quo to which the creditors become entitled in settlement of their claim: if it is adequate then there is no concession of compromise: if is inadequate then a concession must have been granted or a compromise made". (Emphasis added)

Jooste (1987: 324) states the following:

> "(This) involves a buy-out of the creditors' claims by the acquirer. The creditors will cede their claims to the acquirer in return for the agreed reduced number of cents in the Rand. The company receives no

concession nor is any compromise reached between the company and its creditors and accordingly section 20(1)(a)(ii) has no application. The company effectively has a new creditor who is submitted for its previous creditors. The acquirer may agree to back-rank its claim but that does not affect the issue."

Jooste (1987: 330) continues:

> "It is submitted that the elimination of the existing creditors must both in form and in substance, fall short of involving a receipt by or accrual to the company of a benefit resulting from a concession granted by or a compromise with creditors. The relative positions of creditors, vis-à-vis the company before and after the section 311 arrangement is sanctioned will have to be carefully scrutinised to ascertain whether, in reality, such a concession has been granted or compromise made. Any weakening of the creditors' position with a corresponding strengthening of that of the company could bring section 20(1)(a)(ii) of the Income Tax Act into play".

Meyerowitz (2000: 12.142) states that:

> "There is no concession or compromise, merely because creditors write-off the taxpayer's liability as a bad debt. A bad debt written off still remains legally enforceable. To constitute a concession or compromise there must be a waiver or compromise by the creditors which binds them" (Emphasis added)

De Koker (2000: 8.129) determines that section 20(1)(a)(ii) of the Act will only apply if the creditors have definitely waived their right to claim either the whole or portion of amounts owing to them. According to De Koker (2000: 8.129) this section cannot be invoked if there has been no waiver or release by a creditor, even though the creditor may choose to write-off the debt as being bad or irrecoverable.

In ITC 1613: 193, Wunsh J considered this requirement of section 20(1)(a)(ii) of the Act and held that:

> "There can be no doubt that they [the creditors] agreed, by means of the scheme, to receive <u>less</u> than the face value of their claims. This was obviously the reality which induced them to agree to accept, in part-payment of their claims shares of a value for lower than the face value of those claims. This can only be described as a concession or compromise". (Emphasis added)

In ITC 1613: 193, the court held that as the creditors surrendered a part of their claims to the proposer of the scheme for no consideration, this resulted in the creditors receiving less than the face value of their claims, which amounted to a concession or compromise.

On appeal in the Datakor case (1998 CLR 574 (A) 578), the court held that this reasoning of the court *a quo* in ITC 1613, i.e. that the creditors rendering their rights to the proposer for less than the face value amounting to a concession or compromise, is not entirely correct. The court held that the section is not concerned with the relationship between some third party and the creditor, but between the creditor and the taxpayer with the assessed loss. A concession granted to a third party is irrelevant. It must be determined whether the creditor granted a concession to the taxpayer (with the assessed loss). In this regard the court in the Datakor case (1998 CLR 574 (A) 578-579) held (with reference to the capitalisation of the claims) that:

> "The Act is not concerned with the benefit received by the creditor, but with the benefit received by the debtor. The mere substitution of a creditor's claim with a share, even a redeemable share, amounts to a concession. <u>An enforceable obligation is replaced with something of a completely different nature</u>". (Emphasis added)

Based on the above views by writers and the way in which this requirement of section 20(1)(a)(ii) of the Act has been addressed by the courts, it appears that a court will require that the claims of the creditors should at least be <u>waived or released</u> in such a way that a part of, or the whole claim "disappears" or is "given up". The creditor must therefore agree to accept something less than the original face value of the claim. If the full face value of the claims of creditors remain in place and enforceable, then, it is submitted, there should be grounds to argue that there is no concession or compromise. The concession or compromise must therefore influence the value or nature of the creditors' claims. If the value and nature and enforceability of the claims remain unaffected, and it is merely the timing of when the claims will be enforced that are influenced, it is submitted that there could not be a concession or compromise for purposes of section 20(1)(a)(ii) of the Act. If the timing of the enforcement of a claim constituted a concession or compromise, then the provisions of section 20(1)(a)(ii) of the Act should apply to every company with an assessed loss which receives extended payment terms from his creditors. This, it is submitted, could not have been the intention of the legislature with the introduction of section 20(1)(a)(ii) of the Act.

- It is submitted that the concession and compromise must be reached between the creditors and the company with the assessed loss. If the creditors agree with a third party that they will sell their claims to that third party (for less than the face value) then this, it is submitted, should not fall within the meaning of concession or compromise.

3.7 Benefit result from concession or compromise

A benefit will only reduce an assessed loss of a taxpayer if it can be proved that the benefit resulted or arose from a concession or compromise as envisaged in section 20 of the Act. In other words, there has to be a causal link between the benefit derived through the application of the section 311 of the Companies Act arrangement and the concession or compromise made to the taxpayer by his creditors. In this regard Bricout & Emslie in criticising the Datakor case (1999: 226-236) has the following to say:

> "It seems to us, with respect, that Harms JA has—by the manner in which he dealt with the issues—failed to apply with sufficient differentiation the tests of benefit to the taxpayer on the one hand, and concession granted by or

compromise made with creditors on the other hand. In concluding that there had been a concession granted by or a compromise made with the creditors, he relied on the fact that there was a benefit to the taxpayer.

Thus he states in 1055I-1056A:

> 'In consideration for a waiver of their claims the creditors received something different, namely shares. But, said counsel, unless one knows that the shares were worth less than the claims it has not been established that a concession was granted to the company by the creditors. In other words, it may be that the shares might have been worth more than their issue price, in which event the creditors relinquished nothing. I cannot accept the argument. The Act is not concerned with the benefit received by the creditor, but with the benefit received by the debtor.'

Then in 1058A he relies, at least in part, on his finding that there was a concession granted by or compromise made with the creditors to justify the conclusion that there was a benefit to the taxpayer, thus:

> 'Indeed, the concession by the creditors (to waive the balance of their exigible claims against the taxpayer in return for a nebulous "right" of redemption of redeemable preference shares) must of necessity translate into a benefit to the taxpayer.'

We agree, but the converse is not necessarily true. While there can be no doubt that the notions of benefit to the taxpayer and concession granted by or compromise made with creditors are linked—indeed section 20(1)(a)(ii) requires the former to be the result of the latter before the balance of any assessed loss can be reduced—it is submitted that the existence of each is nevertheless discrete and that they must be established independently and in a manner that does not beg the question. This is so, we consider, because it is notionally possible that a company and its creditors could negotiate a win-win solution, whereby there is a benefit to both the company and its creditors without the latter granting any concession or making any compromise. For example, a company with cash flow problems but a rosy long-term future might settle its indebtedness to a major creditor by issuing shares which the creditor in fact prefers to cash because of a projected rapid increase in the share price. In these circumstances there is a benefit to the company with cash flow problems, but not necessarily—it is submitted—a concession granted by or a compromise made with the creditors.

On the facts of the Datakor Engineering case we agree—for reasons similar to those of Wunsh J—that there was a benefit to the taxpayer and that this benefit did result from a concession granted by or a compromise made with its creditors. (The fact that the creditors were prepared to surrender their rights to the proposer for no consideration is a circumstance indicative of the fact that the preference shares were not worth their face value, which means that the creditors did not receive full value for their claims, which in turn means that they did grant a concession or make a compromise with the taxpayer.) We therefore support the findings of the Supreme Court of Appeal in this regard. Our difficulty, however, is with the Court's reasoning, which seems to exclude the possibility of a benefit to a company without any concession or compromise on the part of the creditors. This is the only logical inference from Harms JA's finding that there was a concession granted by or a compromise made with the creditors because there was a benefit to the taxpayer.

However unlikely it may seem in the context under discussion, we respectfully suggest that a win-win solution to a problem should not be excluded from the realm of possibility when one asks whether there has been a concession granted by or a compromise made with the creditors. It may be that such a concession or compromise invariably results in a benefit to the debtor; non-constat, however, that a benefit to the debtor always entails a concession granted by or a compromise made with creditors. It is an elementary principle of economics that a bargain may be struck which benefits both parties without any concomitant disadvantage for either of them.

A curious feature of Harms JA's judgment is the fact that he relies on the dictum of Nicholas AJA supra in relation to the existence of a concession granted by or a compromise made with the creditors, and the commentary of Professor Blackman -cited above- in relation to the existence of a benefit to the taxpayer, when in fact each of these authorities makes the very same point. Perhaps the explanation lies in the existence, with great respect, of a flaw in the reasoning of Harms JA (reliance on the existence of a benefit to the taxpayer when testing the existence of a concession granted by or a compromise made with creditors and vice versa). Harms JA's use of two authorities making the same point is perhaps consistent with two different questions answered by asking, in effect, only one of them."

Therefore, if there is no benefit, even though there is a concession or compromise, or if there is a benefit which is not resulting from a concession or compromise as envisaged, then this requirement, it is submitted, will not be met. With regard to the meaning of the terms "benefit and "compromise or concession" refer to the discussion under paragraphs 3.3 and 3.6 above, respectively.

3.8 With his creditors

De Koker (2000: 8.129) and Meyerowitz (2000: 12.141) express opposing views regarding the question whether section 20(1)(a)(ii) of the Act applies to a compromise or concession with all creditors or merely some creditors. De Koker (2000: 8.129) states that it may be suggested that the provisions of section 20(1)(a)(ii) of the Act applies not only when a debtor makes an arrangement with all his creditors as a body to release him wholly or partially of obligations, but also when a creditor on his own initiative releases a debtor from either the whole or a portion of a debt. De Koker (2000: 8.129) uses the example of a holding company releasing its subsidiary of obligations and the example of a debtor making a compromise with some of its creditors. According to De Koker (2000: 8.129) the South African Revenue Service accepts this principle and endeavours to enforce it, although it conflicts with the case of Blue Moon Investments v COT 1966 (4) SA 205 (RAD), 28 SATC 173.

The judgement in Blue Moon Investments v COT, 1966 (4) SA 205 (RAD), 28 SATC 173 was based on the provisions in the Rhodesian Income Tax Act in force at the time, which is similar to section 20(1)(a)(ii) of the Act. The case supports the view that section 20(1)(a)(ii) of the Act applies only when a compromise is made with a general body of creditors and not merely with one or a few of the creditors. It could effectively be contended that by the use of the words "made with his creditors", the legislature envisaged that before the provision would operate the concession must be granted or a compromise made with the whole body of creditors. If the situation was envisaged that a compromise or concession with one or merely some of the creditors would invoke section 20(1)(a)(ii) of the Act, the words "made with any of his creditors" should have been used (Blue Moon Investments v COT 1966 (4) SA 205 (RAD), 28 SATC 173 207D-H: De Koker (2000: 8.129). ANON (1969: 95) supports the view that the Blue Moon case established that section 20(1)(a)(ii) of the Act would only apply if every single creditor who was a party to the arrangement or compromise agree to release the taxpayer either in whole or in part from a part of the debt he was owed. If the creditor released the taxpayer out of own initiative, for instance where a holding company released a subsidiary company, the section would not seem to apply. The point of a creditor releasing the taxpayer out of own initiative was not argued in A v COT 1969 (2) SA 689 (R), 31 SATC 66, and it seems that the Rhodesian section applies to an arrangement or compromise with only one creditor this appeared to be accepted by the Commissioner (ANON. 1969: 95-96).

Meyerowitz (2000: 12.141) argues that section 20(1)(a)(ii) of the Act refers to creditors and liabilities in the plural and that while the Interpretation Act 33 of 1957 (hereafter referred to as the Interpretation Act) states that the plural imports the singular, it is always subject to the context. Meyerowitz (2000: 12.141) continues by stating that in the context of section 20(1)(a)(ii) of the Act the plural does not include the singular and that the section deals with a general compromise with or concession by creditors and not an arrangement with an individual creditor for release or reduction of a liability. In the author's view, the latter case could give rise to a recoupment.

In a recent Income Tax Special Court case, Case 8533, Melamet J had the opportunity to decide on the use of the word "creditors". The taxpayer claimed in respect of its year of assessment ending 30th November 1985 a deduction of R1 679 213, being expenditure incurred in respect of goods imported from a group company in the course of the taxpayer's trade in South Africa, creating an assessed loss of R1 962 828. During August 1985, however, the taxpayer was released from indebtedness of R1 679 213, this being the method chosen by the group company to inject capital into the taxpayer.

The Commissioner, in determining the taxpayer's assessed loss, reduced the loss by the amount of R1 679 213, initially purporting to do so in terms of section 8(4)(a) of the Act (i.e. including this amount in the taxpayer's income as a recoupment). The taxpayer contended that a benefit capable of being valued had been received, whereby its liabilities to its creditors had been reduced, and that such liabilities arose in the ordinary course of the its trade. It was contended, however, that the benefit did not result from a concession granted by or a compromise made with its creditors, but with a single creditor. It was argued on behalf of the taxpayer, relying on the Blue Moon case, that a compromise made with, or a concession granted by, a single creditor did not fall within the scope of section 20(1)(a)(ii) of the Act (Case 8533: 138-140)

According to Melamet J, the Blue Moon case did not support the taxpayer's contention since the case dealt with the question whether there is a conflict between two subsections in the Rhodesian Income Tax Act, 16 of 1954, which differ in material respects from the provisions of section 20(1)(a)(ii) of the Act. In respect to the body of creditors in Case 8533 (Case 8533: 139), Melamet J held that:

> "Subsection 20(1)*(a)*(ii) does not specifically require the concession to be granted by, or the compromise to be made with, the general body of the taxpayer's creditors. There is nothing in the wording of the section to justify such a limitation.
>
> The use of the plural 'creditors' and 'them' in themselves do not indicate that the general body or more than one creditor must make the concession to enter into the arrangement."

The court held that there was nothing in the context to indicate that the plural used in the section should not include the singular. After referring to section 6(b) of the Interpretation Act, Melamet J held in Case 8533 (Case 8533: 138-140) that:

> "On the contrary, it seems illogical to allow a taxpayer with an assessed loss to retain the full benefit of the allowance if he receives a concession conferring a large benefit from an individual creditor but not if such concession emanates from the general body of creditors. This savours of

> regarding such concession by the individual creditor as a windfall and runs contrary to the objective of the provisions, which I have set out above.
>
> If the body of the creditors only were intended one would have expected that, for the sake of consistency, the expressions 'compromise' or 'arrangement' appearing in s 103 of the Companies Act 46 of 1926 (now s 311 of Act 61 of 1973) would have been used."

It is arguable that section 20(1)(a)(ii) of the Act was enacted to prevent a company in financial difficulty from obtaining the dual advantage of reaching a compromise with its creditors and of being able to furthermore utilise its assessed loss in full. If this is indeed the "mischief" which the legislator sought to remove then what appears to be significant is the benefit obtained by virtue of the compromise and not the number of creditors with whom the concession or compromise was entered into. For example, the benefit arising from a concession made by or compromise entered into with a single creditor may in fact be much greater than that entered into with a group of creditors. The issue of quantifying the benefit therefore becomes relevant once again.

3.9 Liabilities reduced or extinguished

Case law or writers have not addressed this requirement of section 20(1)(a)(ii) of the Act. The reason for this is apparently because a compromise or concession *prima facie* presupposes a reduction of liabilities or the extinguishing of liabilities. The correctness of this assumption is open to debate. However, the fact remains that if there is no reduction or extinguishing of liabilities, even if all the other requirements are present, then section 20(1)(a)(ii) of the Act cannot be applied.

The important aspect of this requirement is the reference to the parties. The terms "his" and "them" must be considered. It is submitted that there can be little argument that the "his" refers to the taxpayer with the assessed loss. Further, it is submitted that the "them" refers to the creditors of the taxpayer with the assessed loss. Therefore, if the taxpayer with the assessed loss has existing liabilities, which is not reduced or extinguished as a result of a concession or compromise, then section 20(1)(a)(ii) of the Act cannot be applied. This part of the requirement therefore, it is submitted, does not look at the creditor's position, but at the taxpayer with the assessed loss. It is the taxpayers' liabilities that must be scrutinised to determine whether they have been affected. If not, it is submitted, section 20 cannot be applied.

Neither section 20(1)(a)(ii) of the Act nor section 1 of the Act contains a definition of the term "liability". Section 20(1)(a)(ii) of the Act qualifies the liabilities with the words, "provided such liabilities arose in the ordinary course of trade", which is discussed in paragraph 3.10 below. In Fairlands (Pty) Ltd v Inter-Continental Motors (Pty) Ltd (1978 (2) AD 270 275H-276H) the Appellate division held that the words "liable" and "liability" are, *prima facie*, words with many shades of meaning, the precise meaning to be attributed to them varying with the context in which the words occur. After referring to the Oxford dictionary meaning of the word "liability" as meaning legally bound, Rabie JA held that (Fairlands (Pty) Ltd v Inter-Continental Motors (Pty) Ltd 1978 (2) AD 270 276B-E):

> "In legal language, I think, the word "liability" is often used in the primary sense given in these definitions, i.e., the condition, or state, of being bound, or answerable, under an agreement, which is a broader concept than mere liability to pay what is due"

AC 000 (South African Institute of Chartered Accountants, (hereafter SAICA, 1990) governs the disclosure framework of financial statements. In respect of liabilities and the meaning of the word "liability" from a financial reporting and accounting perspective, AC 000 (SAICA, 1990) states the following:

> "A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefit will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably".

It is arguable that the above statement includes redeemable preference share capital. AC 000 (SAICA, 1990) defines equity as "the residual interest in the assets of the enterprise after deducting all its liabilities". Based on a wider meaning of liabilities it is arguable that the conversion of debt to preference shares could constitute a mere change in the form of the liability from a liability to repay a debt to a liability to redeem preference shares at a later date. This would appear to be the case from an accounting and financial reporting point of view.

Section 1 of the Act defines "equity share capital" in relation to any company as:

> "its issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution, and the expression 'equity shares' shall be construed accordingly". (Emphasis added)

This definition apparently excludes preference shares from the concept of equity. This exclusion lends support to the wider interpretation of the word liability, since preference shares could have specific provisions in respect of the redemption of the shares, the dividend rights attributable to each share and capital in certain circumstances, to name but a few. The memorandum and articles of association govern the issuing of preference shares by a company. The rights attributable to the preference shares are generally arranged in the preference share agreements (Cilliers et al., 1992:215-224). Preference shares invariably carry a preferential right to dividends, which in the case of par value shares is expressed as a percentage of the nominal amount of the shares. Dividends can only be claimed if there are sufficient funds available for such a declaration and the dividend has been declared as prescribed in the articles. Regarding the preference shareholders' rights to share in the repayment of capital upon the liquidation of the company, and there is no express stipulation in this regard, the preference and ordinary shareholders must share in the capital on a *pro rata* basis (Blackman, 1995: 100-102).

In the Datakor case (1998 CLR 574 (A) 580-581), Harms JA approved Blackman's view regarding the issue of whether redeemable preference shares are debt. Blackman (1995: 103) states that:

> "Although there are similarities with debt, redeemable preference shares are not debt. The right to redeem is not created in the public interest and is solely for the benefit of the company. The interest of the creditors cannot be affected by a waiver by the company of its rights to redeem; on the contrary, their interests are best served if there is no redemption."

Blackman (1995: 103) continues by stating that no member, nor anyone else, has grounds for complaint if the company decides not to redeem the shares. If the company enters into an agreement whereby it renounces the right to redeem *pro tanto,* only the company's rights are affected.

Blackman (1995: 100-102) furthermore states that there is nothing in section 98 of the Companies Act, or in the common law, which obliges the company to redeem, or which prohibits an agreement not to exercise the right to redemption, unless, possibly, where the effect of the agreement is to deprive the shares concerned of their character of redeemable preference shares, for example by providing that they are not to be redeemed under any circumstances. Where a redeemable preference shareholder has the right that the company redeems his shares, and the company does not have the available profits or is in fact unable to issue fresh shares to cover the obligations, the redeemable preference shareholder will not be able to enforce his right, his only remedy being an order for the winding-up of the company (Blackman, 1995: 103). This is the ultimate sanction against a company, yet its the only sanction available to the preference shareholder, as opposed to the sanctions that a creditor could use before applying for liquidation.

In light of the nature of preference shares it could be argued from an accounting perspective that after the conversion of the debt to equity (in the form of redeemable preference shares) the company would still be indebted to the holding company. The rights of the holder of a subordinated debt could be viewed as being similar to the rights of the redeemable preference shareholder. Arguably, the subordinated debtor would still stand in front of the shareholders and the above view would consequently depend on the facts of each case (Cilliers et al., 1992: 224-226; section 98 of the Companies Act). The accounting treatment and tax treatment, as a result of the legal interpretation of certain items, have on occasion differed. For commercial reasons, the treatment of items such as stock was brought in line with the accounting treatment to avoid confusion. Consequently, the nature of preference shares could still be open to treatment similar to the accounting treatment.

3.10 Liabilities arose in the ordinary course of trade

The last requirement of section 20(1)(a)(ii) of the Act that has to be satisfied in order for the section to apply, is that the liabilities (which are affected) towards the creditors should have arisen within the ordinary course of the taxpayer's trade. It is important therefore, to determine the meaning of the words "in the ordinary course of trade" within the context of this section.

Despite its wide meaning the definition of the term "trade" does not embrace all the activities of a taxpayer that might be productive of income (De Koker, 2000: 8.126).

De Koker (2000: 8.129), submits that liabilities arising "in the ordinary course of trade", would include liabilities incurred on income or revenue account (for example, debts incurred for goods bought for resale) as distinct from liabilities incurred on capital account, for example debts incurred for the purchase of fixed capital assets, such as factory buildings, plant and machinery etc.

In the case of A v COT (1969 [2] SA 689 [R]) for instance, Goldin J suggested that when interpreting this statute, effect must be given to the word "ordinary". The judge held in interpreting the word "ordinary", the following:

> "there may be many a case in which the liabilities arose in the course of trade but not in the ordinary course of trade".

The learned judge held that a liability incurred by borrowing money for the purpose of financing the usual income producing activities which constitute the trade of the taxpayer, is a liability which arises in the ordinary course of trade. The incurring of such debt can constitute a normal business activity of a trader as the manufacturer of products of the purchase and sale of goods.

In Joosab v Ensor N.O. 1966 (1) 319 (A), Botha JA looked at the meaning of "in the ordinary course of business" as contained in section 34(1) of the Insolvency Act No. 24 of 1926. On page 326 the learned judge at page 326 held:

> "The test for determining whether a transaction was in the ordinary course of business is an objective one, namely whether having regard to the terms of the transactions and the circumstances under which it was entered into, the transactions was one which is normally entered into by solvent businessman".

De Koker (2000: 8.126) makes the following comment in respect of the term trade:

> "The definition of the term trade in s 1 ... is very wide, and includes a profession, business, employment, calling occupation, venture, the letting of property and the use or grant of certain intellectual property. Nevertheless, in spite of its wide meaning the definition of trade does not embrace all the activities of a taxpayer that might be productive of income."

The liabilities, which are reduced or extinguished as a result of the concession or compromise, must have arisen in the "ordinary course of trade". De

Koker (2000: 8.129) states that liabilities arising "in the ordinary course of trade" would include liabilities incurred on income or revenue account (giving the example of debts incurred to buy goods for resale) as distinct from liabilities incurred on capital account (for example debts incurred for the purchase of fixed capital assets). Consequently, it is arguable that the test for determining whether a transaction was "in the ordinary course of trade" is an objective one, namely, whether having regard to the terms of the transaction and the circumstances under which it was entered into, the transaction was one which would normally have been entered into by a businessman. De Koker (2000: 8.129) appears to argue that only liabilities that are deductible in terms of the general deduction formula will have arisen in the "ordinary course of trade". Section 20(1)(a)(ii) of the Act applies only when creditors have waived their rights to claim either the whole or portion of the amounts owing to them (ITC 1613: 195).

Section 20(1)(a)(ii) of the Act cannot be invoked when there has been no waiver or release by a creditor, even though the creditor may choose to write off the debt as being bad or irrecoverable in his books (De Koker, 2000: 8.129). The last scenario would typically be a situation where a debt is written off as bad, without the taxpayer being aware of the creditor's treatment of the debt.

Meyerowitz (2000: 12.142) states that there is no compromise or concession merely because creditors write off the taxpayer's liabilities as bad debts. A debt written off still remains legally enforceable and in order to constitute a concession or compromise there must be a binding waiver or compromise by the creditors. The liabilities concerned, according to Meyerowitz, had to arise in the ordinary course of trade and could include both capital expenditure not taken into account in the determination of taxable income (e.g. loans, the purchase price of, or money borrowed to purchase fixed assets such as buildings, machinery, etc.) or revenue expenditure (e.g. the purchase price of stock in trade, rent etc).

The question which arises is whether all liabilities, whether allowed as deductions or not in the determination of taxable income or the assessed loss, fall within the provisions of section 20(1)(a)(ii) of the Act as long as they arose in the ordinary course of trade (Meyerowitz, 2000: 12.142). Meyerowitz (2000: 12.142) is of the view that the section is open to this construction and finds support from the Rhodesian court where the section has been so constructed.

In A v COT (1969 2 SA 689 (R), 31 SATC 66) a holding company waived its rights to recover from a subsidiary company a portion of a debt due to it as a result of a loan of money to the subsidiary company.

The subsidiary had an assessed loss, and the High Court of Rhodesia held that it was correct to reduce the assessed loss by the value of the concession granted to the subsidiary in terms of provisions similar to section 20(1)(a)(ii) of the Act (ANON, 1969b: 95; De Koker, 2000: 8.129, Meyerowitz, 2000: 12.142 and ANON, 1969a: 207). When delivering the judgement in respect to the question of liabilities arising "in the ordinary course of trade", Goldin J held in A v COT (1969 2 SA 689 (R) 691D) that:

> "In my view, a liability incurred by borrowing money for the purpose of financing the usual income-producing activities which constitute the trade of the taxpayer, is a liability which arises in the ordinary course of trade. The incurring of such debts can constitute as *normal* a business activity of a trader as the manufacture of products or the purchase and sale of goods."

The court held that the motives that induce a creditor to lend money at all or on unusually easy or desirable terms are not relevant considerations. In the words of Goldin J (A v COT 1969 2 SA 689 (R) 691F-H):

> "It is not part of the Appellant's case that if it had not been able to borrow from the creditor company nobody else would have advanced loans or credit facilities to such an extent. But, even if that had been the position, the fact that only one possible person existed, who for reasons and motives peculiar

to himself was prepared to lend money, does not give rise to a situation which is not covered by the expression in the ordinary course of trade. The borrowing of money and the purpose for which it was borrowed arose in the ordinary course of Appellant's trade. The fact that the lending of money was not part of the creditors' trade or that the loans were not made in the ordinary course of the creditor's trade is not relevant. It is not necessary to consider whether liabilities incurred for the purchase of fixed capital assets are covered by this expression."

After referring to De Koker the court continued:

"The cost of establishing or adding to income-earning plant or equipment is not part of the performance of business operations and it is not directly connected with income-producing activities. In other words, such expenditure does not fall into place as 'part of the undistinguished common flow of business done'. But each case will depend on its own facts and a rigid application of the distinction between capital expenditure and expenses incurred in the production of income is not possible or justified. Effect must be given to the word 'ordinary' and therefore there may be many a case in which the liability arose in the course of trade but not in the 'ordinary course of trade'. Usually a liability which arises 'in the course of trade' or 'in the ordinary course of trade' would in each case be incurred on income or revenue account." (A v COT 1969 2 SA 689 (R) 692A-C).

The court didn't find it necessary in its conclusion to consider the above aspect in detail. It found that it was not part of the Appellant's case that if not the whole debt then at least a portion of the debt was not incurred in the ordinary course of trade. Acknowledging that while certain sums may have been spent on items which do not form part of its ordinary trade, the court found that there was no evidence upon which to determine the amount involved. Moreover, the amount of the debt in respect of which the creditor company waived its right to recover, namely, £387,804, greatly exceeds the sum by which the assessed loss was reduced, namely, £241,471.

In the court's view it was clearly not possible to say what portion of the liability, if any, did not arise in the ordinary course of trade and whether such portion of the debt is greater than the amount by which the commissioner had reduced the assessed loss. Moreover, the total liability incurred by the taxpayer exceeded the amount in respect of which the creditor company had waived its rights to recover (A v COT 1969 2 SA 689 (R) 692D-E).

Consequently, the court found that the liability arose in the ordinary course of the taxpayer's trade, since the taxpayer had required money to finance its usual income-earning operations and had to resort, during the relevant period, to borrowing the amount required by it (A v COT 1969 2 SA 689 (R) 692F-G).

ANON (1969a: 207) (reporting on the judgement of A v COT 1969 2 SA 689 [R]) requested the Secretary of Inland Revenue (as the Commissioner was then known as) to express their view of the judgement in A v COT (1969 2 SA 689 [R]). Their letter and the Secretary's reply is quoted below:

> "Sir,
> ASSESSED LOSSES: COMPROMISE WITH CREDITORS
> Section 20(1)*(a)*(ii) of the Income Tax Act provides for the reduction of balance of assessed loss by the amount or value of a benefit resulting from a concession granted by or a compromise made with creditors whereby the liabilities to them have been reduced or extinguished, *provided such liabilities arose in the ordinary course of trade.*
>
> Do you in practice accept that the liabilities referred to are those which have been taken into account in the determination of the taxable income, and that liabilities on capital account, such as loans obtained to finance the trade, do not fall under section 20(1)*(a)*(ii)? We have in mind, for example, the case of a holding company which has lent money to a subsidiary for the purpose of financing the subsidiary's trading activities and decides to write the whole or portion of the loans off because of the subsidiary's financial position."
>
> *The Secretary's reply*
> ASSESSED LOSSES: COMPROMISE WITH CREDITORS
> Your understanding of the matter as stated in your letter of the 26th September, 1968, is correct. For section 20(1)*(a)*(ii) to apply it must be shown that the creditor was the person in whose favour there was created a credit which was allowed as a deduction under sections 11 to 20 with the exception of the deductions specifically excluded in terms of section 8(4)*(a)*. Consequently, in the case referred to by you the balance of assessed loss of the subsidiary company cannot be reduced unless the loan which the holding company intends writing off consists in whole or in part of amounts allowed

as deductions in the determination of the assessed loss of the subsidiary company."

ANON (1969: 207) concluded by stating that the Secretary's view was supported by the construction of the *proviso*, and had the merit of being equitable. The underlying reason for the proviso is to ensure that where the taxpayer has had the benefit of deducting losses and expenditure incurred in the production of income in determining the assessed loss, and as a result of a concession or compromise the taxpayer is released from the obligation to pay such losses or expenditure, the taxpayer should not continue to benefit from the assessed loss to the extent of such relief. The authors argue that there is no good reason why liabilities that did not affect his taxable income should go to reduce an assessed loss because they have been compromised.

It is arguable that Meyerowitz's view is more favourable, since the general deduction formula comprises among others, two distinct requirements, namely the "capital / revenue" requirement and the "trading" requirement. Although capital expenditure may not meet the former requirement, such expenditure may still meet the "trading" requirement and consequently satisfy the "ordinary course of trade" requirement contained in section 20(1)(a)(ii) of the Act. It would seem that the distinction between capital and revenue expenditure is not justified in the context of section 20(1)(a)(ii) of the Act, since the section merely refers to the "trading" requirement and not to the general deduction formula.

3.11 Conclusion

Getz and Jooste's argument in favour of the preference share scheme is useful as a summary of the above (Getz & Jooste 1995: 67). It should be noted however, that some of the comments made relate to the preference share scheme involving more than one creditor. Their argument is extensively quoted for the sake of completeness. The authors argue that as a result of the reasons discussed below, the application of section 20(1)(a)(ii) of the Act could be rendered wholly or partially inoperative by the use of preference shares.

Firstly, no benefit has in fact been received by or accrued to the company in that although the form of the liability has changed (i.e. the creditor's claim in the form of a long-term subordinated debt into redeemable preference shares) the amount thereof (i.e. the liability to redeem at the issue price thereof is equal to the unpaid value of the creditor's claims) and the obligation to repay has remained the same as before (Getz & Jooste 1995: 67). The preference shares is a cost to the taxpayer, and it could be argued that investors will be unwilling to invest in further preference shares, since such a large investment exists.

It is a general rule that a company cannot issue shares on the terms that it shall or may redeem them at an agreed future date, as such redemption would amount to a purchase by the company of its own shares, which is illegal. There is one exception to this rule, in the form of the provisions in the Companies Act regarding preference shares, which may be redeemed either unconditionally or at the option of the company. As stated above, the preference shares may only be redeemed out of the proceeds of a fresh issue of shares or out of profits, which would otherwise have been available for dividends.

From a financial point of view, redeemable preference shares may be regarded in the circumstances as a hybrid form of shares and debentures incorporating features of both, though in law they are clearly treated as shares (Getz & Jooste 1995: 67-68; section 98 of the Companies Act; Blackman 1995: 100-103; AC 000 [SAICA, 1990]).

It is accordingly arguable that in substance if not in form, a redeemable preference share is analogous to an obligation to repay a debt in that the company has either an actual (if the shares are redeemable on or before a fixed date) or a contingent (if the shares are redeemable at the option of the company) obligation to repay to the holders of the shares the issue price thereof.

It is furthermore notable that the Financial Mail, in discussing the definition of debt and equity for the purpose of the debt to equity ratio, includes redeemable preference shares as part of the meaning of debt, and excludes redeemable preference shares in its definition of total shareholders' funds (Getz & Jooste, 1995: 68; ITC 1613: 196).

The obligation to redeem, where the shares are redeemable on a fixed date, is enforceable in the sense that it is submitted that failure to redeem can result in the adoption by the shareholders of the ultimate sanction against the company, in the form of winding-up. The ultimate sanction of a shareholder is likewise to wind-up a company in the event of failure by the company to pay a debt that is due and payable. The position in South African law regarding the remedies of a shareholder if a company defaults in redeeming the preference shares where an actual obligation exist, does not appear to have been considered by the courts. Although the shareholders are unlikely to be able to compel the return of capital by suing in debt thereof or by seeking specific performance, it is submitted that such a shareholder may well succeed in an application to wind up the company on the ground that the company's default makes it just and equitable to place it in liquidation (Save perhaps, where the company is indeed lawfully able to redeem the shares but deliberately defaults in doing so, Getz & Jooste, 1995: 68).

If the reasoning of Grant's case is followed by the South African courts (to the extent that the lawful minimum has been paid for the allotment or issue of shares, no concession or compromise can objectively be said to be present) section 20(1)(a)(ii) of the Act will have no application (Getz & Jooste, 1995: 68).

In monetary terms the true (market) value of a creditor's claim at the date of liquidation is generally significantly less than its face value. If one assumes, as is generally the case, that the company on sanction has no creditors and that the redeemable preference shareholders are entitled on winding up to the repayment of the issue price of their shares in preference to other classes of shareholders, it is submitted that in most if not all instances the true market value of the redeemable preference shares at date of sanction is unlikely to be less than the true market value of the creditor's claim immediately prior to the compromise, or date of winding up. This, it is submitted, will especially be the position in the circumstances described above. Accordingly, the former creditor of the company, based on a calculation of the true value of its claim immediately prior to the compromise or rather concession, has not accepted anything less in value by their acceptance of the redeemable preference shares appropriately valued as to their true market value at the date of sanction (Getz & Jooste, 1995: 68-69).

Getz and Jooste continue to discuss what effect (if any) the absence of a right to a dividend in respect of a redeemable preference share would have, and whether a benefit would arise. In their example the question of *mora* interest in respect of a creditor's debts not being paid is discussed. It is submitted that since the holding company's debt is subordinated and non-interest bearing with no due date for payment of the debt, this question would not generally arise (Getz & Jooste, 1995: 69).

In light of the above, it is apparent that the issue of whether section 20(1)(a)(ii) of the Act could be invoked where a company is involved in a section 311 of the Companies Act scheme of arrangement and more specifically where the company coverts its debt into redeemable preference shares, is still a contentious matter. Although it is arguable that a benefit could exist, the quantification of the benefit could prove to be problematic, since the balance sheet will not materially change in the situation where the redeemable preference shares are issued for a value similar or greater than the value of the debt (ITC 1613: 195; Datakor case).

In addition, the argument is in favour of the fact that section 20(1)(a)(ii) of the Act should not be applied in light of the fact that the question remains as to whether an amount is received as a benefit. The wording of section 20(1)(a)(ii) of the Act requires that both the creditor and the taxpayer's position should be considered to determine the benefit. Since the creditor receives preference shares he receives a benefit, consequently not only the taxpayer receives a benefit. The *quid pro quo* indicates that both parties are bargaining. Of importance in considering the application of section 20(1)(a)(ii) of the Act is the consideration of the elements as a whole, as isolating the elements could create problems with interpretation (Datakor case 577).

In conclusion, it is submitted that the preference share scheme is not uncomplicated from a tax point of view, and should be approached with caution.

The issues involved in the application of section 20(1)(a)(ii) of the Act are not at all settled law. Challenges remain, and the initiative of taxpayers will remain at the forefront of new schemes involving the preservation of assessed losses whilst ridding companies of unwanted debts. The preference share scheme involving a holding company and its subsidiary should be distinguished from a scheme involving trade creditors. Our courts have not made any decisions in this regard.

The question remains as to whether the application of section 20(1)(a)(ii) of the Act could be avoided where the subsidiary firstly issues the preference shares and thereafter repays the debt. This is a possibility although the rights of other creditors would have to be considered as well as the implications where the subsidiary is a non-resident company.

The application of section 103(2) of the Act by the Commissioner should in addition to section 20(1)(a)(ii) of the Act be considered and consequently remain an issue. The provisions and implications of section 103(2) of the Act are discussed in chapter four.

CHAPTER 4

SECTION 103(2) OF THE ACT: UTILISATION OF ASSESSED LOSSES IN COMPANIES

4.1 Introduction

In this chapter the provisions of section 103(2) of the Act are broken down into its requirements and are analysed and discussed in detail with reference to relevant case law.

Section 103(2) of the Act provides that:

> "Whenever the Commissioner is satisfied that any agreement affecting any company or any change in the shareholding in any company..., as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment, has ... been entered into or effected by any person solely or mainly for the purpose of utilising any assessed loss or any balance of assessed loss incurred by the company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty of levy on income, or to reduce the amount thereof, the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed." (Emphasis added)

Section 103(2) of the Act is directed at defeating tax avoidance schemes, including trafficking in assessed or assessable losses. It has been held that this section should be construed so as to advance the remedy provided by the section and suppress the mischief against which the section is directed (Glen Anil Development Corporation Ltd v SIR 1975 (4) A 715 (A), 37 SATC 319; CIR v Ocean Manufacturing Ltd 1990 (3) SA 610 (A), 52 SATC 157).

Essentially, section 103(2) of the Act disallows the set-off of an assessed loss against income arising from any agreement or as a result of the change in shareholding (that is tainted income) if the Commissioner is satisfied that all the requirements of the section have been met.

In the case of ITC 1388 (46 SATC 126) it was held, in respect of the prohibition of the set-off of assessed losses against income, that in order for the provisions of section 103(2) of the Act to apply, all three criteria stipulated in the section have to be met, namely:

- any agreement that has been entered into affecting any company or a change in shareholding has taken place (discussed in paragraph 4.2 below);
- income has been received by or accrued to that company as a direct or indirect result of the agreement or change in shareholding (discussed in paragraph 4.3 below); and
- the agreement or change of shareholding was affected solely or mainly for the purpose of utilising the assessed loss to avoid or reduce liability for tax on the part of the company or any other person (discussed in paragraph 4.4. below).

4.2 An agreement or change in shareholding

The wording of this requirement is extremely wide. Accordingly, the courts, in interpreting this section, essentially sought to give the wording its literal meaning. However, each case will depend on the particular surrounding facts.

It is widely accepted that section 103(2) of the Act will apply to any kind of agreement that affects a company, whether the agreement relates to the shareholding or any other aspect of the company or its business.

Nicholas AJA in CIR v Ocean Manufacturing Ltd (1990 (3) SA 610 (A), 52 SATC 157), held that:

> "The word agreement as used in Section 103(2) connotes a contract; that is, an agreement which is legally binding and enforceable between the parties."

Further, the judge held:

> "Any' is a word of wide and unqualified generality. In regard to the subject matter, there is nothing in Section 103(2) to suggest that the word "any" was used in a limited sense."

The court also held that the phrase "any agreement affecting any company" in section 103(2) of the Act can not be restricted to agreements affecting the control of a company or affecting any person's right to participate in the profits or divisions of the company.

It is accordingly submitted that section 103(2) of the Act will apply to <u>any</u> agreement of any nature affecting the company, whether the agreement relates to shareholding or any other aspect of the company or its business.

4.3 Income received by or accrued to the company

The question whether income was received by or accrued to a company is again a factual enquiry, depending on the particular facts of each case. The courts have held that the wording of this requirement is wide enough to include income produced by the company's own activities in addition to income diverted to the taxpayer from another entity.

Trollip J, in ITC 1123, 31 SATC 48, held that:

> "... the section was intended to apply where income was diverted from another person to a company in order to avoid liability for tax on the part of that person is clear from its very language. But its wording is wide and

> there is no warrant for limiting its application to such cases. That is wide enough to include income from its own activities in contradistinction to income diverted to it. Of course, for the income from the company's own activities to be hit by Section 103(2), it must have been received by or it must have accrued to it as a "direct or indirect" result of the change in shareholding."

This principle was confirmed in Glen Anil Development Corporation Ltd v SIR, 1975 (4) SA 715 (A), 37 SATC 319, where the Appellate Division (as it was then known) held that the provisions of section 103(2) of the Act are not only confined to the instance where there is a diversion of income to the company. Thus, where a business that was previously carried on by someone else, is transferred to a company with an assessed loss, or the business is not transferred, but suspended and thereinafter carried on by the assessed loss company, section 103(2) of the Act could apply.

Accordingly, not only "new" income introduced into the company falls within this requirement, but also income which is produced by existing operations.

4.4 Solely or mainly for the purpose of avoiding tax

In order to fall within the ambit of the provisions of section 103(2) of the Act, the sole or main purpose of an agreement or change of shareholding must have been the avoidance of the liability for tax by utilising a company's assessed or assessable loss. The test in determining whether the change in shareholding or the agreement was entered into solely or mainly for this purpose, it is submitted, is largely a subjective test. Therefore, where the taxpayer is able to provide evidence that the <u>predominant</u> purpose for entering into the transaction is a commercial one and the existence of an assessed loss is merely a subsidiary consideration, then the provisions of the section would not be successfully involved.

In terms of section 103(4) of the Act, if an agreement results in the avoidance of tax, a rebuttable presumption is created that the main reasons for the change in shareholding or the predominant reason the agreement was entered into, was solely or mainly for the purpose of utilising the assessed loss. Through the application of this section the onus is accordingly placed on the taxpayer to prove that the utilisation of the assessed loss was merely a secondary consideration. The presumption envisaged in section 103(4) will, according to Meyerowitz (2000: 29.13), only arise after the Commissioner has proven that tax avoidance, postponement or reduction is apparent in the factual circumstance.

Accordingly, if a taxpayer enters into an arrangement motivated by sound underlying business needs or reasons, and he chooses to structure the transaction in a tax-efficient manner, for example one element of the arrangement includes the presence of an assessable loss and the taxpayer endeavours to structure the arrangement in such a way so that the assessed loss is not negatively influenced as a result of the arrangement, then he is not necessarily guilty of having tax avoidance as one of his main purposes (R Ltd and K Ltd v COT, 45 SATC 148).

In other words, if for example a change in shareholding in a company was clearly and unambiguously motivated in the first instance by cogent business reasons, other than the utilisation of an assessable or assessed loss, section 103(2) of the Act could not successfully be applied by the Commissioner.

The above principle i.e. that taxpayers can arrange their affairs to remain outside the provisions of an act, even a taxing provision, was confirmed by the court in Relier (Pty) Ltd v CIR (60 SATC 1) and more recently in the Supreme Court decision of CIR v Cohange (formerly Tycon (Pty) Ltd).

However, the court in the Relier case also stated that in this regard the question remains as to whether the arrangement was one of substance and not one of form. Although we submit that this does not import the principle of "substance over form" into our taxation laws, we must concede that it requires that a transaction should not be a mere "sham". This means that the parties should not endeavour to avoid the provisions of the Act through simulated transactions and that any agreement should reflect the unexpressed agreement and tacit understanding between the parties. However, the fact that the terms of a transaction are normal and that the parties acted at arm's length, would not assist a taxpayer in showing that section 103(2) of the Act is not applicable. It will merely assist the taxpayer in proving that the transaction was not mainly tax driven.

In ITC 983 (25 SATC 55) for instance, it was held that:

> "...for the section to operate, the avoidance or reduction of tax must at least have been the principal purpose of the taxpayer. In the present case the Court is satisfied that although the avoidance or reduction of tax was one of the purposes, it was not the main purpose...." (Emphasis added)

As the test whether the transaction was entered into mainly or solely to avoid tax as envisaged in section 103(2) of the Act is largely subjective, the intention of the taxpayer for entering into the transaction should be carefully considered (SIR v Gallagher 1978 (2) SA 463 (A); ITC 1388, 46 SATC 126) and would be imperative to prove that the transaction was motivated by a sound underlying business rationale. However, no clear guidelines exist to determine the intention of a taxpayer, as the courts have held that the determination of a taxpayer's intention would be dependent on the particular facts of each case.

4.5 Conclusion

In summary, a scheme of arrangement in terms of section 311 of the Companies Act and therefore the preference share scheme constitutes an "agreement" as defined for the purposes of section 103(2) of the Act.

However, where a taxpayer can show that the acquisition of a business was clearly and unambiguously motivated by good business reasons, other than the utilisation of a tax loss, the added advantage of a tax loss in the acquired company should not be sufficient grounds for the Commissioner for Inland Revenue to successfully apply the provisions of section 103(2) of the Act.

However, if the acquired company was for example involved in a line of business entirely different to that which is conducted by the proposer of the scheme or the acquired company is simply an empty shell, barring the assessed loss, the burden of discharging the onus of proof weighs heavily upon the proposer to show the contrary.

In conclusion, should the Commissioner succeed in invoking the provisions of section 103(2) of the Act, the implication for the company which has been acquired by the proposer will be that the Commissioner is entitled to disallow the set-off of the assessed loss or the balance of the assessed loss against the income in question. This does not necessarily mean that the assessed loss will be lost in its entirety. The provisions of section 103(2) of the Act may only be imposed upon "tainted" income, that is income which is channelled or diverted into the acquired company directly as a result of the sanctioning of the scheme that was solely or mainly utilised for the purposes of being set-off from the assessed loss.

CHAPTER 5
CONCLUSION

5.1 Summary

It is apparent that the issue of whether section 20(1)(a)(ii) of the Act could be invoked where a company in terms of a section 311 of the Companies Act scheme of arrangement converts its liabilities to redeemable preference shares is still a contentious matter. On the face of it the argument that there are substantial similarities between the interest bearing debt and the redeemable preference shares, since one form of debt is replaced with another, is justified. As a result it could be submitted that section 20(1)(a)(ii) of the Act should not be invoked to reduce the acquired company's assessed loss. Although it is arguable that a benefit could exist, the quantification of the benefit could prove to be problematic, since the balance sheet will not materially change in the situation where the redeemable preference shares are issued for a value similar or greater than the value of the debt (ITC 1613: 195; A v COT 1969 2 SA 689 (R); the Datakor case).

In addition, the argument is further in favour of the fact that section 20(1)(a)(ii) of the Act should not be applied in light of the fact that the question remains as to whether an amount is received as a benefit. The wording of section 20(1)(a)(ii) of the Act requires that both the creditor and the taxpayer's position should be considered to determine the benefit. Since the creditor receives preference shares he receives a benefit, consequently not only the taxpayer receives a benefit. The *quid pro quo* indicates that both parties are bargaining. Of importance in considering the application of section 20(1)(a)(ii) of the Act is the consideration of the elements as a whole, as isolating the elements could create interpretation problems (Datakor case at 577).

5.2 Conclusion

The frequent use of the section 311 of the Companies Act share of arrangement procedure proves that there is still a lively interest in the utilisation of this mechanism. Despite the Robin and Datakor cases, section 311 of the Companies Act scheme of arrangement and preference share scheme in particular is far from dead, and it appears that such schemes are to continue as part of the current attorney's standard repertoire for a good time to come. The drafters of section 311 of the Companies Act schemes of arrangement must, however, take great care in the construction and motivations publicly announced in relation to these schemes.

The issues involved in the application of section 20(1)(a)(ii) of the Act are not at all settled law. Challenges remain, and the initiative of taxpayers will remain at the forefront of new schemes involving the preservation of assessed losses whilst ridding companies of unwanted debts. The preference share scheme involving a holding company and its subsidiary should be distinguished from a scheme involving trade creditors. Our courts have not made any decisions in this regard.

Furthermore the scheme must provide some tangible commercial advantages, lest their creator falls foul of the provisions of sections 103(2).

5.3 Recommendations

5.3.1 Section 20(1)(a)(ii) - Preference shares

It is submitted that the preference share scheme is not uncomplicated from a tax point of view, and should be approached with caution. If the scheme is to be adopted the following terms and conditions relating to the issue of the shares should be adopted and could prevent the application of section 20(I)(a)(ii) of the Act in general (Getz & Jooste 1995: 69-70):

- redeemable preference shares, as opposed to preference shares should be issued;
- the amount or value of the redemption must be equal to the issue price of the shares;
- the obligation to redeem the shares should preferably be an actual and not a contingent obligation of the company;
- the shareholders should have a right to the repayment of capital in preference to other shareholders in the event of the winding up of the company;
- provision should be made for a fixed dividend, or variable rate dividend, to be declared by the directors of the company, once the company is in a position to declare dividends; and
- the company should not have the right to issue any shares, whether redeemable or not, ranking in priority to or *pari pasu* with the redeemable preference shares issued in terms of the scheme.

5.3.2 Section 103(2) of the Act - Commercial reasons

As the test whether the transaction was entered into mainly or solely to avoid tax as envisaged in section 103(2) of the Act is largely subjective, the intention of the taxpayer for entering into the transaction should be carefully considered

(SIR v Gallagher 1978 (2) SA 463 (A); ITC 1388, 46 SATC 126) and would be imperative to prove that the transaction was motivated by a sound underlying business rationale. No clear guidelines however, exist to determine the intention of a taxpayer, as the courts have held that the determination of a taxpayer's intention would be dependent on the particular facts of each case.

Listed below are some factors that our courts have considered in the past to determine the intention and motivation of the agreements or changes in shareholding where the application of section 103(2) of the Act has been considered:

- One of the most important factors that our courts consider in attempting to ascertain the purpose of the taxpayer is why that particular agreement, as opposed to any other, was entered into at the time, and why that company in particular was chosen for the transaction, when any other company could have been chosen (Glen Anil Development Corporation Ltd v SIR, 1975 (4) SA 715 (A), 37 SATC 319). Hence, where a choice between different companies had to be made, the courts may look specifically at the reasons behind the decision that was ultimately made. Thus for example, where the agreement could have been entered into with any number of companies, the fact that the particular agreement which resulted in the utilisation of the assessed loss was entered into will be an important guideline in establishing the purpose of the taxpayer.

  Factors indicating why an agreement was entered into with a particular company (as opposed to any other company) could include:

  - the company with the assessed loss can provide expertise lacking in any other company (ITC 983, 25 SATC 55);
  - the particular company was chosen because that route offered the most cost effective way in which to achieve the business objectives of the

parties (Glen Anil Development Corporation Ltd v SIR, 1975 (4) SA 715 (A), 37 SATC 319);

- A non-tax business benefit is usually easier to prove where the acquired company conducts or conducted a similar type of business to the acquiring company (ITC 983, 25 SATC 55; ITC 989, 37 SATC 319; ITC 1347, 44 SATC 33). This could account for such non-tax business motivations as:

  - the obtaining of new sources of a common raw material; or
  - an increased and complementing production facility; or
  - an additional and complementing sales structure; or
  - the existence of a skilled labour force; or
  - existing goodwill.

  It is important to note that the non-tax business motivations which may have prompted interest in the acquisition of the company with the assessed loss should still exist at the time that the acquisition is made to avoid the inference being drawn that the taxpayer's only intention was to utilise the assessed loss in order to avoid or reduce it's tax liability (ITC 1123, 31 SATC 48);

- Subsequent events proving the successful achievements of the business motivations with which the transaction was originally entered into strengthen the conclusion that the tax loss was not the main motivation behind a particular transaction (ITC 983; 25 SATC 55; ITC 1347, 44 SATC 33);

- The use of the acquired company for completely different business operations to that which it carried on prior to the acquisition, could be indicative of a tax motive as contemplated by section 103(2) of the Act. (ITC 1123; 31 SATC 48; ITC 1388, 46 SATC 126);

- If the utilisation of the loss was one of the reasons for the acquisition (or agreement) and the tax saving resulting from it is disproportionately larger than the advantage to be gained from other considerations, the conclusion could be that the acquisition was made solely or mainly to utilise the loss (Glen Anil Development Corporation Ltd v SIR, 1975 (4) SA 715 (A), 37 SATC 319);

- Whether the assessed loss was taken into account when determining the price paid for shares in a company with an assessed loss has been held to be a relevant factor in determining the taxpayer's motive (ITC 989, 37 SATC 319). Hence, our courts have held that the consideration paid for the shares in the company with the assessed loss should be commensurate with the potential non-tax business advantages that motivated the acquisition (ITC 989, 37 SATC 319);

- The price paid for the shares should not be excessive compared to the net tangible assets of the acquired company, otherwise a tax motive may be imputed and the set-off of profit against the existing assessed loss may be disallowed (ITC 983, 25 SATC 55);

- Where an agreement is concluded in terms of which assets are transferred to a company with an assessed loss, the court in CIR v Ocean Manufacturing Ltd (1975 (4) SA 715 (A), 37 SATC 319) ascertained the intention underlying the transfer by referring to the particular transfer agreement despite the fact that the transfer agreement was part of the implementation of a merger agreement, the motive of which was clearly not tax avoidance on the facts. Thus, where an agreement is concluded as part of a larger objective, the careful implementation of the larger objective, as well as the specific transaction, becomes important when attempting to prove a non-tax motive for the transaction; and

- The fact that no mention was made of the assessed loss during the negotiations leading up to the conclusion of the agreement has been one of the factors which have persuaded the courts that the taxpayer's sole motive was not to avoid tax (ITC 1388, 46 SATC 126; ITC 1347, 44 SATC 33). However, it has been held that, where the existence and extent of the assessed loss is apparent, the fact that the assessed loss was not mentioned during negotiations is not indicative of a non-tax motive (ITC 1388, 46 SATC 126). In this regard, the official minutes of the acquiring company would be a legitimate source in determining the motivation of the acquisition (ITC 989, 37 SATC 319). By analogy, any other documentation pertaining to the negotiations surrounding the acquisition may be relevant.

It should be emphasised that none of the above guidelines are decisive in themselves and the guidelines should be interpreted in the context of the factual background of each particular case. Furthermore, it should be noted that the above is not an exhaustive list of guidelines

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