DLA CLIFFE DEKKER HOFMEYR

5 APRIL 2012

TAX ALERT

ACQUISITION OF TRADING STOCK FOR NO CONSIDERATION

Judgment in the case of *Eveready v CSARS (195/11) [2012] ZASCA 36* was handed down by the Supreme Court of Appeal (SCA) on 29 March 2012. This was an appeal from a judgment of the Tax Court in Port Elizabeth reported as *ITC 1851 ((2010) 73 SATC 241)*.

The question that the court had to answer was whether the trading stock that the taxpayer (a company) had acquired through what in essence was a management buy out in 2002 had been acquired for no consideration. If in fact the trading stock had been acquired for no consideration in terms of s22(4) of the Income Tax Act, No 58 of 1962 (Act), then in terms of bringing the cost price of that stock into the trading stock calculation, the cost of that stock would be deemed to be its current market price at the date of acquisition by the new purchaser. In such a case, the new owner of the stock (the taxpayer in this case) would have had a substantial tax deduction in respect of stock that it had not actually paid for.

When this matter came before the Eastern Cape Tax Court (the Tax Court), the South African Revenue Service (SARS) disallowed the deduction based on s22(4), on the basis that they did not believe that the company had acquired the trading stock for no consideration or for a consideration not measureable in terms of money.

The taxpayer then sought to lead evidence on what the Sale of Business Agreement in the relevant transaction had provided with regard to the trading stock. Schedule 6 to the Sale of Business Agreement assigned no value to the inventory and display inventory. The court felt that this was of little "probative value". It was also found that the arbitrary allocation of the purchase price does not establish that no consideration was given for the trading stock. With regard to wanting to lead evidence about what the true intention of the contracting parties was, the court relied on the parol evidence rule on the basis that a contract was intended to provide a complete memorial of the legal act, and extrinsic evidence may not contradict, add to or modify the meaning of that contract (citing *Johnson v Leal 1980 (3) SA 927(A) at 943 B)*.

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On this basis, the court found that the taxpayer's reliance on s22(4) of the Act had been entirely misplaced. The court was, however, satisfied that the taxpayer's conduct had been reasonable given the legal opinions he had obtained concerning claiming the tax deduction under the trading stock rules and did not permit SARS to charge additional interest under s89 *quat* (2).

When this matter came before the SCA it had to be considered that where in Schedule 6 the parties had sought to make an allocation of the purchase price with respect to the inventory and display inventory, it had merely been left blank. On that basis, the appellant had submitted that the schedule demonstrated that the parties intended that no part of the purchase price was paid for the trading stock and accordingly it was acquired for no consideration.

The SCA said that this submission had no merit. Not only did it ignore the context in which the schedule must be read but felt it was also inconsistent with the language of the schedule itself. Having regard to the definitions in the Sale of Business Agreement of "the business as a going concern" and the "business assets", it was apparent from the subject matter of the sale that the purchase price was paid at least partly for the trading stock. Clause 8 required the stocktaking to be done prior to the effective date. Based on the stocktaking, the inventory and display inventory was to be valued on a specified basis. The value of the stocktaking would be used for the purposes of the effective date accounts and the working capital statement. On this basis, the SCA held that the purchase price of the business had not been R80 million but an amount adjusted after the working capital had been established as at the effective date. The payment in respect of the inventory would relate to the effective date adjustment accounts. Schedule 6 did not purport to allocate the R80 million. It purported to allocate the purchase price, which was undetermined until such time as the working capital at the effective date had been fixed. The SCA also held that it would be extraordinary if the seller had given away his trading stock for free in respect of trading stock that the purchaser said had a market value of over R100 million. Accordingly, the finding by the court has been upheld.

In respect of the decision in the court that the taxpayer claiming the deduction had been a reasonable claim, while the SCA felt that the tax opinions had not been as unequivocal as the taxpayer had suggested, they would only interfere if they thought the court had failed to properly exercise its discretion. They did not think that and SARS's claim for interest under s89 *quat* (2) was dismissed.

Alastair Morphet

REDEMPTION OF PREFERENCE SHARES – A RECOVERY FOR PURPOSES OF THE EIGHTH SCHEDULE?

In our Tax Alert of 16 March 2012 (Tax Alert), we discussed the first of the two main issues that arose for determination in a matter before the Johannesburg Tax Court in *A (Pty) Limited v CSARS (Case No: 12644)*. The first issue concerned the applicability of the "clogged-loss" rule contained in paragraph 39(1) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) to the redemption of preference shares. In essence, the court found that although the redemption of preference shares does constitute a disposal for the purposes of the Eighth Schedule, it is not a disposal "*to*" any other person as envisaged in paragraph 39(1) and therefore any capital loss that arises will not be ring-fenced.

The second issue concerned the extent of the taxpayer's capital loss, more particularly, whether the preference dividend and redemption premium paid by the company as part of the redemption or purchase price of the preference shares constituted a "recovery" as contemplated in paragraph 20(3) of the Act. If it did, the base cost of the preference shares must be reduced by the extent of the recovery, effectively reducing the taxpayer's capital loss.

Paragraph 20(1) of the Eighth Schedule provides that the base cost of an asset (the preference shares) is the sum of the expenditure actually incurred in respect of the cost of acquisition of that asset and other amounts referred to in paragraph 20(1). However, paragraph 20(3) of the Eighth Schedule prescribes circumstances when the "*base cost*" must be reduced by certain amounts. In particular, paragraph 20(3)(b) of the Eighth Schedule provides that the expenditure contemplated in subparagraph 20(1)(a) to (g) must be reduced by any amount that:

> "has for any reason been reduced or recovered or become recoverable from or has been paid by any other person (whether prior to or after the accrual of the expense to which it relates)…"

In considering whether there was a recovery of expenditure contemplated in paragraph 20(1) of the Eighth Schedule, the court applied the ordinary dictionary meaning of the word "*recovered*", stating that, to constitute a recovery the taxpayer must have got back the cost (or part) expended in acquiring the asset. The court ruled that the preference dividend and redemption premium paid

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as part of the redemption price were not recoveries in this sense but rather "fruits" of the shares. The preference dividend or redemption premium being akin in nature to rent derived from a rental property. The court added that the fact that the preference dividend and redemption premium are benefits that might have been taken into account in determining the price paid for the preference shares does not convert them into recoveries envisaged in paragraph 20(3).

The taxpayer thus found himself in a favourable tax position in that it was permitted to take into account the full capital loss in determining its taxable income. The capital loss was therefore neither ring-fenced under paragraph 39(1) (as discussed in the Tax Alert) nor effectively reduced in terms of paragraph 20(3) of the Eighth Schedule to the Act.

As mentioned previously, it remains to be seen whether SARS intends appealing the court's finding.

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