TAX004 An analysis of the income tax implications for the seller and purchaser in relation to the assumption of contingent liabilities in part settlement of a going concern

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Abstract

This paper addresses the proposed income tax treatment of contingent liabilities assumed when a going concern is sold. With the transfer of going concerns being common, a critical issue is how agreements should be structured to determine the income tax implications. Currently no prescribed income tax treatment exists in South Africa and the Ackermans case brought this aspect to the fore. The South African Revenue Service issued a discussion paper to address the income tax treatment regarding the assumption of contingent liabilities on the transfer of a going concern. This discussion paper was issued in draft and public comments were due by 31 March 2014. The income tax effects of these transactions can be high in value and have an impact on the future and current tax consequences of an acquisition. This paper will consider the development of the discussion paper and how it has been influenced by the historical treatment of these transactions and applicable case law. An analysis of Binding General Ruling 185, issued on 11 December 2014, which deals with the corporate rules, specifically the disposal of assets and liabilities as part of a group structure is provided. The paper concludes with recommendations as to how agreements should be structured and how these transactions could be treated for the purpose of the Income Tax Act No.58 of 1962.

INTRODUCTION

The assumption of contingent liabilities is a common issue with respect to the transfer of going concerns. No specific income tax treatment has been legislated and the only recourse is to the general income tax provisions as contained in common law and case law.

Cases brought before the courts have proved the importance of investigating and finding a suitable income tax treatment for the assumption of contingent liabilities. In addition, the South African Revenue Service (SARS) issued the following discussion paper in draft for public comment by 30 March 2014: “Discussion Paper on the tax implications for the seller and purchaser in relation to the assumption of contingent liabilities in part settlement of the purchase price of assets acquired as part of a going concern” (the discussion paper).

This paper will provide a critical analysis of the discussion paper in the context of case law and the Income Tax Act No. 58 of 1962 (the Act). It will compare the ruling in Binding Private Ruling 185, issued on 11 December 2014, and dealing with the corporate rules[3], with the discussion paper.

[3] Sections 41-47 of the Act

The paper will also attempt to provide a suitable method for dealing with the tax consequences of similar transactions in accordance with the proposed treatment in the discussion paper and where necessary recommend alternatives.

PURPOSE

The purpose of this paper is to analyse the proposed treatment in the discussion paper in the context of the Act and recent case law. Further, the paper analyses the proposed treatment and considers whether it is appropriate and can easily be applied in practice. It also recommends a solution which is fair to both the fiscus and the taxpayer. Further developments affecting the treatment in the discussion paper are assessed.

RESEARCH METHOD

This paper will address the following question: *"How should free-standing contingent liabilities be treated for income tax purposes when there is a transfer of a going concern?"*

In order to answer this question, the study will investigate the following:

a) What a contingent liability is,
b) The requirements to claim a deduction,
c) Case law dealing with similar concerns and the impact of such on the proposed treatment in the discussion paper,
d) The historic treatment of such transactions,
e) Whether the discussion paper provides a solution which is in accordance with the legislation and which can be applied efficiently.

While undertaking the analysis to address the research question the study will examine the following sub-questions:

a) How can proceeds accrue to a seller on transfer of a contingent liability?
b) Will either taxpayer be able to claim a deduction on such contingent liability if it becomes unconditional?
c) Will the assumption of the contingent liability defer deductions for the purchaser of the going concern?

Limitations of study

This paper takes into account information available as at 30 April 2015. The study will only focus on the income tax implications regarding the transfer of contingent liabilities of South African taxpayers.

AN EXAMINATION OF CONTINGENT LIABILITIES

In terms of International Financial Reporting Standards (IFRS) liabilities are categorised into three groups depending on the level of uncertainty. These liabilities are an ordinary liability which is a definite obligation and has been incurred, a provision which is a liability which will most likely be incurred and a contingent liability which is a possible obligation.

In the legal sense there are two types of liabilities namely a contingent liability and an unconditional liability. A contingent liability is a liability which has an element of uncertainty and therefore has not been incurred and will accordingly only be incurred when the specific uncertainties / conditions have been met. In the decision in *Nasionale Pers Bpk* v *KBI* (1986 (3) SA 549 (A)) the court made it clear that a liability is only actually incurred for income tax purposes when the outcome is certain.

The accounting treatment and recognition of a liability and a contingent liability.

In terms of the conceptual framework within IFRS a liability is defined. IAS37 in IFRS outlines three types of obligations and the recognition thereof. Firstly, the liability which is a definite obligation for which the reporting entity is unconditionally liable. The second is a provision and the third is contingent liability.

A provision, in terms of IAS37, is a liability where there is uncertainty in the timing or the amount; whereas a contingent liability is only a possible obligation where the existence is confirmed by the happening of a uncertain future event (IAS 37,10). Therefore the distinguishing factor between a provision and a contingency for financial reporting purposes is that a contingency has a greater element of uncertainty.

IFRS 3;10 provides guidance on the recognition of liabilities on the acquisition of a business it states *"The acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed…"*

The standard further provides guidance in terms of IFRS3:23 that contingent liabilities should also be recognised even though it is only a possible obligation. This treatment differs from tax treatment.

Contingent liabilities defined in terms of the discussion paper

The discussion paper provides detailed explanations regarding liabilities and only deals with free-standing contingent liabilities. It notes that a contingent liability is an obligation whose existence will only be confirmed by the occurrence or non-occurrence of an uncertain future event. Further a free-standing liability is one which is not linked to a particular asset as those type of liabilities such as an allowance for doubtful debts is a valuation provision.

The discussion paper takes account of the fact that these liabilities are often recognised in the accounting records, however as held in *Sub-Nigel* v *CIR* (1948 AD) there is a difference between accounting and tax treatment and one must look to the language in the Act when considering the relevant tax treatment (Olivier, 2007:601) .

As noted in the discussion paper, a contingent liability cannot be deducted due to the fact that it would not meet the requirements of section 11(a) of the Act as it has not actually been incurred. This is despite the fact that when a provision is raised in the accounting records, which has the same substance as a contingent liability for tax, it is not recognised for income tax purposes, unless it falls into a specific deduction.

Requirements for a deduction

The Act contains provisions on deductions. In determining whether a deduction is available in terms of the Act, it is necessary to consider section 11(a) and also section 23 (disallowed deductions). The preamble to the general deduction formula in section 11(a) requires a trade to be carried on. In terms of section 23(g) no deduction will be allowed to the extent the amount is not incurred for the purposes of trade. Case law has clarified the terms "trade" and "actually incurred".

The general deduction in terms of section 11(a) states:

> *"Expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature"*

The meaning of "trade" and "actually incurred"

In terms of *Burgess* v *CIR* (1933 AD), *trade* must be given the widest possible meaning and includes every profession, business and employment amongst others. In *Caltex Oil (SA) Ltd* v *SIR* (1975 AD), the court held that expenditure is *actually incurred* when the taxpayer becomes unconditionally liable for an amount.

Claiming a deduction for a contingent liability

The characteristic of a contingent liability is that the taxpayer is not unconditionally liable for the amount and therefore it has not been actually incurred. As a consequence the taxpayer is unable to claim a deduction in terms of the provisions of the Act.

The tax treatment in practice and an analysis of the Ackermans case

Ackermans v *CSARS* [2010] ZASCA 131 highlighted transactions that include the assumption of contingent liabilities in part settlement of the purchase price of a going concern and how the free-standing contingent liabilities are treated for income tax purposes and how the treatment suggested in the court decision of the above-mentioned case has affected the outcome. The taxpayer (being the seller) argued for a deduction in respect of the contingent liability assumed by the purchaser as this resulted in less consideration being received.

Ruling of the Ackermans Case

The ruling of the case provided clarity on how important the agreement between the parties is as it will play an integral part in determining the tax consequences. The court ruled the seller was not entitled to the deduction, even though part of the purchase price was foregone. The court also stated as an *obiter dictum* that the purchaser would not be barred from claiming the contingent liabilities when they became unconditional, subject to the further requirements of the Act.

In Binding Class Ruling 029 SARS gave effect to this where a going concern was transferred between companies within the same group in terms of section 44 of the Act. In this ruling the purchaser was entitled to claim a deduction for the contingent liabilities assumed when they were actually incurred.

The importance of the agreement

The agreement is important in determining the tax implications (Rossouw, 2010). The court held that an obligation on the part of the seller had not arisen in terms of the sale agreement. It has merely accepted a lower price. Therefore, it had not incurred expenditure in respect of the contingent liabilities. As noted by Emslie and Davis (2011:341) the situation would have been different if the agreement had said that the seller would pay the purchaser to assume the contingent liability. In that instance the seller would have incurred expenditure.

'*It was held in the recent Supreme Court of Appeal judgment in Eveready v The Commissioner for the SARS (195/11) [2012] ZASCA 36 that the sale agreement had to be interpreted on the facts as they appeared in the sale agreement (para 10, page 5). The Supreme Court of Appeal disallowed oral evidence as to the meaning of the written agreement. The judgment again confirmed the importance of clearly setting out the allocation of the purchase consideration to the various assets during the sale of a sale of business.'* (Fouche, 2013:11).

Past treatment

In the past there has been no prescribed tax treatment for the transactions forming the subject matter of the discussion paper, but the seller would have to determine whether they are entitled to a deduction on the basis that they have incurred expenditure by accepting a lower selling price for the business.

In conducting research for this paper, no authoritative source was available detailing how this treatment was treated in the past. By deducing from cases involving these transactions, in particular the recent *Ackermans* v *CSARS* case, it can be inferred from the facts of the case that sellers would have tended to deduct the contingent liability at date of transfer and the purchaser would not have had any tax consequences in respect of the contingent liability.

Conclusion

These transactions have been commonly contentious in the past (BDO, 2010). The ruling of the court made the importance of the agreement between the parties clear and also that the buyer would potentially be able to claim a deduction when the contingent liability is actually incurred, while the seller would have a higher amount of proceeds on sale. Should the liability become unconditional any deduction would be subject to further requirements of the Act.

A critical analysis of the discussion paper

The discussion paper provides arguments which are both valid in terms of the legislation and in line, to an extent, with previous court decisions, while at the same time proposing specific tax treatments which may prove difficult to apply in practice.

The scope of the discussion paper

The discussion paper addresses contingent liabilities assumed as part of a going concern and does not address those covered within the corporate rules. It is also only applicable to transfer of a going concern and not the transferors of a legal entity. Further the discussion paper only considers free-standing contingent liabilities and does not consider embedded obligations[4].

The consideration of the seller

The view of SARS is that when one transfers a business as a going concern to another, any free-standing contingent liability, if it gets transferred with the business, would essentially reduce the purchase consideration for the purchaser. Therefore in terms of the view taken by SARS it would have an impact on the tax cost of the asset (as well as the availability and timing of tax deductions and allowances) and in order to determine the appropriate impact they would need to refer to the transfer agreement.

The understanding is that the assumption of the contingent liability by the purchaser would reduce the net assets of the business and therefore the purchaser would offer a lower price. In light of the above, the discussion paper addressed the issue of the elements of the purchase price. The paper applied the principles applied in Interpretation Note 58 issued in 2012[5]. The consideration received by the seller includes the amount in *cash or otherwise* as per the provisions of *gross income*.

Therefore the consideration transferred would consist of the amount actually paid and the additional amount in "otherwise" which would be the value of the contingent liabilities assumed by the purchaser. The amount the seller must include as consideration for the assets sold and the contingent liabilities assumed by the purchaser must be allocated to gross income or proceeds depending on whether or not the amount is capital or revenue in nature.

An amount which is capital in nature would result in proceeds accruing to the seller when the asset is sold for the purpose of capital gains tax, while an amount which is revenue in nature would result in gross income.

This application is valid in terms of the *Ackermans* v *CSARS* case as there would be a *quid pro quo* which is essentially the amount of the contingent liability assumed by the purchaser in exchange for a lesser amount paid for the transfer of the going concern.

Other considerations

The discussion paper does not mention how the value should be calculated. This can lead to issues surrounding the tax implications. The discussion paper mentions that SARS will use the purchase price allocation within the agreement as long as there is no evidence that the allocation does not represent the actual facts.

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[4] An embedded obligation is s directly linked to an asset and decreases the value of the asset

[5] This interpretation note resulted from the ruling of *Brummeria Renaissance (Pty) Ltd And Others* V *CSARS* (2007 SCA)

This treatment suggested in the discussion paper will result in onerous work for both the taxpayers and SARS. Due to the insufficient detail regarding the determination of a value in the discussion paper, taxpayers could use this to their advantage to structure transactions in a way to benefit their tax position.

The lack of guidance in the discussion paper on valuation provides uncertainty to the taxpayer and further suggests that these contingencies should be recognised in the agreement in line with IFRS principles and therefore it is arguable that SARS has taken the view of the financial reporting body on how to measure the contingent liability.

Can one be taxed on something they do not have?

The view of the paper is that the consideration transferred to the seller comprises of two components – the amount transferred and the contingent liability foregone.

The issue with this is that the seller is taxed on something which does not exist in terms of legislation. If the Act does not recognise a contingent liability because it has not been incurred, how can SARS interpret the legislation to recognise the proceeds?

Will it be possible for the proceeds to have accrued to the seller as in the case of *Mooi* v *SIR* (1972 (1) SA 675 (A)), where the judgement made it clear that proceeds would accrue to the taxpayer when they are unconditionally entitled to it? Therefore, as a contingent liability is conditional, should the proceeds not be treated the same way? This is an area for further research.

The purchaser of the going concern and deductibility of the contingent liabilities

The purchaser would acquire the going concern through giving consideration for the underlying assets. The discussion paper provides an argument that any contingent liability assumed by the purchaser would decrease the price of the net assets being purchased.

In ordinary business operations it would be expected that a business would have contingent liabilities, for example as they accrue for bonuses and long term employment benefits. In terms of the Act these amounts would only be deductible once they meet the requirements of section 11(a).

The issue for the purchaser is that, even once the contingent liability becomes unconditional another key requirement of the legislation would need to be satisfied. This requirement is that of trade. In terms of *Burgess* v *CIR* (1933 AD) trade should be given the widest interpretation and therefore the purchaser would most likely meet this requirement.

Furthermore, in terms of the requirements of the general deduction the amount must not be of a capital nature. Therefore another issue is that the purchaser, by assuming contingent liabilities will potentially incur capital expenditure. Also the deduction would only be allowed if expenditure incurred was in the production of income (Olivier, 2007:610).

The view of the discussion paper is that the purchaser would only be able to claim a deduction to the extent it meets the requirements of section 11(a). If we consider the underlying business being transferred, that business has met the requirements for the deduction. However, due to the business being transferred between different entities, no entity is being allowed to claim the deduction until such time it is actually incurred.

The treatment of the assets purchased as part of the going concern

The view of SARS is that the assumption of the contingent liabilities will reduce the purchase price of the assets of the going concern and in terms of the discussion paper the taxpayer would need to analyse the terms of the agreement. SARS would use the agreement to determine how the consideration was allocated.

The consideration will be allocated in terms of the agreement. Based on the allocation of the contingent liabilities to each identified asset acquired, the base cost of each asset would be reduced for the purpose of capital gains tax as well as for any capital allowances allowed in terms of the provisions of the Act while the liabilities remain contingent.

Illustrative income tax treatment

Refer to Appendix A which details how the transaction could be taxed in both the hands of the seller and purchaser in terms of the discussion paper.

Binding Private Ruling 185

SARS released Binding Private Ruling 185 (BPR 185) on 11 December 2014, which deals with the disposal of assets and the assumption of (contingent) liabilities in terms of s42 of the Income Tax Act.

SARS ruled that the disposal of the assets "at net book value will constitute an 'asset-for-share' transaction under s42".

It appears from BPR 185 that s42(4) of the Act, which provides that the roll-over relief provided for in s42 would only apply to the extent that the consideration constitutes equity shares, would not be applicable as (presumably) part of the consideration constituting the assumption of the liabilities and contingent liabilities constitutes 'debt' as contemplated in s42(8)(b) of the Act, which is excluded from the application of s42(4) (Cliffe Dekker Hofmeyr, 2015).

Section 42(8) of the Act refers to the disposal of "any business undertaking as a going concern to a company in terms of an asset-for-share transaction and that disposal includes any amount of debt that is attributable to, and arose in the normal course of that business undertaking".

The entire transaction would thus constitute an asset-for-share transaction as defined in s41(1) of the Act, and not only to the extent that the consideration constitutes equity shares (Cliffe Dekker Hofmeyr, 2015).

BPR 185 continues in that the purchaser would only be allowed to claim a deduction in respect of the contingent liabilities to the extent that the requirements of s11(a), read with s7B and 23(g), are complied with at the time that the contingent liabilities are realised. Regard must be had to the context of the business existing prior to the transfer of the business when determining whether the requirements for deduction are met. The fact that the contingent liabilities were assumed as part of the consideration for the assets must be ignored.

The treatment of contingent liabilities in BPR 185 appears to be consistent with the treatment of contingent liabilities in the discussion paper.

Recommendations and Conclusion

Following the study it is evident that income tax consequences are driven by the agreement. From an analysis of the discussion paper and Binding Private Ruling 185 it is clear that an alternative method of interpretation would provide a better result which would be easier to implement in practice.

The transaction

After analysis of the discussion paper it is evident that SARS would be satisfied with the full proceeds (gross of the contingent liability) accruing to the seller at the date of transfer of the going concern and the contingent liability assumed by the purchaser.

The treatment of including the full proceeds in the taxpayer’s gross income is in line with the decision as set out in *Brummeria (supra)* as there is a *quid pro quo* occurring in the transaction as the seller is allowing the purchaser to pay less in exchange for the assumption of the contingent liabilities.

Therefore, applying another decision by the court in *Lace Proprietry Mines Ltd* v *CIR* (1938 AD 267) it is expected that SARS will look at the intention of the parties at the time of the agreement. Economically it would be that the amount would be less since the intention would be to transfer the contingent liabilities in exchange for the lower transfer price.

The background to the proposed treatment

As illustrated in Appendix A, in terms of the discussion paper on transfer of the going concern, no deduction for the contingent liability assumed by the purchaser would be allowed, as it was a deduction for the seller but the amount would be included in the amount of proceeds.

The purchaser would mostly likely not be entitled to a deduction because it was not incurred in the production of income and it could be seen as capital in nature. Should SARS allow the purchaser the deduction then it would be possible for taxpayers to purchase going concerns with large contingent liabilities in order to obtain tax benefits.

The proposed treatment

The proposed treatment will be practical as it is easier to apply by taxpayers. Further, the treatment takes into account some of the considerations of the National Treasury as laid out in the Draft Taxation Laws Amendment Bill of 2011[6].

This treatment would however require amendments to the legislation or a binding general ruling.

The treatment would encompass two parts:

a) The deduction:

   In order to provide efficiency and promote fairness SARS should allow the taxpayer (Seller) to claim a deduction at the time of the disposal.

   Even though this would not meet the general deduction requirements, the recommendation would be for the National Treasury to propose legislation of the following in terms of section 11(a): "Provided where there is a transfer of a going concern from one taxpayer to another, any amount of contingent liability is deemed to be incurred at the date of transfer and the amount is deemed to be that in terms of IFRS"

b) The recoupment:

   In order to ensure fairness, in terms of part a) above there should be a recoupment where the contingent liability deducted by the seller decreases or does not materialise.

The idea with the proposed treatment is that the seller and purchaser should be satisfied with the outcome as it would prove equitable to both parties. The treatment would be relatively easy for compliance by taxpayers and enforcement by SARS.

The treatment would provide a uniform tax effect if the going concern was not transferred to another entity. This further prevents taxpayers from trying to avoid the tax implications by SARS taking the recommendation above into account.

Another consideration is that parties could now add a clause into the agreement that if the contingent liability does not materialise, the seller would be liable to reimburse the purchaser for any recoupment in terms of the Act as described in the recommended treatment above.

[6] In this document the National Treasury had proposed amendments to the legislation which included in terms of a new section11F to deem expenditure to be incurred for a contingent liability in such a transfer of a going concern.

Conclusion

The proposals provided in 7.3. above are more efficient and follow a simpler approach than that of the discussion paper. The final proposal is one which can fit in with ease to the legislation and it achieves the same effect as if the going concern had not been transferred while at the same time providing an efficient method of taxation for SARS.

Appendix A

Illustrative example:

Scenario:

Co S (Seller) a manufacturer has the following on its Statement of Financial Position.

Statement of Financial Position of Co S:

Assets:	**R**	
PPE: Manufacturing Building[7]		1 000
Deferred Tax Asset (provision)		56
Equity:		
Share Capital	556	
Liabilities:		
Accounts Payable		300
Provision for bonus[8]		200

A1: In this scenario Co P (Purchaser) purchases the underlying PPE by assuming the liability of R300 of Co S and giving cash of R700:

Seller:	**Purchaser:**
The seller had a deduction of the contingent liability when actually incurred. On the transfer of the going concern: Proceeds: R1 000 (700 + 300) Base Cost: R1 000 Capital Gain: R0	The purchaser will not be able to deduct the liability as it was actually incurred by Co S. Further the debt is capital in nature so no deduction can be claimed even though it was assumed by the purchaser. The purchaser will claim a capital allowance in terms of s13(1) for the building based on the cost of R1 000.

[7] Assuming it has not been brought into use by the taxpayer as yet

[8] This is a contingent liability for tax purposes

A2: In this scenario Co P (Purchaser) purchases the PPE at its book value and assumes both the provision and liability. The purchaser gives cash of R500.The deferred tax would be derecognised by the seller.

A2.1: Treatment prior to the Ackerman's case:

Seller:	Purchaser:
The seller would deduct the contingent liability of R200 at date of transfer. On the transfer of the going concern: Proceeds: R1 000 (500+300+200) Base Cost: R 1000 (R1000) Capital Gain: R0	The purchaser will not be able to deduct the liability as it was actually incurred by Co S. The purchaser will claim a capital allowance in terms of s13(1) for the building based on the cost of R1 000.

A2.2: Treatment in terms of the Ackerman's case:

Seller:	Purchaser:
The seller will not be allowed to deduct the contingent liability. On the transfer of the going concern: Proceeds: R1000 (500+300+200) Base Cost: R1000 Capital Gain: R0	The same as A2.1 and the purchaser will be able to deduct the contingent liability when actually incurred, provided it meets the requirements for a deduction.

A2.3: Treatment in terms of the discussion paper:

Seller:	Purchaser:
The seller will not be permitted to deduct the contingent liability. On the transfer of the going concern: Proceeds: R1 000 (500+300+200) Base Cost: R1 000 Capital Gain: R0	The purchaser will claim a capital allowance for the building based on the cost of R1 000 less the provision allocated to it of R200. s13(1) (R1 000 – R200) x 5% Once the contingent liability is actually incurred the allowance will be based on the full R1 000.

A2.4: Treatment in terms of the proposals in 7.3 of this paper:

Seller:	Purchaser:
The seller will deduct the contingent liability when it is deemed to be incurred. On the transfer of the going concern: Proceeds: R1 000 (500+300+200) Base Cost: R1 000 Capital Gain: R0	The purchaser will not be able to deduct the liability as it is deemed to be actually incurred by Co S. The purchaser will claim a capital allowance in terms of s13(1) for the building based on the cost of R1 000 Should the contingent liability not become unconditional there will be an inclusion in the purchaser's taxable income.

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