

SOUTH AFRICA / JUDGMENT

X Group (Pty) Ltd v Commissioner for the South African Revenue Service (13671) [2017] ZATC 18 (20 April 2017)

[2017] ZATC 18

COURT
Tax Court

BEFORE
Allie

CASE / FILE NUMBER
13671

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IN THE TAX COURT OF SOUTH AFRICA

(WESTERN CAPE DIVISION, CAPE TOWN)

CASE NO: 13671

In the matter between: X GROUP (PTY) LTD Appellant and THE COMMISSIONER FOR THE SOUTH AFRICAN Respondent REVENUE SERVICE

JUDGMENT:

20 APRIL 2017

ALLIE, J:

1. SARS raised an additional assessment concerning the 2007 year of assessment in which it disallowed and accordingly added back, ninety million rands that Appellant had previously claimed as an expense or loss incurred in the production of income.
2. The facts material to the evolution of the ninety million rands that Appellant paid to ABC Corporation ["ABC"] are as follows:
3. On 12 December 2001, Appellant and ABC entered into a partly oral and partly written agreement in terms whereof the appellant would deliver 540 000 metric tons of coal to ABC between January and December 2002.
4. On 3 December 2002, Appellant and ABC concluded a similar agreement for the delivery of 750 000 metric tons of coal which would occur during January to December 2003.

5. Appellant sold its business as a going concern, to Z Entity (Pty) Ltd ["Z Entity"] on 25 March 2003 with an effective date of the transaction being 1 July 2003.
6. The business was sold with assets and sale contracts including the two contracts with ABC described above.
7. The "assumed liabilities": in the agreement is defined as: "The liability of the business toward trade creditors of the seller, relating directly to the business, as at the effective date, reflected as such in the effective date accounts."

8. Clause 8.2 of the agreement states the following with regard to excluded liabilities:

Save for the obligation of the purchaser to rehabilitate the excluded area, the Z Mining area and the additional Z mining area using the Z rehabilitation fund as provided for in the notarial agreement and in 3.6 and the liabilities attaching to employees, the purchaser does not assume responsibility for the settlement of any other liabilities of the Seller and/or the business of whatever nature, whether actual or contingent, incurred up to the effective date (collectively referred to as 'excluded liabilities')...

9. Z Entity subsequently delivered some coal to ABC in terms of the two sale contracts described above.
10. ABC complained about the quality of the coal and Z Entity did not deliver the full amount of coal. A dispute arose between Z and ABC during 2004, after the effective date.
11. On 5 September 2007, ABC and the Appellant concluded a settlement agreement in terms of which Appellant paid ninety million rands to ABC.
12. At that stage, in 2007, the Appellant no longer carried on the trade of selling coal.
13. The settlement agreement states that: "The Defendant is ordered to make payment to the Claimant of the sum of R90 million in full and final settlement of all claims which the Claimant has against the Defendant arising from whatever cause."
14. No breakdown or apportionment is provided in the settlement agreement so that the purpose of the payment can be determined.
15. Mr D, an auditor, testified that he was asked by Mr F, the managing director of Z Group (Pty) Ltd ["Z"], to become the financial director of Z and Z Entity. As a result of the mining charter, Z sold to Mr G, through H, a 25% share as BEE partner of Z at a price of 250 million rand.
16. Mr D went on to explain that the excluded liabilities included any contingent liabilities. He said that the coal price was \$25 at the time of the agreements with ABC but later it increased to \$40. Z Entity was obliged to supply at the contract price so that meant they would receive less. They had to honour the contract at a loss. The excluded liabilities included any contingent liabilities. Mr F wasn't prepared to incur that loss so he sold the same coal at a higher price to other purchasers on the open market. ABC incurred a loss because they had

to buy the coal on the market and they said held Z Group not Z Entity responsible for their loss. Z Group did not dispute its liability nor did it refer ABC to Z Entity because it had a very friendly agreement with Z Entity as Mr G had paid R250 million for the acquisition of shares. They saw it as a pre-acquisition liability.

17. ABC also complained about the quality of the coal and their claim for compensation included an alleged loss for poor quality coal.
18. Mr D alleged that the 90 million rand that the appellant paid to ABC related to coal that was purchased in 2002 but would only be delivered later and in 2002 the appellant was trading in coal.
19. A further issue raised by Mr D is that ABC didn't consent to the assignment of the rights and obligations under the contract from Z Group to Z Entity and therefore the obligations of Z didn't validly pass to Z Entity and that is why Z accepted liability for ABC's loss.
20. He accepted that the invoices sent to ABC were initially from Z and then after the effective date, the invoices came from Z Entity to ABC. He agreed that ABC ought to have known about the assignment.
21. He alleged that the ninety million rand was an expense in the production of past income.
22. He agreed that to breach a contract by repudiation is not part of the normal course of trade.
23. The Issues for determination are as follows:
 - 23.1. Whether it is necessary for the Z to prove it was carrying on coal trade in 2007;
 - 23.2. Whether ABC consented to the transfer of obligations to Z Entity.
 - 23.3. Settlement agreement- SARS says not clear what they were settling was it claim by ABC or that of its Managing Director as well. Even if the R90 million was payable by Z , it was in respect of a deliberate decision to breach the agreement with ABC. Appellant argued that it's not the lawfulness of the breach that is determinative but whether it was concomitant with the business;
 - 23.4. Whether the interest levied ought to have been limited. Appellant alleges that interest levied should have been limited by the Commissioner. There was additional viva voce evidence that Z believed that they were liable on advice of a senior advocate. That legal opinion and the basis for its conclusion was not presented to the court. The reasonableness of the alleged legal advice can't be determined.
24. The onus is on the taxpayer to show on a balance of probabilities that the expense was incurred in the production of income and the disallowance was incorrect.

25. It was initially contended by Appellant in pleadings that the two contracts with ABC were not transferred to Z Entity but it was conceded by Mr D and submitted by Appellant's counsel that that is no longer their case.
26. Appellant failed to adduce evidence to show that ABC didn't consent to a transfer of the contracts.
27. The letter of repudiation was sent to ABC by Z Entity not Z Group.
28. In the absence of a representative of ABC being called to testify, the appellant has not adduced evidence to demonstrate how the ninety million rand should be apportioned between ABC and its managing director, particularly since the settlement agreement states that it is for compensation due to ABC and to its managing director.
29. Appellant submits that it became an unconditional payment.
30. Respondent closed its case without leading any witnesses.

Applicable Law

31. Section 11(a) of the Income Tax Act 58 of 1962 reads as follows:

For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

- (a) Expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

32. Section 23(c) and (g) provides as follows:

Deductions not allowed in determination of taxable income.—No deductions shall in any case be made in respect of the following matters, namely—

- (c) any loss or expense, the deduction of which would otherwise be allowable, to the extent to which it is recoverable under any contract of insurance, guarantee, security or indemnity.

...

....

- (g) any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purpose of trade."

Whether the expense was incurred in the production of income derived from carrying on trade or was for the purpose of trade.

33. In *Caltex Oil (SA) Ltd v CIR*[1] the court held that:

The expression “expenditure actually incurred” in sec 11(a) does not mean expenditure actually paid during the year of assessment, but means all expenditure for which liability has been incurred during the year, whether the liability has been discharged during the year or not...It is in the tax year in which the liability for the expenditure is actually incurred (if paid in a subsequent year) that the expenditure is actually incurred for the purpose of section 11(a).

34. Accordingly, the 2007 tax year, is the year in which the ninety million rand expense was incurred. At that stage, Appellant was no longer trading in coal.
35. Section 11(a) read with section 23(g) links the expense to the purpose of trade. Section 23(g) therefore qualifies the words: “in the production of income” contained in section 11(a).
36. If the Appellant was trading in horses or wine in the 2007 tax year, the expense of compensation for reneging on contracts for the sale, supply and deliver of coal to ABC, has no bearing on the purpose of the trade that appellant was engaged in by 2007.
37. Appellant’s argument that the expense was a contingent liability that relates to the production of income in the 2003 year of assessment, is not accompanied by persuasive authority lending support to its contention that the provisions of the sale of business agreement proves that the parties contemplated future reckless business decisions which would cause appellant to compensate purchasers of its product and that that would be an instance of a contingent liability.
38. The basis of ABC’s claim clearly involves the deliberate and conscious decision of Mr F to cause Z Entity to breach the agreement with ABC.
39. Mr F proceeded to make a further decision to compensate ABC and its managing director on behalf of Z Group even though Z Entity had assumed the obligation to supply the coal and had accordingly reneged on its obligation to do so.
40. Appellant sought to rely on the lack of express consent by ABC, to the assignment of their contracts to Z Entity, as a reason for Z Group accepting liability to ABC. No correspondence between ABC and the Appellant was provided to support the contention that ABC held Z Group liable because it didn’t consent to the assignment of the contracts.
41. Mr D’s testimony, contradicts Appellant’s above contention because he said that Mr F wanted Z Group to accept liability for the breach because Mr G had paid R250 million for shares in Z Entity.
42. Clause 12. of the sale of business agreement states:

The purchaser and the seller undertakes to use their best endeavours to procure that all other parties (“third parties”) to the sale contracts and the insurance policies shall consent to the cession of rights and the delegation of obligations thereunder from the seller to the purchaser with effect from the effective date.

43. Clause 12.2.1 states:

To the extent that the parties obtained the consent of the third parties...the seller shall be deemed to have assigned to the purchaser...all the seller's rights and obligations in terms of the sale contracts...from the effective date.

44. Clause 12.2.2 states:

To the extent that the parties are unable to obtain consent of any third party...then the seller and the purchaser agree that, with effect from the effective date, they will procure as between them, that the rights and obligations under the sale contracts...shall be for the benefit and account of the purchaser.

45. Clause 12.3 states:

All risk in and benefits to the sale contracts shall be deemed to have passed to the purchaser with effect from the effective date.

46. In addition, after the effective date, 1 July 2003, invoices were sent to ABC by Z Entity and it expressly provided that payment was to be made to the bank account of Z Entity. ABC knew well enough that Z Entity held the rights and obligations in the stead of Z Group under the sale contracts with it.
47. ABC addressed correspondence to Z Entity for deferred delivery of coal on 3 November 2003.
48. Z Entity received payment for coal supplied to ABC after the effective date.
49. Should the court assume, in favour of the appellant, that ABC did not consent to an assignment to Z Entity of the rights and obligations under its sale contracts, inter se, between Z and Z Entity, the latter was deemed to have received the risk and benefits of the sale contracts in terms of clause 12.3.
50. On this issue, SARS argue that on probabilities there had to be consent while appellant says that is not borne out by the documents.
51. Even in the absence of consent, SARS submit that the obligations were transferred in terms of clauses 12.2.2 & 12.2.4. Appellant however alleges that clause 12.3 excluded liabilities
52. Z Group was under no lawful obligation to assume liability to ABC for the breach nor to accept ABC's claim against it.
53. If Z Group chose not to claim compensation from Z Entity for the ninety million rand, it did so for its own strategic, commercial reasons and not because it was lawfully prohibited from doing so.
54. Clause 8.2 of the sale of business agreement states:

Save for the obligation of the purchaser to rehabilitate the excluded area...the purchaser does not assume responsibility for the settlement of any other liabilities of the seller and/or the business of whatever nature, whether actual or contingent, incurred up to the effective date(collectively referred to as the ‘excluded liabilities’”) and the seller undertakes to –

Discharge all the excluded liabilities as and when they fall due...

55. The liability which gave rise to the expenditure had not been incurred during the time when the appellant was still trading in coal.
56. There can be no doubt that no actual liability towards ABC occasioned by a breach of the contract had arisen as at the effective date.
57. As with most sale contracts, there was an obligation to deliver coal to ABC and wilful failure to deliver, could give rise to liability for damages. That does not constitute contingent liability in circumstances where no wilful breach nor dispute between ABC and Z Group had arisen nor had it been contemplated as a contingent liability that Z Group would remain liable for after the effective date, when they concluded the sale of business agreement.
58. In CIR v Golden Dumps (Pty) Ltd,[2] the court held as follows concerning what constitutes a contingent liability:

There is no difference in principle between a case where liability is contingent in the legal sense and one where it is contingent in the popular sense...A liability is contingent in that sense in a case where there is a claim which is disputed, at any rate, genuinely disputed and not vexatiously or frivolously for the purpose of delay. In such a case, the ultimate outcome of the situation will be confirmed only if the claim is admitted or if it is finally upheld by the decision of a court or arbitrator. Where at the end of the tax year in which a deduction is claimed, the outcome of the dispute is undetermined, it cannot be said that a liability has been actually incurred.

59. The Appellant’s argument that a contingent liability encompasses any potential liability irrespective of whether a claim existed at the time when the contract becomes effective is clearly untenable and doesn’t accord with the ratio in the Golden Dumps case.
60. We were presented with no factual evidence to show that deliberate breaches of contracts were an inherent part of operating Z Group’s and Z Entity’s trade.
61. The appellant was unable to provide the court with an intelligible breakdown of how the R90 million is comprised.
62. Mr D said that Mr F would often calculate sums on the back of a cigarette box, thereby implying that Mr F agreed to pay R90 million without creating documentation setting out the detail of the amount.
63. Mr F’s cavalier approach to firstly, creating disputes with ABC and secondly, settling the disputes with ABC and its managing director can’t constitute a bona fide expense in the production of income or for the purpose of carrying on trade.

64. In addition, the settlement agreement states that the payment compensates ABC and its managing director. No information was provided on which amounts were payable to each of the persons being compensated.

Whether the expense was incurred in the production of income

65. In *Port Elizabeth Electric Tramway Co v CIR*,^[3] the court set out the test for determining whether an expense was incurred in the production of income by embarking upon a two stage inquiry, namely –

65.1. Whether the purpose of the act, to which the expenditure relates is to produce income; and

65.2. Whether the expenditure is closely linked to that act closely enough.

66. The clear, plain and unambiguous intention of the legislature in the use of the words contained in section 11(a) is to provide for a deduction of expenses that are necessary or essential or in some close manner required to enable the taxpayer to produce the income from which it seeks to make the deduction.

67. Appellant's papers and viva voce evidence are silent on the explicit connection between profits derived from the sale of coal and its decision to renege on its agreement with ABC.

68. The legislature clearly didn't contemplate that any expense, incurred, however remote it may be to the conduct of trade, ought to be deductible.

69. In *CIR v Nemojim (Pty) Ltd*,^[4] the court held as follows:

It is correct...that in order to determine in a particular case whether monies outlaid by the taxpayer constitute expenditure incurred in the production of income important, sometimes overriding factors, are the purpose of the expenditure and what the expenditure actually affects.

70. Mr D testified that if the ABC contract was lawfully complied with, a profit would still be made albeit a lesser one than if that coal were sold to other purchaser.

71. The negligent, alternatively reckless misconduct of Mr F in deciding not to honour Z Entity's obligations to deliver coal to ABC was not a requirement for the production of income. In fact, no nexus can be established between the income produced by Z Group and the repudiation of the contract with ABC.

72. In our view, Z Group failed to prove, on a balance of probabilities that the R90 million rand was an expense in the production of their income.

Section 89quat Interest

73. As section 89quat(3) was framed at the relevant time, it provided as follows:

Where the Commissioner having regard to the circumstances of the case is satisfied that any amount has been included in the taxpayer's taxable income or that any deduction, allowance, disregarding or exclusion claimed by the taxpayer has not been allowed, and the taxpayer has on

reasonable grounds contended that such amount should not have been so included or that such deduction, allowance, disregarding or exclusion should have been allowed, the Commissioner may, subject to the provisions of section 103(6), direct that interest shall not be paid by the taxpayer on so much of the said normal tax as is attributable to the inclusion of such amount or the disallowance of such deduction, allowance, disregarding or exclusion.

74. Appellant submitted that it had reasonable grounds for claiming the deduction for the following reasons:

74.1. It held the bona fide belief that the expenditure is deductible.

74.2. There was no fraud or misrepresentation.

74.3. It allegedly made full disclosure to SARS.

75. The court has a discretion to confirm or send back for reconsideration, the Commissioner's decision concerning interest. The court is not required to review the Commissioner's decision under section 89quat but must consider the imposition of interest de novo.

76. The exercise of the court's discretion ought to be approached in the following manner:[5]

That the legislator apparently thought that it was necessary to give a special right of appeal in cases where a matter is left to the discretion of the Commissioner appears from a number of instances where that special right is conferred...In all these cases it seems to me that the Legislature intended that there should be a re-hearing of the whole matter by the Special Court and that that Court would substitute its own decision for that of the Commissioner.

77. This approach was confirmed in CIR v Da Costa[6] and ITC 1430 50 SATC 51 at 56.

78. The appellant was fully aware of the fact that it wasn't liable to compensate ABC because Z Entity had assumed responsibility for the fulfilment of its obligations under the sale contracts.

79. According to Mr D, appellant took a robust decision to pay R90 million compensation.

80. Appellant has not adduced concrete evidence in support of its contention that it had reasonable grounds for contending that it was entitled to the R90 million deduction in circumstances where it was not legally obliged to pay the R90 million rand nor was it trading in coal at the time when it agreed to make the payment nor was it necessary to pay the settlement to enable it to produce income.

81. We find that the purpose of the settlement agreement giving rise to the expense sought to be deducted, bears no relation to the trade being conducted by the Appellant.

Costs

82. Under section 130 of the Tax Administration Act, the Court may grant an order for costs against a party if the other party applies for an order of that nature and if the Court finds that the Appellant's grounds of appeal are unreasonable.
83. Having found that Appellant had no reasonable grounds for persisting with the view that the expense is deductible in terms of section 11(a), the costs ought to follow the result.

IT IS ORDERED THAT:

1. The assessment made in respect of 2007 year of assessment is confirmed.
2. Interest imposed by the Commissioner under section 89quat is confirmed.
3. Appellant shall pay the costs, including the costs of two counsel.

R. ALLIE

[1] 1975

(1) SA 665 (A) at 674D-F.

[2] 1993(4) SA110(A) at 118E-H.

[3] 1936 CPD 241.

[4] 1983(4)SA 935 (A) at para16.

[5] Rand Robes (Pty) Ltd v CIR 1944 AD 142 at 150.

[6] 1985(3) 768 (AD) at 774.

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