

The Tax Implications in Structuring a Purchase and  
Sale Agreement of a Business

**BY**

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**DECLARATION**

This research has not previously been accepted for any degree and is not currently being submitted in candidature for any degree.

Signed.....

Date..... 096563

STATEMENT

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## **ABSTRACT**

The buying and selling of a business was previously a fairly simple transaction. A seller had a business he wanted to sell, and a purchaser wanted to buy a business and the two paths met. Those times have changed. More complicated tax laws have been introduced and the structuring of a purchase/sale agreement is much more complicated.

This dissertation is about the structuring and forming of a purchase/sale agreement, examining in detail – from both the sides of the purchaser and the seller. This paper looks at the different entities involved in purchasing and selling eg, sole proprietors, close corporations and so on.

It examines in detail the difference and reasons between the selling of shares of a business and the selling of assets. Discussed in this paper, again from both the seller and the purchaser's view, is an analysis of what is being sold, and what is being purchased. The different ways of paying for the purchase and the different types of payment, eg in kind, royalties etc.

Lastly, but perhaps the most important aspect, are the tax implications in buying and selling a business. Items such as the contents of a Sale Agreement, Fixed Assets, Goodwill, stock etc are also discussed in depth.

# The Tax Implications in Structuring a Purchase and Sale Agreement of a Business

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	<b>Page</b>
<b>Chapter 1 AN OVERVIEW OF THIS STUDY</b>	
1.1 Introduction	3
1.2 The Basis of Tax Planning	4
1.3 Fiscal Consequences Versus The Purchase And Sale Agreement	5
1.4 Basic Requirements of the Purchase and Sale Agreement	5
1.5 The Intention of This Study	6
<b>Chapter 2 DIFFERENT TYPES OF ENTERPRISES</b>	
2.1 Types of Parties in the Agreement	8
2.2 Sole Traders	9
2.3 Partnerships	19
2.4 Companies	23
2.4.1 Tax Disadvantages of Companies	24
2.4.2 Share Dealing	24
2.4.3 The Stigma of Business	25
2.4.4 Assessed Losses	25
2.4.5 Not Recognizing Groups of Companies	26
2.4.6 Trying to Obtain Capital Profits	27
2.4.7 Tax Advantages of Companies	28
2.4.8 Roll of Relief	
2.4.9 Assessed Losses	30
2.4.10 Pre-Incorporation Contracts	30
2.5 Trusts	31

2.5.1	Capital Gains Retained in the Trust	34
2.5.2	Capital Gains Distributed by the Trust	34
2.5.3	Capital Gains Attributed to the Beneficiaries	35

### **Chapter 3 THE PURCHASE AND SALE AGREEMENT**

3.1	Introduction	37
3.1.1	Sale of Shares	38
3.1.2	Sale of Assets	38
3.2	To Sell the Assets or to Sell the Shares	38
3.3	The Purchase and Sale Agreement	39
3.4	Methods of Determining the Subject Matter of the Contract	40
3.5	a Brief Overview of the Purchase and Sale Agreement	40
3.5.1	Memorandum of Agreement	40
3.5.2	Interpretation	40
3.5.3	The Purchase and Sale	43
3.6	Considerations to be Examined	43
3.7	Conclusion	45

### **Chapter 4 GOING CONCERN VERSUS ASSETS VERSUS SHARES**

4.1	Introduction	46
4.2	An In-depth Analysis of Whether to Purchase the Assets of the Business or the Shares of the Business	46
4.2.1	The Seller's Position	47
4.2.2	The Purchaser's Position	51
4.3	Tax Implications Hidden in the Purchase and Sale Agreement	58

4.3.1	Fixed Assets	58
4.3.2	Goodwill	60
4.3.3	Stock	63
4.3.4	Accounts Receivable	64
4.4	Other Tax Considerations	65
4.4.1	Capital Gains Tax	65
4.4.2	VAT	66

## **Chapter 5 DIFFERENT WAYS OF PAYING FOR THE PURCHASE**

5.1	Introduction	70
5.2	Different Types of Payment	71
5.2.1	Payment in Kind	71
5.2.2	Payment in the Issuing of Shares	72
5.2.3	Annuity Type Payments	74

## **Chapter 6 CONCLUSION**

### **A CASE STUDY**

6.1	Introduction	77
6.2	Drafting the Purchase and Sale Agreement	77
6.3	The Financial Statements	78
6.3.1	The Balance Sheet	78
6.3.2	The Income Statement	82
6.3.3	The Cash Flow Statement	83
6.4	Warranties and Indemnities	84
6.5	A Basic Purchase and Sale Agreement	86
6.5.1	Memorandum of Agreement	89
6.5.2	Annexure 1	96
7.	Bibliography	97
8.	Cases	98

# Chapter 1

## AN OVERVIEW OF THIS STUDY

### 1.1 Introduction

*"A panda walks into a café. He orders a sandwich, eats it, then draws a gun and fires two shots in the air. "Why?" asks the confused waiter, as the panda makes towards the exit. The panda produces a badly punctuated wildlife manual and tosses it over his shoulder. "I'm a panda," he says, at the door. "Look it up." The waiter turns to the relevant entry and sure enough, finds an explanation. "Panda. Large mammal, native to China. Eats, shoots and leaves". (Truss. L; 2003)*

The above formed the title of Lynn Truss' book "Eats, Shoots and Leaves", a book which deals with a zero tolerance approach to punctuation. Following on from this, the draughtsmen of purchase and sale agreements must pay particular attention to the use of punctuation, and even more importantly, careful consideration to certain clauses within the purchase and sale agreement of a business, in order to prevent the parties of the agreement from encountering nasty tax surprises.

Gone are the days where all that was required was that the business was sold lock, stock and barrel for a lump sum and this was treated as a receipt of a capital nature thus not attracting any tax at all. This was changed with the judgement handed down in CIR v Niko 1940 AD 416, 11 SATC 124 where the sum paid for the business had to be allocated to individual items such as goodwill, stock, assets and so on. The effect this had was that now with the sale of a business the payment received was now split into Gross Income and Capital.

This decision has made it important to ensure that the purchase and sale agreement specifies an exact apportionment allocated to revenue and the amount allocated to assets, thereby differentiating between revenue and capital.

## **1.2 The Basis of Tax Planning**

Very often the parties to a Purchase and Sale Agreement find themselves in opposition, when it comes to the tax planning of a Purchase and Sale Agreement. The problem that possibly now arises is that the stronger party of the two will be better positioned in order to gain the tax advantage. This will normally lead to an adverse situation for the other party of the Purchase and Sale Agreement. Alternatively the parties can negotiate with the end result being that the tax burden is shared equally. This leads to one of the most important rules in tax planning:

*"Do not allow tax considerations to destroy what could be a good, viable commercial transaction"* (Kruger D; & Scholtz W: 2003)

Further to this one must remember the way the taxpayer translates the Income Tax Act 58 of 1962 (The Act) is not necessarily the same as the Commissioner. Over and above this the majority of tax court cases are shrouded in a veil of secrecy, thus not presenting the taxpayer with the opportunity to establish how the Commissioner thinks, thereby leading us on to another golden rule:

*"Even if a transaction could give rise to an adverse tax consequence do not take this as given. The better thing to do is to go back, identify and analyse all the transactions that gave rise to the tax consequence, and reconsider the transactions one at a time"* (Kruger et al: 2003)

### **1.3 Fiscal Consequences Versus The Purchase and Sale Agreement**

The introduction of Capital Gains Tax (CGT) widened the tax net a little more. It has become just about impossible to call to mind any transaction devoid of some form of tax implication. Further to this, with more and more people leaving formal employment and entering the market as potential buyers and sellers of business's, more emphasis should be placed upon the structuring of purchase and sale agreements of a business.

It must also be remembered that one is not only looking at CGT but also Income Tax, Value Added Tax (VAT) Secondary Tax on Companies (STC) and possibly Donations Tax. If the purchase and sale agreement is not constructed correctly it can have dire effects upon either the seller, the purchaser or both parties. This in turn really tests the abilities of the planner with regards to the tax planning involved in drawing up the purchase and sale agreement.

### **1.4 Basic Requirements of The Purchase and Sale Agreement**

When two parties come together and agree that one will make something available to the other, in return for payment the contract is a sale. The one who agrees to make the item available is the seller, and the one who agrees to pay the price is the buyer or purchaser. The contract can include many other provisions over and above the actual sale of the item, but is not essential. What is important is that there is a valid agreement, written or verbal concerning the price being paid for that item. In the absence of an agreement, there is no sale.

When looking at a purchase and sale agreement of a business, attention must be paid to the standpoint from which the agreement is being drawn. "*Is it from the seller's side?*" or "*is it from the purchaser's side?*". Both the seller and the purchaser will have different reasons for drawing up the agreement. Very often the parties to a purchase and sale agreement will find themselves in adversary positions when considering tax planning.

Some of the more important clauses to be examined in the agreement are, the clauses relating to the purchase price of the business and the prices paid for various assets contained in the business. The assets can be broken down into two rather broad categories, non current assets and current assets - and with a rather difficult to explain intangible item called, goodwill.

When a business is sold as a going concern, the general tendency is to state the business has been sold "lock stock and barrel" for a figure. Herein lies a multitude of problems, as once this agreement has been signed the tax effects are now cast in stone. This now can produce all sorts of nasty tax implications for both the seller and or the purchaser.

### **1.5 The Intention of This Study**

The intention of this study is to view the purchase and sale agreement from both the purchaser's and the seller's view and, walk through the many pitfalls and tax implications that are inherent with this kind of contract, i.e the selling or purchasing of a business. The purchasing of a business can be an extremely complicated affair. Not only must the purchaser investigate all areas of the business being bought, because the seller could have held back vital information in certain areas of the business, or even modified the financial statements in order to cover certain flaws in the business, he must also be aware of the tax implications of the transactions.

From the seller's point of view, over and above the fact that the purchaser must be able to finance the transaction, attention has to be paid to the tax implication of the sale and the structure of the selling price of the business. In undertaking tax planning in any form there are four important points which must always be borne in mind:

- i. Each set of circumstances must be understood in their own context, as generalisations cannot be made with regard to tax legislation.

- ii. Any economic gain that can be attained by a specific transaction should take precedence over any tax advantage gained.
- iii. The precise reason for undertaking a specific transaction should be clear from the start ie. is it to gain a tax advantage or is it for any another reason?
- iv. The transaction should be kept as simple and uncomplicated as possible.

From here we shall take a look at the different types of legal entities that are used in the purchasing and selling of a business. Combined with this, an examination of the basic sections of The Income Tax Act, which will influence the trading of these entities.

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## Chapter 2

### DIFFERENT TYPES OF ENTERPRISES

#### 2.1 Parties in an agreement

Different tax implications will apply depending upon the legal entity chosen, and extreme care has to be taken of whether a company, an individual, a partnership or even a trust is used. What has brought this home even more clearly is the introduction of CGT. Just moving assets from one entity to another can trigger a capital gains event, and even a further capital gains event should the asset be realised again.

In terms of the "*roll over relief*" seen in sections 41 to 47 of the Income Tax Act, one can under certain circumstances, avoid an immediate CGT event, when moving assets from one company to another company, as long as this takes place between two companies within a group of companies.

Looking at the VAT aspect, it has to be established whether the parties are VAT registered or not. Should the seller be VAT registered and the purchaser not, then it is advisable for the purchaser to become VAT registered so that the transaction becomes a zero rated transaction. If the purchaser is *not* VAT registered, the seller will have to account for the VAT on all the assets on which VAT had been claimed at the outstanding book value, making the assumption that is the value at which the assets are being sold. Further to this, should a VAT registered vendor obtain a second-hand asset from a non registered vendor, this then entitles the registered vendor to claim notional input VAT, making a transaction with a non registered vendor beneficial to the registered vendor.

Having mentioned two of the more important tax implications that can be encountered in the purchase and sale of a business or assets, it cannot be

stressed enough how important it is to choose the most suited entity of the taxpayer for the transaction. Over and above this it has to be established, if this is short term, medium term, or long term.

## **2.2 Sole Traders**

When a person conducts a business as a sole trader, the business is merely an extension of the taxpayer, and taxed at the progressive rates applicable to an individual. In this case the sole trader is taxed on all the income generated, and is allowed to use business expenses as a deduction provided they satisfy the requirements of section 11(a) and (b) and section 23 of the Income Tax Act.

Section 11(a) of the Income Tax Act defines the general deductions allowed in determining taxable income, "as expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature". In other words the criteria which has to be met is, any expenditure and losses have to have been actually incurred during the year of assessment in the production of income and must not have been of a capital nature.

An extension of the above :

### **Expenditure and Losses.**

The Act is not clear if there are any differences between expenditure and losses, yet case law has made reference to there being a difference. In *Joffe & Co (PTY) Ltd v CIR* (1946 AD 157, 13 SATC 354), a case based on compensation and damages, in summary the court held that, in order to satisfy the wholly and exclusively for the purpose of trade requirement of section 23(g) as it was then, the damages had to be a necessary concomitant of the taxpayers trade. The court felt that the damages arose out of negligence, and that Joffe & Co were unable to show that such negligence was a necessary concomitant of their trading operations.

In *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936 CPD 241, 8 SATC 13) the courts were called upon to decide whether expenditure incurred by the company as a result of an accident, was deductible, being expenditure in the production of income. Here it was found that the expenditure was closely linked to the employment of the driver and the expense was therefore deductible. There does not appear to be any great difference between expenditure and losses to create any problems of any significance.

### **Actually Incurred**

The mere fact that an expense has been incurred means it is deductible, whether or not it has been paid for in cash. The most important point here is that a liability has been incurred and an expenditure may be claimed.

This was highlighted in *Caltex Oil (SA) Limited v SIR* (1975 (1) SA 665 1975 (1) SA 665 (A) where Botha JA stated (at page 4):

*" The expression 'expenditure actually incurred' in section 11(a) ... means all expenditure for which the liability has been incurred during the year whether the liability has been discharged during that year or not"*

Sometimes it is difficult to establish whether or not an expense has been incurred. One would have to examine the obligations arising out of the contractual agreement. ITC 1945 the court held that a provision for accumulated leave pay was not deductible because there was no provision in the service contract entitling the employee to remuneration instead of leave entitlement.

If an expense which was incurred during the course of the year is unable to be quantified, an estimate, as accurate as possible on the available information would have to be used.

If an expense is conditional upon an event, and it can only be said that once that event has taken place then the expenditure has occurred, then as long

as that expense is conditional, it cannot be deducted for tax purposes as stated by (Huxham, K., Haupt, P., 2004): " The question of whether the expense has incurred or not was summed up by Ackermann J, in Edgars Stores Ltd v CIR 1988 (3) SA 876 (A), 50 SATC 81 as follows:

*"Another well established principle, not challenged in this appeal, is that a distinction must be drawn between:*

- *The case where the existence of the liability itself is conditional and dependent upon the happening of an event after the tax year in question, in which the liability has not incurred in the tax year in question;*

*and*

- *The case where the existence of the liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately determined at the year end, in which event the liability is nevertheless regarded as having been incurred in the tax year in question."*

Two points to remember; if the expense has been paid and the person who has paid it has no right to recover the funds even though the taxpayer may not have received the goods or services, the expense has nevertheless been incurred, and if an expense has not been paid the liability will only be incurred once the taxpayer has received the goods or services.

### **DURING THE YEAR OF ASSESSMENT**

Although this is not stated in the Income Tax Act, the courts have held that the expenditure the taxpayer claims as a deduction, must have been incurred during the year in which it is claimed. Coming back to the case Caltex Oil (SA) Ltd v SIR, Botha JA stated (at page 12):

*"It is only at the end of the year of assessment is it possible, and then it is imperative, to determine the amounts received or accrued on the one hand, and the expenditure actually incurred on the other during that year of assessment."*

## **IN THE PRODUCTION OF INCOME**

This is possibly the most difficult part of section 11(a). Many cases have resulted due to, "*in the production of income*". Eg. Port Elizabeth Electric Tramway Company Ltd v CIR 1936 CPD 241 8 SATC 132, Joffe & Co (Pty) Ltd v CIR 1946 AD 157, 13 SATC 354, Genn & Co (Pty) Ltd, CIR v 1955 (3) SA 293 (A), 20 SATC 113, African Oxygen Ltd, v CIR 1963 (1) SA 681 (A), 25 SATC 67, Allied Building Society CIR v 1963 (4) SA 1 (A).

What emerged from all the above mentioned cases is, a broad test first laid down in the case: Port Elizabeth Electric Tramway Co Ltd v CIR (1936 CPD 241, 8 SATC 13) establishing whether an expense was incurred in the production of income, and then modified in later cases.

The broad test set down by Watermeyer AJP (Port Elizabeth Electric Tramway Company LTD (pages 18 and 19) and modified by the Appellate Division is as follows:

*"All expenses attached to the performance of a business operation bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation"*

Basically the aim of this test is to establish that the expense is in the production of income and this is achieved if one of the following criteria are met.

- if the expense is necessary for the performance of the business operation
- if the expense is attached to the business operation by chance
- if the expense is genuinely incurred for the purpose of carrying on the business operation more efficiently.

It must also be noted that the term in the production of income does not only apply to expenditure that has been incurred once income has been generated or whilst income is being generated. It can also apply to expenditure incurred for the purpose of producing income as was pointed out in Sub – Nigel Ltd v CIR (1948 AD). In this case it was found that even though there was no income, the expenditure had been incurred with the intention of producing income and was therefore deductible.

#### **NOT OF A CAPITAL NATURE**

Just as capital receipts are excluded from the definition of gross income so is capital expenditure excluded in terms of sections 11(a) and 11(b). There is no definition in the Income Tax Act of what constitutes capital expenditure. In Sub – Nigel Ltd v CIR (1948 AD)(at page 397) it was pointed out that:

*" it is impossible to give a definition of what is expenditure of a non-capital nature which will act as a touchstone in deciding all possible cases".*

Certain tests and norms established by the courts over the years are of assistance in determining the capital or revenue nature of expenditure. This was pointed out by Watermeyer CJ in New State Areas Ltd v CIR (1946 AD 610 14 SATC 155) ( page 171) when he stated:

*" The conclusion to be drawn from all these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset*

*for the business it is capital expenditure even if it is paid in annual instalments; if on the other hand, it is in truth no more than part of the cost incidental to the performance of the income – producing machine, then it is revenue expenditure even if it is paid in a lump sum”*

It has also been held that there is no midpoint between capital and income yet in an interesting case *Tuck v CIR* (1988 AD) the court sanctioned the apportionment of income between capital and a non-capital element.

The above information proves that the purchase of buildings, plant and machinery, which are fixed assets, constitute capital expenditure, while the purchase of trading stock constitutes non-capital expenditure. The acquisition of goodwill of a business, which is of enduring benefit, is a capital expense, whilst the expenditure on a continuing basis for an advertising campaign would be of revenue in nature. Not all capital versus revenue decisions are as clear. Each case will have to be decided on its own merits.

In terms section 11(a) interest on a loan used to acquire movable assets or an immovable asset cannot be deducted before that asset has been brought into use. This is referred to as pre-production interest. Section 11(bA) allows the deduction of interest provided the following requirements are met as summarised from (Huxham,K., et all 2004):

- i. the interest might not have been otherwise allowed as a deduction
- ii. the interest must have actually been incurred by the taxpayer
- iii. the loan must have been used for the acquisition and installation of any machinery or building of the taxpayer
- iv. the asset must be used in the taxpayer's trade
- v. the interest must have been incurred before the asset was brought into use.

Section 11(bB) pertains to finance charges and basically is interpreted as any finance charges incurred by the taxpayer in the acquisition of an asset used by him for the purpose of his trade may be deducted. Where the finance charges form part of the asset they will not be subject to wear and tear or any special depreciation allowance.

Section 11(a) must be read in conjunction with section 23 of The Income Tax Act. Section 23 disallows the deduction of certain types of private expenditure and refers to:

- i. any cost incurred in the maintenance of the taxpayer's home
- ii. any domestic or private expenses which include rent, repairs on the domestic premises of the taxpayer unless:
  - such part is specifically equipped for the purpose of the taxpayer's trade and is regularly and exclusively used for the taxpayer's business
  - no deduction shall be granted where the taxpayer's trade constitutes any employment or office unless :
    - a. his income is derived mainly from commission or other viable payments which are based on his work performance and his duties are mainly performed otherwise than in an office which is provided by his employer; or
    - b. his duties are mainly performed in such part.

Basically what all this means is that personal expenditure such as bond interest, repairs to the personal dwelling, the domestic's wages and the cost incurred in running ones private vehicle do not constitute the costs incurred in the running of a business. The net result, whether it is a taxable income or assessed loss, is added to, or deducted from, any other source of income that may have been generated during the course of that particular financial

year. In other words the assessed loss of one trade can be off - set against the income of another trade.

Should the sole trader not trade for a whole year and he has endured a loss in the previous financial year, unlike a company, this will not affect the carrying forward of the assessed loss to the following year of trading. Of additional income the sole trader has to be careful of the recently introduced section 20A of the Income Tax Act. As from February 2004 this section will be used to eliminate the impact of losses on the taxpayer's income, but will only apply if the taxpayer has more than one source of income.

Where the main source is from formal employment and the additional income is from a trade carried out by the sole trader on a part time basis, this type of income/expenditure could be seen as a form of hobby, for example the restoring and selling of vintage motor vehicles. In the situation where the trading is the lesser income in a different field other than the main income, then this income can be construed as being a secondary income, and if a loss was incurred this would be ring-fenced.

It is not quite as simple as has been stated above, but as Anesh Devrajh stated in his presentation of section 20A, to the class of M Com students during 2004, ring-fencing of assessed losses of certain trades (which is applicable to years of assessment ending after 29 February 2004):

*" It is a fallacy that taxpayers incur losses to obtain a tax deduction. The fact of the matter is that the taxpayer incurs these losses in his hobby (and other non trade activities) that do not meet the requirements of s 11 (a) and s 23 (g), but then disguise them so that a reduction of taxes is obtained . This has often been attacked by SARS and the courts have applied a number of tests to determine the deductibility of these losses"*

This has led to the introduction of section 20 A and as Anesh Devrajh sums section 20 A (1) combined with sections 20 A (2), 20 A (3) and section 20 A (5)

*" Section 20A(1) provides that where s20A(2) applies to s20A(3), the assessed loss incurred by a taxpayer in carrying that trade may not be set off against any other income. However, it may be carried forward to the following year and off set against the income of that very trade s20A(5)."*

Section 20A only applies to natural persons and will come into effect from the year ending February 2005.

As summarised in, Notes on South African Income Tax (Huxham, K., et al 2004) point out. The main points of this section are

- i. This section applies to taxpayers whose income for the year is equal to or greater than the level at which the maximum rate of tax applies.*
- ii. The section then applies in one of two situations:*
  - a. The taxpayer has during a five year period ending the last day of the tax year incurred an assessed loss in the relevant trade in at least three years of assessment.*
  - OR*
  - b. The trade in respect of which the assessed loss is incurred is:*
    - Any sport practices by the person or any relative*
    - Any dealing in collectibles by the person or relative*
    - The rental of residential accommodation ( unless at least 80% is used by persons who are not relatives of the person for at least half of the year of assessment)*

- *The rental of vehicles, aircraft or boats as defined in the Eight Schedule (unless at least 80% of such assets are used by persons who are not relatives of the person for at least half the year of assessment)*
  - *Animal showing by the person or any relative*
  - *Farming or animal breeding carried on ( otherwise than on a full-time basis)*
  - *Any performing or creative arts practised by the person or any relative*
  - *Any form of betting or gambling practised by the Person or any relative*
  - *Any form of betting or gambling practised by the person or any relative*
- iii. The provisions of the section do not apply if the trade carried on by the person constitutes a business in respect of which there is a reasonable prospect of deriving taxable income within a reasonable period. However this provision does not apply in respect of the trades listed above (other than farming) if the person has during a ten year period ending on the last day of the tax year incurred assessed loses in at least six of those years ( before utilising the balance of any assessed loss brought forward).*
- iv. All farming activities carried on by one person are deemed to be one trade.*
- v. For the purpose of the section a relative is defined as a parent, child, stepchild, brother, sister, grandchild or grandparent of the person.*

The recently introduced capital gains tax, affords the sole trader an advantage over a company or trust, because any capital gains made on the sale of any business or asset will only be included in the overall income at

25% of the gain. Below, adapted from the capital gains tax seminar, presented by Beric Croome shows a comparison between the various vehicles that can be chosen from which to trade.

Type of Vehicle	Inclusion Rate %	Statutory Rate %	Effective Rate %
Sole Traders and Partnerships	25	0 – 42	0 – 10,5
Trusts			
Special	25	0 – 42	0 – 10,5
Other	50	32 – 42	16 – 21
Companies (including Close corporations)	50	30	15

Table 1.

### 2.3 Partnerships

As (Kruger, et al; 2003.) state :

*"Partnerships should always set the antenna of the tax planner humming. This is so, because while a partnership is not recognised as a taxable entity, it does produce certain fiscal effects that may be harnessed to advantage."*

From the outset it must be made clear that no legal framework exists for a partnership. A partnership is not a legal entity (persona) separate from the partners. The Income Tax Act provides for a partner to be assessed

separately on his share of the profits or losses of the partnership. The factors governing the partnership are set out in section 30 (1) of the Companies Act. This restricts the number of partners to twenty and the VAT Act, which legally recognises the partnership.

*" A partnership is, in terms of normal legal principals, dissolves every time a new partner joins the partnership or a partner resigns, to eliminate practical problems regarding, for example, registration for VAT, the old and new partnerships are regarded as one and the same for VAT purposes. If the old partnership was registered for VAT, the new partnership will have the same registration number as the old partnership. The Receiver must, however, be notified, of the change of partners within 21 days." (Vat News, 1997)*

It is still possible to register a partnership on the payment basis for VAT. This is worth looking at, especially in the early days of trading when cash flow is difficult. The advantage is the fact that this method of VAT collecting and paying over of VAT does not impede on the cash flow of a business as badly as the invoice based method does.

There are basically two types of partnerships, Ordinary Partnerships and Extraordinary Partnerships as summarised from (Huxham, K., et all 2004)

*"In the Ordinary Partnership all the partners are jointly and severally liable for all the liabilities incurred by any one of the partners acting within the parameters of the partnership.*

*In the case of the Extraordinary Partnerships there are two types, Anonymous and En Commandite.*

*With the Anonymous Partnership the Anonymous partner's identity is kept from the general public and other trading entities. The anonymous partner*

*will share in the profits but he does not participate in the running of the business.*

*The En Commandite Partnership's business activities is carried out in the name of only one of the partners. The rest of the partners are not known to the general public or the other trading entities with which the partnership will trade. These undisclosed partners would have contributed financially to the partnership in pre decided ratios, with the proviso that any losses will be restricted to their contributions only. They also share in the profits in the same way as they would have, in the situation of a loss."*

(Huxham, K., et al 2004) goes on further to discuss family partnerships and, as summarised from their book Notes on South African Income Tax :

*"A further complication to partnerships is the Family Partnership, which is a business venture carried on by members of a family. In terms of section 82 the onus is on the taxpayer to prove that a family partnership exists. It is on these grounds that it is recommended that:*

- i. an agreement is committed to writing*
- ii. a separate bank account is opened in the name of the partnership*
- iii. a decent set of books be kept of all financial transactions*
- iv. each partner contributes something towards the partnership whether it be assets, skills or simply money*
- v. any assets given to the partnership, be transferred into the partnership's name.*

*In terms of section 7 (2) of The Income Tax Act income accruing to a husband or wife in the partnership will not be deemed to be the spouses, provided his or her share is reasonable taking into account all relevant factors. Should however one of the spouse's profits in the partnership be*

*excessive, then that portion considered to be excessive will be taxed in the other spouses hands.*

*One of the greatest advantages of The Family Partnership is that section 7 (3) does not apply between the parent and child. In other words there would be no donation between the parent and the child. If however over the passage of time the child's share in the partnership increases and the parent's share decreases this in terms of CGT can be seen as a value shifting arrangement and thereby trigger a CGT event."*

Examining the legal requirements of a partnership, it must be brought to the reader's attention that a partnership is not a legal entity, it does not have a persona distinct from its members. However any immovable property which is contributed to the partnership does not vest in the partners in their personal capacities. This property would be held in the name of the partnership jointly and in undivided shares. This was made clear in Sacks v CIR (1946 AD 13 SATC 343).

Further to this the immovable property would not vest in the partnership but would remain in the name of the individual unless this property is legally transferred into the name of the partnership. Moveable property contributed by a partner to a partnership does not vest in the partnership due to the fact that the partner has contributed it, but rather it vests by operation of law. This transfer of ownership is as a result of a contractual change of intention on the part of the partner thus bringing the property into the partnership.

Viewing partnerships from an income tax point of view, as discussed under Sole Traders, sections 11(a) 11(b) and section 23 of The Act also applies here. Further tax requirements for the partnerships are found in terms of section 66(15) of The Act where the partnership is required to make a joint tax return. Each partner is taxed individually on their share of the profits according to the agreed upon ratio and set out in the partnership agreement.

Should a loss be incurred this loss will be apportioned to the partners in the same ratio as stated in the partnership agreement. Section 77 (7) of The Income Tax Act requires the partners to make a joint tax return. The advantage here, as opposed to a company or close corporation, the loss, goes to the partners personal accounts and does not remain in the partnership as it would in a company and close corporation. Should the partnership not trade for a year the loss in the hands of the individual tax payers is not lost provided they do not draw an income from anywhere else in the following year. The previous year's loss would be set off against income earned in the following year as with a sole trader.

Section 24H is aimed at regulating the tax treatment of limited partners and also clarifying the point of accruals to individual partners in general. The main point of this section is the restriction of any allowance or deduction a limited partner may claim to the amount for which he is liable to his creditors and any income he may receive from the partnership. Should any allowance or deduction not be able to be claimed in the current year due to this restriction, this may then be carried forward to the following year in terms of section 24H (4) .

## **2.4 Companies**

A company as defined in section 1 of The Income Tax Act also includes close corporations. Director is also defined as including, in relation to a close corporation any person who holds office or performs any functions similar to the office or functions of a director of a company.

With regards to the Close Corporations Act, any undrawn profits can be distributed to the members by way of a meeting which has to be minuted. In this case as well as in a company once a decision of this nature is taken and the undrawn profits are distributed between the members or the directors of a company, this now becomes a dividend (Companies Act). This dividend is now subject to Secondary Tax on Companies (STC). This STC is applied over

and above the imposition of sections 11(a), 11(b) and section 23 of The Income Tax Act. The STC applied to companies is found under section 64B and 64C of the Income Tax Act and the applicable rate of the STC is 12.5%.

Effectively a company is subject to income tax at a rate of 30% thereafter any dividends declared on undistributed profits are subject to a secondary tax known as STC at a further 12.5%. The combined tax rate of a company after distributing its profits in the form of dividends is now 37.8%. Compared with the progressive rates applicable to individuals which only reaches a marginal rate of 40% at taxable income of R255 000 and the flat rate of 40% applicable to ordinary trusts still makes the use of a company a good option.

#### **2.4.1 Tax Disadvantages Of A Company**

Some tax disadvantages of companies can be seen in share dealing, the stigma of businesses, assessed losses, not recognising groups of companies and trying to obtain capital profits from a company. In determining the profits or losses of a trader at the end of a year, sales less cost of sales has to be considered. In order to keep the example simple cost of sales would in this case be calculated as purchases less closing stock.

#### **2.4.2 Share Dealing**

Section 22 (1) of The Income Tax Act states the valuing of stock at the end of the financial year is generally the price the trader has paid for the stock. Should the value of the stock have fallen below the original purchase price and the Commissioner is satisfied, the trader is then able to include the closing stock at the lower rate in the determination of his income. This in effect reduces the entity's income. The strange phenomena that happens here is that the commissioner has withheld re-valuing shares in a share dealing company. The effect of this in a company as opposed to a sole trader and a partnership can be seen in the table below:

Sole Traders and Partnerships		Companies and Close Corporations	
Sales	100 000	Sales	100 000
Less Cost of Sales	100 000	Less Cost of Sales	55 000
Purchases	150 000	Purchases	150 000
Closing Stock (Original Value 95 000)	( 50 000)	Closing Stock (Original Value 95 000)	95 000
Taxable profit	Nil	Taxable Profit	45 000

Table 2.

The general perception here is when trading in shares it is better to keep away from companies. (Kruger, D., et al 2003)

### 2.4.3 The Stigma of Businesses

When deciding on the purchase of a property in the name of a company or in the name of an individual, one point should be considered. This point is basically the courts perceptions of companies. Should there be a chance, no matter how slight in the future that this property could be sold and should there be a dispute over the proceeds of this, is it capital or revenue. Then an asset in the hands of a company would more likely be treated as revenue, whereas the asset in the hands of an individual would more likely be treated as capital.

### 2.4.4 Assessed Losses

Section 20 of The Income Tax Act deals with assessed losses and for the provisions of section 20 to apply the entity must be carrying on a trade. A trade as described in section 1 of The Income Tax Act.

Should the entity have experienced a loss in the previous year of trading then that loss will be off set against any profits incurred in the current year. The set off is subject to four provisos as summarised from ( Huxham,K., et all.2004) :

- i. the assessed loss may not be carried forward by anyone whose estate has been sequestrated unless the sequestration has been set aside.
- ii. should a compromise have been made with the taxpayers creditors then the assessed loss must be reduced by the amount of the compromise.
- iii. where an amount has been distributed to a person by a pension or provident fund this amount may not be off set against the assessed loss
- iv. there shall not be any set off against any income derived by any person carrying on a trade in the Republic any assessed loss incurred during the current year from a trade carried on outside the Republic or any balance of the assessed loss from a previous year from a trade carried on outside the Republic.

Provided all the above criteria are met the taxpayer may continue indefinitely adding to or decreasing the assessed loss depending on the trading results for the current year of trading. The problem that occurs is taxpayers other than companies may carry forward an assessed loss, even though no trading may have taken place during the course of a year. A company will however lose the benefit of an assessed loss should it not trade during a particular year.

#### **2.4.5 Not Recognising Groups of Companies**

At present the individual taxpayer is able to off-set any loss incurred in the carrying on of a trade against the income of another trade. This is reinforced by section 20(1) (b) which states

**"20 Set-off of assessed losses – (1)** 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-  
Provided that there shall not be set off against any amount-

(b) derived by any person from the carrying on within the Republic of any trade, any-

(i) assessed loss incurred by such person during such year; or

(ii) any balance of assessed loss incurred in any previous year of assessment, **8.125**

in carrying on any trade outside the Republic. **8.125"**

This says there is one tax imposed on an individual no matter what business he is conducting after allowing all the expenditure in the various businesses. Unfortunately, this vital tax protection does not exist where two companies are trading under one holding company. This was seen in ITC 1123 (1968 31 SATC 48) where a group of companies owned timber mills. Another company in the group bought a consignment of timber from an outside company for another of the company's within it's own group to process in the mill. When the company who had purchased the timber tried to claim the interest as a deduction for the timber it had purchased, this was disallowed. The reason the courts gave was this was not in their production of income.

#### **2.4.6 Trying to Obtain Capital Profits From a Company**

Even with the introduction of CGT it is still an advantage to hold an asset in a capital account, let it appreciate and when it is sold it then becomes capital as opposed to revenue. The reason is that in a company, close corporation and Trading Trust the inclusion rate is 50%. With a sole trader, partnership and a special trust the inclusion rate is 25%.

The inclusion rate refers that only either 50% or 25% of the profit of the sale of the asset is included in the taxable income of the business. CGT is not a separate tax but is additive to the taxable income of the trading entity at the required percentage.

Should the distribution of the proceeds be made in the ordinary trading of the business, this distribution could then attract STC. However, if the distribution is made in the anticipation of winding up of the company or liquidation of the company or upon de-registration of the company then one has to analyse when the asset was sold and when the dividend was declared.

Should the asset have been sold post 1 October 2001 and the dividend declared on or after 1 January 2003 then the difference in the value of the asset between 1 October 2001 and the proceeds of the sale will only be subject to STC.

Should the assets themselves be distributed, this distribution will be subject to CGT in the hands of the company. The distribution would have been seen to take place at market value and the company would also be liable for STC. Should this distribution of the assets have been in anticipation of liquidation, winding up or de-registration of the company then no STC would be payable in respect of pre March 1993 profits or pre October 2001 for CGT. However post 1 October 2001 the profit would still be subject to CGT.

#### **2.4.7 Tax Advantages of Companies**

Some of the tax advantages of companies can be seen in the roll over relief, assessed losses and the pre- incorporation contracts.

#### **2.4.8 Roll Over Relief**

This roll-over relief generally takes place between group companies or between shareholders and the company. Roll-over relief means is that it has the effect of postponing any tax effect whether it be income or CGT in the

hands of the seller. This is done when the seller is seen to have disposed of the revenue assets at tax values and the capital assets at base cost. It can be done from an individual, a company, a close corporation, or even a special trust to a company which is listed or to be listed within twelve months. Alternatively it can be done by an individual, a company, a close corporation or again a special trust to an unlisted company.

The provisos here; in both cases all the assets have to be transferred over to the companies and in the case of the listed company the shareholders have to acquire equity shares. In the case of the unlisted company the shareholders have to acquire the equity shares and have more than twenty five percent of the equity. Sections 41 to 47 of The Income Tax Act cover the roll-over relief.

Notes on South African Income Tax (Huxham, K., et all 2004 p.257) diagrammatically sums the above up extremely well:

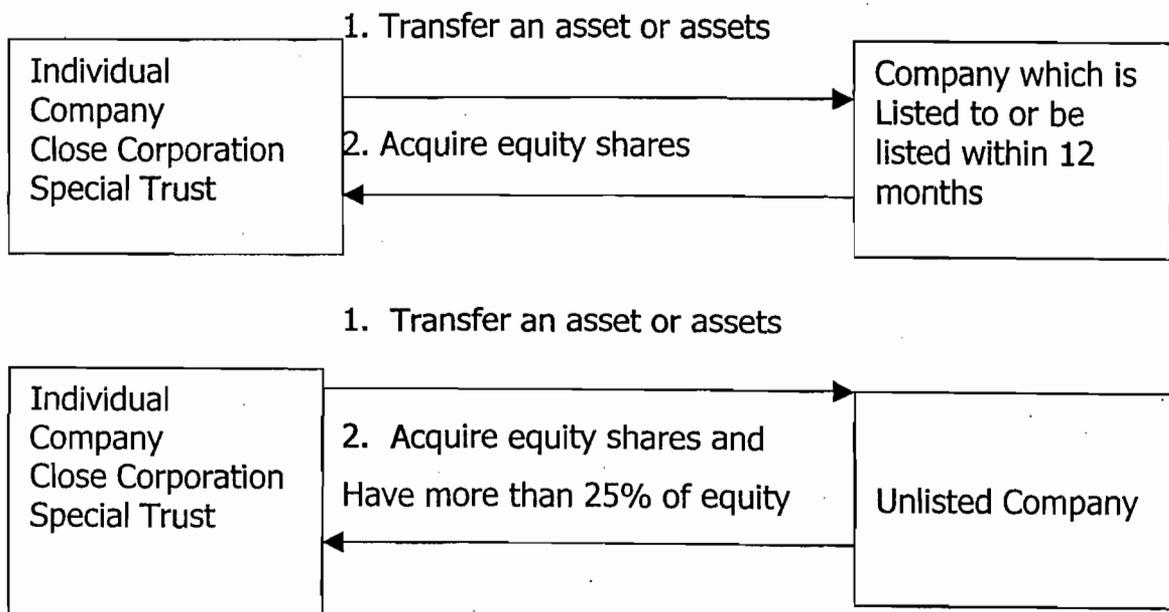


Diagram 1.

#### **2.4.9 Assessed Losses**

An assessed loss will occur when the deductions in terms of sections 11 to 19 of the Act exceed total income. However, the decision to hold the asset in the company in most cases is prompted by non-fiscal reasons. These reasons could be for greater protection, status, the ability to continue holding the asset even after death of a member/director, in other words continuity. It must now be remembered that companies do provide specific tax benefits over and above the flat tax rate of 30%. Another of the advantages over and above the roll-over benefit is making use of an assessed loss in a company.

Even with the introduction of section 103(2), it is still a good tax advantage. Section 103(2) was introduced to try and stem the trade in companies that were being sold with assessed losses. This is an anti-tax avoidance measure which operates only if there is a change in the shareholding of a company or an agreement that can affect the company. In *CIR v Ocean Manufacturing Ltd* (1990 AD 49 SATC 132) the company was taken over with the sole intention of making use of the assessed loss of the company. The Commissioner disallowed the assessed loss to be off set against current income.

In order for the commissioner to be able to implement section 103(2) it has to be proved that the company was purchased for the main reason to make use of an assessed loss. This has become rather difficult with the taxpayers having achieved a fair amount of success in this area resulting this is still a good option.

#### **2.4.10 Pre-incorporation Contracts**

This could present unexpected problems and opportunities in determining who is going to bear the tax on the income generated by a transaction. *ITC 1011* (25 SATC 283) is a good example of the tax consequences in adopting a conventional form of contraction and over looking the obvious. In this case a company, to be formed purchased a building and upon ratifying the

contract would have been eligible to all income generated from the building from the first day of the month preceding the contract. As far as company law and the law of the contract all was in order. From a tax point of view the court was of the opinion that the seller was liable for the tax from the date of the sale until the contract was ratified by the new company, even though the seller was not entitled to the benefit of the income according to the contract. The new company would quite possibly be taxed on the selfsame income when it received it.

What came out of this is that it is impossible to avoid existing tax consequences in creating a contract that has a retrospective effect. The best thing to do in a pre-incorporation is to avoid the situation in which the new company is to benefit from income that accrues prior to the ratification of the contract.

Having covered the main tax advantages and disadvantages of using a company as a player in a purchase sale agreement it could be said that the main reasons for choosing a company would be commercial considerations and limited liability.

## **2.5 Trusts**

In the case of the Trustees of the Phillip Frame Will Trust v CIR (1991 (2) SA 340 (WLD), 53 SATC 166) the courts found that a trust was not a "person" for income tax purposes and on those grounds could not be subject to tax. The Income Tax Act was amended and the definition of a "person" now includes "any trust". (Kruger, D., et al 2003)

There are three parties who could be subject to taxation, the trustees, the trust itself and the beneficiaries.

The diagram below gives one an indication of how the trust would operate.

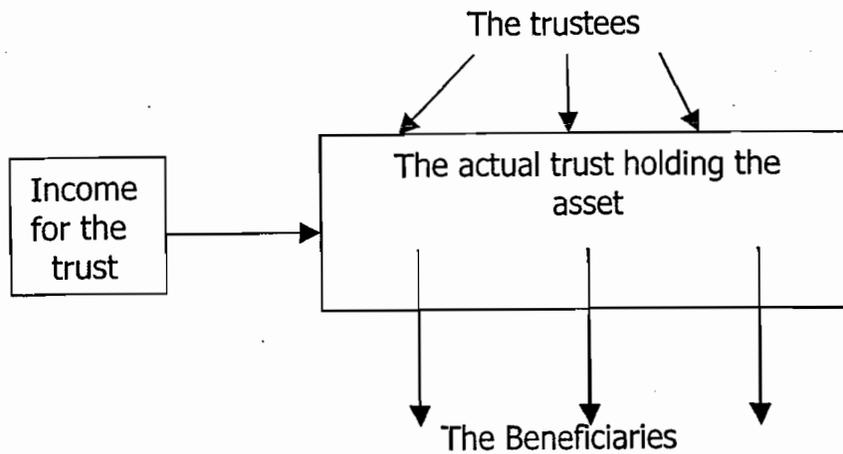


Diagram 2.

The decision as to, who will be taxed depends upon a number of factors

- i. the actual terms of the trust deed
- ii. do the beneficiaries have a vested right to the income
- iii. are the beneficiaries minors
- iv. is the income distributed

Further to this the taxation of the trust will be regulated by the provisions of sections 7(3), 7(4), 7(5), 7(6), 7(7) of The Act.

Section s 7(3) and 7(4) of The Act, tax the parent of a minor child on the income which has been received by the child in consequence of a donation made by the parent.

Section 7(5) of The Act will tax the settlor of the trust on any income which accrues to the trust and is not distributed to the beneficiaries in the same tax year, because the trust deed prohibits the distribution until some event.

Section 7(6) of The Act applies where a beneficiaries right to receive income arises in consequence of the donation being revoked or conferred upon some one else by the donor. Here the donor is subject to the taxation of the income.

Section 7(7) of The Act deems income to be that of the donor if he retains ownership or is once again entitled to ownership sometime in the future.

Section 7(8) of The Act allows for the fact that if a South African resident makes a donation to a non resident then the income is deemed to accrue in the hands of the South African donor and is taxable in his hands.

The above anti-avoidance measures apply when a donation or a settlement, in other words a gratuitous disposition of the donor. This could come in the form of a interest free loan which in turn enables the trust to acquire an income producing asset. This would be considered a continuing donation as in *Joss v SIR* (980 SATC 206).

Previously the profits or losses of trusts could be passed on to the beneficiaries, however these losses incurred by trusts have now been ring – fenced. This applies to new trusts to new trusts formed after 11 March 1998 and in respect to existing trusts this applies on or after 1 January 1999.

With all the anti-avoidance provisions in place for the trust it still remains one of the better options when drafting a purchase and sale agreement.

- there is no STC payable on the distribution of income.
- income into the trust does not lose its identity as it moves through the trust to the beneficiaries as was seen in *Armstrong v CIR* (1928 SATC). A tax free dividend received by the trust would be a tax free dividend in the

hands of the beneficiaries provided it is distributed in the same financial year that it was received in the trust.

An ordinary trust is taxed at a flat 40% whereas a special trust is taxed on the same principal at the same rate as an individual. Special trusts are normally set up for the benefit of physically and mentally challenged persons. Due to the fact that a trust is a legal entity on its own it is therefore taxed as a separate entity for both income tax and VAT. A point to bear in mind here is that the trust and the beneficiaries are connected persons in terms of VAT.

A trust is also taxed on any capital gain. The inclusion here is 50%, identical to that of companies and closed corporations. There are three different ways of handling the CGT in a trust. These are capital gains retained in the trust, capital gains distributed by the trust and capital gains attributed to the beneficiaries.

### **2.5.1 Capital Gains Retained in the Trust**

Should a resident of South Africa make a donation to the trust in the form of an interest free loan and the trust makes a capital gain on that donation, which is not distributed to the beneficiaries then the donor is taxed on the capital gain.

The advantage of this is that the donor/resident is a natural person and the inclusion rate of the capital gain will therefore be 25% as opposed to 50% in the hands of the trust.

### **2.5.2 Capital Gains Distributed by the Trust**

Should a capital gain be made to a beneficiary and the creator of the trust has the right to revoke the beneficiary's right to the capital distribution, then the capital gain is taxed in the hands of the creator.

Should the capital gain be distributed by the trust to a non resident and the gain is attributed to the donation of a South African resident, then the South African resident is taxed on the capital gain.

### **2.5.3 Capital Gains Attributed to the Beneficiaries**

Should the trust distribute an asset to a beneficiary who is a South African resident, then the gain made by the trust will be taxed in the hands of the beneficiary. This of course would be subject to anti-avoidance provisions where the beneficiary is possibly a spouse or minor child. If the trust sells an asset and makes a capital gain and then distribute the gains to the beneficiaries in the same financial year and, provided the beneficiaries are South African residents, then the capital gain will be taxed in the hands of the beneficiaries at an inclusion rate of 25%.

Where a non-resident trust makes a capital gain and distributes this gain to South African beneficiaries the gain will be taxed in the hands of the South African beneficiaries. Should a South African trust make a capital gain and distribute it to a non resident, the trust is then taxed on the gain.

## **2.6 Conclusion**

The intention of this study is to examine the purchase and sale agreement from both the purchaser's and the sellers points of view, walking through the many pitfalls and tax implications inherent in this kind of contract, bearing in mind the four important points in undertaking tax planning as summarised from (Kruger, D., et all 2003):

- i. Each set of circumstances must be understood in their own context as generalisations cannot be made with regard to tax legislation.
- ii. Any economic gain that can be attained by a specific transaction should take precedence over any tax advantage gained.

- iii. The precise reason for undertaking a specific transaction should be clear from the start ie. is it to gain a tax advantage or is it for another form of planning?
- iv. The transaction should be kept as simple and uncomplicated as possible.

This chapter has examined the choice of entities available, and the effect such a choice could have on factors such as, quality, timing incidence and source. Attention must also be given to the tax status of each party to the proposed contract.

The next chapter gives an overview of a basic purchase and sale agreement and discussed in detail such an agreement.

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## Chapter 3

### THE PURCHASE AND SALE AGREEMENT

#### 3.1 Introduction

Great care and caution must be exercised by both the buyer and the seller when buying and selling a business. The buying and selling of a " *second hand*" business is far more complex than buying a second hand car or a house. Many buyers have found acquiring a business can be an extremely complicated, traumatic experience.

There are many reasons for wanting to sell or purchase a business. The reason for wanting to sell the business may have no bearing on the performance of the business what so ever as Power, RM., 2002 *A New Guide to Buying and Selling Businesses*. Durban. Butterworths pointed out:

*"In one case the two directors and shareholders of a business fell out because one was sleeping with the other's wife, so they decided to sell rather than wind up. The wife decided to go with the new lover. It was not recorded whether she was an asset or a liability, but she certainly was a sleeping partner."*

There are two basic types of transactions in the selling/purchasing of a business. This is either buying the assets or purchasing the shares of the business. In this chapter a brief overview of these two decisions is discussed with an in - depth analysis to follow in chapter four.

### **3.1.1 Sale of Shares**

The owners of the trading entity sell their shares or loan accounts. The purchaser acquires the shares or loan accounts and becomes the owner of the trading entity. The structure of the trading entity will not change, only the ownership of the trading entity has changed. This type of transaction is known as a sale of shares. The trading entity could be a company, a close corporation or even a trust.

### **3.1.2 Sale of Assets**

The share holders do not want to sell the trading entity or conversely the purchaser does not want to purchase the trading entity for what ever reason but rather some or all of the assets of the business. In this transaction " *The Seller*" is the company and the sale becomes the "*sale of a business.*"

The term "*sale of a business*" is used to describe the sale of whatever trading entity has sold the "*business*" and the "*business*" is basically a collection of assets owned by the seller for the purpose of carrying on trading. It must also be remembered that a business unlike any other legal trading entity has no individual identity. It is on these grounds that liabilities of the business are the liabilities of whatever entity is selling the business.

## **3.2 To Sell the Assets or To Sell The Shares**

When buying a business one of the most important decisions to be made is whether the shares of the trading entity of the business itself are purchased as a going concern or whether the assets of the business are purchased. One of the problems of purchasing the shares of the entity is the purchaser is not one hundred percent sure of what is being purchased. There can be a number of problems that have not been declared in the trading entity. Problems such as outstanding debts to creditors, judgements against the trading entity, tax problems for example outstanding Income Tax, outstanding PAYE or PAYE returns, a possible VAT problem or even an unresolved dispute with The South African Revenue Services. Should there

be any uncertain parts, it would then be wise to purchase the business and not the shares.

### **3.3 The Purchase and Sale Agreement**

It has been stated that the parties have to agree upon the conditions of the sale. The item may be moveable, immovable, corporeal or incorporeal. Once this has taken place we then have the basis for a purchase and sale agreement.

Points to consider by both parties when formulating the purchase/sales agreement.

- i. Is the business to be sold as a going concern?
- ii. How are the assets to be sold, at book value or at original cost?
- iii. Will goodwill be attached, if so what value will be placed upon this difficult to explain item?
- iv. Will stock form part of the agreement or will stock become a separate entity?
- v. Are the accounts receivable to remain with the business or do they remain the property of the seller?
- vi. Who is responsible for the accounts payable?
- vii. Will the business remain in the entity it is trading in or will it be moved out of it's present entity into another entity?
- viii. Is there an existing lease with the landlord, if not, can one be negotiated?
- ix. Does the seller remain on for a handing over period ?

These are a few examples of what can be covered in the purchase and sale agreement.

### **3.4 METHODS OF DETERMINING THE SUBJECT MATTER OF THE CONTRACT**

Over and above any legislative requirements of the contract the amount of detail in the contract will depend largely on the type of business being sold and the wishes of the parties concerned. For example the sale of plant and equipment may have a long and complicated explanation or conversely the description of the same plant and equipment may be short and precise. Any item which is commonly known by that name, for example the name of a truck, may be referred to by that name. Reference may be made to a broad class of materials such as metal or to a restricted class such as stainless steel

### **3.5 A BRIEF OVERVIEW OF THE PURCHASE AND SALE AGREEMENT**

The purchase and sale presented here is loosely based upon the model of a purchase and sale agreement found in the Butterworths Business Contracts Compendium Service Issue 9 . September 2000 The adapted contract has been broken down into sub-headings and each heading has a short definition.

#### **3.5.1 MEMORANDUM OF AGREEMENT**

Under the Memorandum of Agreement the parties are identified as the party who is selling the business ("*The Seller*") and the party who is purchasing the business ("*The Purchaser*"). Under this section it is advisable to give a brief history of the seller, address of the business, describe the nature of the business and the style of trading.

#### **3.5.2 INTERPRETATION**

Here one would list item, word or clause that could be construed as anything but what it should be . In other words the precise meaning of all words that could be interpreted incorrectly, a few examples of this would be:

**"Accounts Receivable"** interpreted as all outstanding moneys owed to "The Seller" on the date of the sale. This could include all bank balances and deposits.

**"Audited Accounts"** interpreted as signed financial statements or audited financial statements depending upon the trading entity of "The Seller" relating to the business in respect of the financial year end under discussion. Copies of these must be attached to the purchase and sale agreement by way of an annexure.

**"Auditors / Accounting Officer"** interpreted as either the auditors or the accountant responsible for the financial reporting of the enterprise, depending upon the trading entity of the business. This should also include the name, telephone number and address of either the auditor or the accounting officer.

**"Business"** defined as the business carried on by "The Seller" as a going concern up until the effective date of the sale, and should include the business assets and liabilities.

**"Business Assets"** taken to mean all the assets of "The Seller" used in trading, broken down into :-

#### Non Current Assets

- Fixed Assets
- Moveable Assets
- Plant and Machinery
- Immovable Assets
- Shares

### Intangible Assets

- Goodwill
- Patents
- Trademarks
- Intellectual Property

### Current Assets

- Stocks
- Work in Progress
- Accounts Receivable
- Bank Accounts
- Deposits
- Staff Loans

### Current Liabilities

- Trade Creditors
- Bank Overdraft
- Short Term Liabilities

### Long Term Liabilities

- Long Term Loans
- Assessed losses
- Members Loans

### Reserves

- Non Distributable Reserves
- Distributable Reserves

### **3.5.3 THE PURCHASE AND SALE**

The majority of South Africans have an inherent dislike for paying tax. It is commonly believed, if he can get away with paying less tax, why can I not get away with it?. Tax planning is strategic and necessary, but it should not take preference over a good commercial business deal. The best approach is to take an objective view of the situation and consider all the influencing factors. In this way one would come up with an informed, balanced decision as to which is the best way to go.

Because a person receives payment for a business, considered an asset, does not mean this payment is of capital in nature, however there could be a revenue attachment. Alternatively the entire transaction could be a revenue transaction. Should this be the case then the entire transaction would fall into the taxpayer's gross income thus creating huge tax problems, changing from what would have been a good deal to one that is now a complete loss. Looking at the sale from "The Sellers" point of view, it should be capital in nature or as close as possible.

Taking this a step further and looking at the agreement from "The Purchasers" point of view. "The Purchaser" would of course like the sale to be treated as a lease and the reason for this is because he would then be able to claim a tax deduction for the whole cost of the business he has purchased.

The question posed is... From whose side is the contract drawn up? Is there a happy medium where there will be a win-win situation for both parties.

### **3.6 CONSIDERATIONS TO BE EXAMINED**

Before going into all the considerations that the architect of the purchase and sale agreement would have to consider, one has to now take into consideration CGT. With the introduction of CGT, there are now few capital

revenue transactions which do not attract CGT. Depending on whether the entity is a Sole Proprietor, a Company or a Trust, different percentages of the capital gain would be included in the taxpayer's revenue. ( See Annex A).

When drawing up a purchase and sale agreement one has to establish from whose point of view the contract is being drawn. From "The Purchaser's" point of view the contract should lean towards a Lease Agreement. From "The Seller's" point it would be better as an outright sale of a capital item. This was brought home in *Vacu-Lug (Pvt) Ltd v COT* (1963 (2) SA 694 (SR), 25 SATC 201). Here in the taxpayer had a patent process for lugging tyres throughout the whole of Rhodesia, as it as then known. Before the patent ran out the taxpayer decided to enter into a contract with a company granting the company the right to use the process for even longer.

The contract was a sale of a right, it was drawn up in the form of a lease, granting the company, Northern Rhodesian Company, the use of the right. The effect that this had was that "The Purchaser" was now able to deduct all the payments for the use of the right off against income where as "The Seller" now has to declare all payments as taxable income. The most important factor in this case was the court's decision on the wording of the contract.

On hind sight had the architect of the sale agreement made this an out right sale of the right to make use of the patent in Northern Rhodesia by the company the seller would have benefited. These are the types of nasty tax shocks that "The Seller" of any business would like to avoid.

It has to be established whether or not the business is being sold under suspensive sale agreement or not. The tax effects here are predominately on CGT. The effect it would have is that CGT would only kick in once the final payment has been made and the change of ownership has taken place (paragraph 13 (1) (a) (I) of the eight schedule).

### **3.7 Conclusion**

The different players to the purchase and sale agreement have been examined together with the various tax consequences and advantages they have. A basic introduction to the purchase and sale agreement has been analysed together with an overview of whether to purchase the assets or the shares of the business. Thereafter examining the methods of determining the subject matter with the various considerations which need to be examined.

In the next chapter we look at what actually is being sold.



## Chapter 4

### **GOING CONCERN VERSUS ASSETS VERSUS SHARES**

#### **4.1 Introduction**

Very few people set out with the intention of buying and selling business for a living. Those who do would quite possibly be termed traders in trade and the income generated from this would be defined as revenue and included as gross income with the expenditure generally be allowed as deductions in terms of section 11(a). This study is not aimed at these types of traders but more so at the individual who intends to purchase a business in order to earn a living from it or alternatively for the individual who has been trading and is now considering selling his business.

Based upon this both the purchaser and the seller have to now make an important decision as to whether the sale or purchase should be one of a sale of shares of the company or should it be the sale of the business itself as a going concern. These points were touched on previously, but here follows an in-depth analysis as to which of the two points would be the better decision and under what circumstances the decision should be made.

#### **4.2 An In-depth analysis of whether to Purchase the Assets of the Business or the Shares of the Business.**

A consideration both the seller and the purchaser must take into account is, do they sell/purchase the shares of the business? or do they sell/purchase the asset itself from the business?. In some cases the decision would be made purely on a commercial decision based probably on the history of the company, if available. Does the business have any judgements against it? what is the outstanding tax status of the business?, is all VAT up to date?, what is the PAYE status of the business?, are a few of the factors that would influence the decision of both parties. The seller wishes to release himself of

the business as soon as possible, the purchaser doesn't want to take on the seller's baggage. In the majority of cases, the ultimate decision would be made revolving around the tax aspect, transfer duty and or stamp duty.

#### **4.2.1 The Seller's Position**

One of the most important factors the seller would have to consider when selling assets such as plant and equipment or for that matter any moveable assets is the possibility of the assets giving rise to a taxable recoupment amount in terms of section 8(4)(a) of The Act. The amount to which the assets are sold over and above their original cost price would give rise to a gain of capital in nature.

Section 8(4)(a) of The Act is a general recoupment provision where the sale of a capital asset results in a capital receipt or accrual. In cases where wear and tear allowances have been allowed resulting in a reduction of that asset, the and it is sold for more than it's tax value, the difference between the selling price and the asset's tax value is the taxable recoupment of the asset.

Here is an example which would illustrate the above, from either selling the shares or selling the asset –

Making the assumption that a company had purchased an asset a number of year's ago for R200 000 and over the years had claimed wear and tear to the value of R75 000, the tax value of the asset is now R125 000. The market value of the asset is now set at R300 000. What does the seller do? Does he sell the asset for R300 000? Or does he sell the shares in the business for R300 000?

Clearly from the seller's point of view the better option would be to sell the shares as this would give rise to a capital event. This in turn would trigger a CGT event resulting in an inclusion rate in the seller's taxable income of 25%.

Should he elect to sell the asset out of the company at the market value of R300 000 the company would suffer tax on the recoupment of the R75 000 based on the company's tax rate of 30% this would be R22 500. Further to this there would be capital gains tax on the capital gain included in the company's income at a rate of 50%. There could even be STC over and above this.

The problem that arises when selling the assets are the amounts which have been allowed as deductions in terms of wear and tear and have now been recovered or recouped on the sale of the asset which now forms part of the sellers income. One way of over coming this problem is to take the advice of (Kruger,D., et al 2003), when they say :

*" Valuation is at the best of times an inexact science, and there is always latitude in allocating the purchase price of the assets on a basis which reflects their worth and tax profile"*

Further to this they go on to discuss ITC 1467 (1989 52 SATC 28) and wonder if the judgement would have been any different had the draftsman of the purchase agreement heeded the above advice.

*" The taxpayer owned a property on which it conducted an hotel business. The property was sold, it would seem, for a composite price including both land and the buildings, to a property developer, who promptly demolished the hotel to clear the ground for a sectional title development. The revenue authorities sought to apportion the selling price, and to tax the seller on a part of the selling price as a recoupment of the tax hotel building allowance previously claimed by the taxpayer in respect of the hotel building. The taxpayer resisted on the basis that no portion of the purchase price could be*

*attributed to the hotel building. He argued that while the price paid was much more than the book value of the immovable property, both parties regarded the hotel building valueless, and so the whole of the price paid should be attributed to the land, in respect of which no allowances had been granted.*

*The court ruled that as the property had." ....been sold at a price exceeding the purchase price thereof, the commissioner may tax any recoupments without regard to whether or not the buildings on which allowances had been granted have a value, or if they have, what that value is, or indeed, whether they were still in existence at the date of sale"*

*With the greatest respect, the learned Judge seems to have overstated the position. Certainly, if the buildings had no longer been in existence, it is difficult to see how any portion of the purchase price for the vacant land could ever be said to be a recoupment or recovery of any amounts previously deducted in respect of the now non – existent buildings. In addition whatever may be the common law of property, allowances are granted for tax purposes in respect of hotel buildings only, not the land; and by implication so should the recoupment provisions be applied.*

*It is not unlikely that if the patties had themselves split the purchase price, and had allocated at least some of the amount to the hotel building, no problem with the revenue authorities would have arisen, and the damage would have been limited." (Kruger,D.,et all 2003)*

In another case where the sellers' elected to sell the shares as opposed to the asset, the judgement went against the shareholders of the company. This was the case of Deceased Estate v COT (1949 SATC 305). A company owned a piece of land and a purchaser offered to purchase this property from the company. In the meantime the shareholders of the company

holding the land decided that the purchaser must purchase the shares of the company. In a strange twist the court held that the shareholders had an acute awareness of tax and went this route in order to avoid tax. Based upon this the whole scheme was deemed to be a profit making scheme and taxed on those grounds.

In *Elandsheuwel Farming (EDMS) BPK v SIR* (1978 SATC 163) the court had to decide whether the sale of land by a company gave rise to a receipt of a capital nature or revenue nature. The land had been held by the company for a considerable period and had originally been acquired with the intention of holding as a longterm investment. Subsequent to a change in shareholding in the company, the land was sold and the Commissioner, in assessing the company for tax, treated the proceeds from the sale as a receipt of revenue nature on the grounds that there had been a "Change Of Intention" in the company. It was held that due to the change in shareholding there had been a change in the policy of the company with respect to the holding of the land.

The court held the new shareholders in the company were property speculators and that their intentions had to be imputed to the company and that the company had, therefore had a change of intention. The property had become a revenue asset in the hands of the company and the proceeds on the sale of the property were taxable, being a receipt of a revenue nature. The court appears to have disregarded the separate legal identity of the company in reaching it's decision and judgement must raise serious problems wherever companies holding assets of a capital nature dispose of such assets shortly after a change in shareholders.

When examining the sale of the share or the asset, from the seller's point of view, here is a hypothetical example. Assume that a company purchases a piece of land as trading stock for R200 000 and some time later has an offer for R750 000. The profit of R550 000 would the be subject to tax at company

rate of 30% at the present rate, the tax on this profit would be R165 000. If the shareholder had purchased the shares of the company for R450 000 some time after the value of the land had escalated and then sold the shares for R750 000 the profit would have only been R300 000.

In a situation like this the shareholder has in all probability already made the mistake at the beginning of the transaction. The purchaser must examine whether to purchase the sale of shares or the sale of the asset.

#### **4.2.2 The Purchaser's Position**

The better option for the purchaser would be to purchase the shares of the business. Assuming there are no VAT implications, then the reason for purchasing the shares, as opposed to the property out of the company is because the transfer costs on the shares is around 0.5%. Should the purchaser elect to purchase the property out of the company then depending upon what entity is purchasing the property there would be different transfer costs. The transfer costs for a company or a trust are 10% and the transfer costs for a natural person varies from 0% to 5% to 8% depending on the actual cost of the property. Below is a table depicting the various costs of the property purchased for R750 000

<b>Entity making the Purchase</b>	<b>Effective rate on the Purchase</b>	<b>Cost of Purchase</b>
Company or Trust Purchasing the Land	10%	R75 000
Natural person Purchasing the Land	8%	R60 000
Natural Person Purchasing the Shares	0.5%	R3 750

Table 3.

As can be seen from the above table the most cost effective method with regards to the tax on the above transaction is to make use of the share option, but as has been mentioned on various occasions throughout the text, it is not only tax considerations we must examine. When purchasing the shares in a business, be cautious of the company's background and make a thorough investigation into CGT. The impact of CGT would most certainly be felt in subsequent transactions with regards to the sale of this property should the share option be exercised. The reason being that the original cost of the property is a lot lower than what is now being paid for the shares of the company.

Let us examine the effect of VAT on the above transaction. Assume both parties to the sale of the property are VAT registered vendors the transaction will then be zero-rated. This is due to the fact that the purchaser would be declaring VAT on the sale and the purchaser would be claiming the same VAT as an input. As VAT is levied on the transaction, in terms of section 9(15) of the Transfer Duty Act this transaction is then exempt of transfer duty. The sale of shares in a business does not attract VAT therefore any VAT incurred in the transaction where the shares are being purchased is not deductible. This type of VAT would emanate from the use of a consultant or agent.

When or if the shareholders wish to distribute the undistributed profits this will then take the form of dividends. These dividends would be subjected to STC, which currently stands at 12.5%. When deciding on whether to purchase the shares or the assets in the business, is from the point of view of the deductibility of the interest on the loan, assuming that a loan was raised in order to make the purchase. Should the shares of the company have been purchased then one cannot deduct the interest of the loan which was raised to purchase these shares. This was made clear in *Shapiro v SIR* (1928 NPD 436, 4 SATC 29) The taxpayer borrowed money in order to purchase shares in a company. The purchase of the shares in the company

secured in position as managing director which in turn produced an income for the taxpayer in the form of a salary with fringe benefits. He thus claimed that the interest paid by him on the loan to purchase the shares was an expense incurred in producing his income. The court held that he had earned a salary and that there was no link between the expenditure incurred on raising the loan to purchase the shares and his income and on those grounds he lost the case.

On the other hand there is the case of CIR v Drakensberg Garden Hotel (Pty) Ltd (1960 23 SATC 251). The court had to decide the closeness of the connection between the expenditure and the income earning operations. The taxpayer in this case was able to show a clear connection between interest paid on a loan to purchase shares and the profit of the business. The court was satisfied that as a result of the purchase of the shares, profits (other than dividends) would increase. Therefore the interest paid was deductible, notwithstanding that dividends might not be received in respect of the shares or that such dividends, if received, would be exempt from tax in the taxpayer's hands. Incidentally this judgement was handed down from a court of higher authority than that of the Shapiro case.

The first example given under the seller's position, where the seller had purchased an asset some years ago for R200 000 and over the years had claimed wear and tear to the value of R75 000 with the tax value of the asset now sitting at R120 000. The market value is currently R300 000. Does the purchaser, purchase the share in the company for R300 000? Or does he purchase the asset out of the company for R300 000? Assuming the asset is the only asset in the company, the better option would be for the purchaser to purchase the asset at the price of R300 000. The purchaser now has the advantage of being able to claim the wear and tear allowance on the full R300 000. Should he make the decision to purchase the shares for R300 000 he will only be able to claim wear and tear against the un-depreciated amount of R125 000 as the asset sits in the company's books.

One other point that must be mentioned again, when purchasing the shares of a company, one does not know what else is coming along in the dark reaches of the company. The effect of CGT on the purchase of the shares of the business and the purchase of the assets of the business needs to be considered. A capital gain is the difference between the purchase price of the asset and the selling price of the asset. When purchasing shares in a business, the base cost of the shares of the business is established. The base cost of the shares of the business has no bearing what so ever on the base cost of the assets of the business.

As an example, if the shares of a company have been purchased for R500 000 and the original price of the assets was valued at R300 000 at a certain date, this would be the base cost of the assets and not the R500 000. Should the purchaser wish to sell the business or the assets at a future date the fact that the shares of the business and not the assets were purchased could create a problem for the purchaser should he want to sell later.

The introduction of CGT is sure to provide greater resistance to purchasing shares in a company as opposed to the purchasing of the assets out of the company.

Below is a table of comparison adapted from (Power, R.M., 2003) from both "The Purchases" point of view and "The Seller's" point of view as to purchase and sale the shares of the entity or the business

"The Seller's" standpoint

To Sell Shares	To Sell the Business
i) The sale of shares in most cases will be a capital gain	It is advisable for "The Seller" to obtain as higher price for the capital assets as possible because this will be subject mainly if not all to Capital Gains Tax
ii) Share Transfer and or VAT are generally paid by "The Purchaser"	
iii)	If the business is sold "The Seller" retains the loss
iv) There is no recoupment on the assets if the shares are sold	Should the value of the assets realised be greater than the book value then the recoupment is taxable in the hands of " The Seller"

Table 4. (Power RM 2003) "A New Guide to Buying and Selling a Business"

"The Purchaser's" standpoint

To Purchase the Shares	To Purchase the Business
i)	There are a couple of possibilities here. "The Purchaser" must either obtain the assets for the highest price he can get "The Seller" to agree to selling the assets for. This might even mean that "The Seller" has to write back wear and tear in his books. Alternatively "The Purchaser" should pay the lowest price he can for the assets and a far higher price for the trading stock which would then be offset against income, but not much to write off against wear and tear.
ii) Any tax loss may be kept in the business provided the business continues trading and continues trading in the same vein.	The purchaser of a business is not able to take on the tax loss of a business.
iii) Transfer duty on the shares is only 1% whereas transfer duty on the sale of fixed property is 10%, making the share option the better route to follow.	In this case VAT will be paid on the purchase of the business and if the purchaser is VAT registered. this will then make the transaction a zero rated transaction

Table 5. (Power RM 2003) "A New Guide to Buying and Selling a Business"

### **4.3 Tax Implications Hidden in the Purchase and Sale Agreement**

Gone are the days where all that was required was that the business was sold lock, stock and barrel for a lump sum and this was treated as a receipt of a capital nature thus not attracting any tax at all. This was changed with the judgement handed down in CIR v Nico (1940 AD). In this case the Commissioner sought to include in the gross income the sale of the trading stock which formed part of the purchase price when the taxpayer sold the business as a going concern. The taxpayer in turn objected on the grounds that the amount yielded was of a capital nature. The court found the amount received for stock would form part of gross income as an amount being realised in the use of capital to earn profit. This case highlighted the fact trading stock was part of a going concern. It was on these grounds that the amount received for trading stock on the winding up of the business was considered part of income. This case set the benchmark where the asking price of a business by the seller could no longer be expressed as a lump sum for a going concern. The selling price now has to be allocated to the various items that make up the business, such as fixed assets, goodwill, stock and accounts receivable.

#### **4.3.1 Fixed Assets**

Any asset such as furniture and fittings, motor vehicles, computers, buildings (in certain cases) and plant and equipment would not have been allowed as a deduction of income, but would have been regarded as expenditure of capital in nature. In terms of section 11(e), 12B and 12c the business is allowed to deduct against income, on an annual basis, an amount known as wear and tear. The write - off periods for the different categories of fixed assets can be found in "*Schedule To Practice Note No. 15*" of The Income Tax Act. In the books of the business the assets will be shown at cost less the accumulated depreciation.

Below is a simple illustration of how this would work making the assumption that depreciation is at 15% per annum on a straight line basis:

Year 1	
Asset at Cost	150 000
Less Depreciation for year 1	<u>22 500</u>
Tax Value of Asset at end of year 1	127 000
Year 2	
Opening Value of Asset in year 2	127 000
Less Depreciation for Year 2	<u>22 500</u>
Tax Value of Asset at end of Year 2	105 000
Year 3	
Opening Value of Asset in Year 3	105 000
Less Depreciation For Year 3	<u>22 500</u>
Tax Value of Asset at end of Year 3	82 500

As can be seen from the above example a constant amount is allowed as a deduction against income each year known as wear and tear (depreciation). The above example is based on the straight line method. At the end of year 1 the asset now has a tax value of R127 000, at the end of year 2 the tax value of the asset is now R105 000 and at the end of year 3 the tax value of the asset is now R82 500. Let us now make the assumption that this asset is now being sold for R140 000 at the end of year 2. The entity selling this asset will now be subject to income tax on the R35 000, this is due to the recoupment in terms of section 8(4)(a).

It must also be borne in mind that there will be no CGT on the above transaction because the asset has been sold for less than the original purchase price. Based on the above example, one would put the assets of the business in the purchase and sale agreement at the tax value or what is also known as book value from the point of the seller.

- From the purchaser's point of view, he would want the assets to be placed in the purchase and sale agreement as high as possible. If he could get the seller to include the asset in the purchase and sale agreement at the original price of R150 000. This would be to his advantage because he can now make use of the full wear and tear of the asset and not have to start at the cost of the asset in year 2 being his original cost.
- From the seller's point of view if he included the asset in the purchase and sale agreement at the original price of R150 000, he would then have to write back into his books all the wear and tear he has been allowed as a deduction over the years. Thus, increasing his income by the amount he has written off.

Alternatively had the asset sold for R100 000 at the end of year 2 and this is sold as part of a going concern then this loss would be regarded as a capital loss thus not allowing any deduction from income. Should this asset have been sold at a loss during the course of normal trading, the business would then be able to claim the loss as a scrapping loss.

#### **4.3.2 Goodwill**

Goodwill is the amount paid in excess of the tax value (book value) of the tangible assets. This is treated as a receipt of a capital nature in the hands of the seller. The seller must be aware that the structuring of the purchase and sale agreement can also turn this so-called capital revenue into taxable revenue in his hands. Conversely the purchaser will not be able to claim a deduction in respect of this capital payment. Turning this so-called capital payment into a revenue payment was seen in *Deary v CIR (1920 SATC 92)*, where Deary sold his business to his three clerks who between them could not pay the price of the business including the goodwill let alone raise the finance to do so.

An agreement was drawn up stating amongst other things that Deary would have a share in the profits of the business to the value of 25% for as long as the clerks owed Deary money in terms of the sale. The issue that came before the court was whether Deary was liable for tax on his quarter share of the profits. Deary rightly argued that the sale of goodwill was a capital item. The court held that the income in Deary's hands consisted of profits from the business and on those grounds was revenue in nature and therefore taxable.

What resulted out of this case and subsequent cases is the sale of a capital asset can result in the seller being taxed on the revenue received, provided there is a link between the consideration itself, which is being received by the seller and the income of the purchaser.

Should the purchaser want to be assured of the so-called profits in a business he can make representation to the seller indicating that he would like to pay the goodwill off against the profits. In order to overcome the above mentioned problem of the payments of goodwill being paid in this manner the following would have to be implemented.

The purchase and sale agreement would have to state that X amount is being paid for goodwill, however this will be paid in annual instalments equivalent to a certain percentage of the profits of the business provided there are profits in that year. This method would give the appearance that the reference to the profits is merely a means of determining the amount of goodwill to be paid in a year until the total amount of goodwill has been paid.

No matter how well the contract is drawn up, the bottom line with regards to the question of goodwill is, is this a genuine payment for the purchase of goodwill? If it could be proved this was not goodwill but in fact an annuity linked to the profits of the business this would be taxed in the seller's hands are great as indicated below.

Examining goodwill it can be seen there are two types, namely local goodwill and personal goodwill.

Local goodwill can best be described as to the physical location of the business. For example a business could be situated in a place where there is a high volume of people passing the premises on a daily basis and this business relies upon passing trade. For example, bottle stores, tea rooms, stationery stores and hardware stores.

Now in purchasing a business of the above mentioned type for commercial reasons it does not matter whether local goodwill is being paid or personal goodwill is being paid because of a good manager or for that matter a combination of both types of goodwill.

From a tax point of view here lies a great danger for the seller. This danger lies in section 1(g)(i) of The Income Tax Act

*" for the use or occupation or the right of use or occupation of land of buildings; "*

This section has been invoked successfully by the commissioner to tax the seller of the business on his goodwill in the past. If the seller sells his business for a certain price and over and above that price is an amount for goodwill, the seller has attached goodwill due to the fact of his location, goodwill known as local goodwill. The seller has a lease agreement with the landlord for the next few years or alternatively owns the building and the goodwill is a right to use the premises. Revenue authorities could act upon this. It could be said, the seller has sold the right to the purchaser for the use of the premises and tax the seller accordingly.

One way to overcome this problem is for the seller who is renting the premises to negotiate a new lease with the landlord. In this way it relieves

the original owner of the business from the terms and conditions of the lease he had. This leaves the seller free to ensure the goodwill is capital in nature. Should the original owner of the business either own the premises or sub lease the premises to the new owner, then he will be liable for tax on the subleasing. Goodwill could then be nullified and it would turn from being a capital sale into a receipt of revenue, which thus becomes taxable.

Personal Goodwill revolves around the name of the business, the reputation of the business and the reputation of the owner / managers of the business. From the purchaser's point of view it does not matter whether the amount being paid above the value of the tangible assets is due to personal goodwill, local goodwill or a combination of the two.

The most important point is from the side of the seller because as discussed above the seller can be taxed on the goodwill payments should it be proved these are not capital payments but rather revenue payments.

### **4.3.3 Stock**

It must be remembered that in terms of Practice Note 36 (13 January 1995) taxpayers are required to disclose the basis on which they have valued their stock if it has not been valued at cost. All too often taxpayers under value their stock in order to reduce their profits resulting in a smaller tax burden on an annual basis. Should the taxpayer now want to sell his business, he has a problem with hugely under stated stock. The problem with under stating the stock is that this has a habit of snowballing until it becomes irreversible.

#### **Treatment of under-valued stock**

Once it is in the purchase and sale agreement at whatever value is decided upon it now becomes binding on both parties. At the low value the seller loses on what he has paid for the stock. The purchaser is now at a disadvantage because in his books it will be reflected at the lower of costs

thus artificially lowering his cost of sales and increasing his gross profit creating a greater than true tax burden for him.

Should the seller decide to record the stock cost in his books, for the purpose of the sale and it is detected by the revenue authorities this could possibly be the effect. In the year the stock is recorded at cost it will create a huge difference in his cost of sales thereby reducing his tax liability into one year which could produce a large tax bill in that particular year.

#### **4.3.4 Accounts Receivable**

Generally the debtors of a business, if sold with the business, would be termed a capital asset and the receipt thereof would have to be treated this way in the hands of the seller. Should we make the assumption that the accounts receivable are disposed of at less than face value this would result in a capital loss in the hands of the seller. This is a capital loss resulting in that it cannot be offset against revenue.

Taking the purchaser's point of view he is now acquiring a capital asset. His problem arises if any of the accounts receivable go bad. The purchaser is unable to write these bad debts off in terms of section 11(i) of The Income Tax Act.

One method of over coming this problem would be for the seller to appraise the list of debtors and make a decision of which of these debts could quite possibly go bad and the write these debts off in his books in terms of section 11(i) of the Act. Even though the debt may have been written off in terms of the business it does not relieve the debtor of his obligation to pay his debt. Should this debt be recovered, it would be written back into the books of the business as a bad debt recovered.

This has the effect of making the accounts receivable being written down below their true book value.

#### **4.4 Other Tax Considerations.**

Before going on to analyse how the purchase is to be paid for two other taxes should be discussed here. This is the newly introduced Capital Gains Tax and Value Added Tax and how this could influence the purchasing of a business or asset,

##### **4.4.1 Capital Gains Tax**

CGT was introduced from 1 October 2001. What the actual effect of CGT is, is that one is taxed on the capital gain that one has made on the sale of one's assets during the course of a year. At this point an important fact to bear in mind is that CGT is not a separate tax. Only a portion of this capital gain is added to the income tax of the entity for that particular year and then is taxed at the rate of that entity. However should a capital loss be incurred, in terms of para 9(b) of the Eight Schedule of The Income Tax Act, this loss will not be set off against the income of that particular year but will be held and set off against future capital gains in years to come. The inclusion rates as discussed before are 25% for individuals and special trusts, 50% for companies, close corporations and ordinary trusts.

With the introduction of capital gains tax it has not removed the necessity of determining the nature of the proceeds from the disposal of any assets. For example if an asset was purchased with the intention of revenue then the proceeds from the sale of the asset would have been of a revenue in nature and fully taxable. But on the other hand if the proceeds are of a capital nature then the provisions of the Eight Schedule will apply. The Eight Schedule basically excludes any amount that has been included in gross income.

If one looks at trading stock as an example, even though an asset would have been disposed of here there would be no capital gain as these proceeds would have been included in gross income. On the disposal of an asset held in a revenue account one must be careful it is not subject to double taxation

in both gross income and a capital gain. This can quite easily happen due to the rather broad definition of the term an asset and there are no distinctions between assets held on capital account and assets held on revenue account.

#### **4.4.2 VAT**

With regards to the Value Added Tax Act No 89 of 1991 (the VAT Act) the sale of a business can give rise to a VAT transaction. With regards to the sale of a business one should ideally aim to satisfy section 11(1)(e) of the VAT Act. Section 11(1)(e) which is:

*" 11. Zero rating. – (1) Where, but for this section a supply of goods would be charged with tax at the rate referred to in section 7 (1), such supply of goods : shall, subject to compliance with subsection (3) of this section, be charged with tax at the rate of zero percent where-*

*(e) the supply is to a registered vendor of an enterprise or of a part of an enterprise which is capable of separate operation, where the supplier and the recipient have agreed in writing that such enterprise or part, as the case may be, is disposed of as a going concern: Provided that-*

*(i) such enterprise or part, as the case may be, shall not be disposed of as a going concern unless-*

*(aa) such supplier and such recipient have, at the time of the conclusion of the agreement for the disposal of the enterprise part, as the case may be, agreed in writing that such enterprise or part, as the case may be, will be an income – earning activity on the date of transfer thereof; and*

*(bb) the assets which are necessary of carrying on such enterprise or part, as the case may be, are disposed of by such recipient; and*

*(cc) In respect of supplies on or after 1 January 2000 such supplier and such recipient have at the time of conclusion of the agreement for the disposal of such enterprise or part, as the case may be, agreed in writing that the consideration agreed upon for that supply is inclusive of tax at the rate of zero per cent;*

*(iii) where the enterprise or part, as the case may be, disposed of as a going concern has been carried on in, on or in relation to goods or services applied mainly for the purpose of such enterprise or part, as the case may be, and partly for the purpose, such goods or services shall, where disposed of to such recipient, for the purpose of this paragraph and section 18A be deemed to form part of such enterprise or part, as the case may be, notwithstanding the provisions of paragraph (v) of the proviso the definition of "enterprise" in section 1; or"*

What this means is that the sale of a business or going concern can in terms of the above section be zero rated, This does not only apply to the complete business but also to a part thereof, provided the part which has been sold/purchased is capable of operating independently. The requirements which have to be met are basically:

- The seller must be a VAT registered vendor
- The purchaser must be a VAT registered vendor
- The business or the part that is being sold must be considered a going concern.

Should the purchaser purchase an asset or a going concern and produce products which are zero rated, the purchaser is not entitled to apply section 11(1)(e) of the VAT Act. Should the purchaser use the assets / going concern to produce, say, seventy five percent of his products as VAT rated

products and the balance for export which would then make that twenty five percent zero rated. The purchaser would only then be able to claim the VAT input on seventy five percent of the purchase price of the asset / going concern.

Conversely should the purchaser purchase the asset / going concern from a non registered VAT vendor, and the purchaser is a registered VAT vendor then he is still able to claim the VAT input on the purchase of the asset / going concern. This is done in terms of purchasing second hand goods from a Non VAT vendor and this is what is known as notional VAT.

When examining transactions with a "connected person" the architect of the purchase and sale agreement must take into consideration section 10(4) of the VAT Act which is:

***" 10. Value of supply of goods or services.- (1) For the purpose of this Act the following provisions of this section shall apply for determining the value of any supply of goods or services.***

***(4) Where-***

- (a) a supply is made by a person for no consideration or for a consideration in money which is less than the open market value of the supply; and***
- (b) the supplier and recipient are connected persons in relation to each other; and***
- (c) if a consideration for the supply equal to the open market value of the supply had been paid by the recipient, he would not have been entitled under section 16(3) to make a deduction of the full amount of tax in respect of that supply,***

*the consideration in money for the supply shall be deemed to be the open market value of the supply: Provided that this subsection shall not apply to the supply of a benefit or advantage of employment contemplated in section 18 (3)"*

This means should a person sell an asset/going concern to a connected person, as defined in section 1 of The Income Tax Act, the purchase price will be deemed to be the market value, and not the value of the consideration, making the assumption that the asset/going concern has been sold at below market value. For example, should a person sell an asset/going concern to a connected person for R100 000 and the actual market value is deemed to be R150 000. The seller would have to the account for the VAT output on the market value of R150 000.

How will the purchase of the asset/going concern be paid for? Will the payment be made in the form of a barter, lump sum, annuities, or royalties, to name a few of the methods of payment from which one has to choose. These options will be discussed in the next chapter.

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## **Chapter 5**

### **PAYMENT OF PURCHASE**

#### **5.1 Introduction**

With regards to the type of payment chosen for the actual purchase/sale agreement, this can have a direct bearing as to whether the purchase/sale is one of capital in nature or revenue in nature.

From the purchaser's side, the purchase may have been made for one of two reasons :

- A long term investment
- A short term purchase

Should the purchaser have made the purchase with the intention of making an investment, interpreted as a long-term investment. This investment could be taken as an income-generating asset. A good indication of this would be how is the purchase being paid for. What has been paid up front and the repayments if any, over what period.

Generally speaking, a short term investment would be a scheme for making profit and in a lot of cases the financing of the purchase would be done on the maximum amount of credit possible. Conversely, the seller's best method of securing a sale of capital in nature is to request for the payment of the asset/going concern to be paid in a lump sum. On the other hand should the seller sell the asset/going concern for a lot higher price than the open market value and he carries the interest at a higher rate than the income being generated from the asset/going concern, this could be construed as a profit making scheme.

## 5.2 Different Types of Payments

Over and above the cash type of payment which was discussed in brief above, other types of payments, such as payment in kind, royalties and annuity type will be examined.

### 5.2.1 Payments in Kind

Crudely put this is a type of bartering, a form of transaction which seems to be gathering momentum at present. Basically stated the seller would accept some form or another of asset in return for what he is getting rid of.

Now in terms of section 1 of The Income Tax Act, gross income is defined as such:

**" gross income "**, in relation to any year or period of assessment means-

- (i) in the case of any resident the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, the total amount in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic "

The definition then goes on to list the specific inclusions, but at this point the part of the definition under discussion here is " *in cash or otherwise*". It is an accepted fact that when a transaction of the above mentioned kind takes place a monetary value must be placed on the asset. This was seen in CIR v Butcher Bros (Pty) Ltd 1945 AD 301, 13 SATC 21, where at that point one was unable to place a monetary value on the asset. The court had to decide whether the right to have improvements effected on leasehold property in terms of a lease agreement gave rise to gross income in the hands of the lessor (owner of the property). The court ruled because the Commissioner was unable to establish an amount, the benefit did not constitute gross income in the hands of the lessor. This decision is important, in that it establishes the principal that there must be an amount attached to the item that has been traded, and furthermore the onus lies with the Commissioner.

The mere fact that the amount is difficult to determine does not mean there is no amount. In whatever the form the transaction takes place a value has to be placed on that transaction, and on those grounds the transaction will form part of the seller's revenue or become capital in nature.

On the other side of the coin there the case of *Ochberg v CIR* 1931 AD 215, 6 SATC 1. Here the taxpayer held 100% of the shares in his company, in return for services rendered to his company, the company issued, additional shares to him, the only shareholder. The shareholder was no better off, because he still held 100% of the shares in the company. The court held that the new shares had been received by the taxpayer, for the taxpayer's benefit and not for anybody else's, and that as they had a value, the taxpayer would be taxed on the value of the shares received by him.

The problem these two cases present us, are the principles underlying the two cases cannot be reconciled. This in turn presents the problem that until this issue has been resolved and an asset is used in place of a monetary exchange, the seller must establish the basis on which the asset should be valued and be extremely clear upon this point.

### **5.2.2 Payment in the Issuing of Shares**

This method of payment can work if the person who is selling an asset to a company is a director of the company. One has to examine the advantages and disadvantages from both the seller and the company's side and, the end result before deciding whether to go this route.

In this case the director would have the company issue redeemable preference shares, to the same value of the asset he is selling to the company at a nominal rate per share. Ideally the shares should have a coupon value at the rate equivalent to the going interest rate. There are advantages from both the seller's point of view and the company's point of view.

From the seller's standpoint he has a greater amount of shares in the business, giving him that much more voting power. He has redeemable preference shares with a coupon rate at a stated value, he now escapes having to charge interest as if he was a creditor of the company which would be taxable in his hands. Should there be a cash flow problem and he does not get paid out in a particular year, this is not then income which would have been accrued to him thus making it taxable even though he had not received it.

The advantages of this type of transaction from the company's side, it can be seen that if there is a cash flow problem, it does not have to meet the repayments of a loan that would have been needed to finance this purchase. Should there be an inadequate cash flow in a year there would be no declaration of a dividend. The only other advantage to the company would be the fact that this transaction would strengthen the balance sheet by having less liabilities and a greater share capital.

Conversely, there are a higher number of disadvantages for the seller than the company. Let's look at this transaction from the company's standpoint first of all. The biggest disadvantage to the company is that it is unable to deduct from its income the issuing of the shares and the payment of the dividends.

Taken from the director's side, he would have to forgo the right of being a creditor to the company and, should problems arise, it would be to his disadvantage. Section 8E of The Income Tax Act refers to:

*"Dividends on certain shares deemed to be interest in relation to the recipient thereof."*

The interpretation of this section is, any dividends paid on redeemable preference shares, which are redeemed within three years of issue, will then

constitute interest in the recipients hands thus making them taxable. As already mentioned, dividends may only be paid out of profits and should there not be profits for a few years the director's capital is tied up without any returns.

In conclusion, on the payment of issuing shares, one has to examine all the above mentioned advantages and disadvantages, but the final decision would most probably be made on other aspects. Aspects such as the financial situation of the business, the willingness of the director to have his capital tied up for some years without reward. Other aspects which could influence the decision to go this route could be the tax situations of either the company or the director or both, to name a few reasons that could influence the decisions.

### **5.2.3 Annuity Type Payments**

An annuity is defined as :

*"annuity* n - a sum of money payable annually; an investment insuring fixed annual payments. **Annuitant**, n one who receives an annuity."

(Anon., 1995 Cassell pocket English Dictionary)

As( Kruger D, et al 2003) states :

*" The courts have, from time to time, attempted to isolate and describe the qualities of an annuity. Thus:*

- *There must be an annual payment, though each annual payment could be divided into weekly or monthly instalments;*
- *The payments must be repetitive, recurring from year to year, for at least some period of time;*
- *The recipient must have a right to receive the amounts, that is to say, a legally enforceable right."*

The above definitions are not precise enough for one to be able to safely use the annuity type of receipt on the sale of an asset or going concern. Further to this, there are many sections in The Income Tax Act which do not smile favourably on annuity type receipts.

In drawing up a purchase and sale agreement the purchaser is unable to raise finance or alternatively it is decided between the purchaser and the seller that the purchaser will pay the asset / going concern off over a period of time. Careful attention should be exercised when defining payments. Monthly/annual payments can be defined as both an annuity and as instalment payments.

For example, should it not be stated that the asset/going concern is being sold for a fixed amount, payable over a fixed period. But rather that the purchaser will be paying an amount on an annual/monthly basis over an indefinite period, this could most definitely be construed as an annuity. In order to prevent this type of thing happening it should be stated in the contract that the purchaser will be paying a fixed amount over a fixed period for the asset/going concern. This can include interest and or finance charges as well.

What has been described above is from one extreme to another. There is a huge grey area between these two poles and it is this area that has caused many problems over the years. One of the cases where this problem can be seen in is ITC 713 (1950 17 SATC 337). In this case a taxpayer owned a manufacturing business which he sold for the sum of fifty pounds per month payable for the rest of his life.

The issue that the courts had to contend with was, this fifty pounds per month for life was it of a capital nature or was it revenue. The Commissioner contended it was revenue and taxed him accordingly. In his summing up of the case Lucas J stated:

*"The contention advanced on behalf of the appellant is that the fifty pounds per month for life which he is to receive is a capital amount and not income in terms of the Act. There is no fixed amount determined as purchase price. It might be fifty pounds, the first payment, or it might go on for twenty years..... The agreement is quite clear that on death of the appellant the payments by the purchaser will fall away completely. This in my view, is entirely different from the position where a fixed amount has been agreed upon and then provision made for such payments in instalments"*

So one can go on mentioning the various cases which either decided whether annuity payments were of a capital payment on the asset/going concern. The problem here is, if the payment is considered to be an annuity payment, both the purchaser and the seller lose on the deal. The seller from the point that this income is now considered to be revenue in his hands and taxed accordingly and not as a capital gain and taxed on a lower rate, and the purchaser will not be allowed to deduct this payment as an expense, it will still remain a capital payment from his side.

The test that can be applied here is:

- Does the payment in instalments reduce a debt over a period of time? or
- Are the instalments merely a contractual agreement payable indefinitely?

In summing up it can be seen how important it is for the architect of a contract to be precise should a payment in instalments be considered as one of the options of payment. He must leave no reason for doubt in anybody's mind as to what the payments are for and how they are to be paid and over what time they are to be paid.

## **Chapter 6**

### **CONCLUSION**

#### **A CASE STUDY**

##### **6.1 Introduction**

There have been many purchases which have proved to be a complete disaster for the buyer, very often because the purchaser did not carry out an in-depth investigation. On the other hand there could have been incorrect disclosure in the financial statements, bad drafting of the purchase and sale agreement or misunderstanding the legal and accounting terminology.

This chapter deals with the areas of a purchase and sale agreement which can be costly or a complete disaster, from both a commercial point of view and from a tax perspective.

##### **6.2 Drafting the Purchase and Sale Agreement**

Once the Memorandum of Agreement as discussed under point 3.5.1 in chapter three has been drawn up then one proceeds to include the various accounting and legal terminology and their meanings under the heading Interpretation. There have been numerous instances where because of bad drafting or lack of clear interpretations the purchaser has purchased something completely different to what he thought he was buying. Alternatively the seller could be selling a lot more than he thought he was selling.

In one instance a purchaser paid market prices for obsolete stock and not the cost price he had envisaged, and all this was due to bad wording of the relevant definitions. It cannot be stressed strongly enough that the definitions of both legal terms and accounting terms must be understood by

all the concerned parties. It has been known for lawyers, auditors and the courts to differ in interpreting the words "*net asset value*"

What is actually being sold can also cause problems more especially on the sale of a going concern. For example if the definition of the going concern being sold, excluded certain assets that were fundamental to the operations of the business, this would result in the fact that the purchaser would have to pay for assets he thought he had already purchased with the going concern.

### **6.3 The Financial Statements**

It is important that both the seller and the purchaser are able to understand and interpret the financial statements. The salient features of financial statements are discussed here together with the tax implications from both the seller and the purchaser's angle. Commercially, from the purchaser's side an understanding of the financial position of the business and its future potential is important, otherwise the price paid for a going concern could be way out of proportion.

#### **6.3.1 The Balance Sheet**

The balance sheet can be compared to a photograph depicting a snap shot of the business at a particular moment in time. A simple balance sheet consists of:

- i) Assets
- ii) Liabilities
- iii) Capital

Two points must be borne in mind when examining the balance sheet:

- The position of a business can change dramatically in a matter of months, weeks or even days.
- Many relevant aspects of the going concern are not recorded in the financial statements.

On these grounds should the decision be made to purchase the going concern on financial statements that are a few months old, the appropriate warranties should be included in the purchase and sale agreement. These will be discussed under warranties.

### **i) Assets**

Broadly speaking the assets are the way in which the capital employed in the business has been invested. The assets can be divided into three broad categories, fixed, current and intangible assets.

The fixed assets can be subdivided into moveable and immovable. The immovable assets would consist of land and buildings. Looking at the balance sheet and establishing that the greater portion of the capital invested is in land and buildings then one has to decide what is the best thing to do. Does one purchase the land and buildings out of the trading entity or does one purchase the trading entity itself. This was discussed under 4.2 (An In-Depth Analysis of Whether to Purchase the Assets of the Business or the Shares of the Business.)

The moveable assets usually consist of assets such as vehicles, machinery, tools, equipment and computer equipment. These moveable assets are generally shown at cost less accumulative wear and tear. Here again as discussed under 4.2, from the seller's side his best option is to include the moveable assets in the purchase and sale agreement at book value. Should he write back the wear and tear this will increase his profits thus creating an income tax problem for himself.

The purchaser needs the moveable assets to be included in the sale agreement at as higher price as he can possibly get them in order to be able to take advantage of the wear and tear allowances.

Current assets comprise inventory. Accounts receivable (debtors) money in the bank and any other assets which can be converted into cash within a year.

Inventory (stock) must be stated at cost in the purchase and sale agreement if not, then as discussed in 4.3.3, terms of Practice Note 36 (13 January 1995) requires the seller to disclose the basis on which he has valued the stock. Either way overstated or understated this will have a direct effect on both the seller's and the purchaser's gross profit.

Should the accounts receivable be sold with the going concern this would be termed a capital asset and tax accordingly. This from the seller's point of view is good but from the purchaser's point of view it means that should any debts go bad he would then not be able to write them off. In order to overcome this problem there should be a provision for bad debts made in the seller's books.

The concept of goodwill is a difficult concept to come to terms with. Goodwill can be described as the difference between the selling price and the net worth of the going concern being purchased. Payment of goodwill is considered a capital payment, which in terms for the seller will be taxed as CGT. In the seller's hands this is a good thing but in the hands of the purchaser this goodwill is a capital item with which he can do nothing, it will just sit in the balance sheet. It is on these grounds that in the purchase and sale agreement the purchaser wants to get the fixed assets valued as high as possible and the goodwill as low as possible.

## **ii) Liabilities**

The liabilities can be either short-term or long-term. Short-term liabilities are generally payable within a year and are commonly referred to as current liabilities. Current liabilities consist of creditors (accounts payable), bank overdrafts, provisions and estimates of amounts owing in the short term.

Taxation owing is generally the actual or an estimated amount owing to the South African Receiver of Revenue which is considered a current liability.

Long-term liabilities are repayable later than one year and these liabilities may be secured or unsecured. Debentures and mortgage are also considered long-term liabilities.

Should the sale consist of a going concern and the trading entity is being purchased then the purchaser must ensure that all known liabilities have been accrued in full. Provision should even be made for all expenses to be insured even if the full amount of the liability is unknown. One can never be too sure when purchasing a complete going concern. The better route to take is for the seller to accept all liabilities in his personal capacity and the selling price of the going concern to be adjusted accordingly. A final point on liabilities. Should they be purchased with the going concern do include a warranty in the purchase and sale agreement.

### **iii) Capital**

The equity of the business is made up of the initial capital the member/ shareholder invested into the business. Coupled to this any retained earnings in the business and non-distributable reserves.

## Important Points to the Balance Sheet

The definitions that are important and must be clearly understood when reading a balance sheet are:

Employment of capital	Total assets minus current liabilities
Capital employed	Total equity and long-term liabilities
Net asset value / net worth	Total assets minus total liabilities. The actual value of the business can be described as it's net worth. This would form the basis of the sale price and anything paid over this would be considered goodwill.
Working capital	Current assets minus current liabilities. An important point to remember here is that there should be sufficient working capital to cover the business obligations as they fall due.

Table 6.

### 6.3.2 The Income Statement

The income statement also known as the profit and loss account depicts how much profit or loss the business has achieved during the period under question.

The purpose of the income statement is to indicate the profit or loss of the business generally over a period of a year. This is done by comparing revenue received against all the relevant expenses incurred in generating the

sales. The gross profit is determined by taking into account all the actual stock that has been sold. The actual stock that was sold is known as the cost of sales. The cost of sales is determined by adding opening stock to purchases and then subtracting closing stock. Although wear and tear is only an internal transaction in a business it is treated as an expense in the income statement.

The operating expenses of a business are all the expenses incurred in the running of that business. Expenses such as advertising, accounting fees, bank charges, rent, salaries directors remuneration are just a few.

### **6.3.3 Cash Flow Statement**

The cash flow statement provides the reader with the information of where the funds have come from and how the funds have been spent during the financial year under question. The cash flow statement is drawn up by comparing the previous year's balance sheet with the current year's balance sheet and adjusting profits for non-cash items, items such as wear and tear.

The cash flow statement highlights cash generated from basically three areas:

- i.) operating activities
- ii.) investing activities
- iii.) financing activities

The source of the funds are shown to come from:

- i.) profits from operations
- ii.) investment income
- iii.) decreasing of working capital
- iv.) cash injections from members / shareholders or financial institutions

The application of the funds would generally include:

- i.) increase in working capital
- ii.) increase in assets
- iii.) decrease in liabilities

The important aspect of the cash flow statement is that it gives the purchaser the insight into how much money has been injected into the business during the previous year and how it has been spent during the year.

#### **6.4 Warranties and Indemnities**

As has been mentioned throughout the above text, should the purchaser at any time be in-doubt or uncertain about anything in the financial statements of the business / going concern, then he should certainly include either a warranty or an indemnity in the purchase and sale agreement.

##### **Warranties**

A warranty is an undertaking given by the seller to the purchaser that certain circumstances do exist. Warranties should form an important part of a purchase and sale agreement, because the purchaser is relying on the seller's presentation of the financial statements and all other matters relating to the business. Should the warranty be breached the seller must make good the losses suffered by the purchaser.

A sharp purchaser should insist on (and the seller should attempt to resist) warranties when selling/buying the business/going concern. Some of the areas that warranties can cover are:

- i.) partnership agreements
- ii.) business books of record are in order
- iii.) the trust deed for a trust

- iv.) founding statements for a close corporation
- v.) all contractual and statutory obligations have been met
- vi.) all assets are free from any encumbrances or defects
- vii.) all assets are correctly insured and policies are up to date
- viii.) assets are in good working order and condition
- ix.) the company has ownership of the assets
- x.) financial statements are prepared in accordance with the generally accepted accounting practice and fairly present the state of affairs of the company.
- xi.) There are no liabilities other than what is on the balance sheet
- xii.) There are no contracts with employees past or present

The above list is by no means a complete list of what warranties can be built into a purchase and sale agreement, but merely to be used as a guideline when drawing up a purchase and sale agreement.

### **Indemnities**

An indemnity is an undertaking given by the seller to the purchaser that any loss suffered as a result of a breach of contract, including a breach of warranty will be made good by the seller. An indemnity should be insisted on if it is known there is an unquantified outstanding claim such as a legal dispute. The indemnities would include items such as:

- i.) any liability whether actual or contingent arising prior to the effective date and not reflected in the balance sheet
- ii.) any liabilities for taxation not provided for in the financial statements and taxation should include normal tax, vat, all other forms of taxation, taxation arising from reopening of previous tax assessments and any penalties or interest incurred
- iii.) any cost which may be incurred with respect to the above mentioned tax implications.

Those are just a few of the major items which can be looked at when building in an indemnity into a purchase and sale agreement.

### **6.5 A Basic Purchase and Sale Agreement**

Included is a basic balance sheet in order to show what is used from the close corporation and sold as a going concern to a different entity. It must be remembered that what is taken from this close corporation must be able to trade as an entity in order to be considered as a going concern. The purpose of this example is to give an idea of how to set up the purchase and sale agreement and how to structure the selling / purchase price of the going concern. Further to that the purchase and sale agreement also describes how payment is to be carried out.

When structuring a purchase and sale agreement all the above points which have been discussed must be taken into consideration. One must look at the type of entity from which the going concern is being purchased, evaluate whether it is a viable concern to purchase and how to purchase it. Does one purchase the shares or the entity. Alternatively, does one change to another trading entity and if so, what type of entity, a close corporation, a PTY, a trust, a partnership a sole trader. Examine all the possible income tax ramifications, VAT implications, CGT impact at a later date. Establish why the asset or going concern is being purchased, is it to generate an income or to sell on at a later stage.

Establish if at any stage there will be any chance of STC, if so then this could possibly rule out companies making a stronger leaning towards trusts, sole proprietors or partnerships.

Summing up what to look for and what not to do, in order to draw up a purchase and sale agreement as tax effective as possible, one must take cognisance of what was stated in the introduction:

*" Do not allow tax considerations to destroy what could be a good, viable commercial transaction "* (Kruger,D., et al 2003)

Here now is a basic balance sheet of a fictitious company used to illustrate what should be used in a purchase and sale agreement. Also a purchase and sale agreement loosely based upon the purchase and sale agreements found in Butterworths Business Contracts Compendium.

# ABC PRODUCT DISTRIBUTION CC

## BALANCE SHEET

AS AT 29 FEBRUARY 2004

	Notes	2004 R	2003 R
<b>ASSETS</b>			
<b>Non-current assets</b>		2 217 100	1 308 288
Fixed assets		1 265 122	1 108 288
Goodwill		200 000	200 000
Investments		751 978	0
<b>Current assets</b>		4 562 674	4 120 933
Loans receivable		21 000	0
Inventories		0	41 510
Accounts receivable		2 543 410	1 673 108
Bank balances		1 998 264	2 406 315
<b>TOTAL ASSETS</b>		<b>6 779 774</b>	<b>5 429 221</b>
<b>MEMBERS INTEREST AND LIABILITIES</b>			
<b>Members interest and reserves</b>		740 743	119 441
Members interest		100	100
Distributable reserves		740 643	119 341
<b>Non-current liabilities</b>		4 137 419	4 247 983
Member's loans		3 593 145	3 769 029
Long term liabilities		544 274	478 954
<b>Current liabilities</b>			
Accounts payable		1 901 612	1 061 797
<b>TOTAL MEMBER'S INTEREST AND LIAB.</b>		<b>6 779 774</b>	<b>5 429 221</b>

## 6.5.1 MEMORANDUM OF AGREEMENT

Entered into between:

ABC PRODUCT DISTRIBUTION CC

Trading As: Quality Care Products

Of 22 Waterford Crescent

Mayville

(hereinafter called "the seller")

PLINKIES DISTRIBUTION CC

Of 136 Mineral Road

Greystone Park

(hereinafter called "the purchaser")

### **History of business**

The seller at presently carrying on a business at 22 Waterford Crescent, Mayville as the sole distributor for Dixie Products under the name of Quality Care Products. Dixie Products manufacture a range of skin care products known as Soft Skin. The seller has the sole distribution rights both in South Africa and across the borders. The seller does not carry any stocks, as orders come in, the seller places those orders with the manufacturer and within days has the order filled and delivers accordingly. The seller operates a fleet of trucks which transverse the length and breath of South Africa. Monthly trips are also made into surrounding countries in order to fulfil orders. The

fleet of trucks consist of 2 MAN trucks and 4 Ivecos. The business has been trading for the past five years.

## WHEREBY IT IS AGREED AS FOLLOWS:

1 The seller is presently carrying on business at 22 Waterford Crescent, Mayville as a distributor of skin products under the name of Quality Care Products

2 The Seller has agreed to sell and the Purchaser has agreed to purchase the business as a going concern.

### **1 Interpretation**

1.1 In this agreement and in the annexes to this agreement (other than documents/accounts prepared before the date of signature of this agreement)

1.1.1 any gender includes the other genders;

1.1.2 a natural person includes a juristic person and vice versa;

1.1.3 the singular includes the plural and vice versa.

1.2 In this agreement the following expressions bear the meanings assigned to them below and cognate expressions bear corresponding meanings

1.2.1 **"accounting officer"** means the accountant who is responsible for signing off the annual financial statements;

1.2.2 **"accounts receivable"** means the claims of the Seller against all persons who are indebted to the Seller on the effective date and includes all claims which the Seller has against sureties and all bank balances and deposits

- 1.2.3 **"annual financial statements"** means the signed annual financial statements of the Seller relating to the business in respect of the year end (February 2004) prepared in accordance with the generally accepted accounting practice, copies of which are annexed hereto....
- 1.2.4 **"business"** means (Quality Care Products) business carried on by the Seller as a going concern as at the effective date, and includes the business assets.
- 1.2.5 **"business assets"** means all the assets of the Seller used in or in connection with the business comprising -
- 1.2.5.1 business name
  - 1.2.5.2 contracts
  - 1.2.5.3 fixed assets
  - 1.2.5.4 goodwill
- 1.2.6 **"business name"** means the name (Quality Care Products) and any business or trade name in connection with or normally associated with the business on the effective date;
- 1.2.7 **"contracts"** means all agreements of whatsoever nature relating to the business excluding all financial leases, credit agreements, franchises and any partially executed orders and tenders;
- 1.2.8 **"fixed assets"** means all fixed assets of whatsoever nature or kind owned and used by the Seller in or in connection with the business on the effective date, which all assets are listed in annex.....
- 1.2.9 **"goodwill"** means the goodwill attached to the business.

NOW THEREFORE IT IS HEREBY AGREED AS FOLLOWS:

**2 Sale and Purchase** The Seller hereby sells to the Purchaser who hereby purchases at the price and upon the terms and conditions hereinafter mentioned the said business (Quality Care Products) as a going concern.

**3 Effective date** This agreement shall take effect from the close of business on the 30 March 2004 when the assets shall be transferred to the Purchaser and all risk and benefits shall pass:

**4 Assets** The assets of the said business shall comprise:

4.1 the fixtures and fittings presently kept in or about the premises including in particular those articles set out in the schedule hereto in Annex 1;

4.2 the book debt of the said business with a 15% (fifteen percent) provision for bad debts written into the books of ABC Production Distribution CC as at the effective date, the Seller's right and title to which he hereby cedes; assigns and makes over to the Purchaser with effective from the said date;

4.3 all office equipment stationery, ledgers and all other books and documents relating to the business

4.4 all the motor vehicles purchased and used for the purpose of the business in particular those set out in the schedule hereto;

4.5 the goodwill of the said business including the benefit of all existing contracts.

**5 Price** The purchase price of the said assets shall be:

5.1 in respect of the furniture and fittings R61 124 (sixty one thousand one hundred and twenty four rand)

5.2 In respect of the motor vehicles R1 169 345 (one million one hundred and sixty nine thousand three hundred and forty five rand )

- 5.3 in respect of the computer equipment R34 653 (thirty four thousand six hundred and fifty three rand)
- 5.4 in respect of accounts receivable R2 161 899 (two million one hundred and sixty one thousand eight hundred and ninety nine rand)
- 5.5 in respect of goodwill R1 572 979 (one million five hundred and seventy two thousand nine hundred and seventy nine rand)
- 6 **Payment** The purchase price shall be paid as the sum of R 3 500 000 (three million five hundred thousand rand) upon the date of signing this agreement and as to the balance of the purchase price in monthly instalments of R 200 000 (two hundred thousand rand) each, payable on or before the last day of each month commencing on the 30 April 2004. The balance of the purchase price outstanding shall bear interest at 15% (fifteen percent) per annum calculated monthly from the effective date.
- 7 **Liabilities** The Seller shall remain responsible for and shall pay all the debts and liabilities in respect of the said business and shall indemnify the Purchaser from all actions, claims and demands in respect thereof.
- 8 **Reservations** The sale is subject to:
- 8.1 the purchaser obtaining a lease or sublease of the premises upon the terms and conditions as are contained in the Seller's lease, providing that the Purchaser shall be liable for the rent in respect of the effective date.
- 8.2 the Seller will procure the preparation of the financial statements at

the cost of the Seller and copies delivered to the parties within seven days of the effective date.

- 9     **Notice of Sale** The seller hereby undertakes at his own expense to publish the notice of the intended sale of the said business as required in terms of the Insolvency Act
- 10    **Restitution** In the event of the conditions set out in clause 8 hereof not being fulfilled by the 30 April 2004 then the agreement shall be of no further force or effect and the Purchaser shall immediately restore to the Seller all the assets of the said business still in his possession and the Seller shall refund to the Purchaser all amounts of the purchase price and interest.
- 11    **Default** In the event of the Purchaser failing to make payment of any instalment by the due date, or in the event of the Purchaser going insolvent then the whole of the balance outstanding shall become due and payable forthwith.
- 12    **Costs** The costs of the preparation of this agreement including stamp duty shall be borne by both parties in equal shares.
- 13    **Value Added Tax**
- 13.1   The business is sold as a going concern.
- 13.2   The business will be an income earning activity at the time of transfer.
- 13.3   The assets necessary for the carrying on of the business will be transferred to the purchaser.

13.4 The purchase consideration includes value added tax at the rate of zero percent

13.5 In the event that the sale is subject to value added tax at the standard rate, the Seller is entitled to recover the value added tax so payable from the Purchaser.

SIGNED at Durban on 31 March 2004

Witnesses:

1.....

2.....

(Signatures of witnesses)

.....

(Signature of seller)

Witnesses:

1.....

2.....

(Signature of witnesses)

.....

(Signature of purchaser)

**6.5.2 ANNEXURE 1**  
**SCHEDULE OF ASSETS**

**Furniture and Fittings**

Oak Desk	6 200
Reception Desk	4 800
Standard desks x3	4 500
High back executive chair	1 200
Office typists chairs x 4	1 400
Lounge suite	8 326
Coffee tables x 4	1 976
Filing cabinets x 6	6 300
Stationery cabinets x 3	6 100
Shelving units x 3	5 400
Office partitions	7 922
Pictures	3 641
Carpeting	3 359

**Motor Vehicles**

MAN Truck x 2	650 000
Iveco Trucks x 4	519 345

**Computer equipment**

Computers x 4	21 924
Printers x 4	5 800
Photo copier	6 929

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