Discussion paper on the assumption of contingent liabilities in a going concern acquisition

SARS released the above discussion paper in December 2013 and it was open for comment to 31 March 2014.

It deals with the treatment of so-called ‘free-standing’ contingent liabilities from the points of view of the seller as well as the purchaser, where the contingent liabilities are assumed by the purchaser as part settlement of the purchase price for the acquisition of the assets of a going concern.

It distinguishes between valuation provisions, ‘embedded’ obligations and free-standing contingent liabilities. A valuation provision, for example a provision for doubtful debts and an embedded obligation, for example the statutory duty to reforest timber plantations after harvesting, have an impact on the market value of the asset to which they are attached. On the other hand a free-standing contingent liability, for example a bonus provision or post-retirement medical aid provision, is a distinct obligation which is separately identifiable and is not embedded in an asset that is separately recognised for tax purposes. This type of contingent liability does not have an impact on the market value of an asset recognised for tax purposes.

It is important to realise that a business as a whole is not recognised as a single asset for income tax purposes. Therefore, according to the paper, allocation of the purchase price needs to be made against each individual asset.

An important viewpoint of the paper is that when the purchase price of assets is partly settled by an amount paid in cash and partly by the purchaser assuming a free-standing contingent liability, the seller is entitled to two ‘things’ from the purchaser for the sale of the assets, namely, the cash and the benefit of being relieved from the obligation to settle the free-standing contingent liability if and when it becomes unconditional in the future. The amount of the cash received and the amount of the benefit received must be brought into account for tax purposes. Generally the free-standing contingent liability is valued at the face value of the amount negotiated and stipulated in the agreement of sale. In reaching the agreed amount the seller and purchaser may have incorporated an element of discounting. However the agreed amount is not subject to any further discounting for income tax purposes.

The paper reaches the conclusion that the seller must account for the above amount as additional proceeds immediately i.e. on conclusion of the agreement of purchase. In circumstances where the purchase price is reduced by the value of the contingent liabilities the seller will not have incurred any expenditure as a result of the reduction in proceeds. This principle is in accordance with Ackermans Ltd v CSARS .

The paper takes the stance that the contingent liabilities are assumed by the purchaser as a means to settling or partly settling the purchase price for the assets acquired and as such is directly related to the acquisition of the assets. Given the scope of the discussion paper, this statement is obvious. It is however unlikely to apply to every assumption of a free-standing contingent liability by the purchaser of a business. For example, one of the reasons for acquiring a business may be the quality of the workforce. The workforce is however unlikely to appear on the list of ‘assets’ acquired as part of the business.

In contrast with the immediate income tax implications that arise for the seller, the purchase is only entitled to a deduction when and if the contingent liability becomes unconditional. Therefore, if and when the contingent liability becomes unconditional, the amount incurred must be allocated among the assets acquired. This can for example increase the amount available for purposes of capital allowances or the cost of stock.

Below we have included the worked example taken from the Appendix to the paper.

Annexure A – Example

X and Y enter into an agreement of sale under which X acquires the assets detailed in the table below. The assets constitute the acquisition of a business as a going concern.

Asset	**Purchase price**
	R
Bank account	50 000
Debtors (expected to be fully recoverable, no provision for doubtful debts)	50 000
Trading Stock	200 000
Computers	150 000
Plant and Machinery	400 000
Goodwill	250 000
Total purchase price	**1 100 000**

The purchase price is to be discharged by a cash consideration of R120 000 and X will assume responsibility for settling the trade creditors balance of R160 000 and the contingent warranty liability of R820 000 (to the extent it materialises in the future). X determines that the cash and the assumption of the trade creditor and contingent warranty liability will be allocated to bank, debtors, trading stock, computers, plant and machinery and goodwill. That is, the cash of R120 000 will be allocated to bank (R50 000), debtors (R50 000) and trading stock (R20 000); the trade creditors of R160 000 will be allocated to trading stock and the contingent warranty liability will be allocated to trading stock (R20 000), computers (R150 000), plant and machinery (R400 000) and goodwill (R250 000).

Seller – tax considerations as at the date of sale

Asset	**Purchase price**	**Tax impact**
	R	
Bank account	50 000	No gain or loss – purchase price equal to base cost.
Debtors (expected to be fully recoverable, no provision for doubtful debts)	50 000	Proceeds of R50 000 – sold at original face value therefore no gain or loss on disposal.
		a) a recoupment/revenue loss [section 8(4)(a) and section 11(o)] and
		b) a capital gain (Eighth Schedule).
Plant and Machinery	400 000	Proceeds of R400 000 – consider whether there is –
		a) a recoupment/revenue loss [section 8(4)(a) and section 11(o)] and
		b) a capital gain (Eighth schedule).

Goodwill	250 000	Proceeds of R250 000, internally generated and no base cost Therefore a capital gain of. R250 000.
Contingent warranty liability		No expenditure has been incurred as at date of sale – no deduction.

Purchaser – tax considerations as at the date of sale

Asset	Purchase price	Tax impact
	R	
Cash	50 000	N/A
Debtors (expected to be fully recoverable, no provision for doubtful debts)	50 000	N/A
Trading Stock	200 000	Expenditure incurred and deductible under section 11(a) at the date of transaction equals R180 000 (cash R20 000 and trade creditors R160 000). R20 000 is not deductible because as at the date of sale the expenditure has not yet been incurred.*

Computers	150 000	As at date of sale the Purchaser has not incurred expenditure and will not qualify for the section 11(e) allowance.*
Plant and Machinery	400 000	As at the date of sale the Purchaser has not incurred expenditure and will not qualify for section 12C allowance.*
Goodwill	250 000	As at the date of sale the Purchaser has not incurred expenditure and will not have base cost at that date.*

* If the free-standing contingent liability materialises and X incurs expenditure in settling it, X must consider whether X is entitled to a deduction or allowance under section 11(a), section 11(e) and section 12C as appropriate, taking into account that the expenditure was incurred partly for the settlement of the purchase price allocated to trading stock, computers, plant and machinery and goodwill, in that order.

The amount of expenditure actually incurred is the amount which is taken into account – if the amount of expenditure actually incurred is less than the amount of the free-standing contingent liability as valued at the date of sale then X will be limited to the amount of expenditure actually incurred; if the amount of expenditure actually incurred is more than the amount of the free-standing contingent liability (as valued at the date of sale) it means the assets were more expensive than X originally envisaged and X may take the actual amount of expenditure incurred into account when determining what allowances and deductions are available.