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Assumption of contingent liabilities in restructuring transactions

The tax treatment of contingent liabilities transferred and assumed as part of disposing of a business has been contentious for a number of years. Interpretation Note 94 provides clarity about SARS' views in this regard. Two recent rulings that deal with transactions where the corporate rules apply and the transferee assumes contingent liabilities from the transferor would suggest that some interpretation risk or uncertainty may still exist in this context.

The Income Tax Act contains a number of special rules, often referred to as the corporate rules, to facilitate certain restructuring arrangements in a tax neutral manner. These rules were amended in 2017 by the addition of a definition of debt, which specifically includes a contingent liability. Two recent binding private rulings deal with the assumption of contingent liabilities in such transactions and the impact thereof for the party that assumed it.

Background

A number of the corporate rules provide relief where one party to the transaction (*transferee*) assumes certain liabilities (including contingent liabilities) from the other (*transferor*) as consideration in exchange for the transferee acquiring assets from the transferor. One example of such a rule is found in section 42(8).

While the addition of the definition of debt has provided certainty as to whether the disposal of the assets qualifies for relief in terms of the corporate rules, it does not address the deductibility of expenditure incurred in respect of these contingent liabilities when they eventually materialise and the transferee makes payment.

Rulings issued

Binding Private Rulings 317 (BPR317) and 319 (BPR319) deal with transactions where a going concern is disposed of in terms of a transaction that qualifies for relief under the corporate rules. The proposed transactions considered in both rulings involve that the purchaser of the business (transferee) assumes contingent liabilities from the seller (transferor) in exchange for the assets of the business. In BGR317 the nature of the contingent liabilities is not specified, while BGR319 indicates that the contingent liabilities related to leave pay and future staff incentive bonuses.

Both rulings indicate that the transferee will be entitled to claim deductions for these contingent liabilities when they materialise and the resulting expenditure is incurred.

Analysis

The tax treatment of contingent liabilities transferred by the seller of a business and assumed by the purchaser has been contentious for a number of years, as highlighted in *Ackermans Ltd v C:SARS* in 2010. Interpretation Note 94 (IN94) provides some guidance.

SARS' views in IN94 indicate that it is unlikely that the seller (who transfers the contingent liability) will incur expenditure in respect of such a contingent liability prior to transfer, but this may depend on how the assumption has been structured (see para 5.2.3. of IN94). From the purchaser's perspective, the expenditure incurred in respect of the contingent liability will be incurred to acquire the business (assets) and its deductibility should be considered as part of the cost of the assets.

In the context of transactions where the corporate rules are applied, the historical cost of the assets would generally be transferred to the transferee. As a result, the contingent liability assumed will not reflect in this cost. In this regard, SARS states in IN94:

> "… the expenditure that is incurred by the transferee when the free-standing contingent liability materialises must be evaluated within the context of the nature of the going concern business as carried on by the transferor before the transfer and by the transferee after the transfer. In making such an evaluation no regard must be had to the fact that the assumption of the contingent liabilities by the transferee was part of the consideration for the acquisition of the assets. The circumstances under which the free-standing contingent liability arose in the hands of the transferor as well as the transferee must therefore be taken into account in determining the deductibility of the expenditure."

This view appears to extend the treatment of the two taxpayers involved to be the same person to the deductibility of this expenditure. While this makes sense in principle, it is quite difficult to find support for this position in terms of the current wording of the law. The recent rulings may suggest that there is still some interpretation risk and uncertainty in this regard.