CANCELLATION OF CONTRACTS

Parties wishing to cancel a contract should try to do so within the same year of assessment as it was entered into, to avoid adverse cash-flow consequences.

The Taxation Laws Amendment Act, 2015, introduced a number of amendments to, *inter alia*, certain sections of the Income Tax Act, 1962 (the Act), and certain paragraphs of the Eighth Schedule to the Act in order to address the cancellation of contracts. These amendments came into effect on 1 January 2016.

The principle underlying these amendments is that prior year assessments cannot be reopened to take account of subsequent events.

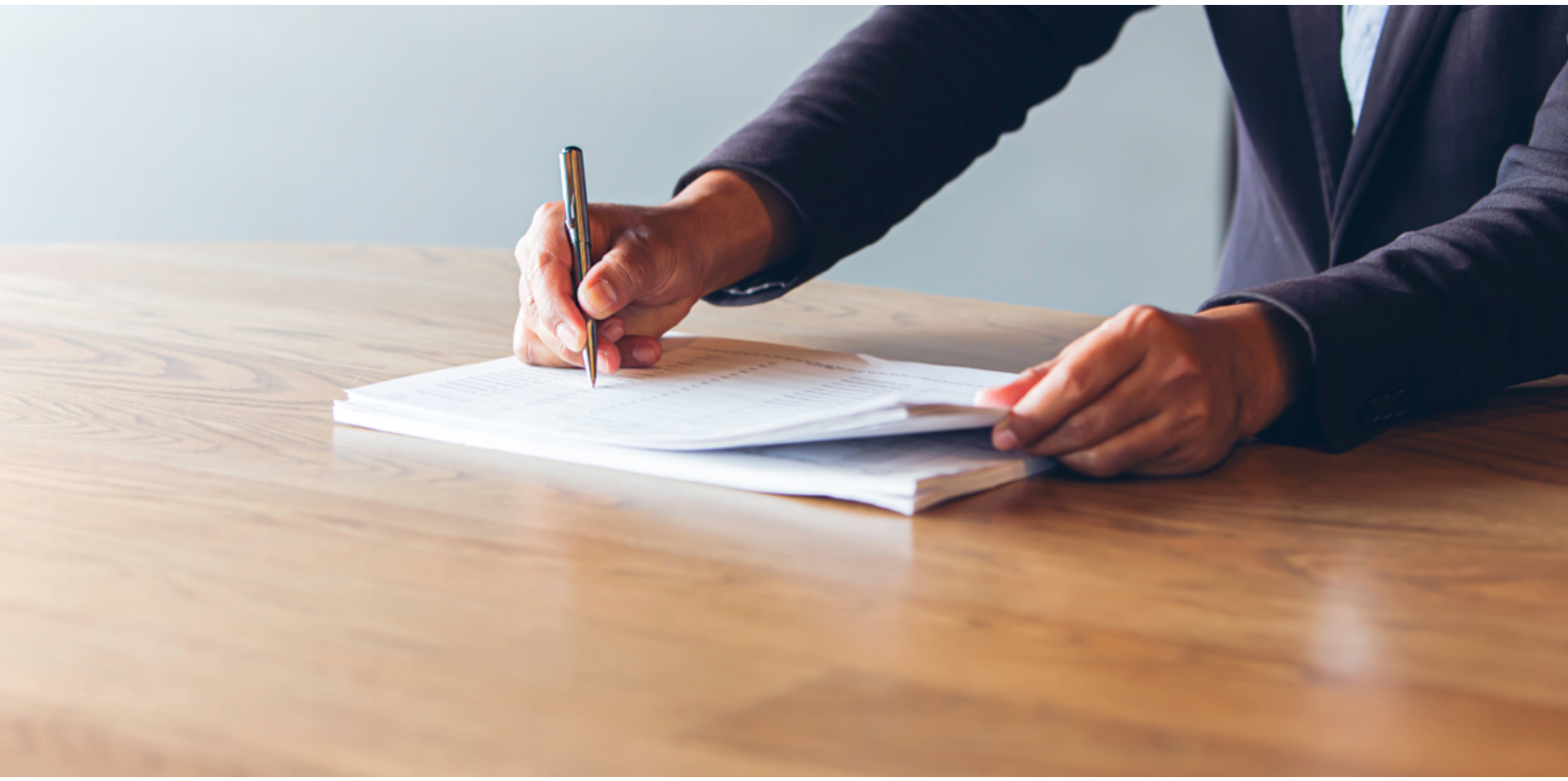
In *Caltex Oil (SA) Ltd v Secretary for Inland Revenue*, [1975], Botha JA stated the following at paragraph 15:

> "What is clear, I think, is that events which may have an effect upon a taxpayer's liability to normal tax are relevant only in determining his tax liability in respect of the fiscal year in which they occur, and cannot be relied upon to redetermine such liability in respect of a fiscal year in the past."

The taxpayer in *New Adventure Shelf 122 (Pty) Ltd v Commissioner for South African Revenue Service*, [2017], learned this lesson the hard way when it lost its appeal to the Supreme Court of Appeal (SCA). The company had sold immovable property in 2007. It cancelled the contract in 2012 and reacquired the property. The SCA rejected its bid to have the capital gain that arose in 2007 redetermined retrospectively.

When an agreement is cancelled –

- in the same year of assessment, paragraph 11(2)*(o)* of the Eighth Schedule provides that the disposal must be disregarded, provided that the parties are restored to the same position as before the agreement; and



- in a subsequent year of assessment, a capital gain recognised in the year of disposal is reversed as a capital loss under paragraph 4*(c)* of the Eighth Schedule in the year of cancellation, while a capital loss arising in the year of disposal is reversed as a capital gain in the year of cancellation under paragraph 3*(c)*.

Under paragraph 20(4) of the Eighth Schedule, the seller's base cost is restored to its pre-sale amount plus the cost of reimbursing the buyer for any improvements effected by the buyer. It would appear that paragraph 20(4) applies to a cancellation during the same year of assessment as well as one that occurs in a year of assessment subsequent to the year of disposal.

It will be evident that the legislature made no provision for the reopening of assessments to reverse the consequences. There are in fact very few situations in the Act in which a reopening of an assessment to give effect to a subsequent event is possible.

One exception to this rule appears to be when an executor disposes of an asset, which had been bequeathed to the surviving spouse, to a third party. In this situation, the roll-over under section 9HA(2) of the Act, read with section 25(4), becomes inapplicable. It may be necessary to reopen the deceased's last tax return to recognise the deemed disposal at market value.

A similar result may ensue when a surviving spouse enters into a redistribution agreement because the asset he or she ultimately acquired may not be what was bequeathed to him or her. It is unsatisfactory that future events are allowed to influence how the deceased person will be taxed.

Agreement

Claassen's Dictionary of Legal Words and Phrases defines an agreement as follows:

> "A contract is an agreement between two or more persons which gives rise to personal rights and corresponding obligations; in other words, it is an agreement which is legally binding and enforceable by the parties (*Wille's Principles of South African Law* 6ed 301); *Wilken v Kohler* 1913 AD 135 140; *Pattison v Fell* 1963 3 SA 277 (N) 279."

It is worth bearing in mind that the articles of association of a company (now incorporated into a company's Memorandum of Incorporation) represent a contract between the members and the company (see *Hickman v Kent or Romney Marsh Sheep-breeders' Association*, [1915]). This fact can be relevant when dealing with agreements involving the cancellation of share transactions.

Return of the same asset

Paragraph 11(2)*(o)* requires that the person that disposed of the asset reacquire "that asset". In other words, the disposer must be restored with the same asset.

A question arises as to how this will be possible, for example, with identical assets such as dematerialised shares. The Eighth Schedule is concerned with the disposal and reacquisition of rights. In *Standard Bank of South Africa Ltd and Another v Ocean Commodities Inc and Others*, [1983], Corbett JA stated the following (at 288):

> "A share in a company consists of a bundle, or conglomerate, of personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends."

It is submitted that as long as a shareholder receives a share with rights that are identical to those of the share disposed of, the shareholder would have met the "same asset" requirement.

In practice, SARS accepts that the specific identification method can be used in relation to dematerialised shares under paragraph 32 on a nomination basis. In SARS' *Comprehensive Guide to Capital Gains Tax* (Issue 9) it is stated in chapter 8.36.2 ("Permissible methods for determining base cost of identical assets") that dematerialised shares can be identified by date of acquisition and cost. This approach by SARS recognises the fungible nature of dematerialised shares.

What constitutes a cancellation?

Sometimes an agreement will contain a cancellation clause which may be triggered by a resolutive condition. For example, section 24N(2)*(d)* of the Act enables a capital gain to be recognised on a due and payable basis, subject to a number of conditions, one of which is that the purchaser of equity shares must return them "in the event of failure by the purchaser to pay any amount when due".

But contracts can also be cancelled by agreement. *Christie's Law of Contract in South Africa* states the following (at pages 506–507):

"Both paragraphs 11(2)*(o)* and 20(4) require the parties to be restored to the position they were in prior to entering into the agreement but do not give any indication when this will be regarded as having occurred."

> "When the parties to an existing contract come together in an agreeing frame of mind and formally, or informally, agree to vary or discharge their contract we have no difficulty about describing what has happened as a variation or discharge by agreement, or a cancellation by agreement."

What constitutes restoration to the position prior to entering into the agreement?

Both paragraphs 11(2)*(o)* and 20(4) require the parties to be restored to the position they were in prior to entering into the agreement but do not give any indication when this will be regarded as having occurred. However, paragraph 20(4) recognises that the buyer may improve the asset while holding it and permits the seller's original base cost to be increased by any expenditure the seller incurred in reimbursing the buyer for improvements. This rule recognises that improvements to an asset can be made before it is returned to the seller.

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2015*, which supported the insertion of paragraph 11(2)*(o)*, does not provide any comment on the restoration requirement.

One of the common-law remedies available under contract law is *restitutio in integrum.* This is described in the *Glossary of Foreign Terms* (RD Claassen: June 2020), which forms part of the index to the South African Tax Cases Reports, as follows:

> "Restitution in full, by which the parties to a contract are restored to the same position as they occupied before the contract was entered into."

It was no doubt with this remedy in mind that paragraphs 11(2)*(o)* and 20(4) were drafted.

In *Hall-Thermotank Natal (Pty) Ltd v Hardman*, [1968], the court cited *Wessels, Law of Contract* (2 ed (1951) at 4742) as follows:

> "Although there must be restitution, and although the parties must be placed as much as possible in the position in which they were before the sale, yet a *restitutio in integrum* in the case of sale does not imply that the article must always be restored in exactly the same condition in which it was at the moment of delivery. As the fault is due to the seller the court ought to give considerable latitude to the buyer. All the latter need therefore to do is to restore the article subject to such incidents as it may be liable to in the ordinary course of affairs, either from its inherent nature or from the legitimate use to which the buyer put it prior to the discovery of the defect. The very contract of sale gives the purchaser the right to deal with the thing bought, and if it deteriorates in the hands of the buyer whilst making a reasonable use or trial of it, the reduction in value resulting from such depreciation must be borne by the seller, and does not preclude a *restitutio in integrum*."

The same quote is cited in *Van Der Boon NO v Moletsane*, [2020] (at 6).

On the question of unjust enrichment, the court in the *Hall-Thermotank Natal* case observed as follows (at 832):

> "The basis of *restitutio in integrum* is the equitable doctrine that no one is permitted to enrich himself unjustly at the expense of another."

While the case dealt with a seller who was at fault, which may not always be applicable, the case is useful in that it emphasises the point that the asset need not be in exactly the same condition as when it was first acquired. It stands to reason that most assets would experience some change in value or condition.

If the application of paragraph 11(2)*(o)* or 20(4) is prevented when these changes are of a minor nature, it would not advance the purpose of the provision, which was to avoid onerous tax consequences for a seller who was restored to the same economic position.

A minor change in value would not amount to an unjust enrichment that results in the parties not being restored to their pre-sale position.

In *Natal Joint Municipal Pension Fund v Endumeni Municipality*, [2012], Wallis JA stated the following in relation to the interpretation of statutes or contracts (at 604):

> "A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document."

He continued (at 610):

> "An interpretation will not be given that leads to impractical, unbusinesslike or oppressive consequences or that will stultify the broader operation of the legislation or contract under consideration."

Conclusion

If parties to a contract wish to cancel it, they should try to do so during the same year of assessment in order to take advantage of paragraph 11(2)*(o)*. Cancelling the contract in a subsequent year of assessment will not help to undo the adverse cash-flow consequences of paying tax upfront and then being rewarded with a capital loss in the year of cancellation. Whether the parties have been restored to the position they were in prior to entering into the agreement is a question of fact, but the common-law remedy of *restitutio in integrum* at least offers some flexibility in the interpretation of the cancellation provisions of the Eighth Schedule.

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Acts and Bills

- Income Tax Act 58 of 1962: Sections 9HA(2), 24N(2)*(d)* & 25(4); Eighth Schedule: Paragraphs 3*(c)*, 4*(c)*, 11(2)*(o)*, 20(4) & 32;
- Taxation Laws Amendment Act 25 of 2015.

Other Documents

- *Claassen's Dictionary of Legal Words and Phrases* RD Claassen [online] (My LexisNexis: June 2020);
- *Wille's Principles of South African Law* 6ed 301;
- *Christie's Law of Contract in South Africa (*G Bradfield 7 ed (2016) (at pages 506&507) [online] (My LexisNexis: 31 December 2015);
- *Glossary of Foreign Terms*, RD Claassen [online] (My LexisNexis: June 2020);
- South African Tax Cases Reports; Index;
- *Wessels, Law of Contract* 2 ed (1951) (at 4742);
- SARS' *Comprehensive Guide to Capital Gains Tax* (Issue 9) (paragraph 8.36.2) (issued on 5 November 2020).

Cases

- *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* [1975] (1) SA 665 (A); 37 SATC 1 (at 15);
- *New Adventure Shelf 122 (Pty) Ltd v Commissioner for South African Revenue Service* [2017] (5) SA 94 (SCA), 2 All SA 784 (SCA), 79 SATC 233;
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] (4) SA 593 (SCA);
- *Wilken v Kohler* [1913] AD 135 (at 140);
- *Pattinson and Another v Fell and Another* [1963] (3) SA 277 (D) (at 279);
- *Hickman v Kent or Romney Marsh Sheep-breeders' Association* [1915] 1 Ch 881 (at 900);
- *Standard Bank of South Africa Ltd and Another v Ocean Commodities Inc and Others* [1983] (1) SA 276 (A) (at 288);
- *Hall-Thermotank Natal (Pty) Ltd v Hardman* [1968] (4) SA 818 (D);
- *Van Der Boon NO v Moletsane* [2020] JDR 2499 (FB) (at 6).

Tags: redistribution agreement; dematerialised shares; resolutive condition; *restitutio in integrum.*