

INTERPRETATION NOTE 140

DATE: 31 October 2025

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTION 23(e)
SUBJECT : THE MEANING OF RESERVE FUND UNDER SECTION 23(e)

Preamble

In this Note unless the context indicates otherwise –

- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Purpose

This Note considers the meaning of “reserve fund” for purposes of section 23(e).

2. Background

The general deduction formula under the Act to determine a person’s taxable income derived from carrying on any trade consists of a positive test in section 11(a) as well as a negative test in section 23. These two sections must be read together in order to determine whether a taxpayer will be entitled to a general deduction. Section 23(e) prohibits specifically any deduction relating to income carried to any reserve fund or capitalised in any way.

It is a common practice for businesses to establish a reserve fund for future costs and financial obligations. It further is generally accepted accounting practice to create a provision for contingent or anticipated liabilities.

This Note considers the meaning of reserve fund as envisaged in section 23(e). Other provisions in the Act that allow specifically for the deduction of a reserve in certain circumstances are listed but not considered in detail in this Note.

Owing to the specific terms of different types of insurance policies, this Note does not consider whether so-called self-insurance policies may be considered to be a reserve fund. The interpretation and application of section 23L are also beyond the scope of this Note.

3. The law

Section 23(e) of the Act reads as follows:

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

(e) income carried to any reserve fund or capitalized in any way;

4. Application of the law

In determining a person's taxable income derived from carrying on any trade, section 11(a) provides a deduction for –

- expenditure and losses,
- actually incurred,
- in the production of income,
- which is not of a capital nature.

In addition, expenditure and losses must be claimed during the year of assessment in which they are actually incurred.

A reserve fund is generally created to meet future contingent costs or financial obligations, especially those arising unexpectedly. The creation of a reserve fund and the transfer of income to such a fund therefore does not amount to expenditure or loss actually incurred. It is also not an expense incurred during that year of assessment. In addition, should section 11(a) be inconclusive, section 23(e) further prohibits the deduction of any income carried to a reserve fund or capitalised in any way.

Section 23(e) applies only when income is transferred to a reserve fund. The term “income” is defined in section 1(1) as “the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II”. The Court held in ITC 1839¹ that expenditure that was reserved is clearly not income. In the context of section 23(e), “income” may have a wider meaning and not merely be limited to “income” as defined in section 1(1). In ITC 343² commission was erroneously received as income in one year of assessment and the taxpayer transferred it to a reserve the following year. The court found that the amount so transferred was still not allowed as a deduction despite it not accruing to the taxpayer.

For purposes of gross income, an amount is received by a taxpayer only if it is received on behalf and for the benefit of the taxpayer.³ An amount received by a taxpayer on behalf of another person is therefore not included in gross income and will not be income for the purpose of section 23(e).⁴

¹ 72 SATC 61 at 73.

² 8 SATC 370.

³ *Ochberg v CIR* 5 SATC 93 and *Geldenhuijs v CIR* 14 SATC 419.

⁴ See Interpretation Note 117 “Taxation of the Receipt of Deposits”, available at www.sars.gov.za, for a consideration of “received by” and the treatment of various forms of deposits.

The Act, however, provides for the deduction of a reserve in specified circumstances. Examples of these specific statutory reserves that are not covered under section 23(e) are –

- doubtful debts (section 11(j));
- an amount paid in the form of a lump sum by an employer under a policy of insurance with an insurer in relation to former employees or dependants for purposes of making a contribution to a medical scheme or fund (section 12M);
- traders that are permitted to deduct from income unrealised losses on trading stock on hand at the end of the year of assessment when the market value of the stock has fallen below cost (section 22);
- the special allowance made for credit agreements (section 24);
- the allowance for contingent development expenditure granted to township owners (section 24);
- the deduction of “future expenditure” on contracts (section 24C);
- the deduction of expenditure on repairs to ships (section 24P);
- the transfer by a vereniging⁵ of its profits to a price stabilisation fund for distribution to its members [section 27(2)(h)];
- the deduction of reserves for unexpired risks and unpaid claims, whether intimated or not, granted to short-term insurers (section 28);
- a farmer that disposed of any livestock because of drought and the whole or any portion of the proceeds of such disposal is deposited in an account in the farmer’s name with the Land Bank (paragraph 13A of the First Schedule to the Act).

4.1 Meaning of reserve fund

In determining whether any income⁶ carried to a reserve fund is deductible or prohibited under section 23(e), it is necessary to establish the meaning of “reserve fund” envisaged in section 23(e). Since the Act does not define “reserve fund”, the expression must be interpreted according to its ordinary meaning as applied to the subject matter with regard to which it is used.⁷

The *Cambridge English Dictionary*⁸ describes a reserve fund as:

“money that is kept by an organisation to pay for something that may happen in the future”.

The *Free Dictionary*⁹ describes a reserve fund as:

“funds taken out of earnings to provide for anticipated future payments”

⁵ As defined in section 1 of the Wine and Spirit Control Act 47 of 1970.

⁶ See 4.

⁷ Kellaway, EA (1995) *Principles of Legal Interpretation of Statutes, Contracts and Wills* at 224. Butterworths.

⁸ <https://dictionary.cambridge.org/dictionary/english/reserve-fund> [Accessed 31 October 2025].

⁹ www.freedictionary.org [Accessed 31 October 2025].

The word “reserve” is sometimes used as a synonym for “reserve fund”. According to *Dictionary.com*,¹⁰ “reserve” is defined as:

“cash, or assets readily convertible into cash, held aside, as by a corporation, bank, state or national government etc, to meet expected or unexpected demands; something kept or stored for use or need; a resource not normally called upon but available if needed.”

In ITC 343¹¹ it was held that a reserve is equal to a reserve fund. In this case the taxpayer was informed that a company had paid certain commission money *ultra vires* to it. The taxpayer consequently agreed to refund the commission paid to it if repayment was demanded. The taxpayer proceeded to place the amount of commission so earned to a reserve account. The amount of this reserve was claimed as a deduction in the determination of its taxable income. This deduction was disallowed and on appeal it was held by the court that carrying income to a reserve is not to be distinguished from carrying income to a reserve fund so as to take such a case out of the prohibition imposed by the specific section of the Act.

4.2 Judicial consideration of reserve funds

The Act’s predecessors¹² had provisions that prohibited a deduction of income carried to a reserve fund similarly to that in section 23(e). Those earlier provisions were considered in a number of court cases.¹³

The taxpayer in ITC 183¹⁴ carried on business as a motor garage proprietor. He claimed to deduct, amongst others, in the determination of his taxable income reserves for servicing cars. Under the sales agreements under which the taxpayer disposed of cars, he guaranteed the car for a period of 12 months. During this period, he undertook to replace any defective part and to supply at his garage free service by mechanics in making adjustments or replacements. It was estimated that this contingent liability amounted to £15 in respect of each car sold. The court confirmed that as the cost of servicing was allowed as and when the service was rendered, and the Act specifically prohibited the deduction of amounts carried to any reserve fund, the claim for the reserve fund was not admissible.

In ITC 423¹⁵ the taxpayer’s main business consisted of the supply of certain perishable goods under contracts entered into with various large consumers. Under those contracts, the taxpayer undertook to fulfil, at a specified flat rate price during the whole periods of the contracts, all orders placed with it by such consumers. Owing to the nature of the goods it was impossible for the taxpayer to purchase or carry reserve supplies, and in order to fulfil orders under the contracts the taxpayer purchased the goods from time-to-time in the open market at current market rates. The market rates for these goods fluctuated seasonally and were normally much lower in the first half of the year than in the second. While the flat rate prices payable by the consumers over the whole year permitted a profit to the taxpayer on the year’s working, the year’s profit would necessarily represent the amount by which the profit in the first half of the year exceeded the loss in the second half of the year. The taxpayer sought to deduct a certain amount, being a round figure estimate made, as provision for liability in respect

¹⁰ www.dictionary.com/browse/reserve [Accessed 14 February 2025].

¹¹ 8 SATC 370.

¹² Section 12(e) of Income Tax Act 40 of 1925 as well as section 12(e) of the Income Tax Act 31 of 1941.

¹³ Some of the judgements precede the introduction of, for example section 24C, that may currently provide for relief.

¹⁴ (1930) 5 SATC 262.

¹⁵ (1938) 10 SATC 335.

of uncompleted contracts. The court held that the deduction claimed, being the amount carried to reserve to meet **anticipated losses**, was prohibited by the Act which provided that no deduction shall be made in respect of income carried to any reserve fund or capitalised in anyway.

In ITC 505¹⁶ the taxpayer hired certain machinery under leases, which provided for the payment of a monthly rental and on the expiration or earlier termination of the lease from any cause, a stipulated sum by way of what was described as additional rent. During the year of assessment, the taxpayer deducted an amount credited to an account named return payment reserve. The amount was merely the creation of a reserve to meet the future liability under the leases in respect of additional rent. It was held that the sum claimed could not be deducted.

The taxpayer in the case of *Pyott Ltd v CIR*¹⁷ sold both the commodity and the container in which it is packed subject to an obligation to repurchase the containers when these are returned by customers. The taxpayer made provision for refunds on the return of containers. The court held that the amount received for the containers constituted cash, which was not subject to any reduction or discounting and therefore had to be included in the gross income of the taxpayer at its full value, while the provision made to meet future claims for refund on the return of containers constituted a reserve for a contingent liability, which was expressly forbidden. In this regard the court¹⁸ held as follows:

“The second part of the third question raises the point whether this “provision” is not in conflict with sec 12(e) of the Act, which forbids any deduction in respect of “income carried to any reserve fund . . .” in my opinion it is, as soon as it is found to have been made out of “income”, as it undoubtedly was made in the present case. It is a reserve out of income to provide for a contingent liability, and, as such, it seems to me to be the very thing which is forbidden by the sub-section in question.”

It was the practice of the taxpayer in ITC 684¹⁹ to purchase on local auction markets, on orders received from overseas customers, wool of the uncleaned, unscoured and greasy types. In determining the price at which a consignment of wool so purchased was to be charged to the overseas customers, it was necessary to estimate the probable weight of clean wool which would be derived from the consignment after the process of cleaning and scouring had been completed, the price for the consignment then being charged out according to an agreed price per pound of clean wool. If the amount of the price so estimated should prove to be incorrect by more than 1% on determination of the true clean wool content of a consignment, the necessary adjustment one way or the other was made between the parties. In the accounts submitted by the taxpayer in support of its returns of income, certain amounts were set aside and transferred to a contingency account as a provision against possible under yields on wool shipped to overseas buyers in accordance with these arrangements. It was held that in the absence of any specific provision in the Act for the making of an allowance for a reserve created to meet a contingency of this kind and having regard to the specific section of the Act prohibiting any deduction relating to income carried to a reserve fund, the deductions claimed were not allowable.

¹⁶ (1941) 12 SATC 160.

¹⁷ 1945 AD 128, 13 SATC 121.

¹⁸ 1945 AD 128, 13 SATC 121 at 127.

¹⁹ ITC 684 (1949) 16 SATC 368.

The current section 23(e) was also considered in a number of court cases. The same approach followed under the previous similar provisions is also applied to the current law.

The Court stated in ITC 1839:²⁰

“Section 23(e) provides that no deduction shall be made in respect of ‘income carried to any reserve fund or capitalised in any way’. Mr *Bhana* submitted that, precisely by reason of the fact that the relevant amount related to provisions for expenditure which had not, at the time (1 March 2004), actually been incurred, it has been capitalised. The court does not understand Mr *Bhana*’s submissions as the instant matter does not involve the carrying of income to a reserve fund or capitalisation of income. The matter before the court is whether certain expenditure is deductible. Expenditure is clearly not income.”

In *C:SARS v Big G Restaurants (Pty) Ltd*²¹ the Supreme Court of Appeal confirmed the legal position by stating the following:

“Section 24C constitutes an exception to the general prohibition contained in s 23(e) of the Act, which provides that no deduction shall in any case be made in respect of income carried to any reserve fund or capitalised in any way.”

4.3 A reserve fund to be distinguished from other instruments

An important characteristic of a reserve fund is that the taxpayer can easily access the fund to use it for the intended purpose or any other purpose, anticipated or unexpected, that may arise.

A reserve fund is normally a separate savings account or other highly liquid asset. There are no guidelines or restrictions under the Act governing the use of a reserve fund, however, by its nature, the reserve fund is required to be easily accessible. The extent of that access would depend on the type of account created to house that fund and the facts of each case should be carefully considered.

The reserve fund can be distinguished from, for example, a trust account, which is set up on behalf of a third party for the benefit of that third party, to which the taxpayer has access. However, the funds in a trust account do not accrue to the taxpayer.

In some cases taxpayers take out a policy from an insurer instead of creating its own reserve fund. Often the risk assessment is based on arbitrary estimates. Under such policy the lump sum premium is normally held by the insurer in an experience or similar account generating interest for the benefit of the taxpayer. Under these policies the control and management arising from it are normally exercised by the insurer and the insurer has minimal insurance risk. The taxpayer is normally entitled to the balance of the funds at the end of the term of the policy or at termination of the policy. Depending on its terms, the policy might in legal substance be considered to be a reserve fund. The terms and conditions of each insurance policy will have to be considered to evaluate whether such a policy falls within the ambit of section 23(e).²²

²⁰ 72 SATC 61 at 73.

²¹ 2019 (3) SA 90 (SCA), 81 SATC 185 at 191.

²² Due to the complex nature of insurance policies it is not the purpose of this Note to consider the various scenarios or factors indicating that the policy is in substance a reserve fund. The interpretation and application of section 23L are also beyond the scope of this Note.

The above type of insurance policy should be distinguished from an insurance policy taken out to cover specified contingencies or events and in which case the insurer undertakes significant insurance risk. The latter type of insurance policy taken out from an insurer may not be affected by section 23(e). The terms and conditions of each policy must be considered.

Take note that section 12M(2)(b) provides specifically that an amount paid in the form of a lump sum by an employer under a policy of insurance with an insurer in relation to former employees or dependants for purposes of making a contribution to a medical scheme or fund can be claimed as a deduction from income.

Example 1 – Reserve fund in the form of an insurance policy

Facts:

Company A has decided to take out an annuity policy with an insurer to cover future anticipated expenses arising from its retired employees for which the company remains liable instead of creating its own reserve fund. The company does not have immediate access to the funds and the policy is controlled and managed by the insurer. The insurer does not carry any risk and the company remains liable for the future anticipated expenses. The terms provide that should the policy be terminated, the balance of funds is returned to the company. Any possible implications under section 23L should be ignored for purposes of this example.

Result:

Company A remains liable for the payment of the anticipated expense. Company A has set aside its income in the form of a policy to cover these anticipated expenses. The money has been reserved and despite the company not having immediate access to the funds, the funds will be returned to the company and the annuity policy may be considered a reserve fund. In the absence of section 23(e) the payment of the premiums may have been considered under section 11(a). However, section 23(e) prohibits the deduction.

5. Conclusion

Under section 23(e), the deduction of any income carried to any reserve fund or capitalised in any way is prohibited unless the Act provides specifically for the deduction of a reserve. Such reserves created are generally not expenditure actually incurred in the production of income.

Reserve funds are normally separate accounts or highly liquid assets controlled by the taxpayer and which allow the taxpayer easy access to the funds to settle contingent liabilities or anticipated expenditure and losses.

The reserve fund can be distinguished from, for example, a trust account, which is set up on behalf of a third party for the benefit of that third party.