South African Revenue Service

DRAFT INTERPRETATION NOTE

DATE:

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. A reserve fund can be set up in various ways in an attempt to exclude it from the ambit of section 23(e).

This Note considers the meaning of reserve fund for purposes of section 23(*e*). There are further provisions in the Act that allow for the deduction of a reserve in certain circumstances which are not considered in 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 an expenditure or loss actually incurred. It is also not an expense incurred during that year of assessment. In addition, should the provisions of 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. "Income" is defined under 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* 1839[1] 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 limited to "income" as defined in section 1(1). In *ITC* 343[2] 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 this was still not allowed despite it not accruing to the taxpayer.

The Act, however, provides specifically for the deduction of a reserve in certain specified circumstances. Examples such as the allowance granted for doubtful debts [section 11(*j*)] and the special allowance made for credit agreements (section 24) are special exceptions provided for in the Act. Other exceptions are to be found in section 22 under which traders 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; the allowance for contingent development expenditure granted to township owners (section 24); and the deduction of reserves for unexpired risks and unpaid claims, whether intimated or not, granted to short-term insurers (section 28). Yet another exception is provided by section 24C, which permits the deduction of "future expenditure" on contracts.[3] These specific statutory reserves are not covered under section 23(*e*).

1 72 SATC 61 at 73.
2 8 SATC 370.
3 This is not an exhaustive list.

4.1 Meaning of reserve fund

In determining whether any income[4] carried to a reserve fund is deductible or prohibited under section 23(e), it is necessary to establish the meaning of the term "reserve fund" envisaged in section 23(*e*). Since the Act does not define "reserve fund", the term must be interpreted according to its ordinary meaning as applied to the subject matter with regard to which it is used.[5]

The *Cambridge English Dictionary*[6] 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*[7] describes a reserve fund as:

> "funds taken out of earnings to provide for anticipated future payments"

The word "reserve" is sometimes used as a synonym for "reserve fund". According to *Dictionary.com*,[8] "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 343*[9] 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 predecessors[10] 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.

The taxpayer in *ITC 183*[11] 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

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4 See **4**.
5 Kellaway, E A (1995) *Principles of Legal Interpretation of Statutes, Contracts and Wills* at 224. Butterworths.
6 **https://dictionary.cambridge.org/dictionary/english/reserve-fund** [Accessed 30 August 2024].
7 **www.freedictionary.org** [Accessed 30 August 2024].
8 www.dictionary.com/browse/reserve [Accessed 30 August 2024].
9 8 SATC 370.
10 Section 12(*e*) of Income Tax Act 40 of 1925 as well as section 12(*e*) of the Income Tax Act 31 of 1941.
11 (1930) 5 SATC 262.

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 423*[12] 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 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 505*[13] 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*[14] 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 court[15] 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."

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12 (1938) 10 SATC 335.
13 (1941) 12 SATC 160.
14 1945 AD 128, 13 SATC 121.
15 1945 AD 128, 13 SATC 121 at 127.

It was the practice of the taxpayer in *ITC 684*[16] 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.

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*:[17]

> "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*[18] 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 funds 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, 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.

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16 ITC 684 (1949) 16 SATC 368.
17 72 SATC 61 at 73.
18 2019 (3) SA 90 (SCA), 81 SATC 185 at 191.

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 make provision by means of an insurance policy taken out from a third party to cover future expenses or contingent liabilities. The control and management arising from the policy and access to the money under the policy are normally exercised by the third party. Depending on the purpose of the policy and the terms of said policy it might in substance be considered to be a reserve fund. The facts of each case will have to be considered to evaluate whether such a policy falls within the ambit of section 23(*e*).

An insurance policy taken out from a third party to provide for future expenses or contingent liabilities should be distinguished from an insurance policy taken out to cover certain specified contingencies or events. An insurance policy taken out from a third party may not be affected by section 23(*e*) as an expenditure for the payment of the policy premium will actually have been incurred. However, should the terms of the policy indicate rather that this policy was in fact a reserve fund as envisaged by section 23(*e*), the deduction of the premiums will be prohibited. 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 is specifically provided for under section 12M. The facts of each case have to be considered.

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

Facts:

Company A has set aside funds in the form of an annuity policy with a third party to cover future anticipated expenses arising from its retired employees for which the company remains liable. The company does not have immediate access to the funds and the policy is controlled and managed by the third party. The company remains liable for the future anticipated expenses and should the policy be terminated, the funds are returned to the company. Does this policy qualify as a reserve fund?

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 still accrue 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. The creation of such reserves are 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 allows the taxpayer easy access to the funds to settle contingent liabilities or anticipated expenditure and losses. Provision made by taking out a policy

from a third party to cover contingent liabilities in which all control to the funds are managed by the third party may also be disqualified from deduction as it may fall within the ambit of a reserve fund as envisaged by section 23(*e*) if, for example, the taxpayer still has access to the funds. The facts of each case would need to be considered carefully.

A policy taken out from a third party to provide for future expenses or contingent liabilities should be distinguished from an insurance policy taken out to cover certain specified contingencies or events. An insurance policy taken out from a third party may not be affected by section 23(*e*) because it is not a reserve fund as expenditure for the payment of the policy premium will actually have been incurred such as provided for under section 12M.

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