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MASTER OF COMMERCE

(TAXATION) DISSERTATION.

AN ANALYSIS OF THE

APPROACH OF THE COURTS

IN DETERMINING THE CAPITAL

AND REVENUE NATURE

OF INCOME AND EXPENDITURE.

NOVEMBER 2002

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**AN ANALYSIS OF THE APPROACH OF THE COURTS IN
DETERMINING THE CAPITAL OR REVENUE NATURE OF
INCOME AND EXPENDITURE.**

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Submitted in part fulfillment of the requirements for the

degree of

Master of Commerce (Taxation) in the

School of Accountancy at the

University of Durban – Westville

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November 2002

ABSTRACT

The aim of this research is to analyse the approach of the courts in determining the capital and revenue nature of income and expenditure.

DECLARATION

I hereby declare that unless specifically indicated to the contrary in the text, this dissertation is all my own original work.

ACKNOWLEDGEMENT

I would like to express my sincere thanks to my wife Zukiswa and our daughters Lusanda and Viwe for their support, encouragement and understanding of long hours without my company. Also I would like to thank my Personal Assistant, Angela Stevens for helping me with typing and proof reading.

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INTRODUCTION

The concepts income and capital are not defined in the Income Tax Act 58 of 1962, nor is there any guidance pertaining to the distinction between the two concepts.

Recourse has to be had to the way the courts approach and determine what is capital as opposed to income. As the case law shows, the interpretation of the courts may vary between a restrictive and, or a wide interpretation of the two concepts depending on the facts and merits of the case.

This research seeks to highlight problems relating to interpretation of statutes generally and more specifically Tax legislation. Rules of interpretation and construction of statutes will be discussed with specific reference to case law. Central to these rules is the process of legal

reasoning which depends to a large extent on the nature and context of the use of words. Words are by their nature capable of more than one meaning depending on the intention of the legislature when drafting the statute and the context within which they are used.

The fine line between practice adopted by the South African Revenue Service (SARS) and the provisions of the various Tax legislation will be closely examined. This will be done with a view to distinguishing between practice and the legislative imperatives of the Tax legislation. In addition, the extent to which the Constitution has influenced SARS will be discussed.

The vexed nature of the distinction between capital and income has generated a lot of case law precisely because of the fine line that needs to be drawn between the two concepts. Sometimes, and to a great extent, the distinction is so blurred that the taxpayer has to adduce

evidence relating to his intention when he first acquired the asset; and his intentions when he disposes of the same asset. In terms of S.82 of the Income Tax Act, the taxpayer bears the onus of proof on a balance of probabilities about what his intention was when he first acquired the asset, and the nature of the transaction when he disposes of the same asset. The taxpayer can have more than one intention or a mixed intention, and alternative intention, or a change of intention.

Further, the same asset can have its proceeds as income or capital depending on whether it is a fixed or floating capital of the taxpayer concerned. The case law relating to the above problem areas and the way our courts have grappled with them will be closely examined, discussed and analysed.

S.1 paragraphs (a-n) of the Income Tax Act bring any income under the gross income definition irrespective of whether such income is in reality

of a capital nature. Two cases, one an Australian case and another a South African will be discussed with a view to clarifying the fact that 'income', though not defined in the Act; is implicit in the definition of the gross income.

S.11 (a) of the Income Tax Act permits a deduction of expenditure and losses actually incurred during the year of assessment in the production of income, provided they are not of a capital nature. As in the case of gross income, it is not always easy to distinguish between an expense of a capital and income nature, and once again guidance is to be sought from the courts.

The key question that has to be answered as a test is whether the expense was made with a view to creating an enduring benefit; and if it is found to be so, then it is capital. However, cases involving intangibles are problematic in that the decision as to whether the expense is made,

with a view to creating an enduring benefit is subjectively determined. It is submitted that it is, among other things on this basis that the distinction is not easily decided.

The newly introduced Capital Gains Tax (CGT) does not reduce the uncertainty which arises when one has to decide whether a profit or expenditure is of a capital or income nature. This is because the applicable rules and rates are different to those applying to ordinary income. CGT is determined in terms of S.26A of the Income Tax Act read with the 8th Schedule to the same Act. The distinction between the capital and income nature of income and expenditure is determined by the decisions of the courts.

Having highlighted the difficulty with which the distinction between capital and income is made; the research seeks to discuss and analyse

various court decisions and principles upon which such decisions were made.

It is hoped that as its broad rationale the research will enable the financial and tax advisors and estate planners to structure the affairs of their clients in line with the approach adopted by our courts.

CHAPTER 1

INTERPRETATIONAL PROBLEM

1.1 INTRODUCTION

Words are by their very nature imprecise because they are capable of a wide range of meanings depending on the context, syntax and semantics.

However, once the document has been written it must speak for itself with little or no contemporaneous reference to other documents at all.

The high level of 'precision' expected of a written text borders on the ideal and demands the drafter of the document to traverse every eventuality and possibility. More often than not, the contents of the documents are challenged for vagueness and, or contradiction.

Language is therefore the first point of entry into the meaning of any text

be it a statute, a will or a contract document. Language finds expression by means of words used in the text.

The golden rule is to ascertain the intention of the drafter of the document when interpreting it and give effect to what was intended when construing it. In other words, words are to be given their literal meaning first, unless doing so would lead to absurdity which was never intended by the drafter.

However, it is in the process of ascertaining the intention that words lend themselves to ambiguity and vagueness which lead to long drawn out arguments.

In order to understand and master the interpretation of the statute, it is important to understand the process of legal reasoning.

1.2 LEGAL REASONING

In the context of legal reasoning, the law and its interpretation is often clear and straight forward if read without any reference to the facts. However, in order for the law to find expression, it has to be applied to the facts of a given situation.

The facts bring a totally different dimension to the law in as far as its interpretation is concerned. The first step in the process of legal reasoning is to ascertain the true facts. Relevance is of paramount importance. Anything which will help to prove or disprove the point in issue is relevant.

The precise meaning of the words used and the convergence on what they mean will to a large extent lead to the easy resolution of the dispute. But the nature of words is such that this is not always the case.

The more complex the subject matter of the statute, as is always the case in the Tax legislation; the more difficult to get to its precise meaning and intention. By way of example, S.1 paragraphs (a-n) of the statutory definition of the gross income deem items to be income irrespective of whether they are in reality of a capital nature. If this be the case then, it follows that some items as listed in paragraphs (a-n) are deemed to be income whereas they may be capital.

In *Pyott Ltd v CIR*¹, it was contended that there is no half-way house between income and capital; meaning that the amount is either income or capital. The difficulty comes when there is a receipt or accrual which is neither the product or fruit nor the consideration, for the disposal of a capital asset or income asset. Fortuitous windfall like winning lottery competitions or inheritance can indeed be regarded as half-way house in

¹ 1945 AD 128 at 135, 13 SATC 121.

nature but are regarded as capital in nature due to the fact that they are not received for services rendered as contemplated in paragraph (c) of the gross income.² It would appear for the amount so received to be regarded as income as contemplated in gross income definition in paragraph (c) it has to be received for services rendered. It follows that the amount so received is not taxable because it has not been received for services rendered i.e. for the amount to be taxable, employment has to be a *sine qua non* of its receipt. It makes legal sense and sound logic therefore to conclude thus;

Reasoning in law does not require a 'right answer' but a well-reasoned position based on facts and established law. What is required above all is a precision, a clear statement.³

1.3 THE NATURE OF WORDS

Judge Learned Hand once said the following:

² ITC 1683 (Cape) 62 SATC 406.

³ Clark GJ, Great Sayings by Great Lawyers, Vernon Law Books, Kansas City 1926.

'In my own case the words of such an Act as the Income Tax, for example, dance merely before my eyes in meaningless procession: cross-reference, exceptions upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which is within my power if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at all times I cannot help recalling a saying of William James about certain passages of Hegel: That they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are

strung together with syntactical correctness.⁴

In another context Albert Einstein once said: 'The hardest thing in the world to understand is the income tax.'⁵ Both quotations confirm the assertion made earlier that the more complex the idea of the subject matter of a statute, the more difficult it becomes to get its true meaning and intention.

The source of difficulty is partly due to the ambiguity and vagueness of the words used. To remedy the situation the courts apply *casus omissus*. Each of these concepts is going to be discussed below in relation to their relevance in the interpretation of statutes.

⁴ A. Cox 'Judge Learned Hand and Interpretation of Statutes (1946 – 1947) 60 Harvard Law Review 370 at 389 – 90'

⁵ Williams R.C, Income Tax and Capital Gains Tax in S.A. Law & Practice, 3rd edition Butterworths (2001) at v

1.3.1 Ambiguity

Black's Law Dictionary defines ambiguity as 'an uncertainty of meaning or intention as in a contractual term or statutory provision.' Judicial usage sanctions the application of the word 'ambiguity' to describe any kind of doubtful meaning of words, phrases or longer statutory provisions. "If words in particular context do in fact convey to different readers a range of meanings derived from not fanciful speculation or mistakes about linguistic usage, but from true knowledge about the use of words, then they are ambiguous."⁶

Ambiguity can arise in various ways namely;

- In semantics where a word has more than one meaning
e.g. the word 'intended' can mean 'calculated' or 'likely'.

The word 'coast' or 'coastline' in our statute law is ambiguous'⁷

- Syntactically (grammatically) this can be illustrated as follows "the liquidator shall call upon the company '*immediately to lodge the document*' – does this mean that the liquidator must immediately call on the company to lodge, or that the company is required to lodge immediately?"⁸

- In a statute where a word/phrase is capable of more than one meaning this may lead to a conflict or contradiction of

- the meaning conveyed by a statute.

⁶ J.L. Montrose (1960) 76 LQR 361.

A *locus classicus* of the above is the phrase of the definition of the gross income which refers to 'accrued to'.

'Accrued to' was construed to mean 'entitled to' per Watermeyer J.⁹ However, in another context 'accrued to' was construed to mean 'instalments'.¹⁰

In CIR v Delfos¹¹, the phrase 'accrued to' was construed to mean 'due and payable'.

Similarly, the words 'income' and 'capital' are construed to convey different meanings in different contexts. It is against this backdrop that the facts of each case are said to change the meaning of the word as originally written in

⁷ S v Beyleveld and others 1964 (1) SA 269 (T) at 273.

⁸ H.R. Halilo "The Great South-West African Diamond Case" A Discourse (1959) 76 SALJ 151 at 176.

⁹ Lategan v CIR 1926 CPD 203 at 209, 2 SATC 16 at 20.

¹⁰ Ochberg v CIR 1933 CPD 256, 6 SATC 1 at 6-8.

the statute. This does not mean the word is changed willy-nilly but that it is construed to enunciate the intention of the Legislature without which absurdity may be caused.

The receipt and accrual may both occur in the same tax year, or the accrual may occur in the one tax year and the receipt in another as was the case in Delfos case.¹² To avoid the anomaly which may occur if 'accrued to' is not construed to mean 'due and payable' Stratford JA confirmed the interpretation of De Villiers JA in the case of Delfos. Where there is ambiguity, it is an established

¹¹ 1933 AD 242, 6 SATC 92.

¹² Delfos (Supra)

principle of interpretation that *contra fiscum* should be applied i.e. a less burdensome interpretation should be applied to favour the taxpayer.¹³

As the attributes of reason and logic are ascribed to the Legislature, likewise the interpretation of an enactment necessitates logical reasoning especially in as far as the application of its provisions to concrete situations is concerned.¹⁴ Nevertheless, absurdities are by their very nature inconsistent with and repugnant to juridical reason and logic.¹⁵ It is for this reason that absurdity must be avoided: *interpretatio quae porrit absurdam, non est admittenda*. However, because of subjectivity in understanding what amounts to absurdity, what is said to

¹³ Estate Reynolds v CIR 1937 AD 57 at 70

¹⁴ Du Plessis, L.M. The Interpretation of Statutes, Butterworths (1986) at 96

¹⁵ Ibid at 96

be absurd must be 'so glaring' that it could never have been contemplated by the Legislature.¹⁶

1.3.2 Vagueness

It implies uncertainty in the application of a language to a number of situations which may lend the subject matter obscure and elastic to the point of losing its intended meaning completely. However, vagueness has an inherent advantage and potential for liberal and equitable interpretation of a statute.¹⁷ Du Plessis' assertion has to be accepted with caution because a vague provision is capable of any interpretation because of its open ended nature, and this can be disastrous.

¹⁶ Venter v R 1907 TS 910

¹⁷ Du Plessis (Supra) at 105.

1.3.3 *Casus Omissus* (Omissions)

The Legislation is presumed to have exhaustively enacted everything and therefore it is not the duty of the courts to furnish omissions in the language of the Statute. This theory of interpretation has application in the light of the maxim: *ad ea quae frequentus accidunt jura adaptantur*. (laws are adapted to those cases that most frequently occur) and *casus omissus et oblivion datus communis juris relinquitur* (a case omitted and consigned to oblivion is left to the disposal of the common law).

The rule against the application of *casus omissus* by our courts goes against the maxim by Cicero; '*valeat aequitas, quae porribus in causis parria juror desiderat*' (let equity prevail, which demands like rights in like cases).

However, the presumption against the furnishing of omissions by the courts is disregarded if doing so would lead to an absurdity that would never have been intended by the Legislature.

In the case of *CIR v Louis Zinn Organisation (Pty) Ltd*¹⁸ where it was contended that Parliament was guilty of a *casus omissus*, Schreiner JA in delivering the judgment responded: 'No doubt such oversights, just like tautology, occur in Acts of Parliament, but a construction which avoids them is to be preferred to one that does not.'

Therefore the maxim *casus omissus* is part of the juristic technique available to the court in ascertaining of legislative policy in order to favour a person against whom if not applied would be burdensome.

1.4 CREATIVE ROLE OF JUDGES

It is impossible for the drafters of the legislation to make provision for each and every eventuality and possibility when drafting a statute.

In *Venter v R*¹⁸ Innes CJ remarked as follows: No matter how carefully words are chosen there is a difficulty in selecting language which, while on the face of it expressing generally the idea of the framer of the measure, will not when applied under the circumstances fall short of it.

The interpretation and construction of the provisions of the legislation is left to the judiciary and this process produces what is commonly referred to as case law or the judge-made law. By the application of the principle

¹⁸ 1958 (4) SA 477 (A).

¹⁹ *Supra*

of *stare decisis et non quieta movere* i.e. stand by the decision and do not disturb what is settled – lower courts are bound by the previous decisions of higher courts to them.²⁰

Whilst the pull of the past is strong, the past should not be allowed to enslave the present and even the future. Courts can depart from the decision previously made on sound reasoning.²¹

1.5 CONCLUSION

Laws are made to fulfil and promote a social purpose, and in the process of their interpretation regard must be had to their true context and intention. It is for this reason that they are infused with value judgments.

²⁰ For more details see W.j. Hosten, A.B. Edwards et al. Introduction to South African Law and Theory (1983) ch IV.

²¹ The Rules of Precedent Applied in the South African Courts by Ellison Kahn (1967) 84 SALJ 43.

The concepts used in judicial reasoning are not 'absolute eternal reality, unrelated to the social purpose they might be designated to serve.'²² Our reliance on the case law derives from the role played by logic and rationality which inform the principles upon which cases are decided.

It is against this background that the importance of what the courts say in extending what the statute is silent on, was conceived.

²² E Bodenheimer *Jurisprudence: The Philosophy and Method of the Law* (1974) 385-quoted by G.E. Devenish: *Interpretation of Statutes* (1992) at 278.

CHAPTER 2

INTERPRETATION OF STATUTES

2.1 INTRODUCTION

Admittedly, whilst the case law or the judge – made law is important, the statutory law is equally important if not more. There are many reasons for this assertion, but only one merits mention: The statutory law is the fundamental law of which the case law is its corollary. It is considered crucial for a brief discussion to be made on how the process of interpretation and construction is made in order to appreciate the derivation of case law and its standing legitimacy.¹

In addition, a knowledge of how the judges reach their conclusions and the tools they use to unlock the proverbially locked statute will enable the

¹ For more on the subject see G.E. Devenish's *Interpretation of Statutes* Juta (1992)

reader to assign meaning to the statute as intended by the Legislature.

An examination of whether Fiscal legislation ought to be interpreted differently from the other statutes is going to be made especially in view of the perceived and apparent differences in the approach adopted by the courts.

Further, the extent to which the South African Revenue Services (SARS) adopts its own practice notes to pronounce on tax issues where the Act is silent, will be closely examined with a view to determining its legality and constitutionality. The practice notes are published in the Government Gazette for the benefit of the general public.² However, the practice notes do not have the force of law and are thus not binding. It is on this basis that they are challenged by taxpayers especially where their

² R.C. Williams *Income Tax and Capital Gains Tax in South Africa Law & Practice*, 3rd edition Butterworths (2001) at 19

operation has not been endorsed by the courts of law.

It can also be argued that some of the provisions of the Act that SARS administers can, and have indeed been challenged for being unconstitutional. The nature and provisions that have been challenged constitutionally will be discussed.

2.2 INTERPRETATION AND CONSTRUCTION

Construction and interpretation are commonly used interchangeably, although they are not the same.³

Construction is the drawing of conclusions with respect to subjects that are beyond the direct expression of the text, from elements known and

³ U.S. v Witberger, 5 Wheat (US) 76,5 L.. Ed. 37

given in the text. Interpretation is the process of discovering the true meaning of the language used.⁴ With regard to interpretation basic assumptions are made and these relate to:

- a) That the statute once written speaks unequivocally for itself and is free from ambiguity and, or vagueness. (Precision of meaning of words used).
- b) That the words used convey the true intention of the drafter of the statute.

It follows from the above that interpretation process examines what is clearly conveyed by the words used and whether the intention of the drafter is indeed what it is said to be. A *locus classicus* would be the meaning of the 'capital nature' or 'income/revenue nature' of accrual and expenditure.

⁴ Bloomer v Todd, 3 Wash. T. 599, 19 Pac. 135, ILRA III.

In *COT v Booyens' Estate Ltd*⁵ Wessels J said:

'Although the Act does not define capital, it does define income, and as the latter is definitely related to the former, we must presume that the Legislature assumed that the ordinary economic meaning is to be attached to the word 'capital'.

In *COT v Booyens's* case Wessels J applied interpretation to say what income is in terms of the Act, precisely because the Act indeed says what 'income' is, quite unambiguously.⁶ From what 'income', is the intention of the Legislature is established.

However, when the Learned Judge says '..... as the latter (capital) is definitely related to the former (income) we must presume that the Legislature assumed that the ordinary economic meaning is to be attached to the word 'capital', he is engaged in something beyond

⁵ 1918 AD 576

⁶ Ibid

interpretation which is construction. This conclusion is made on the basis of the fact that the Judge inferred and concluded on what is not written in the statute – ‘something beyond the direct expression of the text’ so to speak, as capital is not expressed at all in the Act.

From the above distinct application of interpretation as opposed to construction, it is submitted that interpretation precedes construction. It follows that the court will first look at the intention of the legislature from the clear language of the statute, and if it is not clear it will proceed to the process of construction.

Construction is the second level of enquiry, which seeks to go beyond the language of the statute by resorting to extrinsic aids in order to arrive at the required conclusion. The conclusion referred to includes the reason

for the enactment of the statute, intended scope and purpose.⁷ As in the US in the South African context as well, there seems to be an intermarriage between the literalist approach, (i.e. the true meaning of the statute is to be sought in the *ipsissima verba* used by the legislature) and the intentionalist which seeks to establish the intention of the legislature.⁸

A *locus classicus* of the intentionalist approach is to be found in *Farrar's Estate v Commissioner for Inland Revenue*:⁹

'The governing rule of interpretation – overriding the so-called 'golden rule' – is to endeavour to ascertain the intention of the lawmaker from a study of the provisions of the enactment in question.'

It is with interest to note that Kotzé J enthroned the above approach as a

⁷ *US v Jackson*, 143 Fed, 78 3, 75 CC A. 41

⁸ Du Plessis L.M, *The interpretation of Statutes* Butterworths 1986 at 141

⁹ 1926 TPD 501 at 508.

rule of construction *universi juris* thus:

'The intention of the legislature can alone be gathered from what it has actually said, and not from what it may have intended to say, but has not said. This is not merely a rule of construction adopted by the Courts of England, it seems indeed one *universi juris*.'¹⁰

And Kotze J's *obiter dictum* above is *a fortiori* in agreement with what Wessels J said in *COT v Booyesen's Estate Ltd*¹¹ that the intention of the Legislature is to be gleaned from what it has said namely 'income' from which it can be inferred that the ordinary economic meaning is to be attached to the word 'capital'.

¹⁰ *Bulawayo Municipality v Bulawayo Waterworks Ltd*. 1915 CPD 435 – 445.

¹¹ *COT v Booyesen's estate supra* at 576.

2.2 INTERPRETATION OF FISCAL LEGISLATION VERSUS

INTERPRETATION OF STATUTES GENERALLY AND SARS

PRACTICE

The Interpretation Act¹² applies in the interpretation of the Income Tax Act but, in the case of conflict or inconsistency, the provisions of the latter override the former.¹³

The same view was expressed in *Nathans' Estate v CIR*¹⁴. The above two assertions may appear to draw a distinction between the rules applicable in the interpretation and construction of the fiscal legislation as opposed to the statute in general to an extent that there is inconsistency in either.

In *Partington v The Attorney General*¹⁵, Lord Cairns remarked *obiter*:

¹² Act 33 of 1957

¹³ R.C. Williams (*Supra*) at 15.

¹⁴ 1948 (3) SA 866 (N) at 880-1, 15 SATC 328.

¹⁵ (1869 House of Lords) at 375

'If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'

In practice SARS has a policy which seeks to dispense a semblance of fairness to the taxpayers.¹⁶ There is clear unwillingness on the part of SARS to cause undue hardship to the taxpayers in circumstances where for example, when the taxpayer is likely to be liquidated as a result of non-payment of taxes due. However, the taxpayer has to prove his unhealthy financial status with audited annual financial statements and bank statements dating back to at least six months. In addition, the

¹⁶ SARS Policy on Compromise and Settlement Offers

taxpayer has to submit a list of his debtors and creditors with amounts he is owed and what he owes.

There are many reasons for this attitude but the main one is the pivotal role that SARS plays in the building of the South African economy, the maintenance and broadening of the tax base. Each business entity that is driven out of business can account for loss of employment, increase in the number of people who stand in line for welfare from the State grant and; such factors could directly lead to increase in crime rate as a result of high levels of poverty.

Nevertheless, this is just a general rule of thumb because each taxpayer is treated differently depending on his record of compliance and behaviour generally.

A closer examination of the South African case law reveals a radical departure from the English approach of the *ipsissima verba* of the

interpretation of the tax legislation. For instance, where there is an ambiguity in a taxing statute the *contra fiscum* principle must be applied to ameliorate the burden imposed on the taxpayer.¹⁷ The principle is well established that in construing a provision of an Act of Parliament the plain meaning of its language must be adopted unless it leads to some absurdity, inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended.¹⁸

In addition, as a further departure from the English approach of not giving effect to fairness in taxing statutes, the South African tax statute contains provisions which are designed to alleviate hardship.¹⁹

Williams quite correctly points out that the exclusion of equitable

¹⁷ Estate Reynolds v CIR 1937AD 57 at 70.

¹⁸ R.Koster & Son (Pty) Ltd & Another v CIR 1985 (2) SA 831(A), 47 SATC 24 at 32. per Nicholas JA.

¹⁹ S.89 quat(3) and (3A) which give the Commissioner for SARS a discretion to waive interest on underpaid amounts of tax where the taxpayer had reasonable grounds for contending that a particular amount was not taxable or that he was entitled to a particular allowance or deduction.

principles in the interpretation of taxing statute is significant in the United Kingdom but is of little significance in South Africa.²⁰ The reason is that in South Africa principles of justice and fairness are enshrined in the constitution and any unfairness may be declared unconstitutional. Taxpayers are afforded a further ammunition against unfairness by the Commissioner for SARS by the Promotion of Administrative Justice Act of 2001.

In *Glen Anil Development Corporation (Ltd) v SIR*,²¹ the Court after referring to various authorities on the interpretation of fiscal legislation went on to say:

'In any event I do not understand the rule to be that every provision of a fiscal statute whether it relates to the tax imposed or not should be construed with due regard to any rules relating to the interpretation of fiscal legislation.'²²

²⁰ R.C. William (supra) at 11

²¹ Ibid

²² *Hleka v Johannesburg City Council* 1949 (1) SA 842 A at 852.

The discretionary powers conferred upon the Commissioner should therefore not be restricted unnecessarily by interpretation.²³

It is submitted that on the basis of the above quoted case law, there is no difference between the interpretation adopted by Courts in fiscal legislation and ordinary legislation generally. Moreso, this is due to the Constitution which enshrines all rights to which all taxpayers are entitled. Like any legislation if tax laws are repugnant to the constitution they can be declared unconstitutional.

2.4 CONCLUSION

The interpretation of fiscal legislation should not be viewed in isolation from the broad spectrum of the statutes of the land. If any interpretational dispute arises the courts are the final arbiters.

²³ Maxwell Interpretation of Statutes 12th Edition at 40 as quoted by G.E. Devenish

Of necessity, all the laws of the land should stand the close scrutiny of the constitutional provisions regardless of whether they are fiscal or otherwise.

The Metcash case²⁴ illustrates a case in point where SARS was challenged particularly S.36 and S.40 of the VAT Act 89 of 1991.

The case concerned the constitutional validity of the abovementioned sections which were alleged by the Applicant (Metcash) to be unconstitutional.

The impugned sections read as follows:

S.36 PAYMENT OF TAX PENDING APPEAL

- (1) The obligation to pay and the right to receive and recover any tax, additional tax penalty or interest chargeable under this Act shall not,

²⁴ Metcash trading Ltd v Commissioner for SARS & Another 2001 (1) BCLR 1 (CC)

unless the Commissioner so directs, be suspended by any appeal or pending the decision of a court of law, but if any assessment is altered on appeal or in conformity with any such decisiona due adjustment shall be made, amounts paid in excess being refunded with interest.....and amounts short-paid being recoverable with penalty and interest calculated as provided in S.39(1).

S.40 RECOVERY OF TAX

(1)

2(a) If any person fails to pay any tax, additional tax, penalty or interest payable in terms of this Act, when it becomes due or is payable by him, the Commissioner may file with the clerk or registrar of any competent court a statement certified by him as correct and setting forth the amount thereof so due or payable by that person, and such statement shall thereupon have all the efforts of, and any

proceedings may be taken thereon as if it were, a civil judgment lawfully given in that court in favour of the Commissioner for a liquid debt of the amount specified in the statement.

- (5) It shall not be competent for any person in proceedings in connection with any statement filed in terms of subsection (2) (a) to question the correctness of any assessment upon which such statement is based, notwithstanding that objection and appeal may have been lodged against such assessment.

In his cogent and incisive judgment Kriegler J held that S.36(1), S.40(2) and S.40(5) of the VAT Act do not oust the jurisdiction of the courts of law. To the extent that it can be argued that section 40(5) does indeed limit an aggrieved vendor's access to an ordinary

court of law, but did not prohibit litigation: such limitation is justified under S.36 of the Constitution.²⁵

As it has been pointed out earlier; reasoning in law does not require a 'right answer', but a well-reasoned position based on fact and established law: What is required above all is precision; a clear statement, which is so cogent that it is consistent with the supreme law of the land – the Constitution.

²⁵ Metcash (supra) paragraph 72

CHAPTER 3

DISTINCTION BETWEEN CAPITAL AND INCOME

3.1 INTRODUCTION

The two concepts 'income' and 'capital' are not defined in the Act but mention is made of items that are statutorily determined and deemed to be included in the definition of the income.¹ The distinction between the two concepts is found in decided cases. It follows that the meaning of the two concepts needs to be ascertained first before determining whether the accrual and, or expenditure is of a capital or income nature.²

¹ R.C. Williams *supra* at 109.

² I SATC 20

An attempt to distinguish between the two concepts will be made with reference to the statutory definition of income and its general category which the Act attempts to define by saying what income is not.³

Case law will be used to illustrate the circumstances under which each concept is seen to the exclusion of the other.

3.2 CAPITAL IN NATURE

In *Smith v SIR*⁴. Steyn CJ remarked as follows:

'In the absence of any indications to the contrary – and I have found none – the word 'capital' has to be given its ordinary meaning. Broadly speaking and for present purposes, it may be said to connote money and every form of property used or capable of being used in the production of income or wealth. Such a commercial or business sense is the sense in which one expects it to be used in the context here in question, and it is to capital in

³ S.1 of the Income Tax Act definition of the gross income.

⁴ 1968 (2) SA 480 (A), 30 SATC 35 at 40 - 41

that sense that, for purposes of S.11 (2) (b) bis at any rate, expenditure is to be related in order to determine whether or not it is expenditure of a capital nature’.

Deducing from the above *obiter dictum* of Steyn CJ, it becomes clear that capital is what is used, whether it be money or property, in the production of income. If for instance, the taxpayer purchases a factory (property) with the intention of holding it ‘for keeps’⁵ and using it to produce income by manufacturing goods for sale, the factory is a capital asset in his hands and the money he receives from the sale of its products is income. A metaphor that may be resorted to is to liken capital to a tree and income to its fruits.⁶

From the above example it is submitted that it is quite simple to distinguish between what is capital and income. The problem though

⁵ Barnato Holdings Ltd v SIR 1978 (2) SA 440 (A), 40 SATC 75 at 91

⁶ Meyerowitz D, Meyerowitz on Income Tax, The Taxpayer (paragraph 8.3)

arises when one tries to determine upon the facts of the particular case whether the receipt or accrual is in respect of the factory/machine/tree or in respect of its products or fruits.⁷

Although in some instances, and by and large the distinction between capital and income is easy to determine, but in some cases it is not, as Lord Greene once observed in *IRC v British Samson Aero Engines Ltd.*⁸

'In many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons'.

Maritz J once said:⁹

'If we take the economic meaning of 'capital' and 'income', the one excludes the other. 'Income' is what 'capital' produces, or is something in the nature of interest or fruit as opposed to principal or tree. This

⁷ Ibid paragraph 8.6

⁸ [1938] 3 All ER 283; [1938] 2 KB 482

⁹ *CIR v Visser* 1936 TPD

economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal or tree in the hands of one man may be 'interest or fruit' in the hands of another. Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset. A farm owned by a farmer is a capital asset; in the hands of a land jobber it becomes stock-in-trade.'

To a great extent to determine whether the asset is of a capital nature is subjectively decided by the taxpayer hence the onus is placed on the taxpayer for him to discharge it¹⁰ on a preponderance of probabilities. It is submitted that the problem is more with the attitude of the taxpayer towards the asset and his intention for acquiring it, than with the asset itself. The question whether an amount is of an income or a capital nature is a question of law, which has to be decided upon the facts of each case.

¹⁰ S. 82 of the Income Tax Act 58 of 1962

3.3 INCOME IN NATURE

It is true that there is no definite test that can always be applied in order to determine whether a gain or profit is income or not, but it may safely be asserted that the revenue or profit which is derived from a thing without its changing owners is rather to be considered as income than as capital – per Wessels J.¹¹

In view of the above assertion, it is clear that 'income considered in relation to capital is revenue derived from capital productively employed'.¹²

In CIR v Guardian Assurance Co South Africa Ltd¹³ it was held that there is no simple and universally valid litmus test whether particular income falls on the one side of the ill-defined border-line between capital and revenue

¹¹ COT v Booysen's Estate Ltd 1918 AD 576, 32 SATC 10 at 15.

¹² Ibid at 25

¹³ 1991 (3) SA I (A) at 19E

or on the other being 'a matter of degree depending on the circumstances of the case.'

That being the case, the principle laid down for distinguishing between income and capital are mere guidelines.¹⁴

Income therefore includes everything that is not of a capital nature; (that is, the gross income definition) and all the items that are deemed to be income irrespective of whether they are capital in nature (in terms of S.1 paragraphs (a – n) of the gross income definition.

With regard to the first part of what income is in terms of the gross income definition Jordan CJ said the following (in an Australian case):¹⁵

'The word 'income' is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income. must be

¹⁴ CIR v Pick 'n Pay Employee Share Purchase Trust 1992 (4) SA 39 (A), 54 SATC 271 at 279.

¹⁵ Scott v C of T (NSW) (1935) 35 SR (NSW) 215

determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts.'

The above *obiter dictum* was supported in the South African case by Wessels J thus:¹⁶

'Although the Act does not define capital it does define income, and as the latter is definitely related to the former, we must presume that the Legislature assumed that the ordinary economic meaning is to be attached to the word 'capital'.

Williams is of the view that at common law, an item does not possess the quality of 'income' unless it is money or that which is capable of being converted into money.¹⁷ It would appear from the above assertion that

¹⁶ COT v Booyesen's Estates Ltd 1918 AD 576

¹⁷ R.C. Williams (supra) at 112

an 'amount' cannot qualify for inclusion in the taxpayer's gross income unless it is either money or that which is convertible into money. In the South African Income Tax Act, the definition of gross income includes the phrase 'in cash or otherwise' which clearly brings non-monetary receipts within the gross income.

However, in an English case of *Tennant v Smith*¹⁸ an agent for a bank was allowed to live, rent-free, in a bank-owned house, subject to two contractual stipulations; he was not to conduct any business in the house except bank business and he was not permitted to sublet the house. It was held that the value of the rent-free residence was not income because it was neither money nor capable of being turned into money.

¹⁸ [1892] AC 150 quoted by Williams at 113

In another English case *Wilkins v Rogerson*¹⁹ which *Williams* distinguishes from the above, a company gave its employees a suit valued at £15 as a Christmas gift. The tailor was instructed to send the bill to the company. It was held that the benefit of the free suit emanated from his employment and was therefore 'income' in the hands of the employee, but that its value was its realisable value to the employee, namely £5, being an amount for which he could have sold it as a second-hand clothing.

On the basis of the latter case decision, it is submitted that the first case *Tennant v Smith* was wrongly decided for the following reasons:

- (i) The value of the rent-free occupation of the bank-owned house by a bank agent could be ascertained or be convertible into money and be taxed as income in the hands of the bank agent.

¹⁹ [1961] ch 133 quoted by *Williams* at 113

(ii) If the convertibility principle was applied in *Wilkins v Rogerson* there is no reason why it was not applied in *Tennant v Smith* as in both cases the subject matter is what is given to the employee as a benefit having as a *sine qua non* or *causa causans* of the employment relationship *vis-à-vis* the employer and the employee.

It is further submitted that had the case of *Tennant* been decided in South Africa, the cash equivalent of the benefit would have been ascertained, converted and taxed as income in the hands of the employee - as in the case of *ST v COT*.²⁰

In *casu*, Whitaker P remarked that the phrase 'by virtue of services rendered' or the taxpayer's employment suggests that there must be a direct link between the cause and the result.

²⁰ (35 SATC 99)

Delivering the unanimous decision of the full bench, in Stander's case,²¹

Friedman JP held:

'Those services did not constitute the *causa causans* of the award.

Stander did not seek the prize by entering a competition. Nor did he

expect to receive anything from Delta for the work he performed for the

dealership. He merely performed his normal duties for which he was

remunerated by his employer.'

Stander it was held, did not receive the prize (trip to overseas for a seven-day holiday) as a result of his employment. When there is the required causal link between the amount received and the services rendered, then paragraph (c) of the gross income operates and, indeed overrides the common law test for capital receipts.

It is submitted that Stander's case is distinguishable from the English case of *Tennant v Smith*.

²¹ 59 SATC 212

Briefly the facts of Stander's case are as follows: Stander was employed by a motor car dealer which held a franchise from a motor manufacturer Delta Motor Corporation. Each year Delta awarded prizes to employees of its various franchise holders in recognition of excellence in the performance of their duties to their respective employers. Like Stander, these employees were not employed by Delta and had thus rendered no services to Delta.

Stander was a book-keeper for a franchise dealer. The court quite correctly held that while Stander's employment with the dealership was a *sine qua non* of the receipt of the prize for an overseas trip for seven days; that did not amount to his employment by Delta. Further there was no causal link between the services he rendered to his employer (the

car dealership) and the receipt of the prize.²² Therefore the prize he received did not fall under the definition of the gross income and for that reason it was not income. The prize was fortuitous.

In the English case *Tennant v Smith* the recipient of the benefits, a rent-free accommodation, was an employee. Consequently, the benefit was received because he was an employee – that fact is enough as a causal link, a *sine qua non* of which is the receipt of the benefit. Accordingly, the employee was supposed to have been taxed on the cash equivalent of the rent-free accommodation. Clearly the convertibility principle was applicable but was regrettably not evoked.

²² E.B. Broomberg, *Tax Strategy* 3rd Edition, Butterworths at 141

CONCLUSION

Whether the receipt or accrual is of a capital or revenue/income nature is a question of law which has to be decided on the facts and merits of each case.

The distinction between the two concepts is further compounded by the many grey areas. For instance, although the two concepts are mutually exclusive it is possible for the single amount to be partly income and partly capital.²³

This situation arises when a lump sum or a parcel of shares is paid out to a taxpayer and such a sum can be legally divisible into two categories *viz.* income and capital.

²³ RC Williams *supra* at 112

According to Williams the leading case supporting the principle is *Tuck v CIR*.²⁴ In *casu*, the value of shares received by a retired employee in terms of a management incentive plan was held to be partly income (for services rendered) and partly capital (for compliance with a restraint of trade clause).

In this case Corbett JA explained it as follows:²⁵

'It seems to me that most problems of characterisation (*of income and capital*) and the valuation of each *element* could appropriately be dealt with by applying the simple test indicated by Watermeyer CJ in the passage quoted from his judgment in the *Lever Bros* case.....viz by asking what work, if any, did the taxpayer do in order to earn the receipt in question, what was the *quid pro quo* which he gave for the receipt?'

There are two dimensions to what Corbett JA said in this case: (1) work

²⁴ *Tuck v CIR* 1988 (3) SA 819(A)

²⁵ *Ibid*

done in exchange for remuneration which translates into income, and (2) what did the taxpayer give i.e. a *quid pro quo* to earn the receipt. This is best illustrated by a case of Higgs v Olivier²⁶ where after the star had completed the shooting of a film (work done) "Henry V", the producers paid Olivier a considerable sum if he would refrain from acting in any competing film for a couple of years: What the taxpayer gave back as a *quid pro quo* for not exercising his right to work.

The film star was paid for the work done (income) and in addition he was given a sum of money "for the loss of a right to exercise his right to earn a living (capital)."²⁷

Apportionment of the lump sum between capital and income is the only logical step aimed at striking the balance between prejudicing the

²⁶ 1952 Ch 311

²⁷ ITC 1338, 43 SATC 171 per Mc Ewan J

taxpayer and giving fiscus an unfair advantage.

Another grey area of whether an amount is income or capital is a loan which is neither income nor capital in the hands of a borrower. This principle is confirmed in the dictum contained in CIR v General Motors SA (Pty) Ltd.²⁸

In addition, the statutory definition of 'gross income' implies that there are only two categories of amounts: capital or income and there is no half way house. This is further confirmed by case law.²⁹

Williams is of the view that the 'intrinsic validity of the above assertion is suspect' in that a gift made to the taxpayer out of affection or a

²⁸ 1982 (1) SA 196 (T), 43 SATC 249 at 254

²⁹ Crowe v CIR 1930 AD 122, 4 SATC 133 at 136 where it was said there is no halfway house – its either capital or income.

banknote picked on the street is surely not income.³⁰ Does it mean that it is capital? Since it does not possess any characteristic of a capital it can hardly be said it is capital either.

By contract Australia recognizes the existence of the third category over and above capital and income.³¹ It is submitted that Williams' assertions as discussed above make sense, and is more preferable.

It is crucial that for an objective determination of what constitutes capital or income, recourse be had to what the courts consider to be its bases.

³⁰ R.C. Williams *supra* at 112

³¹ Ryan *Manual of Law of Income Tax* 6 ed. at 19

CHAPTER 4

THE APPROACH OF THE COURTS IN DETERMINING WHETHER THE RECEIPT IS OF CAPITAL OR INCOME IN NATURE

4.1 INTRODUCTION

The dissenting judgement of Corbett JA in *Elandsheuwel Farming (Edms) Bpk v*

SBI¹ summarizes the entire content of the question of what is the distinction

between capital and income:

“Where a taxpayer sells property, the question as to whether the profits

derived from the sale are taxable in his hands by reason of the

proceeds constituting gross income or are not subject to tax because

the proceeds constitute receipts or accruals of a capital nature, turns

¹ 1978 (1) SA 101 (AD), 39 SATC 163 at 180 - 182

on the further enquiry as to whether the sale amounted to the realization of a capital asset or whether it was the sale of an asset in the course of carrying on a business or in pursuance of a profit-making scheme. Where a single transaction is involved it is usually more appropriate to limit the inquiry to the simple alternatives of a capital realization or a profit-making scheme. Where a single transaction is involved it is usually more appropriate to limit the inquiry to the simple alternatives of a capital realization or a profit-making scheme. In its normal and most straightforward form, the latter connotes the acquisition of an asset for the purpose of reselling it at a profit. This profit is then the result of the productive turnover of the capital represented by the asset and consequently falls into the category of income. The asset constitutes in effect the taxpayer's stock-in-trade or floating capital. In contrast to this the sale of an asset acquired with a view to holding it, either in a non-productive state or in order to derive income from the productive use thereof, and in fact so held, constitutes a realization of fixed capital and the proceeds an accrual of a capital nature. In the determination of the question into which of

these two classes a particular transaction falls, the intention of the taxpayer, both at the time of acquiring the asset and at the time of its sale, is of great, and sometimes decisive, importance. Other significant factors include, *inter alia*, the actual activities of the taxpayer in relation to the asset in question, the manner of its realization, the taxpayer's other business operations (if any) and, in the case of a company, its objects as laid down in its memorandum of association. .

'While the normal type of profit-making scheme, relating to the acquisition and subsequent sale of an asset, contemplates a continuing and unchanging purpose from acquisition to sale, the courts have recognized the possibility of an intervening change of purpose or intention. Thus, an asset may have been acquired with the intention of reselling it at a profit but thereafter the owner's intention may change and he may decide to hold it as an income-producing capital asset or investment. If, while this latter purpose persists, the asset is realized, this change of intention would be a strong indication that it was a capital realization and that the proceeds would be non-taxable . . .

Conversely, an asset originally acquired to be held as an income-producing investment may by reason of a subsequent change of

purpose or intention on the part of the owner become the subject-matter of a profit-making scheme so that the proceeds of and ultimate realization constitute gross income

'In conjunction with what has been stated in regard to change of intention, particularly the kind of change which converts a capital asset into stock-in-trade, must be read the principle that where a taxpayer wishes to realize a capital asset he may do so to best advantage and the fact that he does just this cannot of itself convert what is a capital realization into a business or a profit-making scheme There are, however, limits to what a taxpayer may do in order to realize to best advantage. The manner of realization may be such that it can be said that the taxpayer has in reality gone over to the running of a business or embarked upon a profit-making scheme. The test is one of degree''

Central to the approach of the courts are key questions that have to be answered by the taxpayer as he bears the onus²:

² S.82 Income Tax Act ss of 1962

- What is the taxpayer's intention when acquiring the asset? (*ipse dixit*)³
- What is the taxpayer's attitude towards the asset during its ownership?
- When the taxpayer disposes of the asset what is his motive?
- What is the manner of the disposition (the nature of the transaction)?
- What is the length of time the asset was held by the taxpayer?
- How often does the taxpayer buy and later sell the asset?⁴
- What is the nature of the taxpayer's business?
- The taxpayer has to satisfy the court as to whether he had any income flow and in the absence of which, the court will conclude that the asset is of a revenue nature than capital. An example of such a situation is formed in *SIR v The Trust Bank of Africa Ltd*⁵ where a taxpayer who deals in shares was able to satisfy the court that the purchase and sale of a particular share fell outside its normal business activities, and was

³ Huxham & Haupt, Income Tax 2002 at 27

⁴ *Stephan v CIR* 1919 WLD

⁵ 1975 (2) 8A 652 (AD), 37 SATC 87

therefore capital.

- How is the acquisition of the asset financed? If the purchase of the asset is financed by the taxpayer's own money, the asset is likely to be regarded as capital (investment)
- What is the nature of the asset⁶?

The above questions are by no means conclusive and exhaustive, but the court will consider them important to guide it to the appropriate finding in its enquiry.

This chapter will deal with the intention of the taxpayer, the circumstances under which capital is regarded as fixed or floating capital, and how the proceeds of the realisation companies and trusts are treated by the courts.

⁶ Marson v Mortin (1986), WLR 1343

4.2 INTENTION OF THE TAXPAYER

According to Silke⁷, the intention of the taxpayer is the golden rule and the most important test employed by the courts in deciding with what intention did the taxpayer acquire and hold the asset.⁸

However, the courts do not limit and base their enquiry for their judgement on what the taxpayer says. The varied and subjective nature of the taxpayer's *ipse dixit* necessitates that the courts test its veracity, surrounding facts and evidence⁹.

For instance, the proceeds of a sale of an asset that was acquired and held with the intention of later selling it at a profit, in a profit-making scheme it will be in the nature of income and therefore taxable. It follows that the income is derived from 'capital productively employed to earn that income'¹⁰.

⁷ Silke on Income Tax Vol.1 Chapter 3

⁸ ITC 1462 (1988) 51 SATC 168 at 172

⁹ Huxham & Haupt Sagra at 26. See also ITC 1510 (1989), 54 SATC 30 at 36

¹⁰ Overseas Trust Corporation Ltd v CIR 1926 AD 444

Nevertheless, a word of caution should be sounded at this juncture thus; a decision to sell capital asset cannot per se make the resulting profit subject to tax¹¹.

In CIR v Richmond Estates from the time of its registration, the respondent company carried on business both as a speculator in land and it also drew rent from some of its properties, the objects of the company included both land-jobbing and letting of land. Following a change of intention on the part of the company at the end of 1948, properties which had been bought for re-sale at a profit were afterwards held as an investment i.e. as capital assets as opposed to being held as stock-in-trade so as to receive merely rentals.

Centlivres CJ decided the case on the basis that¹²:

“... although the fifteen properties in question were originally bought for resale at a profit, they were afterwards held as an investment.”

¹¹ CIR v Richmond Estates (Pty) Ltd 1956 (1) SA 602 (A) at 607; See also C: SARS v H.M. Stone (Pty) Ltd an unreported case of the E.C. Income Tax Court, (14 May 1999)

¹² Ibid at 607

Consequently, a profit made when the property was sold was a capital profit, which did not attract tax.

In the unreported case of C: SARS v H.M. Stone (Pty) Ltd¹³, the taxpayer objected to being taxed on the proceeds derived from the sale of the properties which he had held as investments but later sold in order to meet his overdraft liability. The Commissioner treated the proceeds as income. The appeal was upheld on the basis that, the proceeds were of a capital nature.

It is clear from the facts of both cases as discussed above that all circumstances have to be considered because although the intention of the taxpayer is important, it is not decisive.

Corbett JA captures the above situation thus¹⁴:

“ . . . an asset may have been acquired with the intention of reselling it at a profit but thereafter the owner’s intention may change and he may

¹³ Supra (see note 11)

¹⁴ Elandsheuwel v SBI (Supra)

decide to hold it as an income-producing capital asset or investment.

If, while this latter purpose persists, the asset is realized, this change of intention would be a strong indication that it was a capital realisation and that the proceeds would be non-taxable.”

4.2.1 WHAT IF INTENTION WAS NOT PRESENT AT THE DATE OF ACQUISITION

The taxpayer may not have formed an intention at the time of acquisition as to what his purpose for acquisition is.

In *Lace Properties Mines Ltd v CIR*¹⁵, it was held that a definite election made shortly afterwards may be made to relate to the acquisition. However, in *COT v Levy*¹⁶ it was held that the taxpayer’s dominant purpose in purchasing the shares (asset) has to be given effect to after it has been ascertained. This would be the motive that would have induced him to acquire the asset.

¹⁵ 1938 AD 267, 9 SATC 349

¹⁶ 1952 (2) SA 413 (A) at 421 D

It is submitted that the judgment of the latter case is more sound and is to be preferred to the former.

4.2.2 DUAL OR ALTERNATIVE INTENTIONS

The logical conclusion to be inferred from dual intention is that the taxpayer has failed to 'discharged the onus of proof on a preponderance of probabilities that the proceeds were not of a capital nature'.¹⁷

However, where both intentions co-exist they will be considered as equally relevant¹⁸.

4.2.3 WHERE THE INTENTION WAS DONATION AND INHERITANCE

In circumstances when a company has as its stated objects that it deals in and turn to account immovable property, made a profit on the sale of land it acquired by way of inheritance; it was held that both the acquisition and disposal of the

¹⁷ Cot v Glass 1962 (1) SA 872 (FC), 24 SATC 499 at 517

¹⁸ Ropty (Edms) Bpk v SIR 1981 C, 43 SATC 141 (A)

asset were designed in a businessman-like plan¹⁹ and the proceeds were therefore income and were thus taxable in its hands.

However, in CIR v Brooks²⁰ per Beyers JA it was decided that assets acquired as a result of inheritance are of a capital nature and are therefore not taxable.

4.2.4 THE INTENTION OF A COMPANY

As a legal entity, the company has a separate legal persona from its members. It follows that its intention has to be sought from different services i.e. from the name of the company, its objects, its policy, its activities, the circumstances of the acquisition of the property and its method and bases of realization.

The general Silke²¹ contends, to which there may be exceptions, is that the intention of a company will be determined without reference to the intention of

¹⁹ CIR v Strathmore Exploration & Management Ltd 1956 (1) SA 591 (A), ITC 1343 (1981), 44 SATC 11 at 14

²⁰ 1964 (2) SA 566 (A) 26 SATC 91

²¹ Silke chapter 3

its shareholders, except in their capacity as directors of the company. It is the intention of the directors acting as directors that will usually represent the intention of the company. In the case of *CIR v Richmond Estates*²² Centlivres C once said:

“ A company is an artificial person ‘with no body to kick and no soul to damn’ and the only way of ascertaining its intention is to find out what is directors acting as such intended. Their formal acts in the form of resolutions constitute evidence to the intentions of the company of which they are directors . . . ”

However, the objects of the company as contained in its memorandum of association should not be seen as its intention. The intention test of the company still has to be ascertained quite independently from its stated objects. In the absence of any intention then it may well be that *prima facie* then its objects could be regarded as its intention until proved otherwise.

²² 1956 (1) SA 602 (A), 20 SATC 355 at 361

According to Silke²³ the test to be applied to companies is not quite the same as the test to be applied to individuals, in that even if a company carries out an isolated transaction authorised by its memorandum of buying and selling an asset at a profit, it is possible to infer that the transaction is part of a profit-making scheme. This distinction is based on the fact that a company comes into existence for a specific purpose and has no personal interest other than the fulfilment thereof.

4.3 FIXED AND FLOATING CAPITAL

In *CIR v George Forest Timber Co Ltd*²⁴, Innes CJ referred to the distinction between 'fixed' and 'floating' capital as follows:

"Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it remains intact. The

²³ Silke (Supra) Chapter 3

²⁴ 1924 AD 516, 1 SATC 20 at 23

distinction is relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed.”

It follows therefore that to a lawyer books would be a fixed capital as they produce fresh wealth in aid of the skill and knowledge the lawyer derives from them. The application of skill generates fees from the clients that are advised by the lawyer. However, the same books can be floating capital to a bookseller and would from time to time disappear, as his stock-in-trade proportionately with the sales.

Consequently, the proceeds of a fixed capital would be capital in nature and therefore not taxable as the gross income definition provides. On the other hand, the proceeds of a floating capital (stock-in-trade) would be regarded as income and therefore taxable in terms of the definition of the gross income.

4.4 REALISATION COMPANIES AND TRUSTS

It is an established principle of our law that the taxpayer is free to realise his capital assets to the best advantage without attracting tax on the proceeds through the 'realisation company' or 'realisation trust'. This concept was laid down as a principle in *Realisation v Cot*²⁵ thus:

"Where a company is formed for a legitimate purpose unrelated to tax avoidance with the express object of realising assets acquired at its formation from its promoter without attracting tax, and that company does nothing more than realise those assets, then any gains made on a simple realisation of those assets would be regarded as accruals of a capital nature".

In *casu*, the court held that the company was formed to recover capital and not to make profit, and was accordingly held not to be liable to tax.

²⁵1951 (1) SA 177 (SR), 17 SATC 139 at 160

Holmes JA endorsed the existence of 'realisation companies' in South African law in *Berea West Estates (Pty) Ltd*²⁶, where he said the following:

"In general the authorities sanction a proposition which may be illustrated along the following lines: Suppose, for example, A and B and C own a tract of land, not having acquired it with a view to sale, and they wish to realise this capital asset; and they promote a company and become the exclusive shareholders; and they transfer the land to the company for the purpose of realising the asset; and, when it has been sold, the company is to be wound up and its assets distributed among the shareholders. The company would be regarded as a realisation company, and not a company trading for 'profits', and the surplus would be regarded as a capital receipt; unless, of course, the company conducted itself as a business trading for profits, using land as its stock-in-trade".²⁷

The same principle applies to a 'realisation trust':

²⁶ 1976 (2) SA 614 (A)

²⁷ *Berea West Estates* (Ibid at 628B)

“If a trust is formed for the purpose of facilitating the realisation of property and the trust does no more than act as the means whereby the interest of its beneficiaries may be properly realised in the property, surpluses are capital receipts.”²⁸

However, in *Natal Estates Ltd v SIR*²⁹ the taxpayer did ‘something more’ than the mere change of intention and crossed the proverbial Rubicon. In more ways than one this case is distinguishable from the *Berea West Estate*.

In *Natal Estates* case, the taxpayer disposed of land, which it held for many years as a capital asset by entering into the profit-making business of township development and marketing of township land on a wide scale. The Appellate Division held that the company had changed its intention in regard to the land and had gone over to the business of selling land for profit – Accordingly the proceeds of the sale of land were income and taxable³⁰.

²⁸ *JM Malone Trust v SIR* 1977 (2) SA 819 (A), 39 SATC 83 at 94

²⁹ 1975 (4) SA 177 (A), 37 SATC 193

³⁰ Silke chapter 3

CONCLUSION

It is submitted that although the intention of the taxpayer is central in the enquiry on which the courts heavily rely for their final findings and judgment; the subjective nature emanating from the taxpayer's self interest in the outcome demands that a thorough verification of facts be conducted. As shown in the case law, the courts do this by considering all surrounding circumstances and factors that may have a bearing on the intention of the taxpayer.

As previously alluded to, take the taxpayer's intention is not conclusive although it is important, it is submitted that transactions which could be clothed with something else when in fact they mean something different in essence, need to be examined more closely.

The following chapter is going to examine various transactions entered into by taxpayers and establish the approach of the courts in determining whether

proceeds arising from them are capital or income in nature. The guiding principle will be the evidence of the taxpayer and any other relevant factors.

CHAPTER 5

DISTINCTION BETWEEN CAPITAL AND INCOME: SPECIFIC TRANSACTIONS

5.1 INTRODUCTION

Transactions are entered into by taxpayers in the course of either business , trade or in personal isolated instances. It follows that because taxpayers do not have a moral obligation to pay tax but a legal duty to do so, it is within their legal right to structure their transactions to pay least tax or not to pay tax at all

Lord Tomlin captured the above principle thus: ¹

"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.

If he succeeds in ordering them so as to secure this result, then,

however unappreciative the Commissioners of Inland Revenue or his

¹ Duke of Westminster v IRC 51 TLR 467, 19TC 490

fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”

In defence of legality the courts seek to uphold the legally accepted ways and means of avoiding tax. Tax avoidance schemes are dealt with extensively in chapter 23 of Silke.²

5.2 DISPOSAL OF CAPITAL ASSETS

As previously stated, the golden rule is the intention of the taxpayer when he acquired the property³. Although this line of enquiry is fundamental it is not decisive and conclusive. However, it is conceded that the real intention of the taxpayer can be difficult to establish in convincing and watertight terms. For instance, the intention of the taxpayer is one of the elements but not the only element of the problem.⁴

² See further under S.103 of the Income tax Act

³ *Reliance Land and Investment Co Pty Ltd v CIR* 1946 WLD 171 at 178

⁴ *CIR v Goodrick* 1942 OPD, at 15, 12 SATC 279

The problem can be more complex if the various taxpayers participating in the same venture have different intentions⁵.

In CIR v Stott⁶ the facts briefly were as follows:

The taxpayer was an architect and a surveyor practising at Pietermaritzburg, and his occupation gave him opportunities of judging the value of land. He had three classes of investment; stock, mortgages and land. If his funds permitted, he unlisted money in the acquisition of land.

His land investments were as follows:

- First investment was bought some 30 years ago which he let and subsequently sold it at a profit
- Bought a farm in Vryheid district which he let for 5 years, and he had one or two town properties from which he received rent

⁵ ITC 1071 1966 Taxpayer 91, 27 SATC 185

⁶ CIR v Stott (Supra) at 261

- Bought 2 acres at Winkelspruit as a seaside residence – the place became congested, and he decided to move away. In 1918 he cut the property up into 5 lots and sold them.
- Bought 50 acres of land at Ifafa on the South Coast of Natal. Later on he surveyed half of the block in lots and sold these at a profit.
- Bought a small fruit farm at the Bluff. The farm was bought with a long lease but when the tenant failed to pay rent the taxpayer re-let the farm. He later cut up the farm in lots and sold these at a profit.

From the facts of the case, it is evident that the taxpayer had bought the properties for investment purposes and the reasons for that conclusion are as follows:

- The taxpayer was not a land-jobber
- He kept the properties for a long time and only moved or sold because of changed circumstances of the nature of the surroundings of the property, or resold the property because of some other reason other than 'crossing

the Rubicon'. The fact that the taxpayer made profit is not in itself indicative of any change of intentions on his part.

The remarks by Wessels JA in *casu*⁷ are instructive:

"The mere fact that the land was cut up into lots rather than sold as a whole could not by itself alter the character of the proceeds derived from the land from the capital to gross income. Nor could the fact that Stott as a surveyor know somewhat more than the ordinary public about the value of land make any difference. Certainly, the fact that Stott cut up the land himself into lots rather than employ another surveyor could not convert an ordinary investment of capital into a trade or business. Every person who invested his surplus funds in land or stock or any other asset was entitled to realise such asset to the best advantage and to accommodate the asset to the exigencies of the market in which he was selling".

⁷ CIR v Stott (*supra*) at 261

The court came to a conclusion that the proceeds arising from the sale of the capital asset were capital in nature and therefore fell outside the scope of taxation.

It is however submitted that had Stott been a legal entity and not an individual, the decision of the court would have been different. The reason is that if the company carries out an isolated transaction authorised by its memorandum of buying and selling an asset at a profit, it is possible to infer that the transaction is part of a profit-making scheme⁸. It follows that this distinction is based on the fact that a company comes into existence for a specific purpose, which is devoid of any personal interest other than the fulfilment thereof⁹.

In LHC Corporation¹⁰ of SA (Pty) Ltd v CIR case where a company the business of which is to deal in shares buys shares, it makes its profits either by selling or

⁸ Silke (supra) at 23

⁹ CIR v Lydenberg Platinum Ltd 1929 AD 137 at 145 – 6, 4 SATC 118

¹⁰ 1950 (2) SA

holding them which are alternative methods of dealing with the shares for the purpose of making profit out of them – the proceeds therefrom are income in nature. Nevertheless, an exception to the general rule would be a situation where the same company buys shares with the purpose of retaining them as an investment – such shares would be beyond taxation if the company later sells them as they were not acquired or later sold in a profit-making scheme.

5.3 SHARE TRANSACTIONS

Shares may be assets of a capital or income nature depending on the facts of each case. In a case of *Deceased Estate v COT*¹¹ a company that owned land received an offer from a prospective land purchaser. The shareholders of the company refused the offer and instead insisted that the purchaser acquire their shares in the company. The court made an inference that the whole transaction was a profit-making scheme and hence taxable.

¹¹ 1949 (4) SA 491 (SR), 16 SATC 305

Silke¹² is of the view that profits and losses resulting from share transactions are of a revenue nature if the shares were acquired for the purposes of resale at a profit and that there is no reason why transactions on the stock exchange should be governed by different rules. It follows that if shares are acquired not for the purpose of dealing but as an income-bearing asset to hold as an investment, any subsequent profit or loss is capital in nature.

In a situation where one person in a syndicate has a different intention from the majority of the members of the syndicate, it was held that his interest would prevail in determining the nature of any gain made by him personally.¹³

In *Block v SIR*¹⁴ where the facts briefly are as follows: Block acting as a trustee for a company about to be formed, purchased a certain property which was suitable for township development. The company, which subsequently came into

¹² Silke (supra) Chapter 3

¹³ *COT v H & J Hepker* (1933) AD 192, 6 SATC 87

¹⁴ 1980 (2) SA 401 (c), 42 SATC 7

existence, took the necessary steps towards the establishment of a township

During this period the land appreciated considerably and the shareholders, one

of whom was Block decided to sell the property at a large profit. When the

profits were distributed among the shareholders the Secretary for Inland

Revenue assessed Block to pay tax on his share of the profits. Block appealed

against

the assessment raised to the Special Court which ruled against him and upheld

the tax authority's appeal. In further appeal to the Cape Provincial Division

Grosskopf upheld Bloch's appeal.

The learned judge based his judgment on the fact that on account of the

diversity of shareholders, the taxpayer had acquired the shares as capital

investment and the profit that he had received from the company had been

derived from the realisation of an investment.

It is submitted that the objects of the company do not necessarily reflect the intention of the shareholders. In *SIR v The Trust Bank of Africa*¹⁵ Botha A supported the above proposition thus:

“The objective factors, such as the objects of the company as set out in its memorandum of association, the actual nature of the company’s business, the normal business carried on by companies of that type, and the nature of the transaction, may, in an enquiry as to the purpose for which those shares were acquired by such a company, assume greater significance than the intention with which those shares were acquired . . . In such a case it would be extremely difficult for the company to show that a particular share transaction nevertheless falls outside its normal trading activities in the sense that the shares were not acquired for a profitable resale but to be held purely as an investment . . .”

A useful insight into the modern approach to share transactions is provided by

¹⁵ 1975 (3) SA 652 (A), 37 SATC 87 at 104-5

the following:¹⁶

“It is possible where a taxpayer is . . . involved in the share market, and buys and sells shares, his intention with regard to different shares may differ. In other words, the mere [fact] that he is, as it were, dealing in shares quoted on the Stock Exchange, does not mean that all the shares he acquires and sells are necessarily treated as capital or treated as revenue-producing. It is necessary to look at the purpose under which he comes to sell that particular counter.”

With regard to disposal of ‘affected shares’ (as defined)¹⁷, the taxpayer is granted the right to elect that an amount received by or accrued to him as a result of disposal, on or after 14 March 1990 will be deemed, for the purposes of the definition of gross income, to be of a capital nature. The election can be made by any person other than the taxpayer.¹⁸

¹⁶ Per Friedman J, President of the Special Court for Hearing Income Tax Appeals in ITC 1412 (1983), 48 SATC 157 at 160 as quoted by Silke

¹⁷ In S. 9B (1) Income Tax Act

¹⁸ S. 9B (2)

5.4 ISOLATED AND RECURRENT TRANSACTIONS

Whether transactions are isolated or happen as once-off events makes no difference in determining capital or income. The key factor is the nature, if it is profit-making then the proceeds arising therefrom constitute income and are taxable.

The above principle was laid down in *Stephen v CIR*¹⁹. However, the intention of the taxpayer will be decisive at the end.

Silke contends that the superior courts have not yet explicitly disposed of the question whether an individual may be subjected to tax on the proceeds of the asset he acquired with the intention of reselling it at a profit. Especially if such taxpayer is not carrying on the business of dealing in assets of a similar kind. Instead the courts have made a distinction between individuals and companies.

¹⁹ 1919 WLD 1, 32 SATC 54

In CIR v Lydenburg²⁰ the above contention by Silke was confirmed thus:

“ So that ‘continuity’ (as it has been called) is a necessary element in the carrying on of a business in the case of an individual, but not a company.”

Centlivres CJ²¹ expressed the same principle as follows; a company:

“ may carry out an isolated transaction as a profit-making scheme whereas it may not be so in the case of an individual”

It is submitted that the distinction is drawn between a company and an individual because a company exists to make profit whereas an individual may have other interests other than making profit. It follows that it is from these interests of individuals that something other than profit-making may be inferred.

²⁰ 1929 AD 137, 4 SATC 8

²¹ CIR v Paul 1956 (3) SA 335 (A)

CONCLUSION

It is interesting to note that 'once income has accrued or has been received its subsequent disposal or application by the taxpayer cannot alter the incidence of tax thereon'.²²

Consequently, the accrual or receipt of income does not and cannot change taxation on the amount received even if the taxpayer can claim to cede some to the third party (only after it has been received).²³ A crisp question that has to be answered is whether the amount has accrued to or has been received by the taxpayer before it is disposed of? If the answer is in the affirmative, then the next set of questions can follow with regard to whether the amount is taxable or not, having regard to its nature and the transaction that has led to its accrual.

²² Meyerowitz on Income Tax 2000 – 2001 ed. 6.31.

²³ For details see *CIR v Witwatersrand Association of Racing* 1960 (3) SA 291 (A)

The case law has established the basic principles upon which the distinction between capital and income is based in various transactions.

It is submitted that the distinction that is drawn by the court between the frequency of transaction between the companies and individuals; to readily infer profit-making on the part of transactions conducted by companies as opposed to those that individuals enter into; is not satisfactory and convincing.

It is further submitted that the fact that 'the superior courts have not yet explicitly disposed of the question whether an individual may be subjected to tax on the proceeds of an asset he acquired with the intention of reselling it at a profit if he is not carrying on the business of dealing in assets of similar kind'²⁴, is not satisfactory and convincing either. More so, if a distinction is made in this regard between individuals and companies.

²⁴ Silke (supra) Chapter 3

CHAPTER 6

EXPENDITURE OR LOSS: CAPITAL OR INCOME IN NATURE

6.1 INTRODUCTION

As receipts and accruals of a capital nature are excluded from the taxpayer's gross income in terms of the definition of the gross income¹; an expenditure or loss is not deductible if it is 'of a capital nature'.²

The phrase 'expenditure or loss of a capital nature' is not defined in the Income Tax. Recourse has to be had to the decisions of the courts. However, the courts have found it impossible to define the phrase either.³

However, certain capital expenditure as provided by the Act, *viz* Sections 11(d), 11(e), 11(f), 11(o), 12, 12B, 12C and 13 are allowed as deductions.

¹ S.1 Income Tax Act (gross income definition)

² S. 11(a) Income Tax Act

³ *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A) at 595

It follows that the tests that the courts have laid down to determine what 'expenditure or loss of a capital nature' is to be discussed and analysed in the context of various factual situations.

6.2 THE TESTS

Prima facie an expenditure that is made for the creation or extension on an existing structure which would lead to an existence of an enduring benefit, would be regarded as a capital expenditure. Consequently, it would not be an allowable deduction in terms of S. 11(a).

Nevertheless, it is not important or decisive 'that the expenditure should result in the creation of a new asset or in an addition to an existing asset before it can be said that the expenditure is of a capital nature. It will be capital expenditure if, on the facts and circumstances of the case the expenditure relates to the income-earning operations⁴ or is for the enduring benefit of the taxpayer's trade.⁵

In the above-mentioned case two types of income-earning sources are envisaged and distinguished: the corporeal (tangible) and the incorporeal (intangible). It is submitted that the former would be *e.g. a dam, a factory*

⁴ Cadac Engineering Works (Pty) Ltd 1965 (2) SA 211 (A), Heron Investments (Pty) Ltd v SIR 1971 (4) SA 201 (A)

⁵ Atlantic Refining Co of Africa (Pty) Ltd v CIR 1957 (2) SA 330 (A) 1957 Taxpayer 109, 21 SATC 230

(*building*), a truck, a farm etc. all of which constitute enduring operations for the benefit of the taxpayer. The latter type would be a copyright, a goodwill, a restraint of trade, a right etc.

It would appear the determining factor is what Steyn CJ said in *Smith v SIR*⁶

“Expenditure of a capital nature is, of course, not a precise expression. It connotes a relation between expenditure and capital close enough to draw the expenditure into the ambit of capital. The features of that relationship are not readily definable with any precision and our Courts have not attempted any comprehensive definition. The words ‘of a capital nature’ qualify ‘expenditure’...”

The first ⁷ question is not whether this structure is of a capital nature, but whether that to which it relates is capital. This question has to be answered in the affirmative before the court could determine whether or not the connection between the expenditure and the appellant’s capital is sufficiently close to characterise the expenditure of a capital nature.

From what Steyn CJ said in *casu* it is clear that any attempt to define a capital expenditure would defeat the enquiry because the question has been answered by ‘mere *indicia*’ pointing to a conclusion the way or the other;

⁶ 1968 (2) SA 480 (A) at 488 C - D

⁷ *Smith v SIR* (Supra) at 488 E - F

they are not in law the essential distinctive attributes of or point to a conclusion of law, and no matter how conclusively they may point; they remain facts, not legal conclusions.⁸

The question as to whether the expenditure incurred for improvement by a person other than the owner who is not leasing the property is deductible was raised in *CIR v Manganese Metal Co (Pty) Ltd.*⁹

Briefly the facts of the case are as follows:

The taxpayer's company carried on business of converting manganese in raw form to manganese metal and in the process produced a toxic residue with no commercial value which had to be disposed of. The taxpayer entered into an agreement with the town council in terms of which the town council provided the taxpayer with quarry on the council's property for the purposes of disposing of the toxic waste. In order to utilize the quarry the taxpayer constructed a substantial concrete arch dam wall at the mouth of the quarry. The quarry could be used for this purpose for a number of years, after which a new dumping facility would have to be found by the taxpayer.

The taxpayer claimed a deduction for the expenditure incurred in connection with the construction of the dam wall in terms of S. 11(a) of the Income Tax

⁸ *SIR v John Cullum Construction Co (Pty) Ltd* 1965 (4) SA 697(A), 27 SATC 155 at 164

⁹ 1996 (3) SA 591 (T)

Act, alternatively in terms of S.11 (g) of the Act which entitles the lessee to deduct the cost of improvement as follows:

- Annually
- Spread over the period of the initial lease or 25 years (which ever is shorter).
- Reduced for partial year
- Commencing when the improvements are completed
- Provided that the land or buildings are occupied or used by the lessee for the production of income. The Commissioner disallowed the deduction in terms of S.11 (a) contending that the expenditure in question was of capital nature and disallowed it. The expenditure was not incurred in terms of an agreement of lease as contemplated in S.11 (g).

Delivering the majority judgement Wunsh J held¹⁰

“Expenditure directed at the creation or durable enhancement of a capital item, such as immovable property, is of a capital nature, even though the permanent and ultimate benefit thereof will accrue to the owner of the asset if he is not the person who expended the money.”

¹⁰ CIR v Manganese Metal Co (Pty) Ltd (Supra) at 597 H

With regard to the second issue of the alternative claim in terms of S.11 (g), the learned judge said; ¹¹

“I conclude therefore that the respondent (taxpayer) has proved that the expenditure incurred by it was pursuant to an obligation under clause 10 (with the council) and that it is entitled to the deduction granted by S.11 (g).”

It is worth mentioning that, the benefit that the taxpayer was entitled to was an intangible i.e. the right to build a dam and make use of a quarry, both of which he never owned.

It is submitted that the judgement of Wunsh J concurs with the principles laid down in *New State Areas Ltd v CIR* ¹²per Watermeyer CJ:

“When the capital employed in a business is frequently changing its form from money to goods and *vice versa* (e.g. the purchase and sale of stock by a merchant or the purchase of raw material by manufacturer for the purpose of conversion to a manufactured articles) and this is done for the purpose of making a profit, then the capital a employed is floating capital. The expenditure of a capital nature, the deduction of which is prohibited under S.22 (2),¹³ is expenditure of a fixed capital nature not expenditure of a floating capital nature.”

¹¹ Ibid at 615 H

¹² 1946 (AD) 610 as quoted in *CIR v Genn & Co. (Pty) Ltd* 1955 (3) SA 293 (A) at 299 E, 20 SATC 113

¹³ Now S.11(a)

Central to the above quotation by Watermeyer CJ is the notion of the close examination of the transaction itself by the courts, i.e. 'the application of this general guide has been likened to having regard to the 'substance and reality of the transaction'.¹⁴

In CIR v George Forest Timber Co Ltd ¹⁵ Innes CJ made the following statement:

"Now money spent in creating or acquiring an income producing concern must be capital expenditure. It is invested to yield a future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit and money spent working it. The one is capital expenditure the other is not."

The court took the view that the purchase price paid for the forest-bearing land was expenditure of a capital nature, and that it was not permissible to divide the single purchase of the property between the bare land and the forest. It is submitted that should the consideration take the form of a period payment based on the quantity of tree removed, the expenditure would be of income nature.

¹⁴ CIR v General Motors SA (Pty) Ltd 1982(1) SA 196 T, 43 SATC 249 at 253

¹⁵ 1924 AD 516 at 523

However, the exception would be a farmer who acquires a plantation with or without the land on which it stands, he would be entitled to deduct from income the cost of acquisition of the plantation. The principles applicable in George Forest Timber case are therefore not applicable to plantation farmers.¹⁶

On the basis of the above statement two dimensions of the income-earning concern need to be discussed; first, the fact that the expenditure that is incurred is of a capital nature does not mean that money was not spent in the production of income. In essence it means the expenditure is incurred for acquiring a source of income / profit and the expenditure as incurred does not qualify to be allowed as deduction in terms of S.11 (a) – because it is of a capital nature. Secondly, if for instance a taxpayer incurs expenditure in order to produce income itself as opposed to the expenditure made to create a source of income / profit then the expenditure so incurred is not of a capital nature; and is allowed as deduction in terms of S.11 (a).

The above principles were cogently laid down in a case ¹⁷ of COT v Nchanga Consolidated Copper Mines Ltd where a payment by one company to an associated company in consideration for the cessation of production by the associated company for one year was held not to be of a capital nature. The court took the view that the expenditure was not made as part of the cost of

¹⁶ Silke Chapter 7

¹⁷ [1964] AC 947, 26 SATC 37

the income-earning structure, but as part of the cost of the income-earning operation, and considered that the taxpayer proved on a balance of probabilities that the payment was not of a capital nature.

With regards to foreign exchange loss associated with borrowed money, the court had to decide whether the loss was of a capital or income nature.¹⁸ The first line of enquiry was to establish the motive for borrowing the money and its subsequent use. The court held that the money was borrowed for capital purposes only and for that reason no deduction was allowed.

However in *CIR v General Motors SA (Pty) Ltd*,¹⁹ where there were losses that arose when loans that were raised in a foreign currency were repaid. The court took the view that the purpose for the money and its effect were for income-earning operations and the deduction was accordingly allowed.

It would appear where savings are made which lead to the increase of the taxpayer's income as a result of the employment of the services of a consultant such expenditure is allowable. In *ITC 9734 (1993)*, the appellant company, a manufacturer and distributor of plumbing and sanitary-ware, after a merger with another company, engaged the services of a consultant.

¹⁸ *Plate Glass and Shatterprufe Industries Finance Co (Pty) Ltd v SIR* 1979 (3) SA 1124 (T), 41 SATC 103 at 110 - 13

¹⁹ 1982(1) SA 196 (T), 43 SATC 249

The consultant advised that savings of at least R2.3 million could be achieved.

In fact the taxpayer's income increased by R3.1 million. The taxpayer paid R869 000 for the advice and thereafter claimed deductions for consulting fees relating to the running of the factory.

The court held per Melamet J that the deduction was of a revenue nature and was therefore properly claimed.

In ITC 1723 (2002), the court had to determine whether the firm was entitled to deduct legal fees it incurred for raising a bond on a property. The firm owned rent-producing property. IT procured a bank loan which it granted to a newly formed company at a favourable interest rate.

The taxpayer argued that in granting the loan to the newly formed company, it had been able to earn interest income and pursue its secondary business of acting as a finance company.

The court held that the company did not carry on business as a money lender and did not deal with money as stock in trade. It said the money lent by the company to the newly formed part of its fixed capital, not floating capital. The bond-raising fee and expenditure on legal costs, unlike interest paid on either of these items, was of a capital nature. The company was not entitled to deduct the bond-raising and legal fees.

6.3 CONCLUSION

From the discussion and analysis of the case law, it is clear that the tests applied by the courts to determine whether the expenditure is 'not of a capital nature'; are not conclusive as courts rely heavily on the facts and merits of each case.

In *Rand Mines (Mining & Services) Ltd v CIR*²⁰ the above mentioned was aptly expressed as follows:

“ An abiding problem has been to identify and then synthesise into a reasonably accurate and universally applicable yardstick the factors which are indicative of each of the two classes of expenditure. No such yardstick has yet been fashioned and the attempt has come to be regarded as futile and has been abandoned. Instead, the courts have

²⁰ [1997] 1 ALL SA 279 (A), 59 SATC 85 at 92

identified useful *indicia* to which regard may be had, emphasising that they are no more than that and that in each case close attention must be given to its particular facts. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* ²¹ the judge warned against the notion that any of the *indicia* identified by the courts, taken singly, will always lead to the right conclusion.”

Nevertheless, three broad tests have been identified where expenditure incurred is of a capital nature, as follows:

- It adds to the taxpayers income-earning structure
- It is a once-off expense from which future income will flow
- It creates an enduring benefit for the taxpayer

²¹ Per Viscount Radcliffe (*Supra*) at 959

CHAPTER 7

CONCLUSION

Tax Law is by its very nature open to the reproach of being incomprehensible by individuals affected, and even frequently by their legal advisers.¹ This situation has led to an enormous volume of dispute and argument and a great deal of litigation.

As indicated in the introduction many concepts like 'capital', 'income', 'not of a capital nature' are not defined and yet interpretation of the very concepts need to be ascertained by our courts in a way that will convey certainty.

¹ D.M. Walker, the Oxford companion to law, Clarendon Press, 1980 at 1209

Our courts have over the years grappled with quite a number of concepts which are merely written in the statute without being defined. As has been alluded to earlier in this research, words are problematic as they are always capable of different meanings in different situations and to different people at any given time. Leaving the words undefined exacerbates the situation even further.

A *locus classicus* of how the words 'behave' in various contexts is aptly captured by T.S. Eliot in Part V of *Burnt Norton*,² the first of the Four

Quartets:

' ... Words strain

Crack and sometimes break, under the burden,

Under the tension, slip, slide, perish,

Decay with imprecision, will not stay in place,

will not stay still...'

² Quoted by G.E. Devenish *Interpretation of Statutes* (1992) 3

The above situation is worst still if words have to be so eloquently expressed to persuade, dissuade and convince in the heat of litigation.

Great reliance is on the courts to fulfil their creative role and give life to the statutes by interpreting and construing them creatively.

Cross³ opines that many problems and deficiencies in the process of statutory interpretation cannot be solved by legislation or law reform.

This assertion has to a large extent some merit. The legislature cannot foresee every possibility and cover every eventuality when drafting the statutes. It follows that the role of the Judiciary in fulfilling the silent parts of the statute is inevitable.

Problematic interpretations of factual situations by our courts have somewhat been unsatisfactory at times and one hopes that some time

³ Statutory Interpretation 3 as quoted by G.E. Devenish (Supra) at 9

these will be resolved. The first is the distinction between the intention of an individual when disposing of capital assets and the company. The intention is very important because it ultimately determines whether the proceeds of the capital assets are of a capital or revenue nature, and thus are taxable or not.

In *Stephans*⁴ case, the salvaging of a single ship's cargo was considered a business because:

"These salvage operations which were managed by the staff of the appellant's business, and which necessitated as many ordinary business acts such as the engaging of services of men, hiring apparatus, purchasing equipment, the transport of the cargo to Cape Town... stand on an entirely different footing," per Mason J.

The above remark illustrates that from an isolated transaction by a company it can be inferred that the company is involved in profit-making,

⁴ *Stephan v CIR* 1919 WLD 1 at 7, 32 SATC 54

and therefore its intention is to earn income the proceeds of which are taxable.

However, in the case of an individual there has to be continuity of some activities for there to be an inference that the individual concerned has an intention of profit-making. Consequently, the proceeds flowing from such transactions will be regarded as capital income and therefore not taxable.

The above principle was crystallized in the case of CIR v Lydenburg Platinum Ltd ⁵

"So that 'continuity' (as it has been called) is a necessary element in the carrying of a business in the case of an individual but not of a company. Indeed, many cases have come before this court where there has only been one profit-making transaction of a company, and that fact has never been

⁵ 1929 AD 137, 4 SATC 8 at 16

relied upon as in any way decisive of the question whether the profit was made in the carrying or otherwise.”

The distinction that is drawn between the intention of the company and that of an individual by our courts is with respect, superficial, arbitrary and thus cannot be sustained.

An individual can embark in a profit-making activity and earn income but because a profit-making scheme cannot be readily inferred the proceeds can be regarded as capital in nature whereas they are in reality of income nature.

A very clear anomaly is that of Stott's ⁶ case where the taxpayer (or individual) fitted the criterion of continuity of his activities in buying and selling land.

⁶ CIR v Stott 1928 (AD) 252, 3 SATC 253

Stott, a land surveyor and architect by profession bought 50 acres of land at Ifafa in August 1920 with the intention of building a seaside residence. He bought it for £ 990. In April 1921 he was asked to sell 30 acres to which he responded that he had no intention to sell but if he could be offered £ 3,000 he would sell the whole block for that amount. Later on he surveyed half of the block in lots and sold them at a profit. In each of the years 1922, 1923 and 1924 he realised a profit of £ 706. In March 1921, the taxpayer bought a small fruit farm at the Bluff. He then cut up the farm in lots and sold these at a profit of £ 623 in 1923 and £ 624 in 1924.

The decision of the court is criticised on the following bases:

IFAFI PROPERTY

The property was bought (50 acres) in August 1920 at £ 990 for the sole reason of building a seaside residence (investment). When the taxpayer was asked to sell 30 acres within a year in April 1921 (i.e. 8 months

later), he was only prepared to sell it for £ 3,000. Later on he surveyed half of the block in lots and sold them at a profit of £ 706.

It is submitted with respect that the taxpayer had established the requisite continuity which qualifies his activities as profit-making, for the following reasons:

- The taxpayer's stated initial intention was to invest in the property but within 8 months he was prepared to sell 60% of the property at £ 3,000
- Later on he surveyed half of the block in lots and sold them at a profit of £ 706 in each of the years of 1922, 1923 and 1924

THE BLUFF PROPERTY

The taxpayer in 1921 bought the above-named property and cut it up into lots and sold these at a profit of £ 623 in 1923 and £ 624 in 1924.

It is submitted with respect that the length of time within which the property was sold and the effort put into cutting up the lots, cumulatively amounted to embarking upon a profit-making scheme.

The *modus operandi* of the taxpayer and the *res ipso liquitur* are clear; but because he is an individual it is not readily inferred that he had changed his intentions borne out by the profits he derived from the sales.

The majority judgment of the Special Court, it is submitted is preferable for the reasons stated above.

This case shows how creative case law is and how it changes as judges grapple with various issues with which courts are seized.

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