



**Capital versus Revenue – A critical discussion on the correct test to be applied in determining the nature of an asset for Income Tax purposes**

by

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## **DECLARATION**

I, Quentin Quarsingh, hereby declare that the work on which this dissertation is based on is my original work (except where acknowledgments indicate otherwise) and that neither the whole work nor part of it has been, is being, or is to be submitted for another degree in this or any other university. It is hereby presented in partial fulfilment of the requirements for the award of Master of Laws in Taxation.

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Quentin Quarsingh

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Date

## **STATEMENT OF ORIGINALITY**

This project is an original piece of work which is made available for photocopying and for inter-library loan.

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Quentin Quarsingh

## **ACKNOWLEDGEMENTS**

In reading for my Masters, Sabinet was particularly useful. The database provided the majority of secondary sources which have been used herein. The database also introduced me to leading academics in the field whom were subsequently researched.

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## **CHAPTER 1**

### **1.1. Introduction**

The nature of a receipt or accrual gained by an individual taxpayer on the disposal of an asset is of significant importance for income tax purposes. This consideration can be classified as either ‘capital’ or ‘revenue’ as envisaged in the definition of ‘gross income’ in terms of the Income Tax Act.<sup>1</sup> The relevant excerpt of the definition provides that gross income includes receipts and accruals received by a taxpayer...‘excluding receipts and accruals of a capital nature.’<sup>2</sup>

The consequence of this exclusion is that a taxpayer may dispose of an asset and the amount received from such disposal will be excluded from his gross income. Therefore, the taxpayer’s liability for income tax towards the fiscus will be reduced. For this exclusion to apply, however, the asset disposed of must have been a capital asset. It must be noted, however, that a taxpayer will not escape tax liability entirely for the gain received upon the disposal of a capital asset. Capital gains tax, which is dealt with in the Eighth schedule of the Act will still be payable. A ‘capital gain’ is defined as:

‘A person’s capital gain for a year of assessment, in respect of the disposal of an asset during that year, is equal to the amount by which the proceeds received or accrued in respect of that disposal exceed the base cost of that asset.’<sup>3</sup>

A further exposition on capital gains tax and the payment thereof is, however, beyond the scope of this dissertation.

Given the normal tax implications and consequences of the disposal of an asset, it would have been expected and necessary for the Act to deal with the concepts of ‘capital’ and ‘revenue’ in detail. However, the Act is silent on how these terms should be defined and applied.

It is, therefore, necessary to turn to local and foreign courts for assistance to determine whether an asset is capital or revenue nature. Despite the vast array of case law dealing with capital and revenue, ‘the subject is still as murky as ever.’<sup>4</sup> At best, our courts have provided guidelines

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<sup>1</sup> Act 58 of 1962 (hereafter referred to as ‘the Act’).

<sup>2</sup> *Ibid* Section 1.

<sup>3</sup> *Ibid* Section 3 of the Eight Schedule.

<sup>4</sup> G Urquhart ‘Capital v. Revenue: Some Light in the Darkness’ 1979 *Acta Juridica* 299.

which can be used to determine the capital or revenue nature of an asset without providing one infallible test.<sup>5</sup>

A common guideline or factor often assessed has been the broad factor of intention. The intention of a taxpayer at the time of acquisition of an asset,<sup>6</sup> mixed intentions of a taxpayer<sup>7</sup> and a change of intention<sup>8</sup> have been discussed and expounded by our courts in determining the capital or revenue nature of an asset.

Further, some courts have considered whether the taxpayer has engaged in business in a scheme of profit-making.<sup>9</sup> This raises a further inquiry on how this test should be applied. Some courts have employed the use of a purely subjective test,<sup>10</sup> while other courts have proceeded to answer this enquiry by employing an objective test.<sup>11</sup>

Regard must also be given to S102(1)(a) of the Tax Administration Act.<sup>12</sup> This section creates a hurdle for a taxpayer should he wish to challenge the findings of the Commissioner. S102(1)(a) provides that ‘the onus is on the taxpayer to prove that an amount is exempt or otherwise not taxable.’<sup>13</sup> The initial assessment provided to a taxpayer is regarded as being *prima facie* correct.

‘The taxpayer must then prove on a balance of probabilities that he was not engaged in a scheme of profit-making and that the income derived from the sale of the asset was therefore capital in nature and not taxable.’<sup>14</sup>

The varying factors, guidelines, tests and how these tests should apply has resulted in uncertainty in determining the true nature of an asset.

### **1.1. Statement of purpose**

The purpose of this dissertation is to critically analyse the broad definitions of ‘capital’ and ‘revenue’ as used in the Act.<sup>15</sup>

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<sup>5</sup> *CIR v Pick n’ Pay Employee Share Purchase Trust* 1992 (2) SA 245 (AD), 3 of Smalberger J para 2.

<sup>6</sup> *Willcox v CIR* 1960 (4) SA 599 (AD).

<sup>7</sup> *African Life Investment Corporation (Pty) Ltd v SIR* 1969 (4) SA 259 (AD).

<sup>8</sup> *Natal Estates v Secretary of Inland Revenue* 1975 (4) SA 177 (AD).

<sup>9</sup> Note 5 above, 19 of Nicholas AJA judgment para 1.

<sup>10</sup> *Ibid*, which was evident from the judgment of Smalberger J.

<sup>11</sup> *CSARS v Wyner* 2003 (4) SA 541 (SCA), which was evident from the majority judgment.

<sup>12</sup> Act 28 of 2011.

<sup>13</sup> *Ibid*.

<sup>14</sup> AW Oguttu ‘The courts will not be beguiled : schemes of profit-making concealed as capital in nature exposed’ 2003 *Jutas Business Law* 230-233.

<sup>15</sup> Note 2 above.



This dissertation will attempt this analysis by first discussing what makes an asset ‘capital’ and what makes an asset ‘revenue’. Regard will then be given to earlier case law which has dealt with the concepts of capital and revenue. There will be a review of the factual background of these cases and an analysis of the reasoning used by these courts in arriving at their respective decisions.

This dissertation will then critically analyse the factor of ‘intention’ when used to establish the capital or revenue nature of an asset. Regard will be given to the intention of the taxpayer on acquisition of an asset, mixed intentions and a change of intention.

This dissertation will then provide a focused and detailed critical assessment of leading and current case law which has dealt with various factors, considerations and tests in determining the capital and revenue nature of an asset. There will also be a discussion on how these tests have been applied.

### **1.2. Rationale for study**

This dissertation seeks to achieve greater certainty regarding the capital and revenue nature of an asset and how these assets can be so categorised. This study is significant because the tax implications of having proceeds generated from the sale of an asset classified as either capital or revenue, has far reaching tax consequences for an individual taxpayer as well as the fiscus.

As will be shown in this dissertation, there is a vast array of approaches, tests, guidelines and factors which have been considered when making a distinction between capital and revenue. While a vast array of scenarios and approaches provide a broader scope on the topic of capital versus revenue, it does little to provide certainty and clarity to all parties considered.

It is therefore necessary to attempt to streamline the various approaches and tests to the topic under consideration to provide greater certainty and clarity to taxpayers, the fiscus and the legal fraternity at large.

### **1.3. Research questions**

#### **Main research questions**

1. How to determine the capital or revenue nature of an asset for Income Tax purposes?

#### **Research sub-questions**

- (i) How do different factors affect the nature of an asset?
- (ii) Is there a dominant factor which determines the nature of an asset?
- (iii) Is there a test that can be used to determine the nature of an asset?
- (iv) Should the application of a test be objective or subjective?

#### **1.4. Methodology**

This dissertation will be a qualitative analysis of ‘capital’ and ‘revenue’ in terms of the Act.

There will be an analysis of the definition of ‘gross income’ in terms of the Act with specific reference to capital and revenue. This will be analysed first because the Act is a primary source and it is the charging legislation applicable to the research topic.

Historical case law as well as current case law dealing with capital and revenue will then follow. This will be undertaken so that the reader understands what has been held historically compared to what the current position is. These cases can then be compared and contrasted against each other so that the conclusion which will follow will be adequately supported.

Throughout the research, reference will be made to various academic literature which have dealt with the concepts of capital and revenue. I will then advance the argument of the relevant literature and then provide a critique and analysis of the literature. I will also discuss how this literature is applicable to the current discussion.

#### **1.5. Chapter breakdown**

The chapters covered in my dissertation will be as follows:

- **Chapter 2 – Capital and Revenue as defined in terms of historical case law**

The definition of capital and revenue in terms of the Act will be discussed. I will highlight the problem of the Act being silent on the definitions of these terms. I will argue that the lack of a definition of these key concepts has created uncertainty in the minds of taxpayers, tax practitioners and the legal fraternity at large.

I will go into detail with a vast number of historical case law which have dealt with capital and revenue. I will set out the facts of these cases, the outcome of each case and the reasons for the judgment. This chapter will be subdivided under various sub-headings. Under these sub-headings, I will discuss applicable case law and journal articles.

The purpose of this chapter is to highlight what has been held historically. The reader will also be made aware of the lack of certainty and coherence when the terms of capital and revenue are in issue.

I will then conclude this chapter by linking it to my third chapter which will be a discussion on a landmark case which has come up with a test on determining the nature of an asset.

- **Chapter 3 – A critical discussion on the scheme of profit-making test**

I will discuss *CIR v Pick n' Pay Share Employee Trust*.<sup>16</sup> I will critically discuss the judgment by discussing the facts of the case, what was argued, what was held and the reasons for same.

I will also analyse and discuss the minority judgment herein.

I will argue that the approach adopted herein is accepted by the author and I will support this submission based on the majority judgment as well as journal articles.

- **Chapter 4 – A move away from a subjective test to an objective test**

I will discuss *CSARS v Wyner*.<sup>17</sup> I will critically discuss the judgment by discussing the facts of the case, what was argued, what was held and the reasons for same.

I will discuss the scheme of profit-making test. In doing so, I will highlight how the court moved away from the approach adopted in *Pick n' Pay*<sup>18</sup> in that an objective test was favoured. I will further critically analyse the reasons for this new approach.

I will then conclude this chapter by discussing the facts of this case and how the taxpayer merely disposed of her house to her best advantage and only after she was forced to do so. This conclusion will also serve as a link to my next chapter in which the courts appear to have reverted to *Pick n' Pay*.<sup>19</sup>

- **Chapter 5 - A critical discussion on CSARS v Capstone 556 (Pty) ltd**

I will critically discuss *Capstone*.<sup>20</sup> My dissertation will discuss the facts of the case, what was argued, what was held and the reasons for same.

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<sup>16</sup> Note 5 above.

<sup>17</sup> Note 11 above.

<sup>18</sup> Note 5 above.

<sup>19</sup> *Ibid.*

<sup>20</sup> *CSARS v Capstone 556 (Pty) Ltd* 2016 (4) SA 341 (SCA).

I will highlight how the court in this matter appears to have reverted to the *Pick n' Pay*<sup>21</sup> subjective test approach as opposed to the objective test preferred in *Wyner*.<sup>22</sup>

- **Chapter 6 – Conclusion**

My dissertation will conclude by providing a brief summary of what was discussed in the body of my dissertation. I will offer my own opinion based on the literature and case law that was discussed. I will seek to answer the issues raised in my introduction and I will also seek to provide solutions to my main research question and my research sub-questions.

## **CHAPTER 2 – CAPITAL AND REVENUE AS DEFINED IN TERMS OF HISTORICAL CASE LAW**

### **2.1. Introduction**

‘Capital’ and ‘revenue’, in relation to the nature of an asset, are terms which have vexed legal academics and our courts for decades. These terms are synonymous with uncertainty because of the void left by the Act in that no definition is provided. There have been a number of tests, guidelines and factors put forth by academics, scholars and our courts to ascertain the capital or revenue nature of an asset.

Before a discussion on these tests and guidelines is followed, however, it is prudent to discuss what makes an asset a capital asset and what makes an asset a revenue asset.

Emslie<sup>23</sup> briefly distinguishes the key elements of a revenue asset and a capital asset. He argues that if the asset subject to the dispute is part of the income producing machine or structure of the taxpayer, then the proceeds realised by the sale of such an asset will be capital in nature.<sup>24</sup> However, if the asset is held with a speculative intention, and it is subsequently ‘used in a scheme of profit-making, then the proceeds realised from a sale thereof will be revenue in nature.’<sup>25</sup>

In *CIR v George Forest Timber Company Limited*<sup>26</sup> the taxpayer was the owner of land which had a natural forest on it. The taxpayer’s business concerned the felling of trees which were

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<sup>21</sup> Note 5 above.

<sup>22</sup> Note 11 above.

<sup>23</sup> TS Emslie ‘ITC 1427: Options and the sale of the subject matter thereof – A triumph of substance over form’ (1988) 248 *De Rebus* 529-531.

<sup>24</sup> *Ibid.*

<sup>25</sup> *Ibid.*

<sup>26</sup> 1924 (AD) 516.

sawn up in its mill and then sold as trading stock. The issue to be determined was whether the proceeds gained from the disposal of the timber were of a capital or revenue nature. In reaching its decision, the court described ‘capital’ as being wealth used for the production of fresh or new wealth (which is revenue).<sup>27</sup> The court also drew a distinction between fixed capital and floating capital.<sup>28</sup> The court stated that fixed capital is not consumed or lost during the production of income.<sup>29</sup> Fixed capital remains intact.<sup>30</sup> Floating capital, however, disappears or is depleted in the production of income.<sup>31</sup>

It is not a requirement for an asset to be a tangible asset in order for same to be either capital or revenue. This was highlighted in *CIR v Visser*.<sup>32</sup> The taxpayer herein acquired mining options on a farm. However, these options had lapsed before he could exercise them by searching for mineral deposits on the farm. Despite the options having lapsed, the taxpayer was convinced that he could acquire options once more owing to the influence which he had had over the other farmers in the area. The taxpayer then contracted with a third party to assist him in obtaining mining options. In exchange for his assistance, the taxpayer would obtain shares in the third party’s company. The court had to then determine whether the value of the shares so acquired were of a capital or revenue nature.

In reaching its conclusion, the court held that income can be said to be a product of a person’s wits and energy.<sup>33</sup> The shares received were regarded as being such a product owing to the influence of the taxpayer. The shares were thus regarded as being revenue nature and, as result thereof, had to form part of the taxpayer’s normal income.

The distinction between ‘capital’ and ‘revenue’ can be accurately surmised by the fruit and tree analogy as described in *CIR v Visser*.<sup>34</sup> The tree herein represents capital which remains intact and is the source of creation of wealth. Whereas the fruit represents revenue which has been produced for commercial sale. The proceeds gained from the disposal of the fruit are subsequently revenue in nature.<sup>35</sup>

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<sup>27</sup> *Ibid*, 522.

<sup>28</sup> Note 27 above, 524.

<sup>29</sup> *Ibid*.

<sup>30</sup> *Ibid*.

<sup>31</sup> *Ibid*.

<sup>32</sup> 1937 (TPD) 77.

<sup>33</sup> *Ibid*, 82.

<sup>34</sup> Note 32 above, 81.

<sup>35</sup> *Ibid*.

However, it is submitted, that the distinction between ‘fruit’ and ‘tree’ is sometimes a difficult distinction to be made. Factors which make an asset capital in the hands of one taxpayer, may not necessarily result in the same asset being regarded as capital in the hands of a different taxpayer. Therefore, it is submitted, the inquiry must proceed further and the facts and circumstances of each case must be considered holistically in order to determine the true nature of an asset.

This submission is supported by *Overseas Trust Corporation Ltd*<sup>36</sup> where it was held:

‘It was pointed out in *Commissioner of Taxes v Booyesen’s Estate (1918, A.D., p. 576)* that the profit resulting from the sale of an asset might be either capital or income, according to the circumstances. If the transaction were a mere realisation of capital at an enhanced value, the entire proceeds would remain capital; but if it were an act done in the ordinary course of the vendor’s business, then the resulting gain would be income. The reason for the distinction is clear. Where an asset is realised at a profit as a mere change of investment there is no difference in character between the amount of enhancement and the balance of the proceeds. But where the profit is, in the words of an eminent Scotch Judge, see *Californian Copper Syndicate v Inland Revenue (41 Sc.L.R, p.684)*, ‘a gain made by an operation of business in carrying out a scheme for profit making,’ then it is revenue derived from capital productively employed, and must be income.’

This case<sup>37</sup> highlights the point that the capital or revenue nature of an asset should be determined in light of the facts of a particular case. There must be an assessment of whether what was done was simply a disposal of a capital asset at a greater value or whether the taxpayer has engaged in a scheme of profit-making.

As submitted, there have been numerous factors which have been introduced into the debate regarding the capital or revenue nature of asset. However, there is one factor which remains constant in the majority of cases and writings. This is the factor of intention. ‘Intention’ in itself has raised further issues when determining the capital or revenue nature of an asset.

The intention of a taxpayer at the time of acquisition of an asset, his intention while holding the asset, whether there was a change of intention prior to the disposal of the asset, whether the asset was held with mixed intentions and if so, what should be regarded as the taxpayer’s true intention as well as the taxpayer’s intention at disposal of the asset, have all raised further

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<sup>36</sup> 1926 (AD) 444, 452-453.

<sup>37</sup> *Ibid.*

complexities in the pursuit of establishing a test for determining the capital and revenue nature of an asset.

It is therefore necessary to analyse and discuss the factor of intention and how this factor has been used to determine the capital or revenue nature of an asset.

## **2.2. The intention of a taxpayer at the time of acquisition of an asset**

Tsatsawane<sup>38</sup> highlights the importance of a taxpayer's intention at the time of acquisition of an asset. He argues that while intention at the time an asset is acquired is important, it is not a decisive factor since there might have been a change in intention. If the original intention was to acquire the asset and then resell it at a profit, then the profit flows from the productive use of capital employed.<sup>39</sup> Therefore, the proceeds from the sale will fall into the taxpayer's gross income.<sup>40</sup> If, however, the same asset is acquired by the taxpayer and is held not for the purpose of reselling it at a profit, then the proceeds from a subsequent disposal will be capital in nature.<sup>41</sup>

While it is accepted by the author that the intention of a taxpayer is not necessarily decisive, it is submitted that his intention is the most important factor when determining the true nature of an asset.

This argument is supported by Vorster.<sup>42</sup> He argues that the intention of a taxpayer at the time of acquisition of the asset is generally decisive. In order for an asset to be capital in character, the taxpayer must show that the asset was acquired with an intention to hold same with a degree of permanence.<sup>43</sup> However, this does not mean that the taxpayer must rule out any possibility to subsequently sell the asset.<sup>44</sup> In gauging this intention, the courts will have regard to the surrounding factors of a case and they will not rely solely on the *ipse dixit* of the taxpayer.<sup>45</sup>

It is submitted that the views expressed by Vorster<sup>46</sup> advances the argument of this dissertation. Special attention is given to the submission that the taxpayer may have the possibility in mind that he may dispose of his capital asset in the future. The mere fact that he subsequently does

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<sup>38</sup> K Tsatsawane 'Receipts or accruals of a capital nature' (2000) 8(2) *Jutas Business Law* 40-99.

<sup>39</sup> *Ibid.*

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.*

<sup>42</sup> L Tager & H Vorster 'Law of Taxation' 1986 *Annual Survey SALJ* 512 – 513.

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*

<sup>46</sup> *Ibid.*

so does not render the proceeds gained thereto as being revenue in nature. This is in line with the decision of *John Bell*<sup>47</sup> and *Stott*<sup>48</sup> which will be discussed further in this paper. Further, it is accepted by the author that while intention is generally the most important factor to consider, which intention is guided by the *ipse dixit* of a taxpayer, this *ipse dixit* must be scrutinized against the facts and circumstances of each case.

The submission that intention is the most crucial factor when seeking to establish the capital or revenue nature of an asset is also supported by leading case law. This was discussed in *Visser*.<sup>49</sup> In determining the nature of an asset, the court held:

- ‘Regard must be given to the nature of the transaction and the intention of the taxpayer at the time of acquisition of the asset in question.’<sup>50</sup>
- While a taxpayer’s intention at the time of acquisition of an asset is not necessarily decisive, it is always of utmost importance when determining whether profit gain from a subsequent sale of the asset is merely capital appreciation or revenue in nature.<sup>51</sup>
- A taxpayer’s intention is not determined by his *ipse dixit* alone. Rather, his intention is established by paying due regard to all of the facts of a matter.<sup>52</sup>

Tsatsawane<sup>53</sup> is of the view that in determining the intention of a taxpayer, regard should be given to his conduct shortly after the acquisition of the asset in question. He argues that if the asset is held as a fixed asset or the asset is put to productive use to gain an income, then the proceeds are capital in nature.<sup>54</sup> Conversely, the asset will be regarded as floating capital or stock-in-trade where such asset is acquired by a taxpayer with an intention to resell same for a profit.<sup>55</sup> Under these circumstances, the proceeds so realised are then regarded as being revenue in nature.<sup>56</sup> He goes on to qualify these submissions by stating that these are not tests but they are mere guidelines.<sup>57</sup> Further, a court decision should be based on good commercial sense.<sup>58</sup>

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<sup>47</sup> *John Bell & Co (Pty) Limited v SIR* 1976 (4) SA 415 (A).

<sup>48</sup> *CIR v Stott* 1928 (AD) 252.

<sup>49</sup> Note 27 above.

<sup>50</sup> *Ibid*, 81.

<sup>51</sup> *Ibid*.

<sup>52</sup> *Ibid*.

<sup>53</sup> Note 32 above.

<sup>54</sup> *Ibid*.

<sup>55</sup> *Ibid*.

<sup>56</sup> *Ibid*.

<sup>57</sup> *Ibid*.

<sup>58</sup> *Ibid*.



It is submitted that the qualifying text by Tsatsawane,<sup>59</sup> that the conduct of a taxpayer *shortly after* the acquisition of an asset is merely a guideline, is an important qualification to have been made. The reason for same is that this submission is based on the concept of time. The conduct of a taxpayer shortly after purchasing an asset could be to hold the asset as an investment asset for many years. However, disposal of this asset on a grand scale, with extensive development and marketing, could result in the nature of the asset being converted from capital to revenue.<sup>60</sup> Under these circumstances, the proceeds from a disposal will be regarded as being revenue in nature.<sup>61</sup> This is despite the fact that the asset was held as an investment asset for many years prior to its disposal. Conversely, an asset acquired and held for a short period and subsequently disposed of owing to an extraordinary offer does not necessarily render the proceeds thereto as being revenue in nature.<sup>62</sup> This is in spite of the short time between acquisition and disposal. It is to this end, that it is submitted, that it is prudent for a court to evaluate the facts and surrounding circumstances of each case as opposed to timing or good commercial sense, which are merely guidelines.

The intention of a taxpayer when an asset was being acquired, was discussed in *Stott*.<sup>63</sup> Stott had bought and sold various plots of land over a thirty-year period. Two of these sales formed the subject matter of a dispute with the Commissioner.

The first was a large plot of land in Ifafa. Stott was looking to purchase a beach cottage. However, there were no small plots available for sale. Therefore, Stott purchased a large plot of land and subdivided the land into smaller plots. He kept one of these plots for his beach cottage and sold the rest of the smaller plots at a profit.

The second was a fruit farm which Stott had also subdivided into smaller plots and sold at a profit.

The Commissioner argued that Stott, in cutting up and selling the properties, had embarked in a scheme of profit-making with the land being used as trading stock. Therefore, the proceeds so realised should form part of the taxable income of Stott.

The court held:

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<sup>59</sup> *Ibid.*

<sup>60</sup> Note 8 above.

<sup>61</sup> *Ibid.*

<sup>62</sup> *ITC 1427 50 (SATC) 25.*

<sup>63</sup> Note 42 above.

- A taxpayer may invest in land, goods or any other asset. Further, he is also at liberty to dispose of such assets to the best of his advantage. The fact that he does so does not convert what is a capital asset into a trade for the purposes of earning profits.<sup>64</sup>
- When an inquiry is concerned with the activities of a company, even a single transaction entered into by the company may be a transaction done with a business intention. However, there must be an element of continuity before it can be said that an individual is engaging in business activities.<sup>65</sup>
- When determining whether disposing an asset merely represents a change of investment or whether said disposal is tantamount to engaging in business activities to generate a profit, regard must be given to all of the facts and circumstances peculiar to the matter under consideration.<sup>66</sup>
- ‘In determining the capital or a revenue nature of an asset, one must look at the intention of the taxpayer at the time of acquisition of the asset as well as at the time of disposal.’<sup>67</sup>  
‘This is necessary since there may have been a change of intention.’<sup>68</sup>
- The intention of a taxpayer is an important factor to consider. ‘In the absence of any other factors showing that the taxpayer had engaged in a scheme of profit-making, his intention will be the conclusive factor in determining the nature of an asset.’<sup>69</sup>

*Stott*<sup>70</sup> is significant because it provides authority for taxpayers to dispose of capital assets to their best advantage without having the proceeds received forming part of their gross income.

The case is also authority for the general principle that single transactions entered into by individual taxpayers are indicative of capital disposal as opposed to a business intention. While this is accepted by the author, caution must be exercised when applying this principle. If, for example, a taxpayer buys a motor vehicle and he subsequently disposes of it, it could be argued (provided that he is not a motor dealer) that he has engaged in a single transaction. Therefore, any profits realised ought to be capital in nature. If, however, the taxpayer strips the vehicle and sells each part individually, each transaction entered into by the taxpayer could be regarded

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<sup>64</sup> Note 42 above, 281.

<sup>65</sup> Note 42 above, 260.

<sup>66</sup> Note 42 above, 257.

<sup>67</sup> Note 42 above, 262.

<sup>68</sup> *Ibid.*

<sup>69</sup> *Ibid.*

<sup>70</sup> *Ibid.*

as forming part of a business in a scheme of profit-making. It is, therefore, submitted that the factors of intention and nature of the asset must also be considered in an inquiry of this nature.

Further, it is significant to note that the asset in dispute can be adapted to the market in which the disposal will take place. Therefore, a taxpayer intending to dispose of a capital asset is not prevented from altering the form of the asset before disposal.

Finally, the case highlights the importance of intention and it is authority for intention being the most significant factor to consider when seeking to establish the capital or revenue nature of an asset. If there are no other factors indicating the existence of a business activity being pursued, the taxpayer's intention will be the conclusive factor in establishing nature of an asset.

Following *Stott*,<sup>71</sup> the court in *Paul*<sup>72</sup> had to determine whether profits made from the sale of land were capital or revenue in nature. The intention of the taxpayer herein was to purchase a small plot of land for himself. However, the owner of the land was unwilling to do so and required that the taxpayer purchase at least one hundred and sixty-seven acres of land. The taxpayer went ahead with the sale. However, he intended to sell off the surplus land. This generated a profit for the taxpayer which the Commissioner sought to tax on the basis that the taxpayer had engaged in business activities.

In finding that the profits earned were capital in nature, the court held:

- The dominant purpose of the taxpayer was to acquire a small plot of land for his own purposes.<sup>73</sup>
- There was no intention at acquisition to make a profit.<sup>74</sup>

This case is of importance as it amplifies the point an assessment of intention is crucial when establishing the capital or revenue nature of an asset. The mere fact that profits are earned on disposal of an asset is not enough for the asset to be regarded as a revenue asset. There must be a genuine business intention by the taxpayer to engage in a scheme of profit-making.

In *Elandsheuwel Farming (Edms) Bpk v SBI*<sup>75</sup> the intention of a company had to be determined. The taxpayer had been involved in farming activities. These farming activities were initially undertaken by one of its shareholders before the farm was leased. The tenants of the farm also

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<sup>71</sup> Note 42 above.

<sup>72</sup> *CIR v Paul* 1956 (3) SA 335 (A).

<sup>73</sup> Note 71 above, 290.

<sup>74</sup> *Ibid.*

<sup>75</sup> 1978 (1) SA 101 (AD).

used the property for farming activities. The shareholders then resolved to sell their shares in the property and the value of the company's shares were based on the property being designated as agricultural property. The new shareholders had expertise in property development. A year later, the new shareholders procured the company to sell the property to the local municipality and a significant profit was gained from the sale. The issue in dispute was whether the proceeds of the sale were capital or revenue in nature.

The court held:

- Whether proceeds earned from disposing of an asset constitutes gross income or not requires an inquiry into whether the sale amounted to disposal of a capital asset or whether the sale was done in the course of carrying on a business in a scheme of profit-making.<sup>76</sup>
- 'If there was a single transaction undertaken by the taxpayer, the inquiry is limited to the alternatives of capital realisation or a profit-making scheme.'<sup>77</sup>
- The new shareholders engaged in a scheme to make a considerable profit when they had acquired the shares in the farm based on the agricultural value.<sup>78</sup>
- The intention of the shareholders should be attributed to the company itself.<sup>79</sup>
- The company's intention with regard to the land had changed when the new shareholders assumed control of the company.<sup>80</sup>

It is submitted that the principle that the intention of the shareholders should be attributed to the company is accepted by the author. However, the reasoning of the court in arriving at its decision is open to critique as this is contrary to the principles of *Stott*.<sup>81</sup> The dissenting judgment herein provides that the inquiry should focus on what the company actually did as opposed to what the background of the shareholders were. This approach is accepted by the author.

Further, the nature of the sale herein was straightforward which further pointed to the fact that the taxpayer merely sold the land to the best of their advantage as opposed to engaging in a business activity.

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<sup>76</sup> *Ibid*, 103.

<sup>77</sup> *Ibid*.

<sup>78</sup> *Ibid*.

<sup>79</sup> *Ibid*.

<sup>80</sup> *Ibid*.

<sup>81</sup> Note 42 above.

### 2.3. Change of intention by a taxpayer

While it is accepted by the author that simply alienating a capital asset to a taxpayer's best advantage does not necessarily render the profits thereto as being revenue in nature, it is submitted that this will not always be the case. Ferreira<sup>82</sup> submits that situations may arise when a change of intention by a taxpayer may result in the character of an asset, previously held a capital asset, being changed into that of trading stock. Ferreira<sup>83</sup> highlights that the consequence of this change is that a higher tax (normal tax) will be imposed on the proceeds gained on the disposal of the asset. Had the nature of the asset not been changed, capital gains tax would have been imposed which is at a lower rate than normal tax.<sup>84</sup>

Uys<sup>85</sup> argues that there where there is a disposal of an asset, which was being retained as capital, there should be an inquiry into the taxpayer's behaviour prior to his acquisition of the asset as well as an inquiry into his actions in relation to the asset while same was being held. This will assist the courts in establishing the intention of the taxpayer when the asset was subsequently disposed.<sup>86</sup>

The taxpayer's own *ipse dixit*, as submitted by Uys,<sup>87</sup> is an important factor to consider when determining the true intention of a taxpayer. However, the *ipse dixit* of a taxpayer will not be accepted without consideration of objective factors which need to support what the taxpayer alleges.<sup>88</sup> The taxpayer will be unable to discharge the onus placed on him unless his *ipse dixit* is corroborated by objective factors in his favour.<sup>89</sup>

It is submitted that the above argument is accepted by the author. The point to amplify herein is that there are two legs of the inquiry when determining the nature of an asset. The first leg should be to establish the subjective intention of the taxpayer, which will primary be gauged from his *ipse dixit*. Once this has been established, the inquiry should shift to determine whether said *ipse dixit* is supported by objective factors. This approach is a considered approach in that a holistic inquiry is made as opposed to a narrow approach, one which is skewed in favour of

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<sup>82</sup> P Ferreira 'Your change of intention can turn CGT into income tax - Watch out for tax when the intended use of an asset changes' *Tax Breaks Newsletter* (2008) 273 1-2.

<sup>83</sup> *Ibid.*

<sup>84</sup> *Ibid.*

<sup>85</sup> KL de Hart, WR Uys, JMP Venter & JS Wilcocks 'Crossing the Rubicon: Is the use of a realisation company still a viable tax planning tool?' 2015 *Southern African Business Review* 183-205.

<sup>86</sup> *Ibid.*

<sup>87</sup> *Ibid.*

<sup>88</sup> *Ibid.*

<sup>89</sup> *Ibid.*

the Commissioner (a purely objective inquiry) and the other which favours a taxpayer (a purely subjective inquiry).

Our courts have demonstrated that it is only so far that a taxpayer can go before his actions will have the effect of converting what was a capital asset into a revenue asset. This is illustrated in *Natal Estates Ltd v SIR*.<sup>90</sup> The taxpayer, a company in this case, owned several farms in and around the La Lucia and Umhlanga areas. The company's primary business was the growing of sugar cane and the manufacture of sugar. There were concerns that the land owned by the company would be expropriated by government for public benefit. The directors resolved to develop and market the land for residential purposes. In pursuance of this activity, the company appointed engineers, architects and marketers. The developed land was then sold off by the company at a profit. The Commissioner had taken the view that the proceeds thus earned were revenue in nature.

It was held:

- When determining the nature of profits made from the sale of an asset, the taxpayer's primary intention to hold onto the asset for investment purposes is an important factor to consider. However, such intention is not necessarily decisive as there could have been a change of intention. This could arise when considering the method of realisation.<sup>91</sup>
- In order to determine whether a matter is concerned with realising a capital asset on the one hand or, conversely, embarking in a scheme of profit-making by selling land, regard must be given to all the facts of the matter in relation to the usual commercial concept of conducting business with a profit-making motive.<sup>92</sup>
- Some of the facts mentioned above which will be considered include: the intention of the owner when the land was acquired and at the time of disposal of the land, the purposes of the owner; in the case of a company; the owner's activities in relation to the land prior to disposal and the nature and extent of his marketing operations.<sup>93</sup>

In light of the grand scale of development, marketing and disposal, it was accepted that the company had changed their intention from investment to speculation, with the land being

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<sup>90</sup> Note 8 above.

<sup>91</sup> Note 8 above, 199.

<sup>92</sup> Note 8 above, 220.

<sup>93</sup> *Ibid.*

treated as stock-in-trade. The proceeds from the disposal of the land so realised were thus subjected to normal tax.

Prior to this decision, the leading authority dealing with the disposal of a capital asset was *Stott*.<sup>94</sup> Therefore, the taxpayer herein could be forgiven for thinking that they could develop the land and dispose of same on such a large scale without there being tax implications on the subsequent profits gained. It is submitted that the guidelines enunciated herein are only some of the factors to consider. In disputes of this nature, a considered and fair approach would be to consider all of the facts and circumstances of a case. This will ensure that a balance is struck between disposing of a capital asset to the taxpayer's best advantage and engaging in business activities in a scheme of profit-making.

*Natal Estates*<sup>95</sup> can be distinguished from *Berea West Estates (Pty) Ltd v SIR*<sup>96</sup> to show instances where a capital asset can be disposed of profitably without such profits being subject to normal tax.

The taxpayer herein was a realisation company which was formed for the purposes of selling land. The land was held in a testamentary trust. The administration of the trust proved to be difficult which culminated in the winding up of the estate spanning some twenty years. The executors of the estate were under pressure to wind up the estate. It was for these reasons that the land was transferred from the trust to a company so that the land could be sold. The beneficiaries of the deceased estate became shareholders in the company and the profits from the sale of the land were to be distributed to them accordingly. However, the land could not be sold as a whole and it was agreed to subdivide the land into smaller plots and to then dispose of these individual plots. The *modus operandi* of the company was that it would develop a plot of land and then sell same profitably. The profits so realised would then be used to develop and sell another plot of land. This continued for around twenty years. It was then for the court to consider whether the proceeds from the sale of the plots of land were of a capital or revenue nature.

The Commissioner argued that the land had been purchased with the object of selling it at a profit. Therefore, the profits realised were of a revenue nature. The taxpayer argued that it had merely acted as a realisation company. Therefore, the proceeds realised were of a capital nature.

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<sup>94</sup> Note 42 above.

<sup>95</sup> Note 8 above.

<sup>96</sup> 1976 (2) SA 614 (A).

The court held:

- Regard must be given to the reasons for the incorporation of a company, its memorandum of association and its subsequent conduct in order to determine whether the enterprise was acting as a realisation vehicle or whether the enterprise was formed to conduct a business in the pursuit of earning a profit.<sup>97</sup>
- Where a company is formed to realise an asset, and does no more than realise the asset, the proceeds generated from the sale of the asset are not taxable as trading profits. However, if the company conducts its affairs in a manner which shows that it is carrying on a business, using the asset in question in furtherance of the business, then any proceeds earned by disposing the asset shall be deemed revenue.<sup>98</sup>

It was held that, having regard to the totality of facts, the appellant was a realisation company formed purely to further the interests of the beneficiaries by selling land. Therefore, the proceeds gained from the disposal of land were capital in nature.

It is noted that the argument put forth by the Commissioner herein was an objective approach with a narrow application. The argument of the Commissioner was not incorrect. However, it is submitted, that the inquiry had to proceed further than this. The approach adopted by the court incorporated both subjective and objective elements, which is accepted by the author. The court showed that it also did not accept the taxpayer's version in isolation. Their version was only accepted after it was corroborated by objective factors. This was achieved by firstly establishing the reason for the company's incorporation and thereafter assessing their actions to determine whether their sole purpose was to sell a capital asset or to engage in a profit-making scheme. The evidence adduced herein was clear to suggest that the taxpayer's sole purpose was to dispose of a capital asset as their activities in relation to the land did not involve large scale development as was the case in *Natal Estates*.<sup>99</sup>

Emslie<sup>100</sup> discusses a change of intention by a taxpayer to dispose of an asset previously held as a capital asset by analysing *Sam v Commissioner of Taxes*<sup>101</sup> and *ITC 1427*.<sup>102</sup>

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<sup>97</sup> *Ibid*, 61.

<sup>98</sup> Note 96 above, 60.

<sup>99</sup> Note 8 above.

<sup>100</sup> Note 23 above.

<sup>101</sup> 1980 (2) SA 75 (ZR).

<sup>102</sup> Note 53 above.



*Sam*<sup>103</sup> was concerned with the activities of a mining company. The company had acquired an option to purchase a total of sixteen mining claims. The company proceeded to conduct surveys on these claims in order to determine their economic value. The company then agreed to sell all of the claims to a newly formed company after it became apparent that it lacked the necessary funds to embark on profitable mining operations. The company was a 50 per cent shareholder in the new company. The company then took the decision to exercise the options held to acquire the mining claims and these were then immediately transferred to the new company. The issue to be determined was whether the proceeds of the sale of the claims were of a capital or revenue nature. In finding that the accruals were of a revenue nature, the court held that the company had changed their intention. This had occurred when the option was exercised only for the subject matter of such option to be sold immediately. The court held that this was evidence of a scheme of profit-making being undertaken.

*Emslie*<sup>104</sup> correctly points out that this is indicative of form being accepted by the courts over substance. The consequence of this is that taxpayers face the possibility of having proceeds acquired from the sale of property acquired under an option being subjected to normal tax.<sup>105</sup>

The court in *ITC 1427*,<sup>106</sup> however, was of the view that the matter should be decided on substance over form. The taxpayer herein entered into a lease agreement with a company which owned a farm. All of the shares in the company were held by a third party. One of the terms of the lease agreement was that the taxpayer was given an option to purchase either the farm or all of shares in the company. After a year of entering into the lease agreement, the taxpayer was approached by an estate agent to purchase the farm for R700 000.00. The taxpayer thereafter exercised his option to purchase all of the shares in the company for R165 000.00. He then sold these shares to the estate agent on the same day for R700 000.00. The court had to determine whether the taxpayer had engaged in a scheme for profit when he exercised his option to acquire the shares in the farm-owning company only to re-sell them immediately at a profit.

The court held that the intention of the taxpayer at the time when he had acquired the option was of significance. Based on the facts of the case, it was found that option acquired was as a capital asset. The subsequent sale of this asset only took place when the taxpayer herein was

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<sup>103</sup> Note 75 above.

<sup>104</sup> Note 23 above.

<sup>105</sup> *Ibid.*

<sup>106</sup> Note 53 above.

presented with an offer which he could not refuse. Therefore, the taxpayer had not engaged in a scheme of profit-making.

*ITC 1427*<sup>107</sup> is significant for taxpayers as it sets out the authority on disposal of a capital asset shortly after acquisition without having the proceeds deemed revenue in nature. The case also highlights the point that regard should be given to the substance of a disposal as opposed to the form which is accepted. This subjective approach advances the argument of this paper.

#### **2.4. Mixed intentions**

Circumstances do sometimes arise in which a taxpayer acquires an asset with a mixed or dual intention. A dual intention arises when a taxpayer acquires an asset as an investment. However, the possible disposal of the asset at a later stage is not entirely ruled out.

Where situations such as these arise, the onus will be on the taxpayer to show that his dominant or main purpose in acquiring the asset under consideration was for investment purposes. If a taxpayer is unable to prove what his dominant intention was, he will not be able to prove that his dominant purpose was to acquire the asset for investment purposes. This is in accordance with *African Life Investment Corporation*.<sup>108</sup> The appellant company herein had a dual purpose. The first was to trade as a share-dealing company and the other was to build up a portfolio of shares which, it was hoped, would earn dividends. In accordance with its share-dealing activities, the company sold shares and realised a profit. The issue to be determined was whether the gains realised thereto was of capital or revenue. In finding against the taxpayer, the court held that there was no dominant purpose into which the share-dealing activities of the taxpayer could be absorbed as merely incidental.<sup>109</sup> The share-dealing activities of the taxpayer was regarded as having being part of the business structure of the taxpayer company. Therefore, the gains received when the shares were disposed of were revenue in nature.

To this end, it is submitted, that the inquiry is split into two. The first is an analysis and proof of the existence of an investment. The second is the earning of profits or a gain being made. The profit earned must be an incidental by-product in order for same to escape normal tax implications. Where the profit is part and parcel of the investment activities of the taxpayer, or such profit is sought after by the taxpayer, such profit will form part of the taxpayer's normal income.

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<sup>107</sup> *Ibid.*

<sup>108</sup> Note 7 above.

<sup>109</sup> Note 7 above, 251.

A change of intention to sell an asset which was being held as capital, will not be enough to render the proceeds thereto as being revenue in nature. Something more will be required. This was discussed in *John Bell*.<sup>110</sup> The appellant was a company carrying on business in premises which it owned. The company then relocated and it was agreed that the premises will be sold. However, the property market was not thriving at the time and it was agreed that the property will be rented out until the property market was conducive to selling the property profitably. The rental of the property continued for some eleven years until the property market had improved. As a result of this improvement, the property was sold at a profit. The court had to then determine whether the proceeds from the sale were subject to normal tax.

The court held:

- The nature of an asset cannot change from capital to revenue simply because a taxpayer delays in disposing same owing to unfavourable market conditions.<sup>111</sup>
- A change of intention to sell a capital asset, does not render the resultant gain revenue. There must be something more done in order to change an asset from capital to revenue so as to render the resultant proceeds revenue.<sup>112</sup>

It is submitted that the taxpayer herein simply waited for the most opportune time to dispose of the property. It was primarily for these reasons that the proceeds of the sale were regarded as being capital in nature. However, the outcome may well have been different had the taxpayer made improvements and altered the character of the asset during the period of waiting. The inquiry would then have turned to discuss whether the asset was adapted to the market to the taxpayer's best advantage, as was the position in *Stott*<sup>113</sup> or whether the taxpayer had engaged in business in a scheme of profit-making considering the manner of the disposal, as was the outcome of *Natal Estates*.<sup>114</sup>

Solomon<sup>115</sup> discusses the factor of intention with specific reference to a taxpayer whom has mixed intentions. The article discusses this by making reference to two decided cases. It is

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<sup>110</sup> Note 41 above.

<sup>111</sup> Note 41 above, 103.

<sup>112</sup> *Ibid.*

<sup>113</sup> Note 42 above.

<sup>114</sup> Note 8 above.

<sup>115</sup> J Boltar & P Solomon 'Law of Taxation' 1997 *Annual Survey SALJ* 2003.

noteworthy to compare and contrast *ITC 1608*<sup>116</sup> and *CIR v Nel*<sup>117</sup> as both cases involved the disposal of valuable commodities, diamonds and Kruger Rands respectively.

In *ITC 1608*<sup>118</sup> the taxpayer purchased diamonds. The taxpayer alleged that he did not have a clear intention with what he was going to do with the diamonds. He stated that he had thought that he would either sell them at a future date or that they would pass on to his heirs. The taxpayer subsequently sold some of the diamonds at a profit. He alleged that the reason for the sale was a combination of family pressure and also because he needed capital for a business. The issue to be determined was whether the profits so realised were of a capital or revenue nature. The court was of the view that the reasons put forth by the taxpayer for the sale were not credible. The court held that the matter should be determined by assessing the intention of the taxpayer when he had acquired the diamonds.

The court also drew a distinction between goods purchased for the purposes of re-selling same at a profit and goods purchased as an investment where the purpose is not to re-sell same at a profit. The latter may be contemplated by a taxpayer but this is not the purpose for which the asset is acquired.

In finding in favour of the Commissioner, the court held that it could not be said that the diamonds were purchased to generate an income for the taxpayer. Further, it could also not be said that the diamonds were purchased as a hobby. Therefore, the proceeds from the disposal of the diamonds were of a revenue nature.

In *Nel*,<sup>119</sup> the taxpayer stated that he had purchased Kruger Rands as a hedge against inflation. He attested that he had intended that the Kruger Rands will be passed to his children. The taxpayer subsequently exchanged some of the Kruger Rands because of the taxpayer's need to purchase a vehicle for his wife. This transaction realised a profit which the Commissioner sought to tax.

The court considered the facts and circumstances which led to the transaction entered into by the taxpayer. It was held that the sale was done under duress in that it was unusual and unexpected. There had been no intention by the taxpayer to make profit by disposing of the

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<sup>116</sup> 1995 59 (SATC) 63.

<sup>117</sup> 1997 59 (SATC) 349.

<sup>118</sup> Note 87 above.

<sup>119</sup> Note 88 above.

Kruger Rands. Rather, same was exchanged for the acquisition of another capital asset which was the motor vehicle for his wife.

In *ITC 1608*,<sup>120</sup> however, the sale was deemed to be designedly sought for with a profit motive. Further, the nature of the asset sold indicated that this asset could never have been bought for its bare use or as a hobby. Therefore, the nature of the asset could not be said to be capital.

Both of the abovementioned cases advance the argument of this dissertation. They illustrate that certain assets, although similar in nature, do not necessarily render them the same from an income tax point of view. Each case must be adjudicated upon based on its own facts and circumstances. This argument can be advanced by referring to the facts of *ITC 1608*.<sup>121</sup> The asset under consideration herein was diamonds and the court had stated that it could not be said that the asset had been purchased as a hobby. While this may be accepted from the facts established in this particular case, it could be argued that a person with an adoration for diamonds did in fact purchase a diamond in furtherance of this passion. Any proceeds gained from a subsequent sale, it is submitted, would be of a capital nature as there was no profit motive when the asset had been purchased. This is also contingent on the manner of disposal not being done as a business with a profit-making scheme. In light of the above, it is submitted that each case should be considered in light of the facts and circumstances of each case as was the position in *Nel*.<sup>122</sup>

It is also important to note that both cases used subjective tests which were corroborated by objective factors. The respective courts looked at the intentions of both taxpayers when the assets were purchased. The court also considered the factors and reasons for the disposal of the asset in order to determine the nature of the proceeds received. It is this considered and holistic approach which is advanced by this dissertation.

## **2.5. Conclusion**

In any legal inquiry, factors play an important role. It is of importance to establish what these factors are and how they have been interpreted by our courts and academia. As illustrated in this chapter, intention is such factor in an inquiry discussing the capital and revenue nature of an asset. The facts of each case must be assessed to determine whether the inquiry should focus on the intention of the taxpayer at acquisition of the asset, the mixed or dual intention of a

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<sup>120</sup> Note 87 above.

<sup>121</sup> *Ibid.*

<sup>122</sup> Note above 88.

taxpayer or whether there was a change of intention by the taxpayer. While not being decisive, the established intention of a taxpayer will greatly assist when determining whether an asset is of a capital or revenue nature.

The formulation of legal tests also aids our courts, academia and prospective litigants in various disputes. The scheme of profit-making test is the test most associated with a dispute over the capital and revenue nature of an asset. However, application of this test has not been uniform. There is uncertainty regarding what exactly this test entails, what factors are considered in the application of the test and whether the application should be subjective or objective in nature.

It is, therefore, of importance that an examination of the scheme of profit-making test is undertaken.

## **CHAPTER 3 – A CRITICAL DISCUSSION ON THE SCHEME OF PROFIT-MAKING TEST**

### **3.1. Introduction**

The scheme of profit-making test was used in the majority judgment in the landmark case of *CIR v Pick n' Pay*.<sup>123</sup> This test seeks to inquire whether the actions of the taxpayer show that he has engaged in a business venture in a scheme of profit-making. If the facts support this conclusion, the profits earned by the taxpayer will be regarded as being revenue in nature and same will form part of his normal income. The application of the scheme of profit-making test is subjective in nature. However, this has not always been the approach adopted by our courts.

Vorster<sup>124</sup> makes reference to *ITC 1413*<sup>125</sup> which employed the use of an objective test in establishing the capital or revenue character of an asset. The facts herein were similar to that of *Pick n' Pay*<sup>126</sup> in that a trust was formed to enable employees to purchase shares from the company that they worked for. The Commissioner sought to tax the proceeds derived from the sale of shares by the trust. The taxpayer advanced the application of a subjective test and argued that the proceeds received were of a capital nature because there was no intention to make a profit. However, in finding in favour of the Commissioner, the court made use of an objective test. The court found that the shares were purchased at market value and it could be expected

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<sup>123</sup> Note 5 above.

<sup>124</sup> L Tager & H Vorster 'Law of Taxation' 1986 *Annual Survey SALJ* 488.

<sup>125</sup> 1985 48 (SATC) 167.

<sup>126</sup> Note 5 above.

by the trust that when the shares were subsequently sold, they would realise a profit. In light of the invariable profit that the trust would make, it was held that the trust was carrying on a trade resulting in the profits subsequently earned being regarded as revenue in nature.

It is submitted that the outcome of *ITC 1413*<sup>127</sup> was incorrect. The application of the test ought to have been of a subjective nature. *Pick n' Pay*<sup>128</sup> did not follow this approach and there was an adoption of a subjective test. This chapter seeks to demonstrate why this is the correct approach to follow.

### **3.2. CIR v Pick n' Pay analysed**

It is of importance to analyse this case in order to fully understand how the scheme of profit-making test should be applied.

#### **Facts**

The respondent herein resolved to form a trust. The trust was to operate as a vehicle through which employees of the respondent could purchase shares in the company. The duties of the trustees were to purchase shares from the company, to receive applications from employees to purchase shares in the company, to sell shares in accordance with the scheme rules and to administer the scheme.

The employees would pay for the shares within ten years of its purchase or it could be settled between the fifth and tenth anniversary if the employee wished to do so. If an employee was dismissed before the fifth anniversary of the purchase owing to dishonesty or fraud, the trust could purchase the relevant shares which would then form part of the property of the trust.

Shares were acquired by the trust in three ways:

1. Shares which had been purchased by employees whom wished to realise their holdings,
2. If shares were forfeited as a result of dismissal because of dishonesty or fraud or if the employee left the company within five years of the initial purchase,
3. Purchasing the shares on from the market when the trust did not have enough shares available to employees.

The share-dealing activities of the respondent showed that a profit was made during the four years of assessment. Profits were earned as a result of forfeited shares having a higher market

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<sup>127</sup> Note 96 above.

<sup>128</sup> Note 5 above.

value at the date of forfeiture rather than at the date of acquisition. The profits realised accrued to the trust.

### **Issue**

The Commissioner contended that the profits earned by the trust were revenue in nature and should form part of the respondent's normal income. The respondent argued that the profits earned were purely fortuitous in nature and were not intentionally worked for. Therefore, the profits were capital in nature.

### **Held – Nicholas AJA (Minority Judgment)**

- 'The tests for the phrase 'of a capital nature' provide no more than guidelines. Each case must be decided on its own facts.'<sup>129</sup>
- 'The proceeds from a sale of capital asset, even at an enhanced value, remains capital in nature. However, if the acts which led to the earning of the profits were done in the ordinary course of the taxpayer's business, the resultant gain would be revenue in nature.'<sup>130</sup>
- 'The shares purchased by the trust were never purchased to be held. Therefore, they were regarded as floating capital and the subsequent realisation amounted to realisation of floating capital. Therefore, it could not be said that receipts were capital in nature.'<sup>131</sup>
- 'The Special Court had erred when determining the issue after accepting that the trust did not acquire and dispose of the shares in pursuance of a scheme of profit-making. This was not the correct test to apply herein. Following the series of transactions entered into by the trust, the correct test to be applied was whether the activities of the trust amounted to a trade or business.'<sup>132</sup>
- 'It is accepted that the trust did not carry on business in the ordinary sense of the word. However, the fact remained that the trust was concerned with trading in shares and not in realising investments.'<sup>133</sup>

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<sup>129</sup> Note 5 above, 17 of Nicholas AJA, para 1.

<sup>130</sup> Note 5 above, 17 of Nicholas AJA, para 3.

<sup>131</sup> Note 5 above, 38 of Nicholas AJA, para 1.

<sup>132</sup> Note 5 above, 40 of Nicholas AJA, para 1.

<sup>133</sup> Note 5 above, 47 of Nicholas AJA, para 1.



**Held – Smalberger JA (Majority Judgment)**

- ‘There have been various tests and guidelines postulated when determining whether a receipt is capital or revenue in nature. However, these are guidelines only. There is no single infallible test to apply.’<sup>134</sup>
- ‘Conducting a business in pursuit of profits requires an assessment of the taxpayer’s purpose and objectives. The dominant purpose of the taxpayer will be assessed in circumstances where more than one purpose is apparent.’<sup>135</sup>
- ‘A profit motive is not conclusive when determining whether a business is being carried on or not. However, the presence or absence of a profit motive is an important factor to consider.’<sup>136</sup>
- ‘In a tax case, one is not concerned with what the taxpayer had contemplated. There must be an assessment of the objectives of the taxpayer, his aim and his actual purpose.’<sup>137</sup>
- ‘The trust only bought shares when it was obliged to do so and sold shares when it was required to do so. This is not a practice associated with ordinary commercial practice.’<sup>138</sup>
- ‘The trustees did not intend and seek to make a profit. This was not their motive.’<sup>139</sup>
- ‘There was no intention of the trust to engage in the business of buying and selling shares. The purpose of the trust was to act as a conduit for qualifying employees to purchase shares in the company.’<sup>140</sup>
- ‘The receipts sought to be taxed by the Commissioner were never worked for or intended. Rather, they were a consequence of the activities being carried on by the trust. Therefore, the receipts could not be said to be income in nature and were thus capital.’<sup>141</sup>

It is of significance to analyse both the minority and majority judgments above. It is intriguing to note that both judgments were in agreement with many issues. A significant concession

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<sup>134</sup> Note 5 above.

<sup>135</sup> Note 5 above, 6 of Smalberger J, para 1.

<sup>136</sup> Note 5 above, 7 of Smalberger J, para 1.

<sup>137</sup> Note 5 above, 10 of Smalberger J, para 1.

<sup>138</sup> Note 5 above, 8 of Smalberger J, para 1.

<sup>139</sup> Note 5 above, 9 of Smalberger J, para 1.

<sup>140</sup> Note 136 above.

<sup>141</sup> Note 5 above, 11 of Smalberger J, para 2.

made by both judgments was that a taxpayer is at liberty to dispose of a capital asset, even at an enhanced value, without the proceeds being of a capital nature.

However, the essential differences between the judgments were the different tests applied and how these tests were applied. The minority judgment sought to address the issue by applying the activities test objectively. The difficulty of applying such test is that it goes against earlier case law such as *Stott*,<sup>142</sup> *Elandsheuwel*<sup>143</sup> and *Berea West Estates*.<sup>144</sup> All of these decisions adopted a subjective test and were concerned with whether a profit-making scheme was adopted by the taxpayer.

Applying an objective test also fails to consider the individual circumstances of the taxpayer. There are numerous reasons why a taxpayer would dispose of a capital asset. It is submitted that it is prudent to consider these factors when determining whether the taxpayer was truly engaged in a business in a scheme of profit-making.

The majority judgment adopted the scheme of profit-making test and this application was subjective in nature. It is submitted that this is the correct approach and this approach advances the argument of this dissertation. The pivotal assessment of the majority lay in the analysis of the intention of the taxpayer. This is purely subjective in nature and its application showed that there was no profit intention by the taxpayer. Further, this subjective intention is not the same intention as dealt with in criminal law. The focus is rather on the purpose or reason why the taxpayer engaged in the relevant transaction.

It must be noted, however, that the surrounding circumstances and the rules of the scheme were considered by the majority. Therefore, it is evident that while the decision fell to be considered on a subjective basis, this was still informed by considering objective factors. It is submitted that this is the method which should be adopted in considering the capital or revenue nature of proceeds of an asset.

### **3.3. Academic analysis**

The reasoning and outcome of *Pick n' Pay*<sup>145</sup> has generated debates on whether the majority were correct in their approach.

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<sup>142</sup> Note 42 above.

<sup>143</sup> Note 59 above.

<sup>144</sup> Note 72 above.

<sup>145</sup> Note 5 above.

A scheme of profit-making has been discussed by Olivier.<sup>146</sup> In her discussion, Olivier<sup>147</sup> discusses three cases and illustrates how matters with different factual backgrounds should be interpreted and applied in terms of their own facts to determine whether a taxpayer has engaged in a scheme of profit-making.

*ITC 1755*,<sup>148</sup> as discussed by Olivier,<sup>149</sup> illustrates how the disposal of a capital asset will not render the proceeds received thereto as being revenue in nature. *ITC 1755*<sup>150</sup> shows that proceeds from the disposal of property will not be regarded as being revenue in nature when the disposal was done under duress.

This reasoning advances the argument trying to be established by this dissertation in two ways. Firstly, that the subjective mind of a taxpayer must be considered in determining whether he has engaged in a scheme of profit-making. Objective factors must be considered. The *ipse dixit* of a taxpayer should not be accepted without an analysis of objective factors. However, the test should be subjective in nature. Secondly, the mere realisation of a capital asset does not automatically render the proceeds gained as being revenue in nature. The proceeds should only be revenue in nature when the taxpayer has crossed the Rubicon<sup>151</sup> and he has engaged in a business in a scheme of profit-making.

Williams<sup>152</sup> uses a case study to determine whether the proceeds from a disposal of an asset, previously held as a capital asset, will be capital or revenue in nature. She argues that the absence of one infallible test will mean that an asset regarded as capital in the hands of one taxpayer will not necessarily be regarded as capital in the hands of another taxpayer.<sup>153</sup> Williams<sup>154</sup> argues that ‘whether or not proceeds of a sale are capital or revenue will be determined by a basic enquiry as to whether there was a scheme of profit-making.’<sup>155</sup> The intention of the taxpayer is seen as central in determining whether an amount will be regarded as capital or revenue.<sup>156</sup> This assessment will be subjective in nature.<sup>157</sup> Williams<sup>158</sup> argues that

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<sup>146</sup> L Olivier ‘Law of Taxation’ 2003 *Annual Survey SALJ* 913.

<sup>147</sup> *Ibid.*

<sup>148</sup> 2003 65 (SATC) 363.

<sup>149</sup> Note 104 above.

<sup>150</sup> Note 106 above.

<sup>151</sup> Note 8 above.

<sup>152</sup> R Williams ‘Revenue versus Capital’ (2010) 10(8) *Without Prejudice* 50-51.

<sup>153</sup> *Ibid.*

<sup>154</sup> *Ibid.*

<sup>155</sup> *Ibid.*

<sup>156</sup> *Ibid.*

<sup>157</sup> *Ibid.*

<sup>158</sup> *Ibid.*

the judicial approach in determining this intention is to look at the taxpayer's intention at acquisition, during the time when the asset was held by the taxpayer and on disposal. However, Williams<sup>159</sup> argues that in principle, intention should only be determined when the asset is disposed of by the taxpayer. Williams<sup>160</sup> argues that the determination that has to be made is twofold. Firstly, the courts will hold an inquiry which will seek to determine the capital or revenue nature of the receipt.<sup>161</sup> Thereafter, it will be for the taxpayer to prove that his intention was to dispose of a capital asset.<sup>162</sup>

Williams' article is of relevance because she highlights the importance of a subjective test in determining the intention of the taxpayer. However, the limited assessment of this intention (at the time of disposal of the asset) can be critiqued. It is submitted that a broader judicial approach is favoured to account for a possible change of intention by the taxpayer.

The scheme of profit-making test was also discussed by Joubert.<sup>163</sup> Joubert<sup>164</sup> examines the 'profit-making scheme test', 'fixed versus floating capital' and 'trading and trading stock'. In criticising the profit-making scheme test, Joubert argues that the majority whom decided *Pick n' Pay*<sup>165</sup> failed to consider the definition of 'trading stock' as defined in the Act. In so doing, he is of the view that the court came to the wrong decision.<sup>166</sup> He suggests that it would be more appropriate to consider whether there is an intention to use the asset as trading stock as opposed to whether there is a scheme of profit-making.<sup>167</sup>

While Joubert does raise a valid argument in his paper, it is evident that he does not adopt a subjective test. Rather, he adopts a more objective approach and limits the inquiry to the nature of the asset and whether same will be regarded as trading stock. This narrow approach will be a dangerous precedent to set as the facts of *Pick n' Pay*<sup>168</sup> show that there was no trade in the ordinary commercial sense of the word. Therefore, it is submitted, it would be superficial to

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<sup>159</sup> *Ibid.*

<sup>160</sup> *Ibid.*

<sup>161</sup> *Ibid.*

<sup>162</sup> *Ibid.*

<sup>163</sup> D Joubert 'Income tax: gross income – capital versus revenue, profit-making scheme or fixed/floating-capital test?' (2009) 30(2) *Obiter* 381-391.

<sup>164</sup> *Ibid.*

<sup>165</sup> Note 5 above.

<sup>166</sup> Note 120 above.

<sup>167</sup> *Ibid.*

<sup>168</sup> Note 5 above.

stamp the nature of the shares in that case<sup>169</sup> as revenue assets and the proceeds thereto as revenue.

Jooste<sup>170</sup> argues that *Pick n' Pay*<sup>171</sup> marks a landmark victory for the application of a subjective test when an inquiry is held to establish the nature of an asset. Inasmuch as this approach is accepted by Jooste,<sup>172</sup> the author rightly brings to attention the *obiter dictum* remarks of Smalberger JA,

‘A different conclusion might have been justified if the making of profits was inevitable. But this was not the case.’ (at page 10, para 2)

This statement is criticized on the basis that if profits are inevitable, they will be regarded as revenue because profits had been foreseen.<sup>173</sup> Jooste<sup>174</sup> submits that if this qualification is accepted, the application of same to the facts of *Pick n' Pay*<sup>175</sup> would result in the proceeds being regarded as revenue in nature. This is because the probabilities of making a profit would have been inevitable from the onset.

The issue raised by Jooste is accepted by the author. The statement by Smalberger JA appears to be at odds with the rest of his judgment. Further, this statement goes against the principles as laid down in earlier decisions such as *Stott*.<sup>176</sup>

It is submitted that the making of profits has never been the determining factor when considering the capital or revenue nature of an asset. It is a factor to consider but the presence of a profit does not necessarily deem the proceeds revenue in nature. Rather, the inquiry has always been to examine the manner in which the proceeds were received and the actions of the taxpayer. It is, therefore, submitted that the remarks of Smalberger JA herein are incorrect. Perhaps this interpretation is not what Smalberger JA had intended when read against his entire judgment. The statement could relate to the activities and purpose of the taxpayer. Smalberger JA could have intended to mean that if the activities and purpose of the taxpayer was to engage in a business to make a profit as a whole, then the resultant proceeds would be revenue.

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<sup>169</sup> *Ibid.*

<sup>170</sup> RD Jooste ‘The Role of Profit Motive in the Capital/Revenue Inquiry’ 1993 *SALJ* 212.

<sup>171</sup> Note 5 above.

<sup>172</sup> Note 127 above.

<sup>173</sup> *Ibid.*

<sup>174</sup> *Ibid.*

<sup>175</sup> Note 5 above.

<sup>176</sup> Note 42 above.

However, it is conceded that this is not a *prima facie* interpretation and is rather read in to fit into the rest of his judgment.

Boltar<sup>177</sup> argues that a purely subjective inquiry when assessing the nature of an asset has not been an approach adopted with haste by our courts. Rather, the decision is informed by considering a range of factors relevant to a specific case.<sup>178</sup> The author argues that the starting position should be that the taxpayer's intention is conclusive.<sup>179</sup> Factors other than intention should only be relevant in ascertaining the stated intention of the taxpayer.<sup>180</sup>

The author agrees with Boltar<sup>181</sup> in that the courts are reluctant to endorse a purely subjective test.

It will be expected that the taxpayer will provide a version of events which will favour himself. It is submitted, therefore, that the adoption of a purely subjective test may lead to unfairness to the Commissioner. However, the solution put forth by Boltar<sup>182</sup> is not accepted by the author in its entirety. As submitted, the version put of the taxpayer will, more often than not, be a version designed to achieve his desired outcome. This outcome will be for profits being regarded as capital in nature as opposed to revenue. The over reliance on his intention and deeming same to be decisive, will skew the inquiry to the taxpayer's favour. Further, this approach is contrary to the onus placed on the taxpayer. Oguttu,<sup>183</sup> in discussing the onus on a taxpayer, rightly suggests that:

‘...the Commissioner's assessment is correct until the taxpayer can prove on a balance of probabilities that he was not engaged in a scheme of profit making and that the income derived from the sale of the asset was thus capital in nature and not taxable.’

Proceeding as suggested by Boltar<sup>184</sup> will have the effect of the onus of proof being placed on the Commissioner because the starting position will be that the intention of taxpayer is decisive. It will then be for the Commissioner to argue that the *ipse dixit* of the taxpayer should not be accepted. It is submitted that intention may be regarded as the most important factor to consider

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<sup>177</sup> J Boltar & C Monteiro ‘Law of Taxation’ 2001 *Annual Survey SALJ* 813.

<sup>178</sup> *Ibid.*

<sup>179</sup> *Ibid.*

<sup>180</sup> *Ibid.*

<sup>181</sup> *Ibid.*

<sup>182</sup> *Ibid.*

<sup>183</sup> AW Oguttu ‘Salvage or profit- making scheme? The circumstances of the sale of a capital asset must be considered’ (2006) 14(3) *Jutas Business Law* 114-118.

<sup>184</sup> *Ibid.*

in an inquiry of this nature. However, regarding same as decisive may be placing an over reliance on this factor.

Olivier<sup>185</sup> discusses the ‘profit-making scheme test’, ‘fixed versus floating capital’ and the ‘fruit versus tree analogy.’ Olivier<sup>186</sup> argues that disposal of the asset itself (the tree) will be regarded as disposal of a capital asset. Therefore, the proceeds will be capital in nature.<sup>187</sup> Conversely, disposal of what is produced by the asset (the fruit) will be regarded as being revenue in nature.<sup>188</sup>

Olivier then analyses the factor of intention in acquiring and disposal of an asset.<sup>189</sup> To this extent, it is submitted, that while the *ipse dixit* of a taxpayer is important, it will not necessarily be decisive. Olivier suggests that the starting point should be to question whether there is an intention to engage in a scheme of profit-making.<sup>190</sup> ‘This should be determined by the facts of the case and regard must be had to the possibility of a change of intention by the taxpayer.’<sup>191</sup> ‘Such change of intention (to dispose of an asset held as capital) will not necessarily stamp the proceeds thereto as revenue.’<sup>192</sup> The facts of a case will determine whether the change of intention by the taxpayer had been so drastic that the capital nature of an asset has now been metamorphosed to revenue.<sup>193</sup>

Olivier’s article is of value because in making out her argument, she suggests that a subjective test appears to be favoured. Objective factors are to be considered; however, those objective factors must then be used to determine the taxpayer’s subjective intention. This is in keeping with the majority judgment in *Pick n’ Pay*.<sup>194</sup>

### **3.4. Conclusion**

It is submitted that both subjective and objective factors should be considered in determining the true nature of asset. The taxpayer’s subjective intention is of great consideration. However, it is vital that objective factors relevant to a specific case must support the subjective intention of the taxpayer.

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<sup>185</sup> L Olivier ‘Capital versus Revenue: some guidance’ (2012) 45(1) *De Jure* 172-177.

<sup>186</sup> *Ibid.*

<sup>187</sup> *Ibid.*

<sup>188</sup> *Ibid.*

<sup>189</sup> *Ibid.*

<sup>190</sup> *Ibid.*

<sup>191</sup> *Ibid.*

<sup>192</sup> *Ibid.*

<sup>193</sup> Note 41 above.

<sup>194</sup> Note 5 above.

It is submitted that the majority in *Pick n' Pay*<sup>195</sup> arrived at the correct decision as the inquiry took into account all of the facts and circumstances of the case. This analysis revealed the true purpose and motive of the scheme, which was at all times to benefit the employees and to retain employees. There was never an intention to pursue a business in order to make a profit. Inasmuch as this is a subjective inquiry, the taxpayer still had to testify and explain why they did what they did. This intention was then tested against objective factors in order to support the subjective intention of the taxpayer.

The argument by the minority, that the shares were purchased not to be held therefore it constituted floating capital, can be criticised. It is submitted that this is a superficial interpretation and an inquiry of this nature must assess the matter at a fundamental level. The author accepts that the shares were never purchased to be held as an investment. However, the assessment must proceed further and there must be an inquiry as to why were the shares purchased. Had the minority considered this, it would have been evident that the shares were being purchased for and on behalf of qualifying employees and not in furtherance of any business interest of the trust. Therefore, the shares could not be said to be floating capital which is ordinarily disposed of to generate income and profits for the person making the disposal. This was clearly not the intention of the trust.

While it is submitted that *Pick n' Pay*<sup>196</sup> is the accepted approach, the new millennium brought with it a new challenge for taxpayers wishing to dispose of a capital asset. In a landmark case, *Wyner*<sup>197</sup> illustrated that the courts have reverted to applying an objective test in determining the capital or revenue nature of an asset. This proved to be challenge to taxpayers as even the disposal of the family home could be deemed a business venture.

It is, therefore, of importance to analyse why the courts have reverted to an objective application and whether this approach is correct.

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<sup>195</sup> *Ibid.*

<sup>196</sup> *Ibid.*

<sup>197</sup> Note 11 above.



## **CHAPTER 4 – A MOVE AWAY FROM A SUBJECTIVE TEST TO AN OBJECTIVE TEST**

### **4.1. Introduction**

It is submitted that the principles of *Pick n' Pay*<sup>198</sup> brought with it a degree of certainty regarding the capital or revenue nature of an asset. The decision brought together the various factors and tests. The case<sup>199</sup> was imperative in highlighting that the factor of intention was the most crucial factor to consider when seeking to determine the capital or revenue nature of an asset. Further, the subjective application of the scheme of profit-making test was the accepted application of the test. This appeared to be the correct approach given that this application encompasses both the interests of the taxpayer and the Commissioner without one having an unfair advantage over the other.

However, the principles of *Pick n' Pay*<sup>200</sup> were not followed by the court in *Wyner*.<sup>201</sup> This court<sup>202</sup> applied the scheme of profit-making test objectively. It is submitted that this is the incorrect application of the scheme of profit-making test. The purpose of this chapter is to critically analyse *Wyner*<sup>203</sup> to support the contention that the court should not have moved away from the principles enunciated in *Pick n' Pay*.<sup>204</sup>

### **4.2. CSARS v Wyner analysed**

#### **Facts**

The respondent was a lessee of a property situated in Clifton. Ownership of the property vested in the Council of the City of Cape Town (hereinafter 'the Council'). However, lessees were entitled to build bungalows on the property and they were also entitled to dispose of the bungalows. If a bungalow was disposed of, the buyer would enter into a lease agreement with the council.

The respondent and other lessees were then given the option to purchase the properties they currently leased or to enter into a twenty-year lease with the Council if they chose not to make

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<sup>198</sup> Note 5 above.

<sup>199</sup> *Ibid.*

<sup>200</sup> *Ibid.*

<sup>201</sup> Note 11 above.

<sup>202</sup> *Ibid.*

<sup>203</sup> *Ibid.*

<sup>204</sup> Note 5 above.

the purchase. The price for the respondent's bungalow was set at R802 000.00. The options available to the respondent were to either:

1. Purchase the property for R802 000.00.
2. Rent the property for a period of twenty years with rental payable at market rates.
3. Vacate the property.

The respondent could not afford to purchase the property or to pay the monthly rental.

The respondent was then approached by Investec to enter into a finance agreement which would enable the respondent to buy the property and then sell it. The relevant clause of the agreement read:

‘...Wyner are purchasing their Clifton Bungalow with a view of selling it within a year. The deal that we have put together gives them the opportunity to capitalise all charges and interest during the year and settle the loan in one lump sum when the property is sold.’

By entering into the finance agreement with Investec, the respondent would also be able realise improvements which she had made on the property. The property was subsequently purchased by the respondents in October 1994. In March 1995, the property was listed for purchase and was then sold in September 1995 for R2 850 000.00.

### **Issue**

The issue to be determined was whether the respondents had engaged in a scheme of profit-making when they had sold their bungalow and whether the profits realised were thus revenue in nature.

### **Respondent's argument**

The respondent argued that amount generated from the sale were capital for the following reasons:

- The purchase price set by the Council was not something which the respondent worked for. Rather, this proved to be a fortuitous decision made by the Council which the respondent could not control.
- The respondent accepted that she might have to sell the property soon after purchase. However, this did not make her a speculator of property whom was engaged in a scheme of profit-making.

- Her primary intention was not to make a profit. Rather, she merely attempted to make the best of a bad situation and dispose of the property which she could no longer afford, repay her loan and acquire a similar property which she could afford.

### **Held**

In reaching their decision, the court held that:

- ‘The respondent obtained financial assistance in order for her to purchase the property so that she could hold it while she attempted to sell it.’<sup>205</sup>
- ‘The purpose of the purchase was to sell same within twelve months with the intention of making a profit.’<sup>206</sup>
- ‘The respondent enlisted the services of an estate agent soon after the purchase indicating her objective of making a profit.’<sup>207</sup>
- The property was not purchased with the intention that the respondent would live in it.
- ‘A distinction must be drawn between the making of the discounted offer, which clearly was fortuitous, and the acquisition of the property for resale, which was anything but fortuitous.’<sup>208</sup> Therefore, the proceeds were held to be revenue in nature.

### **4.3. Critique of CSARS v Wyner**

The reasoning of the court in *Wyner*<sup>209</sup> shows that the court moved away from the application of a subjective test and employed the use of an objective test. It is submitted that this is the incorrect approach as the court failed to take into account the reasons of the purchase and disposal.

#### **4.3.1. Duration for which a capital asset is held**

It has been stated that the duration for which a capital asset is held, prior to being disposed of, is not an absolute sign of the nature of the proceeds thus received.<sup>210</sup> While it is not suggested

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<sup>205</sup> Note 11 above, 14, para 1.

<sup>206</sup> Note 11 above, 14, para 2.

<sup>207</sup> Note 11 above, 14, para 3.

<sup>208</sup> Note 11 above, para 36.

<sup>209</sup> Note 11 above.

<sup>210</sup> *John Bell*, note 41 above, stated that a change of intention to dispose of a capital asset, does not render the resultant proceeds as being of a revenue nature. There must be something more done in order to change an asset from capital to revenue so as to render the resultant proceeds subject to normal tax. *ITC 1427*, note 53 above, stated that the sale of the asset only occurred after the taxpayer received an extraordinary offer. This was not enough for the proceeds so received to be regarded revenue in nature. *Stott*, note 42 above, stated that all of the facts and circumstances of a case must be considered when determining whether the disposal of an asset constituted a change of investment or an operation of business in carrying out a scheme of profit-making.

that the court should not have taken this factor into account, it is submitted that this factor was amplified without consideration for the reasoning behind the quick disposal. The court should have considered the reasons why the respondent acted in the manner in which she did and then assess whether the objective factors of the case support the actions taken by the respondent.

#### **4.3.2. Profit being made**

The court also found that the making of a profit by the respondent was indicative of a scheme of profit-making being carried out. However, this goes against decided case law. *Samril Investments (Pty) Ltd*<sup>211</sup> was concerned with the selling of sand at a profit and whether the profits so realised were of a capital or revenue nature. The taxpayer argued that they had ‘disposed of the right to acquire the sand in a single transaction.’<sup>212</sup> Therefore, it could not be said that they were carrying on business.

In finding in favour of the Commissioner, the court held:

- ‘The capital or revenue nature of a receipt was ordinarily determined by inquiring whether same was acquired through carrying on a business in a scheme of profit-making.’<sup>213</sup>
- ‘However, profit-making is an element of capital accumulation. Therefore, not every receipt resulting from the sale of a capital asset, even though profits were designedly sought, is invariably revenue in nature. Each case has to be decided on its own facts.’<sup>214</sup>

Even though the taxpayer was unsuccessful herein, the principle to extract from this case is that the earning of profits alone does not result in the receipt being revenue in nature. In applying this to *Wyner*<sup>215</sup> it is evident that the making of a profit was inevitable given that the price at which she acquired the property was so far below market value. However, it is submitted that this was not as a result of Wyner having engaged in a scheme of profit-making. If there had been an assessment of all the facts and circumstance of the case, as suggested in *Samril Investments (Pty) Ltd*,<sup>216</sup> it would be apparent that the profit earned was as a result of fortuitousness. The facts further illustrate that the respondent attempted to sell her home only after it became apparent that she could no longer afford to live in it. The proceeds realised from

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<sup>211</sup> *Samril Investments (Pty) Ltd v CSARS* 2003 (1) SA 658 (SCA).

<sup>212</sup> *Ibid*, para 4.

<sup>213</sup> *Ibid*, para 2.

<sup>214</sup> *Ibid*.

<sup>215</sup> Note 11 above.

<sup>216</sup> Note 155 above.

the sale were subsequently reinvested by the respondent in another property, which would be the respondent's home. It is submitted that these actions are not indicative of a business transaction in a scheme of profit-making. Rather, the actions of Wyner show a taxpayer who was merely making the best out of a bad situation.

#### **4.4. Academic analysis**

Wyner<sup>217</sup> has also been criticized by academics. Williams<sup>218</sup> inquires whether a taxpayer would be liable for income tax on the profits acquired by him following the sale of his home. Williams<sup>219</sup> highlights this undesirable effect when considering that the reason for the sale could be to provide for retirement savings for the taxpayer. Taxation of the profits gained would deplete such savings which would have an adverse effect on the future well-being of the taxpayer.<sup>220</sup>

Williams<sup>221</sup> makes reference to *ITC 1616*<sup>222</sup> to warn taxpayers that even profits made from the sale of a family home may be subject to normal tax.

The taxpayer herein was a medical specialist who had moved to the Cape. His wife had resigned from her job owing to the move. The taxpayer then purchased a property that was to be their home. However, he was forced to lease the property as he had already entered into a lease agreement on arrival in the Cape. The taxpayer's wife then found employment and they agreed that it would be more suitable for them to live closer to her workplace. The taxpayer then put the house that he had purchased for sale. The property was subsequently sold at a profit of around R47 000.00. The property had been owned by the taxpayer for about two and a half years before being sold. The taxpayer claimed that the profits generated were of a capital nature. The Commissioner disagreed with this contention and included the amount in the taxpayer's normal income.

The court accepted that the reason for the sale of the property was because of the location of his wife's new workplace. In finding in favour of the taxpayer, it was held that the place of employment of the taxpayer's wife was something which he could not control. Therefore, it could not be said that the profits made were designedly sought. As a result, the sale was held to be a fortuitous disposal as opposed to a scheme of profit-making.

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<sup>217</sup> Note 11 above.

<sup>218</sup> RC Williams 'The taxability of the profit made by the taxpayer on the purchase and resale of his residence' (1998) 115 *SALJ* 612.

<sup>219</sup> *Ibid.*

<sup>220</sup> *Ibid.*

<sup>221</sup> *Ibid.*

<sup>222</sup> 1997 59 (SATC) 272.

Williams<sup>223</sup> argues that the key reasons for this decision were that the taxpayer was not involved with other transactions of this nature and the court disregarded the existence of a possible dual intention by the taxpayer. Further, the court exercised benevolence when assessing the reason for the sale.<sup>224</sup> The taxpayer's first response to the Commissioner in relation to the sale is open to interpretation. The taxpayer had stated:

'The property ... was purchased in order to invest the proceeds of our previous property in relation to the current rise in property prices. Our starting point was the supposition that the resale value of the property would remain related to the prevailing property prices and that the income from letting it would be sufficient to cover the rental of the house in which we live.'

Williams<sup>225</sup> states that a stricter assessment of the facts could have led a different court to the conclusion that the taxpayer had both an investment and speculative intention.

Williams<sup>226</sup> also suggests that the profits would have been subject to normal tax if it was purchased to hold and re-sell at a profit, while the taxpayer lived elsewhere, and looked for another property to purchase as a home.

It is submitted that the court in *ITC 1616*<sup>227</sup> reached the correct decision. The taxpayer's efforts in highlighting his capital intention could have resulted in an adverse finding against him. However, the author accepts that this was a taxpayer whom was being cautious in responding to the Commissioner as opposed to a taxpayer whom was truly engaged in a scheme of profit-making.

It is also significant to note that the court herein adopted a subjective test in assessing the nature of the profits received. The sale only occurred as a result of extenuating circumstances which were beyond the control of the taxpayer.

It is submitted that this reasoning advances the critique of *Wyner*.<sup>228</sup> The taxpayer herein only sold her home when it became apparent that she could not afford to rent the property or to purchase same. Further, as was the case in *ITC 1616*,<sup>229</sup> the taxpayer did not engage in similar transactions which would have indicated a business intention. Rather, the transaction was an isolated sale which served as a means to an end, which was to secure the taxpayer's future place of residence and for her to recoup the value of improvements that she had made on the property.

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<sup>223</sup> Note 169 above.

<sup>224</sup> *Ibid.*

<sup>225</sup> *Ibid.*

<sup>226</sup> *Ibid.*

<sup>227</sup> Note 173 above.

<sup>228</sup> Note 11 above.

<sup>229</sup> Note 173 above.

Oguttu<sup>230</sup> inquires whether the actions of a taxpayer amount to a salvage operation or whether he has engaged in a scheme of profit-making. It is submitted that salvation arises in circumstances when a taxpayer wishes to make the best out of a bad situation and disposes of a capital asset. Oguttu<sup>231</sup> is of the view that proceeds gained from such a salvation will be of a capital nature.

The author accepts the views as expressed by Oguttu.<sup>232</sup> It would be harsh on a taxpayer, whose sole intention is to dispose of an asset without any profit motive, to have to bear the consequences of the proceeds realised thereto falling within his normal income. It is submitted that an inquiry of this nature does not have to go to these lengths which require a taxpayer having to argue that the proceeds earned herein are capital in nature. This submission is based on the fact that there was never an intention, at acquisition or disposal of the asset, to engage in business activities. Absent such business intention, the proceeds earned by a taxpayer would be gained from disposal of a capital asset which any person is entitled to do. Given that the nature of the asset remains capital, the proceeds realised therein will fall outside the taxpayer's normal income.

Oguttu<sup>233</sup> proceeds to discuss a scheme of profit-making by highlighting the point that if there is a purposeful effort by the taxpayer to earn a profit, any subsequent income generated by the taxpayer will be revenue in nature. This is distinct from fortuitous profits which are not worked for by a taxpayer and will be regarded as capital in nature.<sup>234</sup> This is also supported by case law.<sup>235</sup>

However, Oguttu<sup>236</sup> highlights the point that the mere fact that a taxpayer makes an effort to sell a capital asset at a profit, does not necessarily render the proceeds subsequently gained as being revenue in nature. This submission is well supported by case law<sup>237</sup> and further amplifies the point that each case must be assessed on the facts and circumstances relevant to that specific case.<sup>238</sup>

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<sup>230</sup> AW Oguttu 'Salvage or profit- making scheme? The circumstances of the sale of a capital asset must be considered' 2006 14(3) *Jutas Business Law* 114-118.

<sup>231</sup> *Ibid.*

<sup>232</sup> *Ibid.*

<sup>233</sup> *Ibid.*

<sup>234</sup> *Ibid.*

<sup>235</sup> Note 5 above.

<sup>236</sup> Note 181 above.

<sup>237</sup> Note 41 and 42 above.

<sup>238</sup> Note 181 above.

Oguttu<sup>239</sup> suggests that some of these surrounding factors are ‘the manner in which the asset was acquired,’<sup>240</sup> ‘the period for which the asset was owned,’<sup>241</sup> ‘the existence of previous transactions of the taxpayer and how often these occurred,’<sup>242</sup> ‘the nature of the financing for the acquisition of the asset,’<sup>243</sup> ‘the occupation of the taxpayer’<sup>244</sup> and ‘the manner of disposal of the asset.’<sup>245</sup>

While these are some of the general factors which a court must take into account, the occupation of the taxpayer is open to argument, especially in modern society. There are circumstances in which professional taxpayers do engage in business dealings. Therefore, it is submitted, that the occupation of the taxpayer is irrelevant when determining whether he entered into a business transaction. Greater emphasis should be placed on what the taxpayer actually did and the reasons, both objective and subjective, for his actions.

Oguttu<sup>246</sup> argues that the disposal of the property in *Wyner*<sup>247</sup> amounted to disposal of an investment as opposed to speculation. Further, the taxpayer’s background showed that she had not engaged in similar transactions.<sup>248</sup> The proceeds earned by the taxpayer were then used to purchase another bungalow with the residue being invested by her.<sup>249</sup> These actions, Oguttu<sup>250</sup> suggests, demonstrates a change of investment as opposed to a scheme of profit-making.

Oguttu<sup>251</sup> concludes by stating that the facts of *Wyner*<sup>252</sup> demonstrated a salvage operation and not a scheme of profit-making. Therefore, disposal of assets under circumstances of salvage should not be construed as a scheme of profit-making.<sup>253</sup> The proceeds thus earned should be regarded as being capital in nature.<sup>254</sup>

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<sup>239</sup> *Ibid.*

<sup>240</sup> *Ibid.*

<sup>241</sup> *Ibid.*

<sup>242</sup> *Ibid.*

<sup>243</sup> *Ibid.*

<sup>244</sup> *Ibid.*

<sup>245</sup> *Ibid.*

<sup>246</sup> Note 181 above.

<sup>247</sup> Note 11 above.

<sup>248</sup> Note 181 above.

<sup>249</sup> *Ibid.*

<sup>250</sup> *Ibid.*

<sup>251</sup> *Ibid.*

<sup>252</sup> Note 11 above.

<sup>253</sup> Note 181 above.

<sup>254</sup> *Ibid.*



The views of Oguttu<sup>255</sup> further strengthen the argument that the court in *Wyner*<sup>256</sup> had arrived at the incorrect decision. The actions of the taxpayer in *Wyner*<sup>257</sup> did amount to a salvage as they resulted from the taxpayer being unable to purchase or rent the property. Therefore, she had to take appropriate steps to purchase the property and then dispose of same as a means to acquire another permanent property. This was not an ordinary commercial transaction done with a view to make a profit. Rather, the profits were put towards a home for the taxpayer's residence with the balance being invested.

#### **4.5. Conclusion**

It is submitted that the outcome of *Wyner*<sup>258</sup> was regressive in its effect. The court failed to take into account earlier cases which streamlined the capital versus revenue debate. They also failed to consider the scheme of profit-making test in its subjective application. Instead of reinforcing this approach and application, it is submitted that the court took a step backward.

It is submitted that the taxpayer herein disposed of a capital asset shortly after acquisition and that such disposal resulted in a significant gain in profit. However, the court did not take the opportunity to analyse and discuss the reasons behind the sale. Rather, a *prima facie* approach was adopted which, it is submitted, is superficial in its application. The taxpayer demonstrated that there was never an intention to dispose of her home in order to make a profit. This was not the fundamental reason for the sale. The underlying reason was because the taxpayer could not afford to keep her home. This clearly indicates no business intention let alone a profit-making intention. The fact that a profit was subsequently earned should not affect the outcome of the matter as profits on capital disposal alone is not enough to render said proceeds revenue in nature.<sup>259</sup>

The application of a purely objective test was also unfair to *Wyner*. A purely objective test does not afford an opportunity to the taxpayer to explain why a particular course of action was taken.

As submitted earlier, the proper approach in an inquiry of this nature, it is submitted, is the adoption of a subjective test which is supported by objective factors.

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<sup>255</sup> *Ibid.*

<sup>256</sup> Note 11 above.

<sup>257</sup> *Ibid.*

<sup>258</sup> *Ibid.*

<sup>259</sup> Note 165 above.

The approach adopted in *Wyner*<sup>260</sup> has not, however, been followed. The issue of the nature of a receipt was once more determined by the SCA in *Capstone*.<sup>261</sup> The court herein adopted a subjective approach in reaching its decision. It is submitted that this is the correct approach that should never have been diverted from by *Wyner*.<sup>262</sup> It is this subjective approach which this paper now seeks to analyse.

## **CHAPTER 5 – A CRITICAL DISCUSSION OF CSARS v CAPSTONE 556 (PTY) LTD**

### **5.1. Introduction**

The decision in *Wyner*<sup>263</sup> showed a move away from a subjective test to an objective test. The approach has been criticized in the preceding chapter as it fails to take into account the actual intention and purpose of the taxpayer. Further, the nature of the transaction is also not considered. The consequence of this narrow approach is that the true facts and circumstances of a particular transaction are not properly assessed. Therefore, whether or not a profit-making scheme was entered into falls to be determined on objective factors. This approach, it is submitted, is incorrect as there is no engagement with the background to the transaction under consideration.

The capital or revenue nature of proceeds gained by a taxpayer was the subject of dispute in *CSARS v Capstone 556 (Pty) Ltd*.<sup>264</sup> The court herein moved away from the approach in *Wyner*<sup>265</sup> and determined the issue based on the subjective intention of the taxpayer.

*Capstone*<sup>266</sup> is of significance as it re-affirms the submission that the correct test when determining the capital or revenue nature of an asset should be subjective in nature.

### **5.2. CSARS v Capstone analysed**

#### **5.2.1. Facts**

Profurn Ltd (Profurn) ran into financial difficulties at the end of 2001. It had a debt with FirstRand Bank Ltd (FirstRand) in the sum of R900 million and it had owed Steinhoff International Holdings Ltd (Steinhoff) between R70 and R90 million. The liquidation of

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<sup>260</sup> Note 11 above.

<sup>261</sup> Note 20 above.

<sup>262</sup> Note 11 above.

<sup>263</sup> *Ibid.*

<sup>264</sup> Note 20 above.

<sup>265</sup> Note 11 above.

<sup>266</sup> Note 20 above.

Profurn was a major concern to its creditors. The chief executive officer of Profurn was Mr Jooste while the person responsible for Profurn's account at FirstRand was Mr Lategan. Lategan and Jooste discussed the difficulties of Profurn and Lategan was referred by Jooste to Mr Daun. Daun also held a 13 per cent equity in Profurn. 'FirstRand determined that Profurn needed to reduce its debt to them by R300 million in order to survive.'<sup>267</sup> Lategan discussed this with Daun who was of the view that Profurn needed a cash injection and sound management to survive.

Daun had known Mr Sussman whom he held in high regard. Sussman was the executive chairman of JDG. Daun advised that he would make the investment on condition that Sussman took over the management of Profurn. FirstRand then approached Sussman. Sussman agreed to take over the management of Profurn on condition that Daun commit to remain on board as a shareholder. Daun acceded to this request. The respective parties then attempted to rescue Profurn which would involve high risk and take between three to five years to accomplish.

### **5.2.2. The rescue plan**

The agreement was that from the R900 million owing to First Rand, R600 million would be converted into shares with FirstRand underwriting a R600 million rights issue by Profurn. Profurn and JDG would then merge and the 'Profurn shares would be exchanged for JDG shares.'<sup>268</sup> FirstRand would then sell the newly acquired JDG shares for R600 million to a special purpose vehicle referred to as Capstone. Capstone would then be a beneficiary of an investment in the sum of R300 million. The investor was a company under the control of Daun. The investment would be used to settle half of the original purchase price of the shares. R200 million of the balance would be settled by Capstone issuing to FirstRand redeemable preference shares. The balance of R100 million would be settled by way of a loan from FirstRand to Capstone.

A memorandum of understanding was then signed by Daun which gave rise to a binding commitment by all the parties via Capstone.

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<sup>267</sup> Note 20 above, para 4.

<sup>268</sup> Note 20 above, para 6.

### **5.2.3. The memorandum of understanding**

The memorandum of understanding was subsequently amended with the result that FirstRand retained one sixth of its JDG shares. Five sixths, the equivalent of 35 million shares, were transferred to Capstone. Daun then invited Jooste to be a part of the transaction. ‘As a result, half of the 35 million shares were sold to Daun et Cie for R250 million and the other half to Capstone for the same price.’<sup>269</sup> ‘Daun et Cie and Capstone were, therefore, committed to a large investment of indefinite duration.’<sup>270</sup> ‘The profitability of the scheme depended on the ability of Sussman to turn around the operations of Profurn and integrate them profitably into those of JDG.’<sup>271</sup>

### **5.2.4. Capstone incorporated**

Capstone was incorporated on 2 April 2003 and it was wholly owned by BVI. Gensec invested R150 million in BVI on condition that the funds be used by Capstone to acquire the JDG shares. This was subsequently reduced to a shareholder’s agreement between BVI and Capstone. The balance of the purchase price was settled by Capstone issuing redeemable preference shares to FirstRand. As a condition to this undertaking, Capstone was precluded from conducting any business until the preference shares were redeemed. Capstone, therefore, could not dispose of its JDG shares for three years from 30 May 2003 without the consent of FirstRand.

‘There were two additional conditions attached to the acquisition of the JDG shares by Capstone.’<sup>272</sup> ‘Firstly, a due diligence undertaking revealed liabilities for Profurn in respect of tax.’<sup>273</sup> ‘JDG were to be indemnified of such liabilities by FirstRand.’<sup>274</sup> ‘Secondly, the loan agreement between Gensec and BVI provided for an ‘equity kicker’.’<sup>275</sup> ‘This was a portion of any gain in the market value of the JDG shares on the date of repayment of the loan.’<sup>276</sup> ‘This was payable by BVI to Gensec irrespective of whether the JDG shares had been sold or not.’<sup>277</sup>

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<sup>269</sup> Note 20 above, para 9.

<sup>270</sup> *Ibid.*

<sup>271</sup> *Ibid.*

<sup>272</sup> Note 20 above, para 11.

<sup>273</sup> *Ibid.*

<sup>274</sup> *Ibid.*

<sup>275</sup> *Ibid.*

<sup>276</sup> *Ibid.*

<sup>277</sup> *Ibid.*

The merger was then eventually approved in December 2002. The JDG shares were paid for and transferred to Daun et Cie and Capstone on 5 December 2003. By this time, the share price had risen considerably.

#### **5.2.5. Disposal of shares**

A meeting was then held between Jooste and Mr Pagden of Citigroup. Citigroup subsequently made an offer to Daun for the purchase of his JDG shares, which was accepted by Daun. As a result, Daun et Cie and Capstone transferred 14 million shares each to Citigroup. Daun et Cie and Capstone retained 3,5 million shares each. Mayfair Speculators (Pty) Ltd purchased the balance of 3,5 million shares held by Capstone. In essence, Capstone had disposed of all its shares.

On 30 April 2004, the directors of Capstone resigned. The loan was then settled by Gensec and BVI. The equity stood at R45 million.

Capstone paid capital gains tax in respect of the proceeds gained from the disposal of the 17,5 million JDG shares. However, the Commissioner issued an additional assessment in terms of which the proceeds were regarded as being revenue in nature.

#### **5.2.6. Issue**

Whether the profit made by Capstone from the sale of the shares was of a capital or revenue nature.

#### **5.2.7. Case law considered by the court**

In reaching their conclusion, the court considered a number of previous decisions wherein the capital or revenue nature of an asset was analysed.

- *Pick n' Pay*<sup>278</sup> - The capital or revenue nature of an asset was to be determined by the facts of each case.<sup>279</sup> There must be an analysis of what the taxpayer had intended and not what he had contemplated.<sup>280</sup>
- *Overseas Trust Corporation Ltd*<sup>281</sup> - Where a capital asset is disposed of for a value which had increased over a period of time, the proceeds thus received would still be of

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<sup>278</sup> Note 5 above.

<sup>279</sup> *Ibid.*

<sup>280</sup> *Ibid.*

<sup>281</sup> Note 30 above.

a capital nature.<sup>282</sup> However, if the disposal was as a result of a business venture being pursued, the proceeds would then be income in nature.<sup>283</sup>

- *Stott*<sup>284</sup> - The mere act of cutting up land and selling same is not sufficient to stamp the proceeds received thereto as being revenue in nature.<sup>285</sup> Rather, the gain must have been acquired by conducting a business in a scheme of profit-making.<sup>286</sup> Further, there must be an assessment of other business transactions which the taxpayer engages in.<sup>287</sup>
- *Natal Estates*<sup>288</sup> - The taxpayer had crossed the Rubicon when land was developed and sold on a grand scale.<sup>289</sup> Therefore, the land had been used as stock-in-trade with the result that the proceeds gained were deemed to be revenue in nature.<sup>290</sup>
- *Samril Investments (Pty) Ltd*<sup>291</sup> – The test for the nature of a receipt is usually determined by inquiring whether the receipt constituted a gain made by carrying on a trade in a scheme of profit-making.<sup>292</sup> Further, profit-making is an element of capital accumulation.<sup>293</sup> Therefore, even if profits are sought in disposing of a capital asset, it did not mean that the profits were revenue in nature.<sup>294</sup> Each case had to be determined on its own facts.<sup>295</sup>

The court held at paragraphs [31] and [32] that some of the factors to consider are:

- The intention of a taxpayer.
- ‘The nature of the business activities of the taxpayer.’<sup>296</sup>
- ‘The period for which the asset was held and the period it was anticipated to be held at the time of acquisition.’<sup>297</sup>

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<sup>282</sup> *Ibid.*

<sup>283</sup> *Ibid.*

<sup>284</sup> Note 42 above.

<sup>285</sup> *Ibid.*

<sup>286</sup> *Ibid.*

<sup>287</sup> *Ibid.*

<sup>288</sup> Note 8 above.

<sup>289</sup> *Ibid.*

<sup>290</sup> *Ibid.*

<sup>291</sup> Note 165 above.

<sup>292</sup> *Ibid.*

<sup>293</sup> *Ibid.*

<sup>294</sup> *Ibid.*

<sup>295</sup> *Ibid.*

<sup>296</sup> Note 20 above, Para 31.

<sup>297</sup> Note 20 above, Para 32.

- In commercial transactions, there may be no clear intention at the outset. Attempting to discern the correct intention may lead to inaccurate outcomes. Therefore, a better approach would be to accept the uncertainty and factor this into the inquiry.

#### **5.2.8. Subjective test applied**

In reaching their decision, it is significant to note that the court adopted a subjective approach. The court was of the view that given the commercial complexity of the matter, the entire agreement needed to be scrutinized as opposed to a narrow legalistic approach<sup>298</sup>. The court also assessed the events leading to the memorandum of understanding which further points to a subjective approach.

#### **5.2.9. Held**

In criticizing the decision of the Tax Court, the court held:

- ‘The fact that Daun wanted to recover his investment, together with an increase in its value, did not equate to a profit-making intention at the time of his investment.’<sup>299</sup>
- ‘There was no proof that the investment was not a long-term investment. The duration of the investment was dependent on Sussman’s skill in merging the two businesses as well as factors beyond the control of either himself or Daun, such as the general economic climate.’<sup>300</sup>
- The full court was also criticized for failing to consider further implications of the investment. The court held that a complete consideration of the entire transaction was required.<sup>301</sup>
- ‘The primary purpose for the acquisition of the shares was to rescue a business through investment.’<sup>302</sup> ‘In order to achieve this, capital had to be committed for an indeterminate period of time with considerable risk.’<sup>303</sup> Any possible return was unknown. What was to follow a successful business rescue was also uncertain as all options were opened. This is consistent with a capital investment which was realised sooner owing to skilled management and a favourable economic climate.<sup>304</sup>

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<sup>298</sup> Note 20 above, Para 34.

<sup>299</sup> Note 20 above, Para 40.

<sup>300</sup> *Ibid.*

<sup>301</sup> *Ibid.*

<sup>302</sup> Note 20 above, Para 52.

<sup>303</sup> *Ibid.*

<sup>304</sup> *Ibid.*

The making of a profit on sale of the shares turned out to be one of the several options available to Daun. It was held, however, that the making of a profit on disposal of the shares when they were acquired was not inevitable for the following reasons:

1. There was no guarantee that the business could be rescued. This was dependent on Sussman's managerial skills which may also give rise to a return on the investment, although not assured.<sup>305</sup>
2. The proposed action was risky as Profurn faced impending insolvency.<sup>306</sup>
3. Daun had no idea how long the investment would take.<sup>307</sup>
4. What was to follow a successful rescue was left undecided.<sup>308</sup>
5. On the sale of the shares, the prospects to trade the block of shares were low.<sup>309</sup>
6. Jooste strongly advised Daun not to sell the shares because their share price could increase. 'Jooste only managed to persuade Daun to withdraw seven million shares from the book building exercise, half of which was acquired by Jooste through Mayfair Speculators (Pty) Ltd.'<sup>310</sup>
7. Daun's wife urged him to sell his shares as he was overexposed in South Africa.<sup>311</sup>

### **5.3. Analysis**

It is of importance to note that the court herein adopted a subjective approach in determining why the taxpayer had done what they did. It is submitted, that the reason for this approach was primarily because of the complexity of this matter. However, complexity alone is not the sole reason why this approach was followed.

It is submitted that the court was forced to adopt a subjective approach because it is only with such application that a true analysis of the taxpayer's intention can follow.

A pure objective test may have resulted in the court accepting that the taxpayer sought to make a profit which is why disposal occurred. However, the fundamental reason why the sale ensued was not in pursuit of earning profits.

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<sup>305</sup> Note 20 above, Para 46.

<sup>306</sup> *Ibid.*

<sup>307</sup> *Ibid.*

<sup>308</sup> *Ibid.*

<sup>309</sup> *Ibid.*

<sup>310</sup> Note 20 above, Para 49.

<sup>311</sup> Note 20 above, Para 50.



The court also assessed the fundamental reason why the scheme was started, which was to rescue a business and not to earn any profits.

#### **5.4. Conclusion**

The author accepts the decision of *Capstone*.<sup>312</sup> The court highlighted the importance of assessing the subjective intention of a taxpayer when determining the nature of an asset. This was plainly stated by the court when it was accepted that a legalistic approach would be too narrow in its application given the complexity of this matter.

Prior to disposal occurring, the court also went back and discussed at length the reasons for acquisition of the shares. This approach is accepted by the author as it indicates that a holistic approach of the entire transaction, must be assessed to determine whether a business motive in a scheme of profit-making was ever intended.

The court also assessed what the taxpayer had done following acquisition to determine whether their intention at acquisition was carried forth during the time that the shares were held. This is also accepted by the author as it indicates that the intention at acquisition must also be assessed during the time the asset was held. If the taxpayer states that he had a capital intention at acquisition but his actions during the time the asset is held demonstrates a business motive, then profits subsequently earned on disposal will be of a revenue nature. This is because the character of the asset would have been changed by the actions taken by the taxpayer.

It is submitted that the above shows a subjective approach which was reaffirmed by objective factors. This approach is preferred by the author when determining the capital or revenue nature of an asset.

## **CHAPTER 6 – CONCLUSION**

### **6.1. Historical case law**

The historical approach in ‘determining the capital or revenue nature of an asset’ provided little certainty for taxpayers and academics.

There were many cases which addressed the issue but with each having a different approach. Historically, it is submitted, that the three cases which provide the most guidance were *Stott*,<sup>313</sup>

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<sup>312</sup> Note 20 above.

<sup>313</sup> Note 42 above.

*John Bell*<sup>314</sup> and *Natal Estates*.<sup>315</sup> These cases clearly indicated a subjective approach. However, a subjective approach as not accepted by these courts without regard to the argument of the Commissioner. The stated intention of the taxpayer was still tested against objective factors to determine whether the asset was truly capital in nature or whether the taxpayer had engaged in business in a scheme of profit-making.

These cases provided key factors which form the basis of an inquiry of this nature. They also provided boundaries to the liberties granted to a taxpayer when disposing of an asset. This was evident from *Natal Estates*<sup>316</sup> which shows that inasmuch as *Stott*<sup>317</sup> and *John Bell*<sup>318</sup> allow taxpayers to make profitable disposals, there is only so far that he can go before having proceeds earned being subject to normal tax. This is accepted as a fair concession as the fiscus cannot be prohibited from taxing citizens from clear business dealings resulting in unfettered profitable gains.

### **6.2. The formation of a test**

Inasmuch as factors provide guidance, legal tests provide certainty. *Pick n' Pay*<sup>319</sup> brought together the various judicial precedents and the factors and guidelines expounded from them. The case highlighted the importance of not accepting profit-making alone as a reason for deeming receipts revenue in nature. The inquiry must proceed further and there must be an assessment of the actions of a taxpayer and why these actions were undertaken.

The scheme of profit-making test proved to be a fair test which would provide an opportunity for a taxpayer to state his *ipse dixit* and this would then be tested against objective factors. This holistic approach is accepted by the author and accords with *Stott*,<sup>320</sup> *John Bell*<sup>321</sup> and *Natal Estates*.<sup>322</sup>

### **6.3. The move to a purely objective test**

The approach followed by *Wyner*<sup>323</sup> seemed at odds with what has been decided previously. The court failed to take into account the intention of the taxpayer at acquisition, the reasons for

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<sup>314</sup> Note 41 above.

<sup>315</sup> Note 8 above.

<sup>316</sup> *Ibid.*

<sup>317</sup> Note 42 above.

<sup>318</sup> Note 41 above.

<sup>319</sup> Note 5 above.

<sup>320</sup> Note 42 above.

<sup>321</sup> Note 41 above.

<sup>322</sup> Note 8 above.

<sup>323</sup> Note 11 above.

the disposal and the background of the taxpayer. It is submitted that if the court assessed any one of these avenues, the next would have followed naturally. The outcome of this analysis, it is submitted, would have indicated a capital disposal as opposed to a business in a scheme of profit-making. The reason for this submission is because:

- The reduced purchase price was determined by the Council and not sought for by the taxpayer.
- The purchase and resale occurred because the taxpayer could not afford to purchase the property on her own and she could not afford to pay rental at market rates going forward.
- The profits earned by the taxpayer were used to purchase another home in which she lived and the balance was invested by herself.
- The taxpayer had not engaged in any business dealings prior to this transaction.

#### **6.4. Reverting to a subjective test**

The approach adopted by *Capstone*,<sup>324</sup> it is submitted, remedied the defective approach adopted by *Wyner*.<sup>325</sup> The matter showed a clear subjective test which was informed by objective factors.

The *ipse dixit* of the taxpayer was not accepted without scrutiny. There was a clear analysis of the actions taken by the taxpayer. This amplifies that point that the correct test when determining the capital or revenue nature of an asset is subjective in nature. Thereafter, the facts enunciated when employing a subjective test, must be tested and supported against objective factors.

In the final analysis it is clear ‘that the test for determining the capital or revenue nature of an asset for income tax purposes’ was not formulated in 1992, 2003 or 2016. Rather, the test and application was provided decades ago in 1928 in the decision of *Stott*.<sup>326</sup> All that was achieved in the intervening 88 years was to create confusion on settled and accepted principles.

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<sup>324</sup> Note 20 above.

<sup>325</sup> Note 11 above.

<sup>326</sup> Note 42 above.

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14 December 2018

Mr Quentin Silvanus Quarsingh (206514935)  
School of Law  
Howard College Campus

Dear Mr Quarsingh,

Protocol reference number: HSS/2193/018M

Project title: Capital versus Revenue – A critical discussion on the correct test to be applied in determining the nature of an asset for Income Tax purposes

**Full Approval – No Risk / Exempt Application**

In response to your application received on 26 September 2018, the Humanities & Social Sciences Research Ethics Committee has considered the abovementioned application and the protocol has been granted **FULL APPROVAL**.

Any alteration/s to the approved research protocol i.e. Questionnaire/Interview Schedule, Informed Consent Form, Title of the Project, Location of the Study, Research Approach and Methods must be reviewed and approved through the amendment/modification prior to its implementation. In case you have further queries, please quote the above reference number. PLEASE NOTE: Research data should be securely stored in the discipline/department for a period of 5 years.

The ethical clearance certificate is only valid for a period of 3 years from the date of issue. Thereafter Recertification must be applied for on an annual basis.

I take this opportunity of wishing you everything of the best with your study.

Yours faithfully

Professor Shenuka Singh (Chair)

/ms

Cc Supervisor: Mr Chris Schembri and Professor S Bosch  
Cc Academic Leader Research: Dr Freddy Mnyongani  
cc School Administrator: Mr Pradeep Ramsewak

Humanities & Social Sciences Research Ethics Committee

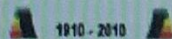
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