Tutorial Letter 102/0/2017

ADVANCED TAXATION

TAX4861
NTA4861

2017

Department of Financial Intelligence

This tutorial letter contains important information about your module.
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PREFACE TO THE INTERPRETATION AND APPLICATION OF LEGISLATION
AND THE TAX CASES SYLLABUS

1 INTRODUCTION

This tutorial letter covers all the cases SAICA considers important court decisions for the ITC tax syllabus. **Part A** of this tutorial letter contains the prescribed list of cases. However, in addition to the cases prescribed, we also include a subsidiary list of cases that students should be aware of. We refer to this list of cases as a “teaching aid”. **Part B** of this tutorial letter contains the “teaching aid” cases. The total number of cases is 83.

You will find that many of the cases in this tutorial letter were covered during the course of your undergraduate studies, but not in detail. This tutorial letter takes the study of these cases to a higher level.

It is important to understand that the study of case law goes hand in hand with and is an integral part of the interpretation and application of legislation. Therefore, these two aspects are dealt with in the same tutorial letter.

2 TIME FRAME

This is a lengthy tutorial letter. Learning unit 1 (Interpretation and Application of Legislation) should take up approximately 30 minutes of your study time. The case law syllabus deals with the practical scenarios to the interpretation of the basic principles of taxation. It covers 60 prescribed cases. It also includes 23 cases that have not been prescribed. We as lecturers regard it as important that students should be aware of these cases, so that they can think their way through a problem, which is asked in an exam scenario or in a practical situation. In spite of the large number of cases, it should only take some five hours to read. After reading this tutorial letter and familiarising yourself with the cases, you should study the cases in conjunction with the relevant tutorial letters that you will receive during the course of your academic year. These respective tutorial letters will, however, not only refer back to the cases contained in this tutorial letter, but will also contain short summaries of the relevant principles established in these cases.

We follow the SAICA syllabus and you will be examinable on case law as follows:

**SAICA: EXAMINABLE TAXATION PRONOUNCEMENTS**

Please note the following with regard to important court decisions:
A mark will be allocated in the exam for stating the correct principles of important cases (e.g. 1 mark) and marks will no longer be awarded for the case names.

*Note, however, that we may formulate a question to provide for the allocation of a bonus mark for stating the correct name of a case.*

3 IMPORTANCE OF CASE LAW

As you will gather from learning unit 1 of this Tutorial Letter, the Income Tax Act, No. 58 of 1962 (“the Income Tax Act”) (like all other legislation) uses words and phrases which it does not define. Accordingly, the judiciary has been tasked with determining their meaning. A large body of case law has accumulated over the years and is used as precedent to guide the judiciary, taxpayers and tax planners, as to the meaning of words and phrases in tax legislation.
Without an adequate knowledge of case law, you would have to guess whether an amount is taxable or not, unless it is a fairly obvious receipt such as an amount received as a salary.

The facts of a case usually tell a human story. It is something you can identify with. The facts are usually easy to remember. The result or the decision is forgotten more easily, especially where ostensibly similar facts lead to different results. This may be because, for example

- the taxpayer was unable to discharge the section 102 of the Tax Administration Act, No. 28 of 2011 (“the Tax Administration Act”) (previously dealt with under section 82 of the Income Tax Act) onus placed upon him,
- because incompetent counsel was used,
- because a higher court overruled a decision of a lower court, or
- the court made a blatant mistake.

Take care to remember the facts of the prescribed cases and reasons for the decision of the court. Then you are unlikely to make the fundamental errors which are often made in the areas of “gross income” and the “general deduction formula”, namely confusing the tests for whether

- a receipt or accrual is of a capital or income nature,
- an expense is of a capital or income nature, or
- an expense is incurred in the production of income.

During our years of lecturing, we have come across many students who, for example, incorrectly use

- the intention test to determine whether expenditure is of a capital or revenue nature,
- the recurring test to determine whether a receipt or an accrual is of a capital nature, or
- a combination of the two tests to determine whether an expense is incurred in the production of income.

We find this type of confusion unacceptable because the tax cases are there to guide us through the problem areas. The student should not confuse these tests if the student reads, understands and studies the cases.

A thorough knowledge of the prescribed tax cases will enable you to answer any tax question put to you. A large portion of the tax legislation reinforces the basic principles of taxation. Usually, where a specific piece of legislation differs from the basic principles, it has been introduced to prevent abuse. Examples are prepaid expenditure, the taxation of income in a donor’s hands instead of the donee’s hands under certain conditions, the incurral and accrual of interest.

4 PRESENTATION OF THE CASE LAW AND HOW TO USE IT

We categorised the prescribed SAICA list of cases and the “teaching aid” cases in paragraph 1. The prescribed list of cases is included in Part A of this tutorial letter, while the “teaching aid” cases are included in Part B. You will find that in some of the notes and lessons after each prescribed case, a cross reference may be made to a case in the “teaching aid” list. It is up to you to decide whether to take your understanding to a higher level. We recommend that you do so. A student should not be taken by surprise if an exam question is set on the facts of a case included in the “teaching aid” list!

This tutorial letter has been compiled to make it easy for you to refer to the required tax cases for each future tutorial letter as and when you study from such a tutorial letter. However, as mentioned above, it is advisable for you to familiarise yourself with the tax cases covered as early as possible. It may seem to be a lot of reading, but the reading can be done, as mentioned previously, in about five hours.
Note that a few of the cases cover more than one category and we have indicated this.

You will notice that each prescribed case commences with an “importance classification”. Each case has been classified as “very important”, “important” or “not very important” and gives a brief synopsis of the principle arising in the case. You should also read the “not very important” cases because you must understand why it is classified as such – it might have been replaced by new legislation which will give you a good insight into the circumstances that the new legislation intend to outlaw.

After the “importance classification”, the “facts” and the “issue” and the results of the case are given. Under the heading “notes”, certain aspects about the case are mentioned. It, inter alia, explains the case further, compares it to other decisions and places it in context.

Most of the cases then contain a final heading entitled “lesson”. The principal lesson learnt from the case is reiterated and sometimes the tax planning opportunities arising from the case are commented on.

The same formula will be followed, where applicable, for the “teaching aid” cases.

Where Latin terminology has been used, its meaning has been amplified as and when necessary. Refer to the terminology list at the end of the tutorial letter for the meaning of some commonly used terms.

5 ACKNOWLEDGEMENTS

The facts of most of the tax cases have been extracted from the LexisNexis Electronic Library on CD-ROM. Wherever possible, they have been simplified.

Many of the ideas expressed in the “notes” and “lessons” have, to some extent, been based on a mixture of commentaries on the cases as expressed by Prof Broomberg (Broomberg on Tax Strategy, 5th Edition, Kruger D, Stein M and Dachs P, LexisNexis, Durban, 2012) Prof Williams (RC Williams, Income Tax in South Africa, Cases and Materials, Fourth Edition, LexisNexis, Butterworths, Durban, 2015) and our opinions. If you wish to do additional reading, refer to these two excellent books on taxation. The relevant page numbers of these textbooks (where applicable) are indicated at the end of each case discussed.

6 LECTURERS

Prof GK Goldswain originally researched and compiled this tutorial letter. Ms A Heyns updated the tutorial letter and added new court decisions, which have been included for the purposes of the 2017 tax syllabus. Prof JS Wilcocks was responsible for quality control.

7 CONCLUSION

We trust that the summaries of the tax cases and the notes and lessons will assist you to understand the subject of taxation more fully. We wish you luck on this journey of discovery.
Please note that 30 minutes has been allocated to the introduction and application of laws and procedures. The following working method is proposed:

1. Study the following definitions in section 1 of the Income Tax Act: (5 minutes)
   - Financial year
   - Person
   - Taxpayer
   - Year of assessment


3. Work through the notes on interpretation of legislation. (10 minutes)

**INTERPRETATION**

**Importance of legislation and case law**

Statutory authority is necessary before a tax can be imposed and it is the statute alone that must be consulted to establish the liability for such tax. Accounting or related principles are not normally of concern in determining the tax liability of any taxpayer, except in instances where the Income Tax Act specifically so provides.

Apart from legislation, which forms the main source of tax law, case law also constitutes an authoritative source. A number of provisions of the acts contain terms that are not defined in these acts (for example, “capital nature” in the Income Tax Act) and it is therefore necessary to refer to case law for guidance on the meaning of these terms. For this reason you will during the course of your studies in taxation be referred to some of the more important case law regularly.

If a taxpayer’s objection to an assessment has been overruled by the South African Revenue Service (“SARS”) and the taxpayer is dissatisfied with such overruling, the taxpayer may appeal to the Tax Board which has limited jurisdiction, then to the Tax Court (previously known as the Special Court for Hearing Tax Appeals). Note that the former term “Special Court” is still used in certain instances in this tutorial letter as that was the wording used by the judiciary at that time. If the Commissioner or the taxpayer is dissatisfied with the ruling of the Tax Court, the dissatisfied party may appeal to the Provincial Division of the High Court or directly to the Supreme Court of Appeal (with the leave of the President of the Tax Court). The Supreme Court of Appeal was previously known as the Appellate Division (these two terms are interchangeable and will both be used depending on the period that the particular case was decided).
The appellant’s (the dissatisfied party) name will appear first in the court case and the respondent’s name (the party that won in the previous court) will appear thereafter. Tax Court cases are reported as ITC cases.

**Legal precedent**

The hierarchical court structure in South Africa is as follows:

- **Constitutional Court**
- **Supreme Court of Appeal**
- **Various Provincial Divisions of the High Court**
- **Various Provincial Tax Courts for hearing tax appeals**

- The system of following legal precedent means that a lower court is normally bound by the decision of a higher court.
- The Tax Court is bound by decisions of its Provincial High Court, but need not follow the decisions of the High Court of another provincial division.
- But having said that, the Tax Courts normally do follow the decisions of other provincial divisions.
- Note, however, that decisions of the Tax Court are not binding on other courts.
- In the same way, a provincial division need not follow the decisions of another provincial division.
- All Provincial Divisions and the Tax Courts are bound by decisions of the Supreme Court of Appeal.
- Unlike civil cases, a taxpayer, if he loses in the Tax Court may appeal to the Supreme Court of Appeal directly. He need not in the first instance appeal to the Provincial Division.

The Constitutional Court does not feature in tax matters unless the Constitution is involved, for example, search and seizure procedures. Any decision by the Constitutional Court must be followed without question by any of the other lower courts.

- **Regulations, practice notes and interpretation notes**

Section 107 of the Income Tax Act enables the Minister of Finance to make regulations regarding certain matters, for example, fixing of the rate per kilometre for using private vehicles for business travelling et cetera. These regulations are thus important as they have an impact on the calculation of certain figures to be used in calculating taxable income.
Sections 75 to 90 of the Tax Administration Act contain an advance tax ruling (ATR) system in SARS. An ATR system is intended to promote clarity, consistency and certainty in respect of the interpretation and application of a tax act to an applicant. The ATR process is rigid and formal, and is not designed to provide answers to an applicant’s queries.

Section 78 of the Tax Administration Act gives the Commissioner the power to issue the following types of rulings:

- binding private rulings; and
- binding class rulings.

In terms of sections 82 to 85 of the Tax Administration Act a specific advance ruling only applies to a person if:

- the provision of the Tax Act can be subjected to an advance ruling;
- the taxpayer’s set of facts or “transaction” is the same as the details specified in the ruling;
- the transaction falls in the effective period of the ruling;
- any assumptions made or conditions imposed by SARS to validate the ruling have been satisfied or carried out; and
- in the case of a “binding private ruling”, the person is an “applicant” identified in the ruling; or in the case of a “binding class ruling”, the person is a “class member” identified in the ruling.

Section 84 of the Tax Administration Act also describes situations where a ruling will be void, for example if the proposed transaction differs from the ruling materially. Also note that section 85 clearly states that an advance ruling will no longer apply if there is a change in legislation or if it is withdrawn.

SARS sometimes publishes practice notes and interpretation notes (note that existing practice notes will either be withdrawn or replaced by interpretation notes), which explain the interpretation of certain provisions of the various acts, for example the normal tax implications of interest paid on money borrowed (Practice Note 31). Some of these practice notes and interpretation notes do not have the force of law as they represent SARS’ interpretation of these provisions. These notes can therefore be challenged by a taxpayer on good grounds.

Note that some interpretation notes, for example Interpretation Note No 47 (issue 3, issued on 2 November 2012), are published as binding class rulings in terms of section 78 of the Tax Administration Act and as such have more authority.

- **Contra fiscum rule**

In the case of doubt regarding a taxing statute, the *contra fiscum* rule must be invoked. This means that an ambiguous provision in a taxing statute must be construed against the larger imposition or the benefit of the doubt must be given to the person sought to be charged. Thus, where a section of the act is reasonably capable of two constructions, the court will place the construction on it that imposes the smaller burden on the taxpayer. However, if the provision in question does not cause any doubt, the rule cannot be applied.

- **Onus of proof**

In terms of section 102 of the Tax Administration Act, the burden of proof that an amount

- is exempt from or not liable to any tax,
- or is subject to any deduction, abatement or set-off,
- or that a valuation is correct,
- or that a particular tax rate applies to a transaction, event, item or class of taxpayer,
- or whether a decision that is subject to objection and appeal, is incorrect,

rests on the taxpayer claiming such exemption, non-liability, et cetera.
This is of vital importance, as a decision of the Commissioner cannot be reversed or altered upon the hearing of an appeal unless the taxpayer shows it to be wrong. The burden of proof is squarely upon the shoulders of the taxpayer to show that it is incorrect. He does this by proving on a “balance of probabilities” (as opposed to “beyond reasonable doubt”) that his argument of the facts is more correct (greater than 50%) than the Commissioner’s. While this does not imply that the Commissioner would seek to take advantage of the situation, it is a fact that taxpayers in certain cases lost their appeals against assessments issued by the Commissioner (causing additional tax liabilities) because they had failed to discharge the onus of proof placed upon them by this section (or the former section 82 of the Income Tax Act).

• Some problems identified in the interpretation of Income Tax Act and Value-Added Tax (“VAT”) Act provisions

Some students battle with the interpretation and application of the provisions of the Income Tax Act and VAT Act. Below are some pointers on how to read and understand the wording of these Acts better.

Firstly, it is important to note the general rule that the wording of a particular provision should be given its literal, grammatical meaning (unless there is ambiguity and a strict literal meaning would lead to absurdity. In such a case, the contra fiscum rule will apply – refer above).

Secondly, when you read through a certain section of the Income Tax Act or VAT Act, note the lay-out of the section – i.e. numbering in the section, for example, is one dealing with a subsection? (e.g. section 11(e) of the Income Tax Act is a subsection of section 11 – we do not refer to it as “subsection 11(e)”); however, it is strictly speaking a subsection of the main section, namely section 11 or perhaps deals with a proviso in the subsection (e.g. refer to provisos (IA) to (ix) to (sub)section 11(e) of the Income Tax Act). Where a particular section or subsection is subject to a proviso –
  • the proviso may refer to an exception or exceptions to the provisions of that particular section/subsection – in other words, it states a different rule/interpretation/application from the general rule which preceded the proviso, or
  • the proviso refers to a condition or conditions that are present where the particular section/subsection or part of it will not apply, or
  • it sets out certain limitations to which the general rule is subject, or
  • it may prescribe additional condition(s) or stipulation(s) to which the particular section/subsection is subject to – however, whatever the purpose of the particular proviso – do not ignore it, as it is there for a reason.

Thirdly, look out for words such as “or” and “and” between provisions of a particular section or subsection. For example, refer to paragraphs (i) to (iv) of the proviso in section 11(c) (legal expenses) – they are linked by the word “and”, which means that all the conditions listed under paragraphs (i) to (iv) must be present for a legal expense to be deductible in terms of section 11(c). But the word “or” refers to the one or the other, but not both or all conditions/requirements/provisions have to be present or satisfied. An example of where the word “or” is used is section 23H (prepayments). Refer to paragraphs (aa) to (dd) of the proviso – if any one of the conditions under paragraphs (aa) to (dd) is present, section 23H will not apply to limit the deduction of the prepayment under review.
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3.2.4 ANGLOVAAL MINING LIMITED v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE, 71 SATC 293

4. **SPECIAL INCLUSIONS IN “GROSS INCOME”**

4.1 Paragraph (a) of the definition of “gross income” – Annuities

4.1.1 SECRETARY FOR INLAND REVENUE v WATERMEYER, 27 SATC 117

4.2 Paragraph (c) of the definition of “gross income”

4.2.1 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v KOTZE, 64 SATC 447

4.3 Officer v employee – “in respect of services”

4.3.1 SECRETARY FOR INLAND REVENUE v SOMERS VINE, 29 SATC 179

4.4 Recoupments

4.4.1 OMNIA FERTILIZER LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE, 65 SATC 159
### CHAPTER 5  THE GENERAL DEDUCTION FORMULA
(study with TL 104 & TL 106)

1  “TRADE”

1.1  General

1.1.1  COMMISSIONER FOR INLAND REVENUE v STANDARD BANK OF SA LIMITED, 47 SATC 179  

2  “EXPENDITURE AND LOSSES ACTUALLY INCURRED”

2.1  General

2.1.1  CALTEX OIL (SA) LIMITED v SECRETARY FOR INLAND REVENUE, 37 SATC 1  

3  “IN THE PRODUCTION OF INCOME”

3.1  Theft by employees

3.1.1  COT v RENDLE, 1965(1) SA 59  

4  “NOT OF A CAPITAL NATURE”

4.1  General

4.1.1  BURMAN v COMMISSIONER FOR INLAND REVENUE, 53 SATC 63  

4.1.2  COMMISSIONER FOR INLAND REVENUE v GENN & CO (PTY) LTD, 20 SATC 113  

4.1.3  ITC 1322, 42 SATC 272  

4.1.4  STONE v SECRETARY FOR INLAND REVENUE, 36 SATC 117  

4.1.5  SENTRA-OES KOOPERATIEF BPK v KOMMISSARIS VAN BINNELANDSE INKOMSTE, 57 SATC 109  

### CHAPTER 6  OTHER MISCELLANEOUS TOPICS

1  TRUSTS: Conduit pipe principle (study with TL 105)

1.1  ARMSTRONG v COMMISSIONER FOR INLAND REVENUE, 10 SATC 1  

2  RECOUPMENTS (study with TL 106)

2.1  General

2.1.1  COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICES v PINESTONE PROPERTIES CC, 63 SATC 421  

3  ASSESSED LOSSES (study with TL 106)

3.1  ITC 1830, 70 SATC 123  

4  VALUE-ADDED TAX (study with TL 103)

4.1  ITC 1852, 73 SATC 253
CASE LAW SYLLABUS

PART A

SAICA’S PRESCRIBED LIST OF CASES

NOTE:

- The cases under Part A are the prescribed SAICA cases. They are the most important court cases and you should know them very well.
- The “teaching aid” cases are also important. They are included under Part B of this study unit. They amplify the prescribed cases and fill in the gaps in your knowledge. You can also expect test and/or exam questions to be set on these cases.

CHAPTER 1

GROSS INCOME

(study with TL 104)

1 “TOTAL AMOUNT”

1.1 General

1.1.1 COMMISSIONER FOR INLAND REVENUE v BUTCHER BROS (PTY) LTD

13 SATC 21 (A) – 1944

Importance classification:

Very important. It analyses the meaning of an amount. It determines the method to be used to value an asset received other than in cash (where there is no employer/employee relationship) and places the onus on the Commissioner, in the first instance, to establish that there is an amount. It is only after an amount is established by the Commissioner that the onus reverts to the taxpayer in terms of section 102 of the Tax Administration Act (previously section 82 of the Income Tax Act). It is also the authority for the proposition that a lease premium is a consideration passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition to, or in lieu of (instead of), rent.

Facts:

The taxpayer owned land which was leased to a cinema company for a period of 50 years with a further option for another period of 49 years. In terms of the lease, the lessee was obliged to erect a cinema building, at its own expense, on the property. On the termination or any renewal of the lease, all buildings and improvements on the land let would become the absolute property of the lessors without their having to pay or being liable to the lessees for any compensation for the buildings or improvements made during the course of the lease. There was no special provision in the Income Tax Act at that time (but it is now covered by paragraph (h) of the definition of “gross income”) whereby an agreement of this nature could be considered to create income in the hands of the lessor. The Commissioner for Inland Revenue considered (and had case law authority to support his view) that the amount expended on the buildings was an amount received or accrued as a premium or like consideration in respect of a grant of a right for the use or occupation of premises. Therefore he was entitled to include the amount so expended in the taxable income of the taxpayer. However, the defence was raised that the tax-
payer would obtain no benefit from the improvements until the expiry of the lease in 50 years’
time and because the buildings may have fallen into disrepair or may even have been
demolished by that time, the valuing of the buildings was impossible. Thus there could be no
ascertainable value accruing to the taxpayer.

Issue:

Could the buildings have an ascertainable value in 50 years’ time?

Held:
The buildings which the lessee company had undertaken to erect, without compensation, would
constitute a consideration in the nature of a premium but only if such right at the date of its
receipt had an ascertainable money value. The rights which had accrued to the lessor company
could not be regarded as constituting an amount received by or accrued to that company in the
year the buildings were completed as they had not, at that date, any ascertainable money value
which could be included by the Commissioner in an assessment for that year.

Notes:
The Appellate Division (now the Supreme Court of Appeal) upheld the argument of the taxpayer,
on the facts. There was no value which could be determined 50 years hence – it was too
problematical or even impossible to determine the value to the taxpayer. Buildings could be
dilapidated, destroyed, et cetera.

The decision in the case led directly to the introduction of the equivalent of paragraph (h) of the
definition of “gross income” which governs improvements to leasehold properties. But this
provision creates an unfair hardship for the lessor – he is taxed at the time the buildings are
completed and such treatment could create a cash flow problem for his business. Legislation
was introduced to ostensibly alleviate this problem in the form of section 11(h). Section 11(h)
provides that the lessor may be granted an allowance as the Commissioner may deem
reasonable having regard to any special circumstances of the case and to the original period for
which the right of occupation was granted. There are no guidelines as to how or when this relief
will be granted other than he does not allow the lessor to spread the income accruing in this
respect over the period of the lease. However, he does allow the lessor’s income so accruing to
be discounted to its present value, taking into account the remaining number of years of the
lease. Currently the rate is believed to be 6%.

It may seem that this case has no real relevance any longer. However, the case is authority for
the proposition that the word “amount” means an amount having “an ascertainable
money value” and that the onus is initially on the Commissioner to prove that an
“amount” has accrued to the taxpayer. It is only after establishing an “amount” (which
has an ascertainable money value) that the onus reverts to the taxpayer.

Lesson:

It is perhaps unfair that the lessor is taxed upfront on the full present value on the
improvements while the lessee may only deduct a portion of the expenditure over the period of
the lease. The tax planner must be aware of the provisions of paragraph (h) of the definition of
“gross income” and the fact that if the improvements do not form part of the income of the
lessor (such as a pension fund), there can be no deduction available to the lessee.1

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1 Broomberg pp 67, 99, 100.
1.1.2 COMMISSIONER FOR INLAND REVENUE v PEOPLE’S STORES (WALVIS BAY) (PTY) LTD
52 SATC 9 (A) - 1989

Importance classification:

Very important as the Appellate Division in this case confirmed the meaning of “accrued to” as applied in the LATEGAN decision as being the amount “to which he has become entitled”. The court did not follow the obiter dicta (an incidental (remark)) of some previous Appellate Division cases that “accrued to” meant an amount, which was “due and payable”. The essential facts of this case are similar to the LATEGAN case.

Facts:

The taxpayer carried on business as a subsidiary in a large group of companies as a retailer of clothing, footwear, household textiles and related goods and sold its wares to its customers for cash and on credit. The bulk of its credit sales were made under its “6-months-to-pay” revolving credit scheme, whereby amounts charged to a customer’s account were payable in six equal monthly instalments. At or soon after every month end, a statement of account was rendered to each customer. The instalment reflected on the statement as payable had to be paid before the next statement date. In other words, a purchase made in January would be reflected on the statement rendered at or soon after the end of that month. One-sixth of the purchase price would be reflected on the statement as payable. It would have to be paid before the date of the next statement rendered or soon after the end of February.

During the 1983 tax year, the taxpayer sold goods under its revolving credit scheme for a total amount of some R1,3m. At year-end an amount of R341 281 representing instalments not yet payable was still outstanding. The Commissioner for Inland Revenue included this amount in the taxable income on which the taxpayer was assessed for normal tax for the year in question, subject to a deduction of R7702 in terms of section 11(j) of the Income Tax Act for debts considered to be doubtful.

Issue:

When does an amount payable in the future accrue to the taxpayer? If it accrues in terms of the LATEGAN principle, what value should it be included at – the face value or the present discounted value?

Held:

That income, although expressed as an “amount” in the definition of “gross income”, need not be an actual amount of money but may be “every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value . . . including debts and rights of action”. That income in a form other than money must, to qualify for inclusion in “gross income”, be of such a nature that a value can be attached to it in money. That the fact that the valuation of the income may sometimes be a matter of considerable complexity does not detract from the principle that all income having a money value must be included. That no more is required for an accrual in terms of the definition of “gross income” than that the person concerned has become entitled to the “amount” in question.

That any right (of a non-capital nature) acquired by the taxpayer during the year of assessment and to which a money value can be attached, forms part of the “gross income” irrespective of whether it is immediately enforceable or not, but that its value is affected if it is not immediately enforceable. That the decision in LATEGAN V COMMISSIONER FOR INLAND REVENUE, 1926 CPD 203, 2 SATC 16, reflects the law correctly. That the value of the instalments not yet payable nor paid at the tax year-end must be included in the taxpayer’s gross income for that tax year. That the outstanding instalments constituted rights to receive payment in the future and these rights had to be valued, such value being obviously
affected by their lack of immediate enforceability; they accordingly had to be valued at their market value.

Notes:

The PEOPLE’S STORES decision confirmed both legs of the LATEGAN decision. Nevertheless, soon after the judgement was handed down, an amendment was rushed through parliament to prohibit the discounting of amounts, which had accrued to the taxpayer from being discounted to its “present value”. The amendment was even made retrospective! The full value rather than the discounted present value is now to be included in “gross income”. See the proviso to the definition of “gross income” in section 1 of the Income Tax Act.

Please note that a credit term is not a condition relating to the sale of goods but rather an agreement to delay the payment. Thus, if there is a condition imposed in terms of a contract, the accrual is deferred until the condition is fulfilled. See LATEGAN’S and MOOI’S cases in this regard.

Also refer to section 24M relating to unquantified amounts and section 24N relating to the disposal of equity shares and that in certain circumstances there is no accrual until the price of the shares become “due and payable”.

Lesson:

From a tax planning perspective, the manipulation of when an amount is received by or accrued to a person can still lead to tax planning opportunities. The easiest tax opportunity is to delay the accrual of an amount to a later year of assessment by, for example, a professional business not billing the client for the work done during a particular year of assessment (the work done is not regarded in terms of section 22 as work-in-progress). Another opportunity is to impose a condition on the accrual (other than a credit term).

1.1.3 WH LATEGAN v COMMISSIONER FOR INLAND REVENUE
2 SATC 16 (CPD) - 1926

Importance classification:

Not very important any longer as the meaning ascribed to “accrued to” by the Cape Provincial Division Court was subsequently confirmed by the Appellate Division in the PEOPLE’S STORES case, namely that the meaning of “accrued to” is the amount “to which he has become entitled”. Its importance is thus more historical because the “entitled to” principle was applied by the Receiver of Revenue (the Commissioner) for some 70 years before being confirmed in the PEOPLE’S STORES case.

Facts:

The taxpayer, a wine farmer, entered into an agreement under which he disposed of the wine he had made during his year of assessment to a Co-Operative company for an amount of £5,924. A portion of the selling price was paid prior to the end of his year of assessment and the balance was to be paid in instalments after the end of the year of assessment. The Co-Operative company of which the taxpayer was a member, deducted from the amount payable to him in respect of the sales, two amounts due to the company as “retention” and “contribution” money. Of these amounts the “retention” money was applied by the company towards its working expenses and the “contribution” money was in part treated as a contribution to the administrative costs of the company. The balance was retained by the company as a

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2 Broomberg pp 78, 155.
reserve – the taxpayer being entitled to receive shares in the company of an equivalent value. The Commissioner included the whole amount of £5,924 for which the wine had been sold in his income. Only the amount that had been actually applied towards meeting the administrative costs of the company was allowed as a deduction. The “retention” reserve was not allowed as a deduction.

**Issue:**

What amount had accrued to the taxpayer in addition to the amount actually received by the taxpayer during the relevant year of assessment? Did it include the instalments payable after the year-end of the taxpayer?

**Held:**

“**Accrued to**” means “become entitled to” and in the context of the facts it included the right to payment in the future. Thus the instalments payable after the year of assessment in respect of the wine produced during the year of assessment formed part of the “gross income” of the taxpayer for that year.

The second leg to the decision held that the amount of the future instalments to be included in the gross income at the end of that year was their discounted value (or rather the present value of the future instalments). The balance of the contribution money in respect of which the taxpayer had been entitled to receive shares had rightly been treated as income, which had accrued to the taxpayer and had been capitalised on his behalf.

**Notes:**

It took some 70 years for the meaning of “accrued to” as ascribed to it in the LATEGAN case, to be confirmed by the Appellate Division (now the Supreme Court of Appeal) in the PEOPLE’S STORES case. The LATEGAN decision and the PEOPLE’S STORES decision have come in for some harsh criticism by academic writers. In MOOI’S case, the court had to add the word “unconditionally” to the phrase of “become entitled to” not to tax a right which at the time received, had a condition attached to it.

As mentioned under 1.1.2, note that the granting of credit does not constitute a condition. A condition in this context would, for example, be a condition in a contract, which delays the passing of ownership in a good until the happening of an event. The granting of a period of credit is a delayed method of payment rather than a condition of sale is reiterated.

A good example of a conditional accrual is a retention clause on a building or supply contract. The retention monies only accrue once the condition has been fulfilled, for example, on the presentation of an architect’s certificate.

The Commissioner was always reluctant to apply the second leg of the judgement, namely to value the amount to be received in the future by discounting it. It was only in the PEOPLE’S STORES case that the Commissioner’s reluctance was challenged. In that case, the Appellate Division confirmed the second leg of the LATEGAN decision but, as mentioned under 1.1.2, soon after the judgement was handed down, an amendment was rushed through parliament to prohibit the discounting of amounts, which had accrued to the taxpayer from being discounted to its “present value”. The full value, without any discount, was to be included in “gross income”. See the proviso to the definition of “gross income” in section 1 of the Income Tax Act.
2 “CASH OR OTHERWISE”

2.1 General

2.1.1 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICES v BRUMMERIA RENAISSANCE
69 SATC 205 (SCA) - 2007

Importance classification:

Important. The taxability of notional interest on interest-free loans was raised in this decision. Please note that the judgement has limited application and should not be used as authority for the general proposition that notional interest on all interest-free loans must be valued and be included in “gross income”. All the tax issues that interest-free loans raise (capital nature, carrying on a trade, deductibility of expenses, et cetera) were not argued at the appeal stage. This judgement applies only to the situation where an interest-free loan is granted in exchange (as quid pro quo) for goods supplied, services rendered or any other benefit granted. This principle enunciated from this case is confirmed in Interpretation Note No. 58 (Issue 2, issued on 4 October 2012)).

Facts:

Interest-free loans were made by occupiers of units in retirement villages. The taxpayers (developers) obtained interest-free loans from a potential occupant to finance the construction of a unit in a particular retirement village. The lender of the interest-free loan was granted a lifelong right to occupy a unit. These rights of occupation were known as “life rights”. The ownership in the unit remained with the taxpayer. When the agreement was cancelled or the lender died, the taxpayer was obliged to repay the loan. The important point to note is that the quid pro quo for the lifelong right to occupy the unit was that the taxpayer received the use of the interest-free loan.

Issue:

Did the taxpayer receive a “benefit” in a form other than cash and if so did such “benefit” fall in the definition of “gross income” as contained in section 1 of the Income Tax Act?

Held:

That the Commissioner’s representative had correctly conceded that the actual receipt of the loan did not result in the receipt of amounts for the purposes of the definition of “gross income”. Even though the receipt of loan capital constitutes a receipt, it does not form part of gross income (CIR v Genn & Co (Proprietary) Limited 20 SATC 113). The argument for SARS was that the right to retain and use the loan capital on an interest-free basis constituted a right which had an ascertainable money value and which accrued to the taxpayers.

That rights of a non-capital nature and which are capable of being valued in money are included under gross income. That the method of valuation of such a right is an objective and not a subjective test. That the fact that a right cannot be alienated, does not negate a value.

That the value of the rights must be determined by applying the weighted prime overdraft rate for banks to the average amount of the interest-free loans during the relevant years of assessment.
Notes:

The right to occupy premises was in this case received on the basis of a quid pro quo that was given by the taxpayer. Unfortunately, the taxpayer did not argue the basis on which the Commissioner valued the right.

The calculation of the monetary value of a life-right over a unit in a retirement village, to be included in gross income, is discussed in Interpretation Note: No. 58 and has the status of a binding general ruling in terms of section 89 of the Tax Administration Act (Binding General Ruling No. 8 (Issue 2)).

In the case of an interest-free loan to a family trust or a group company, there are no specific services that are rendered or quid pro quo given. It is therefore submitted that this decision is not authority for the taxation of an interest-free loan to a family trust or a group company. The circumstances of each case must be evaluated against the quid pro quo given. Otherwise, if there is no quid pro quo, any benefit derived by a borrower from an interest-free loan is capital in nature. Unfortunately, the taxpayer did not appeal on the grounds that the notional interest was capital in nature and on appeal was not allowed to argue the point.

The aspect of whether the taxpayer could now claim deductions which he could not claim previously (because he did not generate “income” as defined prior to the decision) was also not subject to appeal and was not dealt with in the judgement.

Lesson:

The taxpayer found to his cost that he was limited in his arguments on appeal because he had not raised them before he argued the matter before the Supreme Court of Appeal. Perhaps a different decision would have been reached if he had done so.

This judgement does not apply to interest-free loans where no quid pro quo has been given. The quid pro quo aspect (something given in return) is clearly the distinguishing feature of this case.

When something is received in another manner than in cash, it must be valued by adopting some reasonable method of sale. The authority for this case is LACE PROPRIETARY MINES LTD v CIR, 9 SATC 349(A), which case is included in the list of “teaching aid” cases in Part B of this tutorial letter.
3.1.1 GELDENHUYS v COMMISSIONER FOR INLAND REVENUE
14 SATC 419 (A) - 1947

Importance classification:
Very important. It postulates that an amount is only “received” by a taxpayer if it is received by him “on his own behalf and for his own benefit”.

Facts:
The taxpayer, who was a widow, carried on a business as a farmer. She and her late husband were married in community of property and executed a mutual will under which the survivor was to enjoy the fruits and income of the joint estate (a usufructuary interest) for his or her lifetime. The children of the marriage were appointed sole and universal heirs of the estate. When her husband died she accepted the usufructuary benefits conferred on her under the will. Included in the joint estate was a flock of sheep. The taxpayer later decided to give up farming and her children agreed to the sale of the flock. She deposited the proceeds realised into her banking account.

Issue:
Could the proceeds on the sale of the flock of sheep held under a usufruct be regarded as an amount “received” for the purposes of “gross income”?

Held:
That the taxpayer was the usufructuary of the flock and because the number of sheep remaining at the date of the sale was smaller than at the date when her usufruct commenced, there was no surplus progeny to which she was entitled; consequently the whole of the proceeds realised belonged to the heirs and did not form portion of her income and the position was not in any way modified by the special provisions of the Income Tax Act dealing with the incomes of farmers.

Notes:
A usufruct interest is the right to use and take the fruits of property owned by another person. At the end of the usufruct period, the property must be restored to the owner. In GELDENHUYS’S case, decided in accordance with Roman-Dutch law (our common law), the usufruct interest (and thus the “income”) in the sheep was limited to the increase in the number of sheep in the flock. The original number of sheep in the flock or their cash equivalent had to be returned to the owner of the flock of sheep at the end of the usufruct period. The proceeds on the sale of the sheep would have had to be given to the original owners at the end of the usufruct period if no sheep were available to be returned. The owners would not have been taxed on the capital returned but the usufructuary would have been taxed on any interest on the proceeds invested until the end of the usufruct period.

Thus any amount received by a taxpayer acting in the capacity of a usufructuary (unless it is income earned on the capital amount which capital amount later has to be returned to the owner, agent, trustee or guardian of a child to be used for the benefit of the child), does not form part of his “gross income”.
Lesson:

The major tax planning lesson to be learnt from this case is that our common law (Roman Dutch law and Roman Law) plays a large part in determining the tax consequences of a transaction. If a taxpayer can arrange his affairs in such a manner so as to not be the beneficial recipient of an amount which is revenue in nature, he cannot be taxed on such amount. The taxpayer, in the appropriate circumstances, may be able to divert income to someone else or another entity who has a lower tax rate than him, for example, a company which only has a tax rate of 28% (excluding dividends tax) thereby obtaining a tax benefit. The trick, however, is to be able to validly and antecedently divest oneself of the income (without falling foul of our anti-tax avoidance legislation – for example, section 7), that is, divest oneself of the income before it accrues for tax purposes.3

3.2 Illegal receipts and theft

3.2.1 COMMISSIONER FOR INLAND REVENUE v DELAGOA BAY CIGARETTE CO, LTD
32 SATC 47 (A) - 1918

Importance classification:

Important. It introduced the principle, from an early stage of our tax law (1918), that in determining whether an amount is “income” or not, no account must be taken of the fact that the activity involved was illegal, immoral or ultra vires. It is also authority for the proposition that expenditure incurred in producing such income may qualify as a deductible expense. However, the subsequently enacted section 23(o) prohibits the deduction of bribes, fines and penalties. Please note that fines imposed by, for example, a sporting body, are not covered by this prohibition. Thus, provided that such a fine imposed can meet all the requirements of the general deduction formula, such a fine may be allowed as a deduction.

Facts:

The taxpayer company had advertised a scheme under which it sold packets of cigarettes worth 6d for 10s, each such packet containing a numbered coupon. In terms of the advertisement the company undertook to set aside two-thirds of the amount received from such sales as a prize fund from which a monthly distribution would be made to such purchasers of the packets “as the directors of the company should in their discretion determine”. Two monthly distributions to winners were made. A third distribution was due to take place but criminal proceedings were instituted against the officials of the company on the grounds that they were running a lottery. The Commissioner for Inland Revenue argued that the distribution of the prize money was a disposal of profits after they had been earned and, therefore, could not be deducted. He issued an interim assessment based on that argument. The taxpayer’s argument was that the demand for immediate payment on the issue of an interim assessment was not authorized by the terms of the Income Tax Act; that the payments of prizes were outgoings incurred in the production of the income of the company and did not constitute a portion of its taxable income, and that the business of the company was illegal and the State was not entitled to collect tax on the profits of illegal transactions.

Issue:

Whether receipts received in respect of illegal activities constitute “income” and if they did, whether the expenditure incurred in respect of such activities qualify as deductible expenditure?

3 Williams pp 106, 148.
Held:
That the payment of prizes in accordance with the contracts of purchase and sale entered into with the buyers of the packets of cigarettes constituted outgoings incurred in earning the income of the company and did not constitute the distribution of income so earned. That there was nothing in the Income Tax Act which could be construed as debarring the Commissioner from demanding immediate payment of an interim assessment if he considered such action necessary to ensure payment of the tax due. That the legality or otherwise of the business was irrelevant – the income earned was taxable.

Notes:
The fact that an expense incurred is unnecessary or extravagant, does not preclude its deductibility provided that there are no ulterior motives involved, for example, paying a son a salary far in excess of the going rate for the type of work performed. In the same way, it could be argued, based on this case, that money paid as a bribe, provided that the bribe is paid out for the purposes of trade and in the production of income, should also qualify as a deduction. However, the subsequently enacted section 23(o) specifically prohibits the deduction of bribes, fines or penalties but only where such bribe constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act 12 of 2004.

Lesson:
One must always be aware of public policy considerations when dealing with illegal receipts or illegal payments. In ITCA 1490, 53 SATC 108, (you are not required to study this case) traffic fines were not allowed as a deduction as the court held that it was against public policy to mitigate (reduce the effects of) a fine imposed by allowing the amount of the fine as a deduction in spite of the fact that the fine may have met all the criteria of section 11(a) to be allowed as a deduction in terms of section 11(a), for example, overloading a transport vehicle to produce more income. Could this principle of public policy in tax matters not be in conflict with the DELAGOA BAY CIGARETTE CO case? Is there any real difference in allowing a prostitute a deduction for amounts paid to her pimp (prostitution in such circumstances is an illegal activity) and disallowing a deduction for a traffic or other such fine based on public policy? Since the introduction of section 23(o), however, this has been an academic debate, as section 23(o) prohibits the deduction of fines (and bribes) even if they meet all the other criteria for deductibility in terms of section 11(a).

3.2.2 MP FINANCE GROUP CC (IN LIQUIDATION) v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
69 SATC 141 (SCA) - 2007

Importance classification:
Very important. It clarifies the taxability of illegal receipts and ill-gotten gains. It distinguishes the relationship between contracting parties (commercial relationship) and the relationship that a taxpayer has with the fiscus. The tax consequences flow from the relationship with the fiscus rather than from the commercial relationship.

Facts:
During the 2000, 2001 and 2002 years of assessment, Marietjie Prinsloo operated an illegal and fraudulent investment enterprise commonly called a pyramid scheme through various entities in Gauteng and neighbouring provinces with the aid of family and employees and so-called agents who solicited and transmitted investors’ deposits in return for commission. She controlled the various entities in the names of which the scheme was conducted and procured their printing of a range of convincing-looking documentation issued to investors when they made deposits.
As was the pattern with such schemes, it readily parted investors from their money by promising irresistible (but unsustainable) returns on various forms of ostensible investment and it paid such returns for a while to some investors before finally collapsing, owing many millions.

The evidence revealed that most of the money received by the scheme was kept in cash and not banked and this cash float provided the source of payments to investors. However, substantial amounts of money were appropriated by Prinsloo and her accomplices and some investors received payment of their investments plus returns but the majority received less or nothing.

What was of essential importance was that throughout the tax years in question, the perpetrators of the scheme knew that it was insolvent, that it was fraudulent and that it would be impossible to pay all investors what they had been promised.

The appellant contended that because the scheme was liable in law immediately to refund the deposits, there was no basis on which it could be said that the deposits were “received” in the meaning of the Income Tax Act and they were consequently not subject to tax.

**Issue:**

Whether the amounts paid by the various investors could be said to have been received by appellant as gross income within the meaning of section 1 of the Income Tax Act?

**Held:**

That the inference on the facts must be that whatever intention there was at any time on the part of investors to enter into a contractual relationship with the entities concerned and whatever corresponding intention to contract there might have been on the relevant entities’ part prior to 1 March 1999, there could no longer have been any such corresponding intention after that date, as from that date onwards the entities run by Prinsloo made their money by swindling the public.

That it followed that the amounts the entities run by Prinsloo were paid in that period were “received” in the meaning of the Income Tax Act and it was for the appellant to prove the contrary and that the onus was not discharged (it could not be proved).

That the relationship between investor and scheme and the present case (relationship between scheme and fiscus) was different. An illegal contract is not without all legal consequences and it can have fiscal consequences, i.e. the sole question as between scheme and fiscus was whether the amounts paid to the scheme in the tax years in issue came in the literal meaning of the Income Tax Act and unquestionably the amounts did. That the amounts paid to the scheme were accepted by the operators of the scheme with the intention of retaining them for their own benefit and notwithstanding that in law they were immediately repayable, the amounts constituted receipts in the meaning of the Income Tax Act. That, accordingly, the amounts in issue constituted income received and were duly taxable.

**Notes:**

This decision, given by the Supreme Court of Appeal, has given clarity on the issue of whether all illegal gains and proceeds are taxable. Effectively, it followed the decision in ITC 1624 (you are not required to study this case) which followed the Delagoa Bay Cigarette case – look at the nature of the receipt and how the recipient treats such receipt. If he treats it as if it is in the nature of income (Williams’ test), then it is a receipt in the meaning of “gross income”.

In summary, it follows from the decision in MP Finance Group CC (in liquidation) that an amount will be “received by” a taxpayer for the purposes of the definition of “gross income” if he has intended to receive such amount for his own benefit.
It is submitted that the court came to a rather extreme decision, which will have consequences, including Constitutional consequences. The Special Court had previously held that a pyramid scheme is insolvent \textit{ab initio} (from the moment it was entered into) and thus it was legally impossible for any person to receive such an amount for his own benefit and on his own behalf. The Supreme Court of Appeal decided differently, coming to the conclusion that in the case of a swindle, fiscal consequences arise and because the taxpayer treated the deposits as his own, such amounts fell in the ambit of the literal meaning of “received by”.

As far as Constitutional consequences are concerned, the decision could probably be challenged constitutionally by the investors on the basis that they are being unlawfully deprived of their property by the State, namely that tax is being collected from the swindlers to the detriment of the depositors in that it reduces the available amount in the insolvent estate for repayment to the depositors.

Note that SARS issued Interpretation Note No. 80 on 5 November 2014 that deals with the income tax treatment of stolen money. In this interpretation note SARS confirms the principle that was drawn from case law dealing with illegal receipts, namely that the receipt of stolen money comprises gross income and is taxable. The \textit{MP Finance Group CC (in liquidation)} case dealt with money fraudulently received under an illegal contract, but the same principles are considered to apply equally to the theft of money through robbery, burglary or other criminal means. The main issue is whether the thief intended to benefit from the stolen funds and if so, the elements of a “receipt” for tax purposes have been met.

3.3 Deposits

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<thead>
<tr>
<th>3.3.1</th>
<th>PYOTT LTD v COMMISSIONER FOR INLAND REVENUE</th>
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<td>13 SATC 121 (A) - 1944</td>
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\textbf{Importance classification:}

Very important as it introduced the principle that deposit moneys obtained for containers in which goods are sold, are included in “gross income”. Furthermore, the liability for a refund created by the taxpayer for the possible return of the containers is merely a contingent liability and thus a provision. A deduction for a provision is specifically prohibited in terms of section 23(e) of the Income Tax Act but section 24C may be available in the appropriate circumstances.

\textbf{Facts:}

The taxpayer company, Pyott Ltd, carried on business as the manufacturer of biscuits (which it still does to the present day). The biscuits were packaged and sold in tin containers. A deposit was charged for the tin container, which was refundable to the customers on the return of the tin in good condition. Some 25 or 30 per cent of the tins were so returned to the company prior to the Second World War. Owing to the shortage of tinplate during the war years, the deposit on the tins was tripled so as to give a greater inducement to the customers to return the tins. This increase in the deposit paid resulted in some 90 per cent of the tins being returned for a refund. The company set aside, as a provision for allowances on tin containers returnable, an amount representing their liability for refunds. This provision had the effect of excluding the deposits received from the determination of the company’s taxable income. The Commissioner refused to allow the deposits to be excluded in determining the taxable income of the company.

\textbf{Issue:}

Whether the amount of the income (if income at all) received from the deposit transactions the amount debited in each transaction less the amount of the obligations which the taxpayer
undertook to discharge? Furthermore, if the deposits received were regarded as income, was the liability created for the refunds forbidden as a deduction by section 12(e) of Act 31 of 1941 (precursor to section 23(e) of the Income Tax Act)? Alternatively whether the deposit transactions capital in nature, undertaken for the preservation of the asset to it and hence not income in the meaning of the Income Tax Act?

Held:

That the amount received for the containers constituted cash which was not subject to any reduction or discounting and therefore had to be included in the gross income of the taxpayer company at its full value, while the provision made to meet future claims for refund on the return of containers constituted a reserve for a contingent liability, which was expressly forbidden by the terms of section 12(e) of the Income Tax Act, No. 31 of 1941 (now section 23(e)).

Notes:

The court suggested that if the moneys received as deposits for the tins had been banked in a separate trust account set up specifically for the deposits received, then such amounts deposited would not constitute “gross income”.

Lesson:

In addition to the suggestion that a separate trust account be set up to deposit amounts received for deposits on tins received to avoid the deposits being taxable, it is quite possible that section 24C (which section was not in existence at the time this case was decided) can be used to alleviate the problem. The deposit received, if separately charged for, can be regarded as an amount received in advance for a future liability in terms of a contract.

4 "ACCRUED TO"

4.1 General

4.1.1 WH LATEGAN v COMMISSIONER FOR INLAND REVENUE
2 SATC 16 (CPD) - 1926

This case is discussed in paragraph 1.1.3 above.

4.1.2 COMMISSIONER FOR INLAND REVENUE v PEOPLE’S STORES (WALVIS BAY) (PTY) LTD
52 SATC 9 (A) - 1989

This case is discussed in paragraph 1.1.2 above.

4.1.3 MOOI v SECRETARY FOR INLAND REVENUE
34 SATC 1 (A) - 1972

Importance classification:

Very important as the decision amplified the meaning ascribed to “accrued to” by the LATEGAN decision by including the word “unconditionally” to the words “entitled to”. Thus, the meaning of “accrued to” is that the taxpayer must “become unconditionally entitled to” an amount before it accrues to him. Please once again refer to the LATEGAN and PEOPLE’S

4 Williams p 150.
STORES cases if you have not already done so. Remember that the granting of credit can never be regarded as a condition of sale.

Facts:

The taxpayer was granted an option to subscribe for shares in the company which employed him subject to certain conditions, namely that the taxpayer was still in the employ of the company at the time the mine, at which he worked, came into operation. The taxpayer accepted the option and some three years later the mine came into operation and he was able to exercise the option. The option price paid was far below the market price of the shares. The Secretary for Inland Revenue included the difference between the option price paid and the market value of the shares at the time of exercising the option, in the taxpayer's gross income as being an amount, which had accrued to him in respect of services rendered or to be rendered. The taxpayer argued that the only amount, if any, which accrued to him in respect of services whether rendered or to be rendered, was the right he acquired some three years previously to exercise an option at a later date when certain conditions had been fulfilled. The exercise of the option when those conditions had been fulfilled, it was contended, resulted in an accrual arising from the expenditure of the sum paid by the taxpayer for the shares and could not be said to have accrued in respect of services rendered or to be rendered by him to the company.

Issue:

Did the accrual of the shares take place at the time the option was granted or did the accrual take place only when the conditions were fulfilled and the option exercised?

Held:

That the true and real benefit contemplated in the option offer was the right, on the due fulfilment of all the conditions, to obtain the shares at a set price. The relevant accrual of that benefit occurred when the option became exercisable on those conditions being fulfilled some three years later; until the taxpayer had performed those services he did not become “entitled to” any right of option, nor was anything “due and payable” to him. Therefore, whether the interpretation of “accrued” as adopted in LATEGAN’S case or adopted in the case of HERSOV’S ESTATE (“due and payable” principle) is accepted, there was no accrual to the taxpayer until the conditions were fulfilled. Further, that as at that date the taxpayer was in the service of the company, the necessary causal relationship existed between the benefit acquired by the taxpayer and his services to the company to bring the benefit in the statutory definition of “gross income”.

Notes:

After the decision in LATEGAN’S case, the Appellate Division (now the Supreme Court of Appeal) in HERSOV’S ESTATE v COMMISSIONER FOR INLAND REVENUE, 21 SATC 106, cast doubt on the LATEGAN interpretation of “accrued to” and favoured (obiter dicta – as an aside) the “due and payable” principle. However, as we know, the LATEGAN principle was later confirmed in the PEOPLE’S STORES case.

This decision (MOOI) amplifies the meaning of “accrued to” to mean “become entitled to unconditionally”.

This case was the basis for introducing of the then section 8A into the Income Tax Act, which is now essentially embodied in section 8C.
Lesson:

Although the taxpayer lost his case, the judgement led to many tax planning opportunities. The basic tax planning opportunities were discussed under the PEOPLE’S STORES case.\textsuperscript{5}

5 “IN FAVOUR OF”

5.1 General

5.1.1 COMMISSIONER FOR INLAND REVENUE v WITWATERSRAND ASSOCIATION OF RACING CLUBS
23 SATC 380 (A) - 1960

Importance classification:

Very important. This case illustrates the problem encountered by taxpayers in avoiding the accrual of income to the taxpayer which he is then obliged to pay to another person. Once an amount has been beneficially received by or accrued to a taxpayer, he is taxed on such amount even though he may have an obligation to pay it over to some other person.

Facts:

The taxpayer, a non-registered association of racing clubs organized a race meeting on the race-course of the Johannesburg Turf Club, the proceeds of which were to be divided between two non-profit charities. The proceeds of the meeting amounted to £7,906, which sum, together with £369 received from donations, were divided between the two charitable bodies for whose benefit the meeting was stated to be held. The Commissioner included the £7,906 in the taxpayer’s “gross income”.

Issue:

Were the proceeds, which the racing association were obliged to pay over to the charities, to be included in the association’s “gross income”?

Held:

That on the facts, the Association had, in holding the race meeting, embarked on a scheme of profit-making and was liable for tax on the proceeds of the meeting notwithstanding the moral obligation upon it to distribute the proceeds to the charities in accordance with its declared intention. The Association acted as the principal in holding the race meeting rather than as an agent.

Notes:

This case is not in conflict with the GELDENHUYS case. It merely describes the situation where no valid agency exists.

Lesson:

If the charities that benefited from the race meeting had organised it in their own names but had requested the Association to administer and run it on their behalf, then the proceeds would have been received by the Association as an agent rather than as a principal and no tax liability would have been incurred by the Association in respect of the proceeds.

\textsuperscript{5} Broomberg p 155.
In tax terms such an arrangement is referred to as “antecedently” divesting oneself of income. In other words, where a taxpayer divests himself of income prior to it accruing to him by ceding the right to future income, the income accrues to the cessionary rather than the taxpayer.6

6 “RESIDENCE”

6.1 Residence – Meaning of “ordinary resident”

6.1.1 COHEN v COMMISSIONER FOR INLAND REVENUE
13 SATC 362 (A) - 1945

Importance classification:
Very important as it was the first South African case to analyse the meaning of “ordinary resident”. It brings in a type of biblical “prodigal son” principle – where will a person return to after his “wanderings”?

Facts:
The taxpayer, who was domiciled in the Union, was one of two directors of a company carrying on business in the Union. He was requested by his company to go overseas to act as the company’s buyer in view of the difficulty of obtaining merchandise, caused by war conditions. He left the Union in June 1940, accompanied by his family. The permit authorising his departure contained the words “duration 9 months”. In October 1940, he arrived in the United States of America and established his family in an apartment in New York, where he carried on the business operations, which were the purpose of his visit. In 1941, the taxpayer was granted an extension of 12 months in respect of his permit to remain in America. From that date and up to 30 June 1942, neither the taxpayer nor his family had returned to the Union. In 1939, the taxpayer had leased a flat in Johannesburg for a period of 5 years and had furnished it. This flat had been sublet, with the furniture, during the period for which the taxpayer had been in America. During the year ended 30 June 1942, the taxpayer had derived dividends from public companies carrying on business in the Union. He claimed to be exempt from super-tax in respect of these dividends as a result of the provisions of section 30(1)(a) of Act 31 of 1941, which exempted individuals “not ordinarily resident nor carrying on business in the Union.”

Issue:
Was the taxpayer “ordinarily resident” in the Union?

Held:
That the question whether an individual was resident or ordinarily resident in any particular area for the purposes of the Income Tax Act was one of fact. That the question whether an individual was in any one year of assessment ordinarily resident in the Union or elsewhere was not to be determined solely by his actions during that year of assessment; his conditions of ordinary residence during that year could be determined by evidence as to his mode of life outside the year of assessment under consideration; that physical absence during the whole of the year of assessment was not decisive of the question of “ordinary residence”. On the facts, the taxpayer was found to be still “ordinarily resident” in South Africa. The judge referred to the fact that a person’s ordinary residence was the country to which he would naturally and as a matter of course return from his wanderings, his usual or principal residence and could be described as his real home.

6 Williams p 180.
Notes:

This case was decided in 1945. The residence basis of taxation was only introduced in South Africa in 2002. Nevertheless, the concept of “ordinary resident” is used as one of the tests (the other being the physical presence test) for determining the meaning of residence as defined in section 1 of the Income Tax Act. Thus COHEN'S case, which explained the concept of “ordinarily resident,” is the authority, together with KUTTEL'S case for defining the meaning of “ordinarily resident”.

The Special Court (now the Tax Court) had found that Cohen was not carrying on business in South Africa because the mere earning of dividend income did not constitute the carrying on of a business in South Africa. This aspect was not taken on appeal.

Also see SARS Interpretation Note No. 3 (issued on 4 February 2002): "Resident: Definition in relation to a natural person - ordinarily resident", which summarises the factors taken into account in determining whether an individual is “ordinarily resident” in South Africa or not.

As regards the residence of a juristic person, see Interpretation Note No. 6 (Issue 2, issued on 3 November 2015): “Resident: Place of effective management (companies)".

Lesson:

Refer to KUTTEL'S case.

6.1.2 COMMISSIONER FOR INLAND REVENUE v KUTTEL
54 SATC 298 (A) - 1992

Importance classification:

Very important. It amplifies and expands on the COHEN decision as to the meaning of “ordinary resident”.

Facts:

The taxpayer had been assessed to income tax on interest and dividends earned by him during the tax years 1984, 1985 and 1986, a period, he contended, during which he had not been ordinarily resident in South Africa in the meaning of the phrase as employed in sections 10(1)(h)(i) and 10(1)(k)(ii) (note this subsection has since been deleted) of the Income Tax Act. In 1983, he and his wife emigrated from South Africa to the United States. He had obtained a permanent resident’s permit in the United States to open an office to conduct business on behalf of a South African company in which he held shares. He realised a large number of his South African assets and invested the proceeds in Eskom stock to secure the maximum personal income transmissible to him in America. He decided to establish a home in Fort Lauderdale, Florida. He established church membership, opened banking accounts, acquired an office, bought a car and registered with social security. He also obtained a settling-in allowance from the South African exchange control authorities. Since then, apart from visits to South Africa and other countries, the taxpayer had lived and worked in the United States. During the period September 1983 to November 1985 the taxpayer made nine visits to South Africa, staying for up to two months at a time. The purpose of the visits was to attend to the continuing liquidation of his interests, to participate in yachting and personal boat-building activities and to attend to family matters. Of the 31-month period under review, the taxpayer spent, on average, just over one-third of the time in South Africa, and the duration of his visits became less towards the end of the period. During his visits to Cape Town the taxpayer lived in the Llandudno house owned by the company in which he and his wife were the sole shareholders. At no time was it let and consequently it was available whenever the taxpayer
wanted to live in it. During 1985 he effected substantial renovations and extensions to the house. He did so, according to his unchallenged testimony, because he wished portion of his South African capital to be invested in fixed property as a hedge against the falling value of the rand in relation to the United States dollar. The taxpayer also stated that had he not been prohibited by the South African exchange control regulations from taking all his assets out of the country, he would have done so.

**Issue:**

Was he “ordinarily resident” in South Africa during the years under consideration?

**Held:**

That the words “ordinarily resident” were something different and were narrower than just “resident”. A person was ordinarily resident where he had his usual or principal residence. That the formulation of Schreiner JA in **COHEN v COMMISSIONER FOR INLAND REVENUE** should be adopted – that a person is “ordinarily resident” where he has his usual or principal residence, that is, what may be described as his real home. That if one applies that meaning to the words “ordinarily resident”, there can be no doubt that at the relevant times taxpayer was not ordinarily resident in the Republic during the period in question; his usual or principal residence, his home, was in the United States of America. The fact that the taxpayer kept his house in Cape Town was in no way inconsistent with his usual or principal residence or home having been in the United States; retaining a residence in Cape Town was quite consistent with his ordinary residence being in the United States.

**Notes:**

The Commissioner dropped the contention at an early stage of the proceedings that the taxpayer was carrying on a business in South Africa because he only earned dividend and interest income.

The same comments apply to this case as to **COHEN'S** case.

**Lesson:**

To circumvent the “ordinarily resident” rules, it is important to ensure that South Africa is not the real, usual or principle home of the taxpayer. That does not mean that a person may not also have a home in South Africa but that the South African home must not be seen to be the home to which he will return after his wanderings. The physical presence test must also be avoided to remain outside the residence net. 

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7 Broomberg pp 158, 159.
7  "SOURCE"
7.1  General

7.1.1  COMMISSIONER FOR INLAND REVENUE v LEVER BROTHERS & UNILEVER LTD
14 SATC 1 (A) - 1946

Importance classification:

No longer important. South Africa taxes its residents on their worldwide income. In addition, exemptions for interest, Double Tax Agreements and the new source rules for interest (section 9(2)(b)), make this case virtually inapplicable. However, it does discuss the concept of the "originating cause" which is the foundation for establishing the source of a receipt, which is still relevant for receipts/accruals not specifically dealt with under the provisions of section 9 in its revised form. The originating cause of income is answered by taking two factors into account, i.e. (1) what gives rise to the income (in other words, what is the originating cause) and (2) where is the originating cause located?

Facts, issue, held:

None of these aspects are important.

Notes and lesson:

The interpretation of this case by certain academics was that the source of interest was the place where the funds were made available.

Under the new section 9(2)(b), interest is from a South African source if it is paid by a South African resident or it is received or accrues from funds invested or used in South Africa. The new section 50B(1) provides that a 15% withholding tax must be levied on any section 9(2)(b) interest received or accrued from a South African source by or to any non-resident. Section 10(1)(h) still provides an exemption from normal tax for interest accruing to non-residents provided that certain conditions are met. In the case where the interest does not meet the conditions for exemption from normal tax under section 10(1)(h), the interest will, however, be exempt from withholding tax in terms of section 50D(3) (provided the interest was not paid in the form of an annuity). Refer to the relevant sections in the Income Tax Act for further clarification.

8  "EXCLUDING RECEIPTS OR ACCRUALS OF A CAPITAL NATURE"
8.1  General

8.1.1  COMMISSIONER FOR INLAND REVENUE v VISSER
8 SATC 271 (TPD) - 1936

Importance classification:

Not important from a facts point of view but it introduced the "tree and fruit" principle, namely that the tree is capital in nature and the fruit is revenue in nature.

Facts:

The taxpayer, an influential businessman in the area, acquired mining options for a period of two years over certain properties which later were not renewed and expired. Later, a third party negotiated with and offered the taxpayer an interest in a company to be formed if he would
refrain from taking up options in competition with him and assist him to acquire the previously lapsed options. The taxpayer agreed to the proposal. The arrangement was confirmed in a letter, which stated that the taxpayer had been promised shares “in consideration of the services you have already rendered and will be rendering to me and my associates in the venture that we are undertaking”.

**Issue:**

Was the value of the shares, which the taxpayer received, capital or revenue in nature?

**Held:**

That the amount in dispute had accrued to the taxpayer as the product of his wits, energy and influence and as such was not a receipt of a capital nature, but income in nature.

**Notes:**

As mentioned, the court used the tree and fruit analogy as a useful guide but cautioned that what is the principal or tree in the hands of one man may be interest or fruit in the hands of another. For example, law books in the hands of a lawyer are a capital asset; property in the hands of a land-jobber is stock-in-trade (revenue). Adopting a profession is likened to a tree but the earnings from the profession are likened to the fruit of the tree.

The court also referred to the scheme of profit-making test (see **NATAL ESTATES** and **PICK ‘N PAY EMPLOYEE SHARE TRUST** cases for amplification on this test), in its decision.

**Lesson:**

The agreement in this case linked the allocation of the shares to the services rendered. The causal link was established – the reward was for the taxpayer’s wits, energy and influence and thus revenue in nature. Perhaps if the agreement had been concluded in terms of a restraint of trade agreement, the taxpayer may have been able to escape tax.\(^8\) This restraint of trade route is no longer possible for an individual taxpayer as such payments are now taxable – see paragraph (cB) (previously under paragraph (cA), that is until 28 February 2015) of the definition of “gross income”.

### 8.2 Subjective tests – intention, change in intention including “scheme of profit-making”, dominant and mixed motives

#### 8.2.1 NATAL ESTATES LTD v SECRETARY FOR INLAND REVENUE

37 SATC 193 (A) - 1975

**Importance classification:**

Very important. This case resulted in a landmark decision that sent a chill down the spine of taxpayers and tax planners. In determining whether the proceeds on the sale of agricultural land, which had been held as a capital asset for over 45 years was capital or revenue in nature, the court looked to the **intention of the taxpayer and whether it had changed its intention from holding on to the land as a capital asset or to embark on a scheme of profit-making**. The court used the phrase, with apologies to Julius Caesar, that **the taxpayer “had crossed the Rubicon” and gone onto a “scheme of profit-making” in deciding the answer that the profits were of a revenue nature.**

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\(^8\) Williams p 203; Broomberg p 150.
Facts:

The taxpayer company, formed in 1920, acquired as a going concern the whole of the assets of a company, which had for some 25 years been carrying on business in Natal as a grower and miller of sugar. Among the assets so acquired were 21,025 acres of land, much of it planted with cane, 10 miles to the north of Durban city (the area is now known as La Lucia and Umhlanga Rocks) and bounded eastwards by the sea. The business was continued uninterrupted by the taxpayer until the years 1965 to 1970 when the taxpayer sold substantial areas of its land at considerable profit but still kept a large portion. The Durban city council pressured the taxpayer to sell the land as Durban was expanding towards La Lucia and Umhlanga Rocks. If the land was not sold voluntarily, it was likely to be expropriated. In 1957, the taxpayer applied for and was granted a certificate to establish a township at La Lucia but the taxpayer was in no hurry to sell land. After the taxpayer became a wholly owned subsidiary of a parent company (today known as Huletts Corporation Ltd), matters progressed more rapidly in relation to the sale of the taxpayer’s land at La Lucia. The services of town planners, consulting engineers and other professional advisers were engaged. By April 1964, about 188 lots of the 2,350 comprising the La Lucia township lay-out had been sold. In 1965 a company, La Lucia Homes (Pty) Ltd was formed by the taxpayer to construct houses in La Lucia. During 1968 a company, known as La Lucia Property Investments Ltd, and in which 45% of the equity was held by Hulett Investments Ltd and 55% by Anglo American Corporation Ltd, was formed. This company purchased from the taxpayer the La Lucia beachfront and Umhlanga Lagoon areas en bloc for R1.4 million. Although the taxpayer continued for some time to effect sales directly to members of the public, by the latter half of 1968 this had largely given way to bulk sales. These bulk sales were all to companies associated with the taxpayer, one a subsidiary of the taxpayer and three others in which the taxpayer’s parent company held a 45% interest.

Issue:

Were the proceeds of the sale of the land and properties income or capital?

Held:

That in determining whether profits made from the sale of an asset constitute income or an accrual of a capital nature, the original intention of the taxpayer to hold that asset as an investment is always an important factor but such intention is not necessarily decisive. For a supervening change of intention, evidenced by a manner or method of realisation amounting to a scheme for profit-making, renders the profits derived from the sale of the asset liable to tax. That it is not a definitive characteristic of carrying out a scheme for profit-making in land that there should be a buying-in to resell at a profit. That in determining whether any particular case is one of realising a capital asset or carrying on a business or embarking upon a scheme of selling land for profit, the totality of the facts of the case must be considered in their relation to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit. That in any such enquiry important considerations will, inter alia, include the intention of the owner both when acquiring and selling the land; the objects of the owner, if a company; the owner’s activities in relation to the land prior to his decision to sell, and the light thereby thrown on the owner’s statements of intention; the nature and extent of his marketing operations and the like; and the incidence of the onus imposed by section 82 of the Income Tax Act (now regulated by section 102 of the Tax Administration Act). That the Special Court’s consideration of the facts had been in accord with the preceding principles; that the finding of changed intention implicit in the Special Court’s reasoning and its express finding that the taxpayer had “entered the field of township development and the marketing of township land on a grand scale” and gone into the property business – albeit as an ancillary business to that of producing and milling sugar cane and manufacturing sugar – were unassailable on appeal. That the change of original intention in regard to land in Umhlanga Rocks and La Lucia equally embraced the areas therein sold in bulk; that such last-mentioned areas all benefited, and were intended to benefit, from the intensive business activities primarily associated with the preparation for, and promotion of the sale of lots in township development and formed part of...
the same scheme of profitable dealing in land; and that the Special Court’s decision was thus unassailably correct.

Notes:

The proceeds on certain small pieces of land sold by the company, for example, land actually appropriated or the sale of redundant land, were found to be capital in nature.

The argument was raised by the taxpayer that the appreciation in value of the land while held as a capital asset should be excluded from the taxpayer’s taxable profits. However, the judge remarked that legal counsel on both sides concurred that as the Income Tax Act then stood, there was no way of only taxing the profits on the excess of the price obtained over the value as at the date when the taxpayer decided to go into the business of selling land for profit, with his land as the stock-in-trade. Accordingly, no opinion was expressed on the point.

Since the introduction of Capital Gains Tax, relief as in the circumstances of the NATAL ESTATES case is available. Paragraph 12(2)(c) of the Eighth Schedule of the Income Tax Act regarding assets that are held by a person otherwise than as trading stock and are thereafter, because of a change in intention, held by a person as trading stock, the person is treated at the time of the change in intention, to have disposed of the asset for its then market value (paragraph 12(1)). The person is deemed to have immediately reacquired the asset (now held as trading stock) at an expenditure equal to that market value. The capital gain is calculated as the market value of the asset on the date of the change in intention less the base cost of the asset. The market value is also the cost of the trading stock (as noted above, the person is deemed to have immediately reacquired the asset at an expenditure equal to that market value) for normal tax purposes.

Lesson:

This case is a chilling reminder to taxpayers that although a person may realise his capital asset to best advantage, he must be careful not to “cross the Rubicon” and embark on extensive and elaborate activities to realise his capital assets and which activities constitute a scheme of profit-making. If the taxpayer had sold the land in bulk or even just with sub-division rights without developing the township, the proceeds would have been regarded as capital in nature.9 See STOTT, BERE WEST and FOUNDERS HILL (below).

Nevertheless, paragraph 12(2)(c) of the Eighth Schedule now provides relief for taxpayers faced with the problem encountered in the NATAL ESTATES case. Careful planning is necessary to embark on this escape route.

8.2.2 COMMISSIONER FOR INLAND REVENUE v RICHMOND ESTATES (PTY) LTD
20 SATC 355 (A) - 1955

Importance classification:

Important as it is probably the only case where the taxpayer has managed to convince the court of its intention of holding an asset as stock-in-trade to holding it as a capital asset. Paragraph 12(3) of the Eighth Schedule now provides for a change in intention in the same circumstances of this case, for Capital Gains Tax purposes.

It also lays down the principle that the intention of a company is derived from its formal acts (resolutions of directors) and its informal acts. This is especially so in a one-man company

scenario.10

Facts:

The taxpayer company was formed to control the investments and savings of the sole beneficial owner of the shares issued. The beneficial owner was the sole director and managing director of the company. The memorandum of association of the company empowered it to purchase land, deal in land, turn land to account, develop land, lay out and prepare land for building purposes. From the time of its registration the company carried on business as a speculator in land and also drew rent from certain properties which it let. A large part of the company’s business consisted of buying and selling plots in a black township but after 1945 it no longer became possible for the taxpayer company to purchase plots in the township from blacks except with the approval of the appropriate Minister in office. In 1948, the shareholder decided that the company should cease selling its plots in the township and for the future develop its holding of eighteen plots in the township as rent-producing properties. No formal resolution recording this decision appeared in the company’s records. By 1950, the Group Areas Act was passed and the intention of the government was to remove the black inhabitants from the township in which the company had its holding. As this would make it impossible for the company to dispose of its plots to blacks, the shareholder decided that it would be better for the company to dispose of all its improved and unimproved holdings in the township. The company then disposed of fifteen out of its eighteen plots in the township at a substantial profit.

Issue:

Could the company change its intention in relation to an asset from one of revenue-holding to one of capital in nature?

Held:

That the company having changed its intention as regards the properties sold, their sale at a profit as the result of a further decision arrived at owing to a change in conditions outside the company’s control did not per se make the resulting profit subject to tax. That the fact that the change of intention found by the Special Court to have taken place was not recorded as a formal resolution of the company’s directorate but was evidenced only by the statements of the sole director was not a ground for holding that the Special Court could not have reasonably reached its finding of fact on the evidence before it, having regard to the special circumstances of the sole director being also the managing director and the sole beneficial shareholder.

Notes:

The minority judgement of the court held that the subjective change in intention in relation to the properties was insufficient. Something more (demonstrable action) was required, namely that the properties must be made part of the permanent structure of the company. Please note that the term “shareholder” was deleted and replaced with the term “holder of shares”. Keep this in mind each time you come across the term “shareholder” in this tutorial letter. Because most of the cases dealt with in this tutorial letter were decided prior to the amendment, most references are still to “shareholder(s)” as opposed to “holder(s) of shares”.

Lesson:

The minority judgement, which could so easily have been the majority judgement, sends a warning signal to the taxpayer, namely a mere change in intention from a revenue-holding to a

10 Williams p 301.
capital holding is insufficient. It must be followed by an action that demonstrates the change.\footnote{Williams pp 287, 295.}

In this regard, also see paragraph 12(3) of the Eighth Schedule, which provides for a change in intention for Capital Gains Tax purposes.

### 8.2.3 COMMISSIONER OF TAXES SOUTHERN RHODESIA v LEVY

18 SATC 127 (A) - 1952

**Importance classification:**

Important decision. It illustrates the principle that where there are two possible motives at the time an asset is purchased, the dominant motive (if there is one) prevails especially where an individual taxpayer is involved. Where the asset is purchased with a dual motive, one motive not being substantially dominant over the other motive, the revenue motive prevails.

**Facts:**

The taxpayer disposed of his shares in a property-holding company at a profit. He had two purposes for originally purchasing the shares, namely to acquire the shares as an income-earning investment while at the same time not excluding the possibility of a profitable resale of the shares.

**Issue:**

If there are two motives with one motive being more dominant than the other, can the dominant motive prevail if such motive is capital in nature?

**Held:**

That the fact that the taxpayer at the time of purchasing the shares had in mind possible alternative methods of dealing with the property should not affect the issue, if the dominant purpose of the acquisition is clearly established.

**Notes:**

The intention of the taxpayer at the time the asset in question is purchased is all important if there is no change in intention subsequently. If the taxpayer is an individual, it does not matter that the asset in question is purchased with two motives in mind. If the dominant motive can be established by evidence, that motive prevails. This is different to the situation where an asset is purchased with a dual motive in mind, both motives being equally important. In such a case, the revenue motive will prevail. See **NUSSBAUM’S** case in this regard.

**Lesson:**

When the individual taxpayer purchases an asset, he should not be at risk if he also contemplates that he may sell the asset at a later stage at a profit, provided that he can discharge the onus (prove) that his dominant purpose was capital in nature at the time he purchased the asset and that he did not change his intention subsequently.
Important classification:

Important. The Appeal Court in this case extended the principle, previously only applied to companies, that if an individual has a primary or dominant purpose which is capital in nature and a secondary purpose which is revenue in nature, the secondary purpose could, in the appropriate circumstances, taint the primary purpose resulting in profits which were previously regarded as being capital in nature being treated as revenue in nature because the two purposes are pursued simultaneously.

Facts:

The taxpayer, a retired schoolteacher, inherited certain shares quoted on the Johannesburg Stock Exchange some thirty-five years previously and, on that foundation, with active and careful investment, had built up a substantial portfolio of quoted shares over the ensuing years. He said in evidence that his investment decisions were always based on a “pattern of expectations” that a share would pay “adequate” dividends in the short term or “more than adequate” dividends later on. When he bought shares he did so with the intention to produce a sound and increasing dividend income and to protect the capital thus invested from erosion by inflation. He also said that he had never bought a share merely for profitable resale. After his retirement, he began changing his share portfolio. Many of the shares sold had been held for much longer than five years and therefore profits were “inevitable” but some of the shares had been held for five years or less. He added that in the prevailing inflationary economic climate it was “almost impossible to make losses”. For the three years in question, he made over R1 million in profits and the Commissioner sought to tax him on these profits as being a scheme of profit-making. The Commissioner accepted that prior to this three-year-period, the holding of the shares by the taxpayer was on capital account but contended that he changed his intention or at the very least had a dual or secondary intention.

Issue:

Did the large number of purchases and sales during the three-year-period constitute a scheme of profit-making because the taxpayer had changed his intention or because there was a dual intention or secondary intention in regard to the shares?

Held:

That the frequency of the taxpayer’s share transactions, viewing them in isolation, provides evidence of continuity, being a necessary element in the carrying on of a business in the case of an individual and one is struck by the scale and frequency of the taxpayer’s share transactions. That the declared objects and obviously being in business to make profits will generally make it easier to infer a secondary purpose in the case of a company than it would be in the case of an individual. That the dictum in AFRICAN LIFE INVESTMENT CORPORATION, (a case which is not included either on the prescribed SAICA list or the “teaching aid” list) regarding two purposes, should therefore also apply in principle to an individual taxpayer and the dictum has been applied for the purposes of this judgement. That it is clear that the taxpayer’s sales were almost without exception profitable — the taxpayer’s annual profits substantially exceeded his annual dividend income and the profits increased every year and one must conclude that the reason for the decreases in dividend yield was the fact that the market value of the shares had increased and it was essentially this factor, irrespective of the length of time for which the shares had been held, which occasioned the profits. That, given the close watch that the taxpayer kept on his portfolio and on every shareholding in it, and bearing in mind his meticulous attention to detail, it was most likely that
he was aware of the profit implications in selling when the dividend yield had fallen. That in the present case not only was a profit inherent in the sale of shares whose dividend yield had dropped, but the taxpayer manifestly worked for it; he “farmed” his portfolio assiduously and the number, frequency and profitability of sales, especially of short-term shares, bears clear enough testimony to that. That although the taxpayer was primarily an investor and it was wholly consistent with his investment motive that he did not sell certain holdings entirely and that 82% of the shares held at the beginning of the three year period were still held at the end of the three-year-period, this share retention factor therefore detracts in no measure from the force of all those circumstances which point to a subsidiary profit-making purpose. That, while an investor buys shares “for keeps” and generally adds to his portfolio by employing surplus existing income, the taxpayer’s share transactions enlarged the value of his portfolio and, at the same time, generated very considerable, annually increasing funds over and above his existing income. The employment of his capital in this way constituted an additional method of earning income. That, accordingly, the taxpayer had a secondary, profit-making purpose and he had failed to discharge the onus of showing that the profits made were not of a revenue nature.

Notes:

The principle whereby the secondary purpose of an individual could taint the primary purpose resulting in profits which would normally be considered capital in nature being regarded as being revenue in nature, was recognised officially by this decision. In a previous case this principle was found not to apply in the case of an individual. That decision looked at the “dominant” purpose. Therefore, on the face of it, it appears that the two decisions are in conflict. This is not so. In the earlier case, there was a dominant motive and an incidental motive. The incidental motive was ignored as being of little significance. In NUSSBAUM’S case, the primary purpose could not be equated to the dominant purpose as the evidence showed that the secondary purpose embarked on by the taxpayer was, if not equally important, very close to equally important as the primary purpose and for all intents and purposes could be regarded as a dual purpose.

Capital Gains Tax was not in existence at the time this case was decided. If it had been in existence, then paragraph 12(2)(c) of the Eighth Schedule of the Income Tax Act may have been used by the taxpayer to mitigate his tax liability. Paragraph 12(2)(c) of the Eighth Schedule regarding assets that are held by a person otherwise than as trading stock and are thereafter, because of a change in intention, held by a person as trading stock, treats a person at the time of the change in intention, to have disposed of the asset for its then market value. In effect, paragraph 12(2)(c) provides for the proceeds on the sale of an asset formally held as a capital asset but where the intention changed in regard to the asset, to be apportioned into capital and revenue proceeds based on the market value of the asset at the time the taxpayer’s intention changed (the time he “crossed the Rubicon”).

Lesson:

A taxpayer, who purchases shares for investment purposes and speculates in shares, must keep the two portfolios separate so that the speculative shares do not taint the capital nature of the shares purchased for investment purposes as happened in NUSSBAUM’S case. This can be achieved by the taxpayer trading his speculative shares through another entity such as a company (or close corporation) or even a trust. Note that the provisions of section 9C also provide the taxpayer with relief for shares held for at least 3 years.
8.2.5 COMMISSIONER FOR INLAND REVENUE v STOTT
3 SATC 253 (A) - 1928

Importance classification:

Very important. This case was one of the earliest cases decided in the ongoing capital versus revenue saga. It assists in determining what is not considered to be a “scheme of profit-making”.

Facts:

The taxpayer was an architect and surveyor and over the thirty years prior to the sale of the properties in question, he had purchased various properties, some of which he held for a period of time to let or for private purposes (seaside cottage) and later sold them, sometimes having subdivided the property before selling. One of the properties in question was a property, which the taxpayer purchased for residential purposes. This property acquired was larger than the taxpayer required for residential purposes, but the property was only for sale in the one block. The taxpayer built a cottage on the site and then cut up about half the property (property, which he regarded as excess to his needs) into small lots, which he proceeded to sell and from which he derived substantial profits. A further property was purchased to assist tenants who were living there and who feared that they would be ejected. His father had been a missionary and he felt it his duty to assist these people. After the purchase, part of the farm was subdivided and sold to the tenants at a small profit. The third property in question was a small fruit farm, which he purchased subject to a long lease. The tenant failed to pay his rent and the subsequent tenant caused trouble. The farm was then put up for sale and was sold at a profit.

Issue:

Was there a scheme of profit-making in relation to any or all of the properties in question?

Held:

The properties had not been sold in the pursuance of a scheme of profit-making and, therefore, the amounts realised in the hands of the taxpayer constituted accruals of a capital nature.

Notes:

Although the taxpayer’s profession was a surveyor and architect, this aspect, on the facts, did not affect him adversely. The fact that he had dealt in property previously, was not taken into account because the court regarded them as having taken place too long ago and too lacking in information. However, the motives in relation to the properties in question were looked at closely to establish whether there was a scheme of profit-making or not.

The court found that there was no scheme of profit-making in regard to the property purchased to protect the rights of the tenants and later sold to them. His father had been a missionary and the purchase of the property was for philanthropic purposes, which by its very nature excludes a scheme of profit-making.

The judgement also throws light on the principle that a person may realise his capital asset to best advantage and that the mere subdivision of land does not constitute a trade. The decision also lays down the principle that the taxpayer’s intention at the time the asset is purchased is decisive unless there is a subsequent change in intention and the taxpayer “crosses the Rubicon” (NATAL ESTATES) by being involved in a scheme of profit-making.
Lesson:

A taxpayer may realise his capital asset to best advantage and in the case of fixed property, the mere subdivision of land without something extra, would not be considered to be a trade or a scheme of profit-making.\(^{12}\)

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8.2.6  **JOHN BELL & CO (PTY) LTD v SECRETARY FOR INLAND REVENUE**  
38 SATC 87 (A) - 1976

**Importance classification:**

Not very important. It does, however, reiterate the principle decided in the **NATAL ESTATES** case that something more than a mere subjective change of intention is necessary to change a capital asset into stock-in-trade. It also confirms the principle that a person may realise his capital asset to best advantage (**STOTT'S** case) even if this necessitates waiting for a long time while the market value of the asset increases.

**Facts:**

In 1916 the taxpayer company purchased as a going concern, the businesses of fruit-merchants, exporters, importers and distributors then carried on in Johannesburg and Cape Town. In 1924, it purchased the property in which it conducted its business. In 1956, the controlling shareholding in the taxpayer passed to new shareholders. The purpose of the new shareholders was to secure the property as premises for a new business they proposed to establish but one of the shareholders appreciated the possibility of being able at some future date to sell the property at a price well in excess of its book value. In 1957 and 1959, the old and the new businesses were discontinued. The property, which had admittedly until then been held by the taxpayer as a capital asset, was no longer required for its original purposes and from 1957 the taxpayer intended to retain the property to sell it at a good profit when the market for property in the area had risen sufficiently. To this end, the property was leased to a third party for a period of 10 years and then sold. The taxpayer had at no time offered the property for sale – he was approached to sell it.

**Issue:**

Was the profit on the property capital or revenue in nature?

**Held:**

That a mere change of intention (the court was actually referring to the decision to sell the asset rather than keep it) to dispose of an asset hitherto held as capital does not *per se* render the profit resulting from the subsequent disposal of the assets liable to tax; something more is required to metamorphose the character of the asset and so render its proceeds *gross income*. That it could not reasonably be found that the taxpayer had in 1957 embarked on a new trade or profit-making business of dealing in land. That the taxpayer’s decision in 1957 to wait for a time with the object of selling the property at a high profit when the market for property in the area had risen sufficiently, by itself did not affect its character as a capital asset.

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\(^{12}\) Williams p 298.
Notes:

This case reiterated the principles relating to the capital and revenue debate.

Lesson:

Once a decision is taken to sell a capital asset, it does not matter that the taxpayer waits for a time until the value of the asset rises before he sells it. However, this is subject to the proviso that he does not in the interim embark on a scheme of profit-making as was done by the taxpayer in the NATAL ESTATES case. If there is no scheme of profit-making involved, then there would be no necessity to invoke paragraph 12(2)(c) of the Eighth Schedule of the Income Tax Act.

8.2.7 COMMISSIONER FOR INLAND REVENUE v PICK 'N PAY EMPLOYEE SHARE PURCHASE TRUST 54 SATC 271 (A) - 1992

Importance classification:

Important. It reiterates the principles espoused in earlier cases that there must be a scheme of profit-making before the proceeds become taxable (NATAL ESTATES et cetera). The fact that the memorandum of the company permits the company to trade does not automatically mean that the sale of an asset constitutes trading.

Facts:

The taxpayer was the Pick 'n Pay Employee Share Purchase Trust which had been established to administer a share purchase scheme for the benefit of employees of the group. The Trust contended that it was created and maintained to enable employees to purchase shares in Pick 'n Pay, their employer company. It did not acquire shares with the intention of reselling them at a profit in a scheme of profit-making. It purchased shares to make them available to employees entitled to them in terms of its rules and in terms of its constitution was compelled to repurchase shares from employees who were required to forfeit their holdings. The fact whether a profit or loss resulted, was completely immaterial. Moreover, the Trust had no control over the time at which it may have to repurchase a share, particularly when such shares are forfeited. It also had no control over the market price of the share at that time. Any profit or loss was, therefore, purely fortuitous. This was evidenced by the profits and losses made on the purchase of forfeited and other shares. The Trust had never "stocked up", that is, buying when the price was low or bought stock in the hope that the price would rise to make a profit.

Issue:

Were the profits made on the share dealings by the employee share trust capital or revenue in nature?

Held:

That whether or not the taxpayer trust was carrying on a business by trading in shares must be determined applying ordinary common sense and business standards; there was no intention on the part of the trust to conduct a business in shares; it was to operate primarily as a conduit for the acquisition of shares by employees entitled to them in terms of the scheme's rules. That while a profit motive is not essential for the carrying on of a business, its presence or absence is an important factor in determining whether a business is being conducted. That the constraints placed on the trustees in dealing with the shares in question were altogether foreign to trading or business in the accepted commercial sense; on a common sense approach, the trust was not carrying on a business by trading in shares. That even if the trust could be said in
a broad sense to have been conducting a business, **it was not a business carried on as part of a scheme of profit-making.** That the sole purpose of purchasing and selling the shares was to place them in the hands of eligible employees; the forfeiture provision was not intended to yield a profit, its purpose was to deter unwanted resignations. That it was not the intention (purpose) of the company or the trustees that the trust should carry on business by trading in shares for profit; accordingly, the unsold shares held by the trust from time to time did not constitute floating capital; where no trade is conducted there cannot be floating capital. That, therefore, any receipts accruing to the trust were not intended or worked for but purely fortuitous in the sense of being an incidental by-product; they were therefore non-revenue and accordingly accruals of a capital nature.

**Notes:**

This case was decided by a 3 to 2 majority. Nevertheless, it is the majority decision that stands. The minority judgement had held that it is only in the case of a single, isolated transaction that the scheme of profit-making principle is applicable. This principle was rejected by the majority judgement (which judgement prevailed). The profit-making scheme principle was extended to circumstances as in the **PICK ‘N PAY** case. The fixed and floating capital test for determining whether a receipt is of a capital or revenue nature (as espoused in the **GEORGE FOREST TIMBER** case) also appears to have been made redundant by the majority judgement.

**Lesson:**

This case **reinforces the principle that the proceeds on the sale of an asset will only be taxable where the realisation occurred in the course of a scheme of profit-making. This principle is true irrespective of whether it is an isolated transaction or a series of recurring transactions.**

**8.2.8 COMMISSIONER FOR INLAND REVENUE v GEORGE FOREST TIMBER COMPANY LIMITED**  1 SATC 20 (A) - 1924

**Importance classification:**

Not very important in the light of the decision in the **PICK ‘N PAY EMPLOYEE SHARE TRUST** case. The **fixed and floating capital test** has, to some extent, become redundant.

**Facts:**

The taxpayer company carried on a business as timber merchants and sawyers. It acquired about 600 morgen of natural forest for the purposes of its business. The nature of the trees in the forest was such that they did not renew themselves, and for practical purposes the value of the land without the timber was negligible. In the course of its business the company felled a quantity of timber each year which was sawn up in the mill and sold as part of its stock-in-trade. The balance of stock was acquired by purchase from other sources.

**Issue:**

Was the income received from the sale of the natural forest capital in nature?

**Held:**

That the total amount received for the sale of the stock-in-trade in the course of the company’s business came in the definition of gross income, that no part of these receipts constituted

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13 Williams p 275.
receipts of a capital nature.

Notes:

The taxpayer also claimed a deduction for the proportional cost of the property relating to the trees purchased which were felled for sale. The court held that no deduction was admissible from those receipts by way of provisions for redemption of wasting capital. Paragraphs 14 and 15 of the First Schedule now specifically permit a deduction for the proportional cost of trees growing on the property purchased, when sold.

Lesson:

Do not rely on the fixed and floating capital test to determine whether the proceeds on the sale of an asset are capital or revenue in nature. Other considerations are necessary, namely is there a scheme of profit-making involved? (NATAL ESTATES and PICK ‘N PAY EMPLOYEE SHARE TRUST)\(^\text{14}\)

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**8.2.9 BEREA WEST ESTATES (PTY) LTD v SECRETARY FOR INLAND REVENUE**

38 SATC 43 (A) - 1976

**Importance classification:**

Important from the facts and the principle that emerge, namely that a realisation company which was formed for a specific purpose other than the realisation of an asset to best advantage and then realises its asset to best advantage, will not be taxable on the proceeds of the sale. This should be the case, provided the realisation company does not go beyond the mere realisation and embark on a trade or scheme of profit-making, thereby "crossing the Rubicon" (see the NATAL ESTATES case).

**Facts:**

In terms of an inter vivos trust deed, an undivided half-share of K's property was donated in trust for his 13 children but transfer only passed to the trustees after his death. The remaining undivided half-share in the property was bequeathed to his children in terms of his will. To raise sufficient funds to settle the considerable liabilities of K's estate, some of the property was sold piecemeal. Further administration and financial difficulties arose and it was agreed that a company would be formed to acquire the remainder of the property which was to be sold to best advantage and any balance left after satisfying the creditors, would be distributed to the beneficiaries of K's will and the company wound up. The shares in the company were allocated to the heirs and beneficiaries in proportion to his or her entitlement. The property was subsequently proclaimed and could be marketed as a township, provided that the company arranged for the infrastructure (roads, water supplies, and surveys) to be installed.

Save for the periodic investment of temporarily surplus funds, the taxpayer at no time entered any field of enterprise other than that directly relating to the disposal of its land. The taxpayer's general procedure was to develop one area, sell plots, and then use the money to develop a further area. Some 40 years after K's death almost all the land had been sold and the proceeds distributed.

**Issue:**

Were the proceeds on the sales of the property capital or revenue in nature?

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\(^{14}\) Williams pp 210, 223, 267.
Held:

That, in deciding whether a company was merely acting as a realisation company or was carrying on the business of trading for profit, a court is entitled to look at the facts leading up to its incorporation, and to its memorandum and articles, and to its subsequent conduct. That the taxpayer was the machinery for realising the beneficiaries’ interests in the K property; and that the totality of the facts showed the taxpayer to be a realisation company and that he had not deviated from this purpose; therefore, the proceeds on the sales were capital profits and not income.

Notes:

There is no reference to “realisation companies” in the Income Tax Act. However, the court introduced this concept as an exception to the general rule that where a taxpayer acquires property with the intention of selling it (trading), the proceeds are revenue in nature. The courts are usually reluctant (and rightly so) to lift the “corporate veil” and ignore a company’s separate legal persona. However, in tax matters, it appears that this rule is rather flexible, especially where there is a perceived tax avoidance scheme. The concept of a realisation company used together with the lifting of the “corporate veil” principle, led to a favourable decision for the taxpayer in this case. Compare this case to ELANDSHEUWEL’S case where the “corporate veil” was lifted with adverse tax consequences to the taxpayer.

Paragraph 12(2)(c) of the Eighth Schedule of the Income Tax Act regarding assets that are held by a person otherwise than as trading stock and are then (change in intention) held by a person as trading stock, is not applicable in the circumstances of the BEREA WEST case. However, this provision, when applied in the circumstances of the NATAL ESTATES case, leads to a more favourable decision for the taxpayer in that the taxpayer is treated at the time of the change of intention, to have disposed of the asset for its then market value. In effect, paragraph 12(2)(c) provides for the proceeds on the sale of an asset formally held as a capital asset but where the intention has changed in regard to the asset, to be apportioned into capital and revenue proceeds based on the market value of the asset at the time the taxpayer’s intention changed (“crossed the Rubicon”).

Lesson:

In light of the FOUNDERS HILL judgement (below), where a realisation company is merely formed to acquire property and then dispose of such property at a profit (in other words, the only purpose is the realisation of assets/property), the sale will be regarded as part of a profit-making scheme and the proceeds will accordingly be taxable as revenue income. Where, however, there are special circumstances involved for interposing a realisation company, such as in the BEREA WEST case (the company was formed to realise land which was held by different family members), the profit derived from the realisation of a capital asset to best advantage will be capital in nature.

8.2.10 C: SARS v FOUNDERS HILL (PTY) LTD
73 SATC 183 (SCA) - 2011

Important. Prior to this decision by the Supreme Court of Appeal, it was assumed that the use of a realisation company would lessen the burden of proof upon a taxpayer to prove that it merely realised a capital asset to its best advantage and that the proceeds on the sale of the asset would therefore be capital in nature. The decision in FOUNDERS HILL makes it clear that such an assumption is no longer valid and it is only in exceptional circumstances that such a realisation company will not be liable for income tax on the proceeds of the realisation.
Facts:

The taxpayer company (respondent), a wholly owned subsidiary of its holding company, was a “realisation company” which was formed to realise land formerly owned as a capital asset by its holding company. The taxpayer’s main business was to acquire a large quantity of erven from its holding company (held as a capital asset, but which became surplus to its needs) and then to develop and realise same to “best advantage” and in a period of one year of completion of such realisation to be voluntarily wound up.

The taxpayer spent R11 million in developing and marketing the aforesaid properties and in doing so, also engaged the services of another subsidiary to further develop and market the land. While the fellow-subsidiary also acquired land from the holding company and then sold the properties as stock-in-trade, thereby realising profits and declaring the “revenue” profits as taxable income, the taxpayer’s activities and profits were assumed to be in respect of a capital asset and not taxable. The taxpayer was in fact in fact formed as a “realisation company” on legal advice, taking into account two principles: that it was entitled to “realise the property to best advantage” and that in doing so it should not “cross the Rubicon”.

This is an appeal by the Commissioner for SARS against the decision of the court a quo, which upheld the appeal of the taxpayer against the Commissioner’s ruling of assessing the profits as revenue profits and thus taxable income.

Issue:

Were the proceeds on the sales of the land capital or revenue in nature, more specifically:

- Had the property been acquired by the respondent as stock-in-trade or had it had been acquired as a capital asset and if acquired as a capital asset,
- Had it had thereafter “crossed the Rubicon” by commencing to engage in the business of trading in the property?

Held:

That the taxpayer had been formed solely to acquire the property in issue and then developing and selling it at a profit and therefore such property was stock-in-trade. The taxpayer’s business was to develop the erven and sell them and its intention in acquiring them was different from that which its holding company had when it held the erven as surplus land (and as a capital investment). The taxpayer’s profits were gains “made by an operation of business in carrying out a scheme of profit-making” and therefore revenue derived from capital productively employed. Accordingly, the taxpayer had acquired the property as stock-in-trade and had then conducted business in trading in the property and the profits made were taxable as income. It was further held, however, that the taxpayer was not liable for the payment of interest in terms of section 89quat of the Income Tax Act.

Notes and lesson:

The court made a distinction between the facts in question and the facts in the BEREA WEST case (supra). In this case, the realisation company was formed for the sole purpose of acquiring property from the holding company, AECI Ltd, and then developing and selling it at a profit (thus the only purpose was the realisation of the assets (property). In BEREA WEST there was, apart from the purpose of realising a capital asset to its best advantage, a real justification for the formation of the realisation company (in addition to the purpose of realising the assets).

It can no longer be said that the interposition of a realisation company would in some way enhance the intention to realise capital assets, as opposed to trading. The court made it clear that
an interposed realisation company will stand in the shoes of the entity that has transferred assets to it, and hold them in turn as capital assets, only in special circumstances.

Note that this case dealt with the position prior to the introduction of Capital Gains Tax. Thus, if this case had to be decided after CGT was introduced, the taxpayer could have argued that paragraph 12(2)(c) of the Eighth Schedule should apply to apportion the proceeds realised from the sale of the property into capital and revenue proceeds. However, based on the court’s decision that the property was acquired by the taxpayer as trading stock, this argument would probably not have been successful.

**Piercing the corporate veil**

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<th>8.2.11 ELANDSHEUWEL FARMING (EDMS) BPK v SEKRETARIS VAN BINNELANDSE INKOMSTE</th>
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**Importance classification:**

Important from the point of view that it demonstrates that in the appropriate circumstances, the court can pierce the “corporate veil” and look to the profile of the new shareholders to establish whether there has been a change in intention in regard to the capital asset of the company.

**Facts:**

The control of the taxpayer company was acquired by a group of individual land speculators who also became directors of the taxpayer. The taxpayer owned farm land which it leased out for farming purposes. After the change in shareholding, it was decided by the new shareholders that the land be sold to a municipality at a profit.

**Issue:**

Were the proceeds on the sale of the land to the municipality after the change in shareholding capital or revenue in nature?

**Held:**

That the taxpayer originally acquired the land as a capital asset and continued so to hold and use it throughout the regime of the original shareholders. That the factual findings of the Special Court justified the following inferences, namely that the new shareholders being either land speculators or prospective land speculators who appreciated the potentialities of the land for township development, devised a scheme to derive a substantial profit from that potential, namely to buy the shares in the taxpayer at a price based on the land’s value as agricultural land, then to sell the land to the municipality for township development.

That in all the circumstances the intentions of the new shareholders must be attributed to the taxpayer itself. That the Special Court could reasonably reach the conclusion that after the new shareholders acquired control of the taxpayer, a change of policy occurred where under it was decided to deal with the land as stock-in-trade. That consequently the Special Court’s conclusion that the profit in issue attracted tax was one which could reasonably be reached and was thus unassailable on appeal.

**Notes:**

This decision must be read in the context of section 86 of the Income Tax Act as it was then, which did not permit an appeal from the Special Court (now the Tax Court) based on fact.
Appeals could only be based on law. [Section 86A, which was subsequently introduced (in 1976), provided that appeals from a Special Court could be based on law and fact. Section 86A has since been repealed by the Tax Administration Act, but these provisions are now governed by section 134 of the Tax Administration Act.]

In spite of the limitation, there was a 3:2 split by the judges. The majority view was that the Appellate Division (now the Supreme Court of Appeal) could only have dismissed the findings of the Special Court if that decision was one which could not reasonably be reached.

The minority judgement was of the opinion that the appeal should succeed as that all that occurred was that the advent of the new shareholders led to a decision to market and sell a capital asset owned by the taxpayer, namely the land. That, having regard to the straightforward manner in which the land was realised, the Special Court had further misdirected itself in holding that a decision to sell, taken by the new shareholders with their personal intentions and background, sufficed to warrant a finding of a change of policy on the taxpayer’s part which converted the land into the taxpayer’s stock-in-trade. Although regarded as a flimsy reason, the change in shareholding was regarded in the majority judgement as the “something more” required for converting a capital asset into a revenue receipt (NATAL ESTATES and JOHN BELL). The new shareholders made the taxpayer a party to their scheme of profit-making. This reasoning has also been criticised on the basis that the “corporate veil” should not have been pierced in these circumstances.

Lesson:

The taxpayer should always be aware that the “corporate veil” may be lifted in circumstances as was done in this case. This is especially so in tax evasion and avoidance schemes.

**Damages and compensation**

8.2.12 WJ FOURIE BELEGINGS CC v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE 71 SATC 125 (SCA) - 2009

**Importance classification:**

Important. It deals with the capital/revenue nature of compensation received by a taxpayer.

**Facts:**

The taxpayer (appellant), a close corporation, had been the lessee of a certain hotel and conducted business as a hotelier. The taxpayer had concluded a lucrative contract with a company, in terms of which the taxpayer would provide accommodation and meals for overseas guests of the company for a period of approximately two years. Without any notice, the guests prematurely left the hotel, in breach of the accommodation agreement that the taxpayer had with the company. The taxpayer lost its major source of income for the balance of the contractual period, and considerable repairs to the rooms had to be done to return the rooms to a condition in which they could be hired out again. The taxpayer and the company managed to settle the matter out of court and the taxpayer claimed that the compensation so received was capital in nature. The taxpayer, having been unsuccessful in its appeal to the High Court at Bloemfontein, appealed to the Supreme Court of Appeal.

**Issue:**

Was the compensation received of a capital or revenue nature?
Held:

That there was a fundamental distinction between a contract, which was a means of producing income and a contract directed by its performance towards making a profit. In the cases that the taxpayer relied on, the contracts, or more properly the rights and obligations flowing there from, were used by the taxpayers to generate income and thus created income-earning opportunities for the taxpayers. Those contracts were therefore a means used to produce income and were correctly found to have been part of the income-producing structures of the taxpayers. The contract in issue was a memorial of business that the taxpayer had concluded. The contract had been concluded as part of the taxpayer's business of providing accommodation and it was therefore a product of the taxpayer's income-earning activities, not the means by which it earned income and the contract could thus not be construed as being an asset of a capital nature forming part of the taxpayer's income-producing structure. Accordingly, the amount formed part of the taxpayer's gross income and the appeal was dismissed.

Notes and lesson:

Again, it is clear that the facts of each particular case have to be decided on their own merit. The fact that the contract under review would form the taxpayer’s major source of income for the period of its duration, and the fact that its anticipated duration was more than two years, did not transform the contract into part of the taxpayer's income-producing structure; in other words, this was not sufficient to turn the contract into a capital asset of the taxpayer. The capital asset, i.e. income-producing structure, was the taxpayer’s lease of the hotel and what the hotel was used for.

8.2.13 STELLENBOSCH FARMERS’ WINERY LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE  74 SATC 235 (SCA) - 2012

Importance classification:

Important. It illustrates the complexity of classifying the nature of a compensation receipt as either income/revenue or capital in nature.

Facts:

The taxpayer, a producer and importer of liquor products, and a wholesaler of a range of spirits, wine and other liquor products to retailers, had entered into a distribution agreement with an entity in the United Kingdom, whereby the taxpayer acquired the exclusive right to distribute Bells whiskey throughout South Africa.

The period of the agreement was ten years, whereafter the agreement was terminable on twelve months’ notice (thus effectively a minimum period of eleven years).

As a result of company mergers in the United Kingdom and Europe, the UK entity sought to terminate the distribution agreement with the taxpayer prematurely – some three years early. The termination agreement was concluded and the taxpayer received the sum of R67 million as compensation for the early termination of the exclusive distribution agreement.

Issue:

Was the taxpayer compensated for the capital value of the exclusive distribution right, i.e. was the compensation of R67 million paid for the early termination of the distribution right paid as compensation for the loss of the value of the capital asset (distribution right) (and thus filled a
hole in the taxpayer’s assets), or was it paid as compensation for a loss of profits in the sales of Bells?

**Held:**

The Counsel for the taxpayer validly argued that the nature of a receipt is not determined by how it is subsequently treated for accounting purposes. In the valuation of a capital asset, it is not inappropriate to have regard to the profits anticipated from the use of the capital asset.

The facts favour a finding of a capital nature. The financial statements reflected that the receipt was "compensation for the cancellation of the exclusive distribution rights", which points to a receipt of a capital nature.

One of the tests used by the court *a quo* was whether a substantial part of the income-producing structure of the taxpayer had been sterilised by the transaction in question.

The court *a quo*’s reasoning reflected that it erroneously focused on only physical assets, instead of the much more valuable incorporeal assets constituted by the exclusive distribution rights. The compensation for the impairment of the taxpayer’s business constituted by that loss is properly viewed as a capital receipt.

The termination agreement referred to payment of full compensation for the closure of the taxpayer’s business relating to the exercise of the distribution rights (an asset). There is no reference in the agreement to payment for loss of profits.

The taxpayer, that did not carry on the business of the purchase and sale of rights to purchase and sell liquor products, did not embark on a scheme of profit-making and the taxpayer did discharge the onus of establishing that it is a capital receipt.

- **Krugerrands**

| 8.2.14 | COMMISSIONER FOR INLAND REVENUE v NEL |
| 59 SATC 349 (TPD) - 1997 |

**Importance classification:**

Important. The general principles and guidelines laid down by the courts in regard to whether the proceeds on the realisation of an asset are capital or revenue in nature, apply equally to property, shares and even assets such as Krugerrands which do not create a return on investment unless the price of gold increases or the foreign currency exchange rate fluctuates favourably. However, when the foreign currency rate fluctuates favourably, discharging the onus and convincing the court that the proceeds on the realisation are capital, places a large burden on the taxpayer.

**Facts:**

Over three years, the taxpayer purchased 250 Krugerrands with surplus cash that he had available from time to time, at an average price of R280 per coin. His intention, when he purchased the coins, was to hold them as a long-term investment as a hedge against inflation. He did not plan to sell the Krugerrands and thought that his children would inherit them. He did not purchase any further Krugerrands thereafter. The Krugerrands steadily escalated in value over the years and although he had many opportunities to sell them, he never did so and it never entered his mind to do so. However, eleven years later he urgently needed to buy a car for his wife and he was advised by his auditor to exchange 80 of his Krugerrands for a car because he had no cash available to do so. The 80 Krugerrands were then sold for cash and
the taxpayer made a profit of R67 000. The Commissioner, in assessing the profit to tax contended that the nature of Krugerrands was unique, in the sense that they are not income-producing assets other than that they can be worked into jewellery. They do not have any economic utility save for being sold when cash is required. He also submitted that when a taxpayer invests in Krugerrands, he must inevitably envisage a sale of this asset in due course and his failure to realise the investment over many years was because he did not require the additional funds at that time.

**Issue:**

Did the sale of the Krugerrands represent capital or revenue profits?

**Held:**

That the taxpayer was unwilling to sell his Krugerrands but was obliged to do so because he had no other available means and a motor car was urgently and unexpectedly required by his wife and therefore the evidence showed clearly that the taxpayer’s purpose in selling the Krugerrands was not to make a profit but to realise a capital asset in order to acquire another capital asset. That in the transaction under review and especially in the light of the unchallenged evidence, the Special Court correctly came to the conclusion that the Krugerrands in question were purchased, as it were, for “keeps” and that the disposal of some of them was due to “some unusual, unexpected, or special circumstances” which supervened. That it was not correct to say that an investor could only invest in Krugerrands with a view to reselling them at a profit and in several cases the taxpayers had sold Krugerrands that had been bought originally as an investment, to pay for a pressing and unexpected debt which had arisen and in each case the court had held that the proceeds of the sale were of a capital nature. Thus, the disposal of said Krugerrands constituted the realisation of a capital asset.

**Notes:**

The investment in Krugerrands and their subsequent sale at a profit is one of those difficult areas of the tax law. The Commissioner’s argument that the nature of Krugerrands was unique, in the sense that they are not income-producing assets and do not have any economic utility save for being sold when cash is required, was very powerful. Nevertheless, the Appeal Court was not swayed by this argument. Instead, the court elected to follow the same principles and guidelines as espoused in other decisions relating to capital and revenue issues.

**Lesson:**

This decision was a welcome victory for the taxpayer. It has established the rule that all assets disposed of, whether they are income-earning or not, should be subject to the same principles and guidelines when deciding whether the proceeds on the disposal are capital or revenue in nature. The Tax Courts (previously the Special Courts) and the Provincial Divisions of the High Court are obliged to follow this rule in spite of the powerful arguments on the side of the Commissioner for a special rule to be developed in the case where no income is earned on the investment. Perhaps the Commissioner will admit defeat in the case of Krugerrands as any profit arising on the disposal of gold coins is now subject to Capital Gains Tax in terms of the Eighth Schedule to the Income Tax Act.
Trading stock/Employment of capital

8.2.15 ERNST BESTER TRUST v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
70 SATC 151 (SCA) - 2008

Importance classification:

Important. It deals with two aspects, namely the capital or revenue nature of the proceeds from sand removed from a farm by a third party and, if revenue in nature, whether the sand in the ground at the beginning of the year could be regarded as opening (trading) stock and thus qualify as a deduction.

Facts:

A contractor obtained a mining licence to mine sand on a farm from the taxpayer. The taxpayer played no part in the extraction or disposal of the sand. The taxpayer merely required due payment per cubic metre of sand removed as and when it suited the contractor to exercise its rights. The taxpayer contended that the proceeds derived from the sales of sand were capital in its hands. And alternatively had the Commissioner for SARS properly categorised the nature of the income as revenue, the taxpayer was entitled to an opening stock deduction for the sand still in the ground at the beginning of each of the years of assessment valued at its market value.

Issue:

Did the proceeds on the sale of the sand constitute income of a capital or revenue nature and if it was of a revenue nature, was the taxpayer entitled to a deduction for trading stock on hand at the beginning of the year?

Held:

Proceeds received by the taxpayer represented gains made in the operation of an ongoing scheme of profit-making over many years out of the sales of sand and the income so derived was revenue. The agreement was similar to a mineral lease and the rental or royalties were “the product of capital productively employed” and therefore constituted income.

Section 22 was not applicable to unseparated in situ (still in the ground) deposits of sand. Accordingly that the sand deposit could not fairly be described as trading stock held by the taxpayer for the purposes of section 22.

Notes:

The taxpayer was bound to lose his appeal on the first aspect. A previous Appellate Division (now Supreme Court of Appeal) decision had given a similar ruling in regard to the proceeds on the sale of sand deposits.

By claiming that the market value of the sand in the ground (market value equals sale proceeds) should be regarded as opening trading stock, the taxpayer was attempting to show that there was no profit to be taxed. The taxpayer also attempted to rely on a “practice” of SARS to permit a deduction for opening stock in such circumstances. No other evidence was led to prove that this practice was ever accepted by SARS.
Lesson:

A number of lessons can be learnt from this decision:

Precedent is strictly followed and if there is an Appellate Division (now Supreme Court of Appeal) decision against you, you will not win your case unless the previous decision was obviously wrong. This could for example occur if there is a constitutional issue at stake.

If you are going to rely on a “practice” of SARS, make sure you can present evidence that it is a practice, which is generally known in the market place or in a practice note, interpretation notes or public binding rulings issued by SARS. If so, you would be able to argue its application based on the “principle of legitimate expectation”.

Cover all bases in your argument. Unfortunately, the taxpayer did not argue that paragraph 12(2)(c) of the Eighth Schedule was applicable (Capital Gains Tax legislation). See Notes and lesson in Natal Estates case for how this provision could work in favour of the taxpayer.
9 SPECIAL INCLUSIONS IN “GROSS INCOME”

9.1 Paragraph (a) of the definition of “gross income” – Annuities

9.1.1 KOMMISSARIS VAN BINNELANDSE INKOMSTE EN ’N ANDER v HOGAN
55 SATC 329 (A) - 1993

Importance classification:

Important. It illustrates the principle that if a person gives up a right to be paid a capital amount which would not under normal circumstances be subject to ordinary tax in return for the payment of an annuity, the capital status of the amount payable will be lost and the annuity will become revenue in nature in terms of paragraph (a) of the definition of “gross income”.

Facts:

The taxpayer had been seriously injured in a motor vehicle collision and after settling with the Motor Vehicle Assurance Fund, had been compensated for loss of future earnings, to be paid in monthly instalments. The taxpayer contended that the payments were capital in nature and not an annuity.

Issue:

Was the compensation paid an annuity or a payment on capital account?

Held:

Paragraph (a) of the definition of “gross income” includes “any amount received or accrued by way of annuity”. It does not matter whether the annuity is of a capital nature or not. That although “annuity” is not defined in the Income Tax Act, it appeared that an annuity had two essential characteristics (which are, however, in no way exhaustive); it was an annual (or periodical) payment and the beneficiary had the right to receive more than one such payment. That it was significant that the payments expired on the death of the taxpayer and that the obligation to compensate the taxpayer for his future loss of earnings was extinguished and replaced by a contractual undertaking to pay the monthly instalments while the taxpayer was alive, without creating a liquid or determinable debt capable of being reduced by such instalments. That, in the light of the above, read with the essential characteristics of an annuity, the monthly instalments could be regarded as annuities and were not capital in nature.

Notes and lesson:

Even though the compensation was based on the loss of future earnings, a lump sum payment for injuries sustained but calculated with reference to the future loss of income, could be regarded as being capital in nature. The Capital Gains Tax legislation in the Eighth Schedule of the Income Tax Act even provides for an exclusion from Capital Gains Tax in respect of compensation for injuries suffered. See paragraph 59 of the Eighth Schedule.

The trick not to fall foul of the annuity provision, is to determine the full amount to be paid as compensation in respect of injuries sustained and liquidate the amount over a period of time or even in monthly instalments, provided that any amount outstanding at the death of the taxpayer in respect of the capital sum arising from the compensation, is paid to the deceased estate of the taxpayer. In this way, the monthly instalments would not be considered to be an annuity and would thus not be taxable.\(^{15}\)

\(^{15}\) Williams p 375; Broomberg pp 59, 71, 250.
9.2   Paragraph (c) of the definition of “gross income” – Meaning of received by or accrued to in “respect of services rendered . . . or by virtue of any employment”

9.2.1 STEVENS v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
69 SATC 1 (SCA) - 2006

Importance classification:

Important as it is a good illustration of what falls in the ambit of “in respect of services” rendered.

Facts:

The taxpayer, as part of his company’s share incentive scheme had acquired an option to buy its shares but before the option could be exercised, the company announced that it would be voluntarily liquidated rendering such options valueless. The company resolved to pay the taxpayer, as option holder, 75 cents per share ex gratia. The purpose of the incentive scheme had been to promote the retention of employees of ability and expertise who were primarily responsible for the profitability and continued growth of the company. The taxpayer contended that such ex gratia payment was not aimed at compensating the option holders as employees or ex-employees, that is, it was not intended to give them that benefit by reason of their services or their employment but because their option price was below the market value when the special dividend was declared and it was they who were deprived of a contemplated profit.

Issue:

Does such amount received by the taxpayer fall in the ambit of paragraph (c) of the definition of “gross income” in section 1 of the Act?

Held:

That the recipients of the ex gratia payments were employees or ex-employees of the deceased employer’s estate who had enjoyed a benefit directly linked to their employment, who had lost that benefit and who, in the board’s discretion, were deserving in the particular circumstances of a substitute ex gratia payment. Accordingly, the receipt fell in the terms of paragraph (c) of the definition of “gross income” in section 1.

Notes and lesson:

It is clear that the ex gratia (voluntary) payment was received as a direct result of the incentive scheme entered into (paragraph (c) of the definition of “gross income” includes voluntary payments in its ambit). The share incentive scheme was only offered to employees. It therefore follows that the ex gratia payment was received “by virtue of services rendered or by virtue of any employment or the holding of any office” as required by paragraph (c) of the definition of “gross income”. Compare this case to KOTZE’S case (see Part B) where in the circumstances, the payment for services rendered by the taxpayer to the police was not regarded as a payment in the form of an accolade as was the case in GRIFFITHS v MOORE (see notes to KOTZE’S case in Part B).
CHAPTER 2: THE GENERAL DEDUCTION FORMULA

(study with TL 104 & TL 106)

1 “CARRYING ON ANY TRADE”

1.1 General

1.1.1 SUB-NIGEL LTD v COMMISSIONER FOR INLAND REVENUE
15 SATC 381 (A) - 1948

Importance classification:

Very important. It illustrates a number of principles, namely that accounting and business principles are irrelevant – the deductibility or not of an expense is determined by section 11(a) of the Income Tax Act, that claimable expenditure is only deductible in the year incurred (CONCENTRA – you are not required to study this case) and that section 11(a) does not require that claimable expenditure must have produced income in the same year it was incurred.

Facts:

The taxpayer company carried on the business of mining for gold. It made a practice of taking out insurance policies against loss incurred by fire in respect of net profits and standing charges. The insurance against the loss of net profits was undertaken to enable the company to maintain a steady rate of dividend to its shareholders, notwithstanding a cessation of operations in part or in whole by reason of fire; the insurance in respect of standing charges was designed to enable the company to carry on its essential services without loss, notwithstanding any such cessation of mining operations. These insurance premiums were claimed as a deduction by the taxpayer although no insurance claims were made during that year.

Issue:

Were the insurance premiums deductible (in the production of income, not of a capital nature) in spite of the fact that no income was received from insurance claims during that same year?

Held:

That the expenditure on premiums was incurred to earn income in the event of certain happenings and was not of a capital nature. That any amount received under the policies would constitute a trading receipt and consequently the expenditure on the premiums had been laid out or expended for the purposes of the taxpayer’s trade. Thus the expenditure on the premiums of the policies concerned was admissible expenditure.

Notes:

The principle that expenditure incurred in a year of assessment does not have to produce income in the same year of assessment for such expenditure to be considered as being in the production of income, is important.
Lesson:

Many tax avoidance schemes have been based on the authority of this case. The trick is to get a deduction upfront which could shelter other income from tax until the income of the scheme finally accrues, sometimes many years later. However, SARS has become wise to these types of schemes and there now is a plethora of anti-tax avoidance provisions in the Income Tax Act, for example, section 24J.\(^\text{16}\)

1.1.2 BURGESS v COMMISSIONER FOR INLAND REVENUE
55 SATC 185(A) - 1993

Importance classification:

Very important. The facts of the case illustrate the meaning of “carrying on a trade” quite clearly. The “trade” aspect is very important because if no “trade” is being carried on there can be no deduction under section 11(a) for expenses incurred by a taxpayer. The court held that the definition of trade in section 1 should be given a wide interpretation and further pointed out that the definition is not necessarily exhaustive.

Facts:

The taxpayer embarked on a scheme in which money would be borrowed from a bank and invested in an insurance company for a short period in a single-premium pure endowment policy. The insurance company managed the money contributed by the investors by way of premiums in the most advantageous way. The investment carried the risk that the assets might not perform as expected, leaving the investor with no profit but with an obligation to repay the loan. After the taxpayer entered the scheme, the stock market crashed and the value of the fund plummeted. As a result, the partnership accounts reflected a loss in respect of the interest payable to the bank. The taxpayer had provided a bank guarantee and the cost thereof was the only outlay on the part of the individual investor. The policy taken out was a non-standard policy and the proceeds on maturity fell in the investor's gross income. The selling point of the scheme was the suggestion that it provided certain tax advantages in that it was designed to achieve commercial results of a short-term gain on the investment of the borrowed money with some limitation on the extent of the possible losses. No part of the structures could be described as artificial, as each one was designed for a commercial purpose. The taxpayer had testified that the tax savings or tax benefits generated by the scheme did not play a substantial part in his decision to participate in the scheme. The prospect of profit as contained in the brochure’s profit forecasts rather than the tax benefits attracted him.

Issue:

Was the scheme nothing more than a tax engineering device – the fiscal advantage was the tax deferment arising from the difference in time between the incurrence of the liability to pay interest to the bank and the accrual of the benefits under the policy? If the scheme was regarded as “carrying on a trade”, was the expenditure in question not of a “capital nature”? In other words, was the investment in the insurance policy a capital investment in an asset and therefore any gain made by investing in one is, in principle, a capital gain or in the case of the taxpayer, a capital loss and therefore not allowable as a deduction in terms of section 11(a)?

Held:

That no part of the structures could be described as artificial; each one was designed for a commercial purpose. Although there was an expected benefit by reason of the tax deferment,

\(^{16}\) Broomberg p 112.
this arose from the very nature of the transaction, namely that interest became due before any profit was realised and it was not something which was contrived in an artificial way. If a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not cease to carry on a trade because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage; if he carries on a trade his motive for doing so is irrelevant. His evidence that his main purpose in making the investment was to make a profit from it had not been impaired in any way and must stand.

Furthermore, it is well established that the definition of “trade” should be given a wide interpretation and includes a “venture” being a transaction in which a person risks something with the object of making a profit. The taxpayer clearly undertook a venture in that he laid out the money required to obtain a bank guarantee and risked the amount of the guarantee in the hope of making a profit; it was a speculative enterprise par excellence. Although there is an element of risk included in the concept of a “venture” in its ordinary meaning, this must not be taken to mean that a scheme like the present would only constitute a “trade” if it is risky; whether it would or not would depend on its own facts; if there is no risk involved it might still be covered by giving an extended meaning to “venture” or by applying the rest of the definition which is, in any event, not necessarily exhaustive.

Therefore, the investment in the insurance policy in the present case did not constitute a capital asset; the scheme was a short-term speculation with borrowed money and the intention was to surrender the policy after a year or two to realise the appreciation of its underlying assets; the scheme did not in its nature differ from the speculative purchase of land or shares with the intention of reselling at a profit; an asset so held is not a capital asset and a profit made on its realisation does not constitute a capital gain.

Notes:

The word “trade” is defined in section 1. However, to pursue a claim under section 11(a), it is necessary for a taxpayer to be “carrying on a trade”. To meet this requirement, the structure and features of the trade will have to be examined, namely artificial or contrived structures, the financial or other risks involved, the motive to generate a profit and the continuity of the activities. The fact that there is no continuity or there is a lack of a profit motive or risk does not necessarily mean that a trade is not being carried on. However, the taxpayer’s burden of proof increases when one or the other element is not present.

The letting of a rental property, often at a loss (especially holiday houses), falls in the definition of a trade. However, if there is no continuity of the letting, especially in the case of a holiday home which is only let during periods when the owners do not use the home, the owner may find it difficult to claim the expenditure, as it may be argued by SARS, quite rightly, it is submitted, that the owner is not “carrying on a trade”. The practice, however, of SARS is, depending on the circumstances, to permit a portion of the expenditure directly related to the time the house was let, to be allowed as a deduction but limited to the amount of the income received. This means that such activity does not result in an assessed loss for off-setting against other income. Also be aware of the secondary trade ring-fencing provisions of section 20A.

The borrowing of money to lend to someone else at a higher rate is not a “trade” as defined in section 1. Accordingly, unless the taxpayer is classified as a “money lender” (like a banking or some other financial institution), the person lending the money will include in his “gross income” the interest received but will not, in terms of section 11(a), be able to claim the interest paid to borrow the money as there is no trade as defined. This theoretical problem has been covered in Practice Note 31 where SARS recognises the unfairness of the situation and allow the lender to claim any interest paid, up to the amount of the interest receivable, as a deduction.
Lesson:

The taxpayer must ensure that, if possible, all deals and schemes are structured in such a way that SARS will not be able to attack the deductibility of an expense on the basis that a trade is not being carried on. Continuity, expected commercial profit, risk and even normality are factors that must be built into the deal or scheme. It may be insufficient for the activity to fall in the definition of “trade”. Sometimes, something more is required.

2 “EXPENDITURE AND LOSSES ACTUALLY INCURRED”

2.1 General

2.1.1 EDGARS STORES LTD v COMMISSIONER FOR INLAND REVENUE

50 SATC 81 (A) - 1988

Importance classification:

Very important. The principle arising in this case is that before an expense can be deducted in terms of section 11(a), it must be unconditional, that is, the expense must not be contingent. It can only be said that an expense has been actually incurred once the event has taken place. It does not matter that the condition imposed is resolutive (not effective until the condition has been met) or suspensive (coming into effect immediately but suspended until the condition has been met).

Facts:

The taxpayer entered into several lease agreements for premises on which it would conduct its businesses. The rental was determined as a “basic rental” (paid monthly) and a “turnover rental” (to be calculated with reference to the annual turnover). The “turnover rental” could only be ascertainable subsequent to the last day of the taxpayer’s year of assessment in many instances (where the financial year-end of the taxpayer was different to the end of the lease year). The dispute with the Commissioner only related to those instances where the lease year ended after the taxpayer’s year of assessment and the liability to pay turnover rental had not become apparent before the end of the taxpayer’s tax year. Included in the rentals claimed for tax purposes were two amounts representing genuine estimates (the accurate figures being not yet available) of the respective amounts by which the turnover rentals exceeded the basic rentals in the years in question. These estimated rentals were disallowed by the Commissioner.

Issue:

Could the “genuine estimates” of the liability for “turnover rental” be deducted in terms of section 11(a) of the Income Tax Act as having been “actually incurred”?

Held:

That the crucial issue was whether the conditions relating to the turnover rental created a contingent obligation which was incurred, if at all, only at the end of the annual lease period or whether the provisions of the lease gave rise to an unconditional obligation, the quantification of which took place at the end of the lease year. That the obligation to pay turnover rental is contingent until the turnover for the lease year is determined. That consequently, the expenditure relating to the payment of turnover rental cannot be regarded as having been actually incurred in a tax year which ended prior to the termination of the lease year and therefore cannot be deducted in that tax year.
Notes:

The decision in the case goes completely against the matching principle for accounting purposes. However, for tax purposes, the accounting treatment of income or an expense does not matter – the provisions of the Income Tax Act must be adhered to strictly. Nevertheless, the minority judgement was to the effect that there was an obligation to pay turnover rental in addition to the basic rental at the year-end of the company. The obligation was certain but not 100% quantifiable. Therefore, the genuine estimate should have been allowed as a deduction. The majority judgement was also in agreement with the principle but did not find that there was an obligation to pay the turnover rental until the end of the lease year.

Please note that where an asset has been acquired or disposed of for an unquantifiable amount, section 24M is applicable. A similar provision in respect of equity shares is covered by section 24N.

Lesson:

If the obligation is certain but is not able to be quantified, it will qualify as a deduction (other than in cases of an asset or equity share – see sections 24M and 24N). The genuine estimate is allowed as a deduction. But what happens if the estimate turns out to be incorrect? If the estimate is too low and an assessment has already been issued, it is possible for the taxpayer to approach the Commissioner to reopen the relevant assessment (in the prescribed 3 year period) and revise such assessment to take into account the correct figures. If an assessment has not been issued but the return has been filed, the taxpayer could send in an amended return reflecting the correct figures. If the Commissioner assesses the incorrect information, it is then open to the taxpayer to object to the assessment. If this procedure is not followed, no adjustment is available in the following year as the expenditure had not been incurred in that following year.

But if the estimate is too high, some academic writers has postulated that the excess deduction will never be taxed as there has been no “receipt or accrual” for the purposes of either the “gross income” definition or any of the recoupment provisions.17 This may be a simplistic view. The Commissioner may be able to revise the assessment for the relevant year (in the 3 year prescription period) when it is brought to his notice – which the taxpayer should do, in order to not fall foul of the withholding of or non-disclosure of information provisions of section 99(2) (of the Tax Administration Act). If it is not brought to the notice of the Commissioner, the assessment can remain open indefinitely.

2.1.2 NASIONALE PERS BPK v KOMMISSARIS VAN BINNELANDSE INKOMSTE
48 SATC 55 (A) - 1986

Importance classification:

Important. This case reiterates the principle that if a payment is conditional on the happening of an event, whether suspensive or resolutive, the expense is only actually incurred once the condition has been met. Until the condition has been met, it remains a contingent liability.

Facts:

The taxpayer claimed a provision of one month’s salary for bonuses to be paid to staff. The financial year-end of the taxpayer was 31 March but the bonus would only be paid on the following 30 September. The policy in regard to the bonus reads as follows: “The annual holiday bonus is equal to a full month’s salary for officials who have completed a full year’s

17 Williams p 436; Broomberg pp 98, 170.
service and pro rata less for officials who have completed less than a full year’s service. A bonus will only be paid to officials who are in service on 31 October. The full amount of the bonus will be recovered from an official who after payment thereof gives notice of termination of service and leaves the service before 31 October.” The taxpayer accepted that the bonus – pro rata to length of service – was immediately payable in the case of an employee whose service terminated through retirement on attaining retirement age or by reason of ill health or on reorganisation of the taxpayer’s activities or, in the case of female employees, by reason of pregnancy. In its accounts as at 31 March, the taxpayer’s practice was to include, in the case of an employee who already had six months’ service, half the amount of the anticipated bonus payable on 30 September if then still in the taxpayer’s employ.

Issue:

Was the provision for bonuses an expense “actually incurred” during the year of assessment for the purposes of section 11(a)?

Held:

That it was unnecessary to attach a precise juridical label to the conditions in question, that is, whether they were resolutive or suspensive conditions. That predominant was the fact that the future uncertain event (namely whether the employee would be in the taxpayer’s employ on 31 October) to which the coming into effect of the particular consequence, that is, the legal obligation to pay a holiday bonus to an employee, was made subject, was an event which fell outside the tax year of the taxpayer. That the question whether the taxpayer was in law obliged to pay a holiday bonus to an employee could only be answered on 31 October, and not 30 September. That the provision for the bonus had, accordingly, not been actually incurred.

Notes:

Although this case dealt with a provision for a bonus, the provision for leave pay also followed similar principles. Legislation was subsequently passed to regulate the deductibility of leave pay. Prior to 1 March 2013, the provisions of section 23E applied. In terms of section 23E, the taxpayer was deemed not to have incurred expenditure in respect of leave pay until it was actually paid by him or became due and payable by him and such leave pay was deemed to accrue to the employee concerned on the date on which such expenditure was deemed to have been incurred by the taxpayer. Section 23E was, however, repealed and replaced by section 7B, with effect from 1 March 2013. In terms of section 7B, an amount in respect of variable remuneration (i.e. commission, leave pay, bonus, et cetera) is deemed to have accrued to the employee, and constitutes expenditure incurred by the employer, on the date of payment by the employer to the employee.

Lesson:

There must be a legal, unconditional liability to effect payment during the year of assessment even if the actual payment only takes place after year-end of the taxpayer. Provisions or contingent liabilities are disallowed as a deduction in terms of section 23(e) of the Income Tax Act.
2.1.3 COMMISSIONER FOR INLAND REVENUE v GOLDEN DUMPS (PTY) LTD
55 SATC 198 (A) - 1993

**Importance classification:**

Very important. The principle arising from this case is that if the outcome of a legal dispute is unresolved by the end of the year of assessment of the taxpayer, any possible compensation payable is only incurred when the dispute is settled. Thus, if a case goes to court, it is only when the court makes its decision that the expenditure is actually incurred (but only if a party does not appeal against the decision).

**Facts:**

A dispute arose between the taxpayer and a former employee, which resulted in the taxpayer withholding the delivery of shares previously promised to the employee. The employee instituted legal proceedings to compel the delivery of the shares promised. The legal proceedings were instituted in 1981 but the action was only heard in 1983. The appeal by the employee to the Appellate Division was upheld in 1985. The taxpayer was then ordered to deliver the shares promised to the employee. The taxpayer claimed the cost of the shares awarded as a deduction in terms of section 11(a). The Commissioner for Inland Revenue contended that the expenditure on the shares had been “actually incurred” during the 1981 year of assessment when the action had been instituted. The taxpayer countered that the expenditure was “actually incurred” only in 1985 when the dispute was finally resolved.

**Issue:**

When was the expenditure on the shares “actually incurred”?

**Held:**

That a liability is only contingent in a case where there is a claim which is genuinely disputed and not vexatiously or frivolously made for the purposes of delay; only if the claim is admitted or if it is finally upheld by the decision of a court or arbitrator will a liability arise. That, where at the end of the tax year in which a deduction is claimed, the outcome of the dispute is undetermined, it cannot be said that a liability has been actually incurred; the taxpayer could not properly claim the deduction in that tax year, and the Commissioner could not, in the light of the onus provision in (the since repealed) section 82 of the Income Tax Act (as previously stated, the onus provisions are now contained in section 102 of the Tax Administration Act), properly allow it. That in the present case, because the crucial date, namely the last day of the 1981 year of assessment, the outcome of the action instituted by the employee claiming delivery of the shares in question was undetermined. The liability on the part of the taxpayer was then “no more than impending, threatened, or expected”; the ultimate outcome would only be known on the delivery of the Appellate Division’s judgement, which lay four years in the future. That, accordingly, the expenditure in question was not “actually incurred” if its existence was the subject of a bona fide dispute as was clearly the case in the present instance; only after the decision of the Appellate Division in 1985 was the expenditure “actually incurred”.

**Notes:**

A claim for compensation is not “actually incurred” if it is genuinely resisted or disputed. On the other hand the employee would not have been taxed on the amount in dispute as he was not “entitled to” the amount until the dispute was settled.
Lesson:

If the taxpayer had not won this case, the Commissioner would have been able to argue that no claim for a deduction was possible as the disputed claim had arisen in a prior year and had not been claimed. Also see the comments under **EDGARS STORES** in regard to the request to the Commissioner to reopen a previous assessment.\(^{18}\)

### 2.1.4 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v LABAT AFRICA LTD

[2012] 1 All SA 613 (SCA), 74 SATC 1

#### Importance classification:

Very important. The Supreme Court of Appeal overturned the decision of the courts a quo and held that the issue of shares as consideration do not constitute “expenditure” actually incurred.

#### Facts:

In terms of a sale of business agreement, the taxpayer company issued part of its own authorised share capital as consideration for the trademark that it purchased from the seller.

#### Issue:

The only issue on appeal was whether the issue by a company of its own authorised capital in exchange for a trademark constituted “expenditure actually incurred” for the purposes of section 11(gA) of the **Income Tax Act**.

#### Held:

That the court a quo did not deal with the meaning of “expenditure” but with the question when the expenditure was actually incurred. However, the issue in this case was not when liability arose. The transfer of the shares took place against the assignment of the trade mark and the taxpayer sought to claim the allowance in the year the obligation was incurred. That the question that the court a quo should have posed was whether the issuing of shares by a company amounts to “expenditure” and not whether the undertaking to issue shares amounts to an obligation, which it obviously does. **The terms “obligation” or “liability” and “expenditure” are not synonyms. The liability or obligation must be discharged by means of expenditure** (timing is not the question). The term “expenditure” is not defined in the **Income Tax Act** and therefore, its ordinary meaning must be attributed to it. Its ordinary meaning refers to the **action of spending funds; disbursement or consumption; and thus, the amount of money spent**.

In the context of the **Income Tax Act** it would also include the disbursement of other assets with a monetary value. **Expenditure**, accordingly, **requires a diminution (even if only temporary) or at the very least movement of assets** of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.

**That the issue of shares does not involve a movement of assets, even though the value of the shares might be diluted or diminished in the hands of the shareholders and accordingly, the issue of shares cannot qualify as “expenditure”.**

The appeal was accordingly upheld.

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\(^{18}\) Williams p 439; Broomberg p 155.
Notes and lesson:

The courts *a quo* compared the agreement under review to an agreement for the acquisition of the trademark whereby the seller would purchase an agreed number of the unissued shares of the purchaser at an agreed price and the proceeds of such sale would then be applied to payment of the purchase consideration of the trademark. In terms of such an agreement, there could be no doubt that the transaction would constitute or involve an expenditure by the company of a portion of its share capital. The courts *a quo* failed to see any difference between the construction of such an agreement and the agreement under review.

When the Supreme Court of Appeal considered the position of the courts *a quo*, it held that the courts *a quo* missed the point in coming to this conclusion, as one has to give meaning to the contract as stipulated (unless there is simulation involved, which was not the case in present). Accordingly, the fact that the parties may have constructed their agreement differently and tax-efficiently is irrelevant.

Furthermore, subsequent to the events giving rise to the appeal in the North Gauteng High Court, section 24B was introduced into the Income Tax Act and the appellant (Commissioner for SARS) also contended on appeal that the use of the word “deemed” in section 24B(1) was an indication that, but for such deeming provision, the issue of shares would not constitute “expenditure actually incurred”. In the judgement, it was held that this argument of the appellant was not convincing and it did not help the court in deciding the issue before it.

Although the above contention was rejected by the courts *a quo*, in light of the judgement of the Supreme Court of Appeal, one has to take note of the relevant sections in the Income Tax Act, which allow for a tax deduction where shares are issued in exchange for or as consideration for an asset(s) acquired, i.e. section 24B(1) (deleted with effect from 1 April 2013); section 40CA and section 24BA. Sections 24BA and 40CA have replaced section 24B(1). Section 24BA applies with effect from 1 January 2013 and section 40CA applies with effect from 1 April 2013. Note that where shares are issued in exchange for the rendition of services, such issue will not be deductible for tax purposes, as it does not constitute “expenditure” actually incurred (as held by the Supreme Court of Appeal in *LABAT AFRICA LTD*) and it is also not dealt with by any particular section of the Income Tax Act.

3 “IN THE PRODUCTION OF INCOME”

3.1 General

| 3.1.1 | PORT ELIZABETH ELECTRIC TRAMWAY COMPANY LTD v COMMISSIONER FOR INLAND REVENUE | 8 SATC 13 (CPD) - 1935 |

Importance classification:

Very important. This is the leading case on the meaning of the phrase “in the production of income”. The test postulated is to enquire whether the purpose of the expenditure is to produce income. If so, was it necessary for the performance of the act or even attached to it by chance; and was the expense so closely connected with the income earned that it may be regarded as part of the cost of performing it? This is the “closely connected” test or as referred to in the later case of *JOFFE*, the “inevitable concomitant” test.

Facts:

The taxpayer company carried on business as a tramway transporter. A driver of one of its tram-cars lost control while descending a steep gradient. He died some time later as a result of
the injuries sustained in the accident. A claim was made in terms of the Workmen's Com-
pensation Act, on the taxpayer for damages. The Cape Provincial Division of the Supreme
Court compelled the taxpayer to pay an amount as compensation to the driver's widow. In
addition, the taxpayer also incurred legal costs in resisting the claim. The taxpayer claimed
these two amounts as a deduction but these claims were disallowed by the Commissioner.

Issue:

Could either or both of the claims made (compensation and legal costs) be claimed as a
deduction in terms of section 11(a) of the Income Tax Act as being expenditure incurred “in the
production of income”?

Held:

That section 11(a) permits the deduction of all expenses attached to the performance of a
business operation bona fide performed to earn income, whether such expenses are
necessary for its performance or attached to it by chance, provided they are so closely
connected with it that they may be regarded as part of the cost of performing it. That as
the employment of drivers was necessary for the carrying on the business of the company and
the employment of drivers carried with it, as a necessary consequence, a potential liability to
pay compensation if such drivers were injured in the course of their employment. The payment
made by the company by way of compensation was to be regarded as part of the cost of the
company's operations to earn income and so deductible in terms of section 11(2)(a) of the
Income Tax Act, 1925 (equivalent to the now section 11(a)). That the legal costs incurred in
resisting the claim for compensation had not been expended in an operation entered into to
earn income and were not allowable as a deduction.

Notes:

This decision, together with the LATEGAN decision (explaining the meaning of “accrued to”),
are landmark judgements. Incidentally, both decisions were handed down by Judge
Watermeyer. The decision attempts to set the limits for the interpretation of the phrase “in the
production of income” as used in section 11(a) of the Income Tax Act. But the words used in
the judgement are vague and even confusing. Pronouncements not necessary for the
judgement (obiter dicta) are included in the judgement, which has led to further confusion.
Together with Watermeyer's judgement in the JOFFE case (which appears to be completely
contradictory to the PORT ELIZABETH ELECTRIC TRAMWAY decision – see JOFFE
decision), it is a miracle that these judgements can be followed in the present day to determine
the meaning of “in the production of income”.

There is no requirement that expenditure be “necessarily” incurred. Thus, if a taxpayer wishes
to go on a business trip overseas, it does not matter that he travels first class rather than
economy class. His deduction is not limited to the cost of an economy class ticket.

Expenditure and losses do not literally produce income. Rather work or service or operational
activities produce income – expenditure is attendant on performance of such operations,
sometimes necessarily, sometimes not.

Please note that it is not only revenue expenditure that can be incurred in the production of
income – capital expenditure can also be incurred in the production of income. The test
whether expenditure is capital or revenue in nature is not the same test as for determining
whether expenditure is “in the production of income”. See the NEW STATE AREAS case for
the capital expenditure tests.

As a result of the decision in this and the JOFFE cases in regard to the legal fees being disal-
allowed under section 11(a), the legislature stepped in and promulgated section 11(c). This
section allows legal expenses to be claimed if the expenses were incurred “in the ordinary course of or by reason of the ordinary operations of” the taxpayer. Thus, the test under section 11(c) has a wider ambit than the words “in the production of income”.

Lesson:

Sometimes the test espoused in this case and the JOFFE case, leads to absurd results. Broomberg on Tax Strategy, Fifth Edition, Butterworths at page 252 describes some of the absurd results, namely where there has been theft in a company by an employee, the loss suffered as a result of the theft was only deductible if a lowly clerk or saleslady or like employee is the thief – the theft by a managing director is not allowed as a deduction. But this would depend on the facts. In this regard, see RENDLE’S case in Part B of this tutorial letter.

In another case, the South African Railways parked a trailer in front of the taxpayer’s entrance. The trailer was moved and during the night, a motorist crashed into the trailer. The damages were not allowed as a deduction as “the third party who drives past a factory at night is not essential to the taxpayer’s trade”. In a further case, an employee took a customer’s car for a joyride and damaged it. Compensation was paid but was not allowed as a deduction as the compensation paid was not an inevitable result of the business conducted by the taxpayer. But Broomberg also points out that the taxpayer has won some victories, namely a seller of lamps was allowed to deduct the damages paid when one of the lamps exploded. Broomberg further advises (on page 253) that the draftsman of a contract might spell out in a damages clause that the obligation to pay damages on the happening of the prescribed events is a condition of the other party entering into the contract. This advice is based on the consideration that moved the court in COT v CATHCART, 27 SATC 1. In that case, the taxpayer, an architect, had been able to obtain a job only if he was prepared to guarantee that the roof of the building he was to design did not leak. It was held, as a matter of principle, that if a guarantee is given to secure a contract, which yields income, the cost of honouring the guarantee can be said to be incurred in the production of income and would be deductible.19

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### 3.1.2 JOFFE & CO (PTY) LTD v COMMISSIONER FOR INLAND REVENUE

13 SATC 354 (A) - 1945

**Importance classification:**

Very important. It restates and amplifies the principle espoused in the PORT ELIZABETH ELECTRIC TRAMWAY case regarding the meaning of the phrase “in the production of income”. The “close connection” test is also referred to as the “inevitable concomitant” test.

**Facts:**

The taxpayer company carried on business as engineers in reinforced concrete. The taxpayer company supervised the building of a concrete hood (tower) for a power station, which collapsed and a workman employed by the building contractor was killed by the falling material. In a delictual court action, it was established that the taxpayer company had been negligent in the performance of its work and it was required to pay damages to the relatives of the deceased workman. The Commissioner disallowed the claim for compensation as well as the legal costs incurred in defending the action.

**Issue:**

Were the compensation and legal costs paid deductible in terms of section 11(a) as being incurred “in the production of income”?

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19 Williams p 459; Broomberg pp 251, 252, 253.
Held:

That the expenditure had not been incurred to earn profits, nor, as it had not been established that negligent construction was a necessary concomitant of the trading operations of a reinforced concrete engineer, had it been incurred for the purposes of the taxpayer’s trade. The legal expenses were also not deductible.

Notes:

This case is often used by students (and even some academic writers) as authority for the proposition that whenever compensation is paid as a result of negligence on the part of the taxpayer, such payment will not be considered to be “in the production of income” and therefore no deduction is possible. One has to be very suspicious of such a broad and wide sweeping approach to the problem. One must always look at the facts. It is true that Watermeyer CJ in this case disallowed the compensation paid as a deduction on the basis that negligent construction was not a necessary concomitant of the trading operations of a reinforced concrete engineer. However, it was clear that the taxpayer had failed to discharge the onus placed on him (as provided for in the new section 102 of the Tax Administration Act; previously section 82 of the Income Tax Act). Negligence must be proved to be an inevitable concomitant of the type of trade being carried on. A good example would be a restaurant serving meals. If food is not kept under strict hygienic conditions, it is liable to cause food poisoning. Even the best measures taken in this regard would not guarantee that a client will not get food poisoning.

Lesson:

Do not automatically assume that because negligence is involved, any compensation paid in regard thereto will be disallowed as a deduction. Look at the facts of each case and whether the onus can be discharged. To ensure the deductibility of any claim arising as a result of negligence on the part of the taxpayer, it may be necessary to follow Broomberg’s advice and build the compensation terms into a contract. For further explanation in this regard, see the PORT ELIZABETH ELECTRIC TRAMWAY case.20

3.1.3 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v BP SOUTH AFRICA (PTY) LTD 68 SATC 229 (SCA) - 2006

Importance classification:

Not very important. It confirms the principle enunciated in the PORT ELIZABETH ELECTRIC TRAMWAY case that the purpose of the expenditure must be looked at to determine whether such expenditure produces income as defined. If it does not produce income as defined, then a deduction is prohibited in terms of section 23(f) of the Income Tax Act. Additionally it confirmed the test postulated in the NEW STATE AREAS case for testing whether an upfront rental payment where the benefit lasts for 20 years, is capital or revenue expenditure.

Facts:

The taxpayer company, being a marketer of petroleum products, was wholly owned by a British parent company.

Two items of expenditure were at stake.

The first claim concerned interest paid on a loan from its parent company, which at the same time required that dividends be declared quarterly. The company had sufficient funds to pay the

20 Williams p 459; Broomberg pp 251, 252.
full dividends without any loan from the parent. However, the loan was required for the purchase of capital equipment so that the business could expand. If the dividends had not been declared, the taxpayer could have funded the purchase out of its own funds. The obtaining of the long-term loan also enabled the company to make additional local borrowings (local borrowings were restricted in the case of a foreign owned company).

The second claim concerned a lump sum “upfront” rental payment in respect of leases, which endured for some 20 years. The purpose of the lump sum payments “upfront” was to secure sites from which the taxpayer’s petrol could be sold and from which income for twenty years would be produced.

**Issues:**

Was the purpose of the loan to fund the dividend or was its purpose to fund taxpayer’s income-producing activities?

Were the upfront rental payments capital or revenue in nature?

**Held:**

In regard to the first claim, that it could not be said that without the loan there would have been no dividend paid because there was adequate cash available to pay the dividend. There was therefore no need to borrow money to pay that dividend. It followed that the purpose of the taxpayer as far as the loan was concerned, was to continue its income-producing activities and that the interest paid on the loan was an expense incurred to produce income in the meaning of section 11(a) of the Income Tax Act.

In regard to the second claim, the mere fact that a payment constitutes a payment of rental does not qualify it as revenue expenditure. That in the circumstances, the lump sum payments were more closely related to the taxpayer’s income-earning structure than its income-producing operations as they were incurred not to carry on the business of the taxpayer but to establish it. That in the light of the nature of the payments, being lump sums, the nature of the advantage obtained, being security that the taxpayer’s products would be sold from the leased premises and the substantial periods involved, the expenditures in issue were of a capital nature. Accordingly, the rental payments were not deductible during the year that they were incurred (as per section 11(a)), but were deductible over the duration of the leases in proportionate instalments (as per section 11(f) – deduction of lease premiums).

**Notes and lesson:**

Not much can be learnt from this case as it followed a previous precedent. It is surprising that the taxpayer pursued its claim in respect of the upfront rental. It was merely another name for a lease premium and had to be written off over the period of the lease in terms of section 11(f). Also see section 23H regarding the deduction of prepayments.

**3.1.4 COMMISSIONER FOR INLAND REVENUE v DRAKENSBERG GARDEN HOTEL (PTY) LTD**

23 SATC 251 (A) - 1960

**Importance classification:**

Important, as it highlights the fact that an immediate assumption should not be made that interest expenditure incurred on a loan utilised for the acquisition of shares is not deductible for tax purposes (for the reason that it is incurred in the production of dividends, which constitute exempt income), but an enquiry should first be made into the purpose for acquiring the shares.
Facts:

The taxpayer, a private company, leased a hotel from another private company, the Stiebel company for 4¼ years. It then sublet the hotel to a partnership that ran the hotel. A farm, on which there was a trading store, surrounded the hotel premises. The taxpayer leased the store initially from one of the Stiebel company’s two shareholders and then later from the Stiebel company itself. So at this point the taxpayer held two leases from the Stiebel company. The taxpayer then acquired all the shares in the Stiebel company to obtain absolute control over the hotel and store premises (thus to secure and preserve the two leases). Interest was payable on the outstanding balance of the purchase price of the shares. It is this interest that the Commissioner disallowed as a deduction in the hands of the taxpayer. The taxpayer appealed against the Commissioner's assessment to the Special Court, which upheld the taxpayer's appeal.

Issue:

Was the purchase of the shares and the production of the taxpayer’s rental income sufficiently closely connected to warrant the deduction of the interest paid on the outstanding balance of the purchase price of the shares?

Held:

That the taxpayer’s purpose in buying the shares was not to secure dividend income, but to ensure the taxpayer’s control of its revenue-producing asset and thereby securing the continuance of an increased income from its trading or business operations. The Special Court’s decision that the payment of interest and the production of the taxpayer's income was sufficiently close to warrant its deduction was upheld and the appeal was accordingly dismissed.

Notes and lesson:

The principle established in DRAKENSBERG GARDEN HOTEL is that interest paid on money borrowed to acquire shares is deductible for tax purposes, if the taxpayer's purpose with the acquisition of the shares is to ensure the continuance of its trade or business income and in doing so, to secure an increased income. Remember, the onus of proof rests on the taxpayer.

* Principle of apportionment (dual/mixed purpose) *

**3.1.5 COMMISSIONER FOR INLAND REVENUE v NEMOJIM (PTY) LTD**

45 SATC 241 (A) - 1983

Importance classification:

Important. It determined the principles and formula for apportionment for the purchase of shares in anticipation of a “liquidation” dividend and extended the principle and formula to “dividend stripping” operations.

Facts:

The taxpayer company was admittedly a share dealing company, making profits from buying and selling shares in dormant companies holding cash reserves available for distribution by way of dividend. In common terms, it carried on dividend-stripping operations. When the company was so “stripped”, the taxpayer sold the shares at a loss (because all the reserves had by that time been declared as dividends). The dividends received by the taxpayer were exempt from tax in terms of section 10(1)(k) and the whole loss on the sale of the shares was
claimed as a deduction being off-set against a bag cleaning business operated by the company. The Commissioner limited the loss on the sale of the shares to the proceeds received for the shares.

\section*{Issue:}

Was the total loss on the sale of the shares, which arose solely as a result of the dividend stripping by the taxpayer, deductible in terms of section 11(a) or was part thereof not deductible by virtue of section 23(f), which does not permit a deduction for expenditure incurred in respect of amounts received or accrued which do not constitute “income” as defined?

\section*{Held:}

That the taxpayer had a dual purpose, namely the receipt of moneys on resale of the shares (which would constitute income in its hands) and the receipt of a dividend after declaration thereof (exempt income in its hands). That the expenditure in issue thus did not pass the dual test of sections 11(a) and 23(f) of the Income Tax Act. That it would be appropriate to apply the principle of apportionment used in the RAND SELECTION case (not part of SAICA’s list of prescribed or “teaching aid” cases) which said principle, although not expressly mentioned in the Income Tax Act, had also been used in several other cases where a taxpayer had in a globular sum incurred expenditure for two purposes, only one of which qualified for deduction. Thus only a proportion of the expenditure on the shares would qualify as a deduction.

\section*{Notes:}

It was assumed prior to this case that the RAND SELECTION decision only applied in cases where the purchase and the liquidation took place in the same year. The court mentioned that although the Income Tax Act did not expressly sanction apportionment of lump sums at that time, apportionment was a “practical” solution. Section 23(g) now sanctions apportionment where there is a trade and non-trade or private purpose.

\section*{Lesson:}

Obtaining large tax benefits (assessed losses) from dividend-stripping operations is no longer possible.

\begin{center}
\textbf{3.1.6 COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE v MOBILE TELEPHONE NETWORKS HOLDINGS (PTY) LTD}

76 SATC 205 (SCA) - 2014
\end{center}

\section*{Importance classification:}

Important. This case dealt with the deductibility of audit fees incurred for a dual or mixed purpose and the apportionment thereof for income tax purposes, in terms of the provisions of section 11(a) read with section 23(f) and section 23(g) of the Income Tax Act.

\section*{Facts:}

The taxpayer company (respondent) is the holding company of five directly held and a number of indirectly held subsidiaries and joint ventures. The taxpayer company is in turn a wholly owned subsidiary of a listed entity and the collective business of this group of companies is the provision of mobile telecommunication networks and related services. The taxpayer company’s business activities comprised the earning of dividends from the holding of shares in its subsidiaries, as well as the provision of loans. The provision of loans, in turn, comprised loan funding to its subsidiaries (mainly interest-free) and loan funding as part of a debenture scheme
The taxpayer company had claimed the deduction of the audit fees incurred in respect of the annual statutory audit of the company's financial statements for each of the 2001 to 2004 years of assessment. In addition, the taxpayer company had also claimed a professional fee (training fee) incurred in its 2014 year of assessment, for the “implementation, adjustment, fine tuning and user operation of a new accounting computer system”. The Commissioner for SARS disallowed the professional fee in full on the basis that the expense was capital in nature. The Commissioner apportioned the deduction of the audit fees incurred for each year of assessment, on the basis of the ratio between the interest income and the dividend income. Because the dividend income comprised most of the taxpayer company's income each year, most of the audit fees were disallowed every year, leaving a small percentage of between 2% and 6% that was allowed as a deduction in each of the relevant years of assessment.

The taxpayer company appealed the Commissioner's finding to the Special Income Tax Court, which upheld the Commissioner's decision that the professional fees were of a capital nature. However, the Tax Court held that a 50/50 apportionment of the audit fees was appropriate as a deduction for income tax purposes.

The taxpayer company appealed to the South Gauteng High Court against the judgement, on the basis that most of the audit fees had to be allowed as a deduction, because most of the time during the audit was spent with regard to work done in respect of the interest income and not the dividend income. The taxpayer company also contended that the professional fee must be allowed in full, as the fees were incurred in respect of the training of staff on the new accounting computer package. The South Gauteng High Court allowed a 94% deduction of the audit fees, whereas the professional fee was allowed in full.

The Commissioner appealed against the decision from the South Gauteng High Court to the Supreme Court of Appeal.

**Issue:**

Were the audit fees deductible only to the limited extent originally allowed by the Commissioner, or to such other extent allowed by the Supreme Court of Appeal? and

Is no deduction in respect of the professional fee permissible? Alternatively, is the professional fee subject to the same or a similar basis of apportionment to the audit fees?

**Held:**

That it was well settled that, to determine whether moneys outlaid by a taxpayer constitute "expenditure incurred in the production of the income", important and sometimes overriding factors are the purpose of the expenditure and what it actually affects. The court thus had to assess the closeness of the connection between the expenditure and the taxpayer company's income-earning operations. That the Tax Court’s conclusion that “the auditing of financial records is clearly a function which is ‘necessarily attached’ to the performance of the taxpayer company’s ‘income-earning operations’, cannot be faulted. That, where, as in the present case, expenditure is laid out for a dual or mixed purpose, an apportionment of such expenditure is in principle approved. That apportionment is essentially a question of fact depending on the particular circumstances of each case. The apportionment must be fair and reasonable. That the taxpayer company's value overwhelmingly lay in its principal business as a holding company of extremely valuable subsidiaries. That it appears that the time spent specifically on dividend and interest entries between them may well have made up a small
component of the overall audit time. That the audit function involved the auditing of the taxpayer company’s affairs as a whole, the major part of which concerned the consolidation of the subsidiaries’ results into the taxpayer company’s results. That it follows that any apportionment must be heavily weighted in favour of the disallowance of the deduction given the predominant role played by the taxpayer company’s equity and dividend operations as opposed to its far more limited income-earning operations.

That it would be fair and reasonable that only 10% of the audit fees claimed by the taxpayer company for each of the tax years in question should be allowed.

That, with regard to the professional fee, given the inadequacy of the evidence given by the taxpayer company, it was impossible to determine whether the professional fee could legitimately be deducted by the taxpayer company and that the deduction of the professional fee should accordingly be disallowed in full.

Notes:

The onus of proof is on the taxpayer. Thus, if the taxpayer was able to give sufficient evidence with regard to the deductibility of the professional fee paid, the outcome would most likely have been different and the professional fee paid, could have been allowed as a deduction.

- Payments made to dependants of deceased employees

### 3.1.7 PROVIDER v COMMISSIONER OF TAXES, SOUTHERN RHODESIA

17 SATC 40 (SR) - 1950

#### Importance classification:

Important. Expenditure voluntarily incurred may be claimed as a deduction in terms of section 11(a) if the purpose of the expenditure was to induce an employee specifically or the workforce in general, to enter into or to remain in the employ of the taxpayer.

#### Facts:

The taxpayer company had inaugurated two schemes for the benefit of its employees – a “Life Assurance Scheme” and a “Service Bonus Scheme”. In terms of these schemes, which were both non-contributory and could be withdrawn at will by the company, the company undertook to pay, firstly, a bonus on retirement to any employee who had been in the company’s service for a certain period, and, secondly, a benefit to the dependants of men who died in the company’s service, the amount of the bonus or benefit, as the case might be, being graduated in accordance with the length of the service of the employee. The Commissioner allowed the deduction of the bonuses but not the benefits paid to employees’ dependants.

#### Issue:

Do the payments made to the dependants qualify as a deduction as being incurred “in the production of income”?

#### Held:

That no clear distinction could be drawn between the two sets of payments and that because both were clearly designed by the taxpayer to induce its employees to enter and remain in its service, they could be validly deducted as constituting expenditure actually incurred in the production of income.
Notes:
To be incurred “in the production of income” does not mean that a taxpayer is legally obliged to incur the expenditure. *Ex gratia* payments made by an employer to promote a happy and contented staff may also qualify for a deduction under section 11(a) under certain conditions, namely if there is a contract in existence with an employee for a deferred payment on retirement or if there is an established policy to that effect. This case is the authority for the proposition that a prior contract with an employee for the payment of a gratuity on retirement is not necessary as long as there is an established policy of which the employees are aware – this policy creates the necessary close connection between the payments and the production of income, for example a thirteenth cheque Christmas bonus or bonus paid on the anniversary of an employee’s birthday. The same principle applies for a redundancy payment. If there is no contract or policy in place, the *ex gratia* payment would not be allowed as a deduction as it would be regarded as a reward for past services and would thus not be in the production of income.

Perhaps the taxpayer was lucky in this case in that he managed to discharge the onus (prove) that there was a policy in place. However, the principle is sound.

In any event, section 11(m) of the Income Tax Act provides for a deduction for annuities paid to former employees or partners if the former employee or partner has retired from the taxpayer’s employ on the grounds of old age, ill health or infirmity. The annuity will also qualify for a deduction if the payment is made to a person who is dependant for his maintenance on a former employee or partner immediately prior to his death.

**Lesson:**

If there is no policy in place, then in order to secure a deduction in the circumstances of retirement, any amount paid not in the form of an annuity must be paid in terms of a contract. Section 11(m) only applies to the deductibility of annuities.²¹

4 “NOT OF A CAPITAL NATURE”

4.1 General

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**Importance classification:**

Very important. The judgement sets out and discusses the main tests used to determine whether an item of expenditure is capital or revenue in nature.

**Facts:**

The taxpayer company carried on the business of gold mining. The company was required by law to install a system of water-borne sewerage and to link it up with the local authority’s system. The system installed consisted of sewers and connections on the company’s property and sewers on land outside the company’s property linking up the system with the local authority’s main system. The system was installed at the cost of the local authority but the cost was recovered by way of charges payable by the company over 60 months for the cost of the

²¹ Williams p 453; Broomberg pp 212, 213.
system on its own property (which would become its own property) and over 180 months for the cost of the system which was not located on its own property (to remain the property of the local authority). When claimed as a deduction, the Commissioner disallowed all the monthly amounts payable to the local authority as being expenditure of a capital nature.

**Issue:**

Was either or both of the instalments payable in respect of the sewerage system to the local authority capital in nature?

**Held:**

That while the payments made in respect of the internal sewers were clearly of a capital nature, being the payment of instalments towards the acquisition of an asset which remained the property of the company, the payments made in respect of the external connections, which did not produce any permanent asset for the company, constituted in effect a charge for the use of the local authority’s system, which did not lose its nature of a recurrent business charge by reason of the fact that it had been commuted into a fixed payment to be paid off by a series of instalments over a period of years.

**Notes:**

Several tests were used by the court to determine whether the expenditure was capital or revenue in nature. The main test used in this decision was to enquire whether the expenditure is to be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning structure, the “operations v structure” test.

The other tests used for assistance in deciding the matter were the “fixed v floating capital” test which is akin to the aforementioned test (GEORGE FOREST TIMBER) to establish whether there was any enduring benefit or permanent asset created by the expenditure and even the recurrence test, which is not of much use.

The judge also pointed out that the purpose (intention) of the taxpayer in incurring the expenditure is an important factor in determining the true nature of the expenditure. But the effect of the expenditure is also important.

(See the GENN case in Part B of this tutorial letter).

**Lesson:**

There is usually no “one test” that will cover all circumstances. A combination of all the tests will usually lead to a correct decision. The purpose of the taxpayer and what the effect of the expenditure actually is, must also be taken into account. The “enduring benefit” test or enquiring whether an asset of a permanent nature has been created, are also very useful in the decision making process.

**4.1.2 RAND MINES (MINING & SERVICES) LTD v COMMISSIONER FOR INLAND REVENUE**

59 SATC 85 (A) - 1996

**Importance classification:**

Not very important. The principle applied is the same as applied in the NEW STATE AREAS case, namely the “enduring benefit” test and the test whether the expenditure is more closely linked to the income-earning structure or the income-earning operations of the taxpayer.

**Facts:**

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22 Williams p 571.
The taxpayer was a mine management company and a member of a large group of mining companies. Its principal function was the administration and management of some forty mines controlled by the group. The group’s policy was to require the taxpayer to manage all its mines as it would ordinarily not invest in a mine unless it could be managed by the taxpayer. However, a mining company outside the group ran into financial difficulties. Negotiations by the group took place to acquire a controlling interest in the ailing company conditional upon the cancellation of an existing management agreement and the conclusion of a new management agreement between the company and the taxpayer. The cancellation of the existing management agreement was effected by the parties involved but the cost to effect this “management termination agreement” was the sum of R30 million to the taxpayer who then entered into a management contract which included, *inter alia*, a term that the contract would last for a period of not less than twenty years. The group had invested in excess of R300 million to acquire the controlling interest in the ailing company. However, when the price of platinum dropped, the group elected to relinquish its controlling interests in that newly acquired company. As a consequence, the taxpayer was obliged to terminate its management of that mine. The taxpayer, however, had already received R30 million in management fees (which had been taxed) by the time it was obliged to terminate that management agreement. Thus, for all intents and purposes, the taxpayer had received *via* management fees, the amount originally paid for the right to manage the mine.

**Issue:**

Was the sum of R30 million paid by the taxpayer for the right to manage the mine capital or revenue expenditure?

**Held:**

That the *expenditure in question was made to acquire an asset which was intended to provide an enduring benefit* for the taxpayer as the contract was to endure for at least twenty years; there was also the sheer size of the expenditure — R30 million — and its relative uniqueness in that never before and on only one other occasion since had the taxpayer paid to acquire a management contract. It was not the taxpayer’s stock-in-trade. Cumulatively regarded, these factors give the expenditure the colour of a capital outlay. That the *expenditure in question had been incurred to acquire an asset which added to the income-earning structure of the business and not expenditure routinely occurring in the running of the taxpayer’s business* and the contracts in themselves generated no income but they did provide the taxpayer with the opportunity of generating income by providing the management services for which payment would be made. That the management contracts were assets of a capital nature which constituted part of the income-earning structure of the taxpayer and they were comparable in principle with franchise agreements, the cost of acquisition of which is not regarded as revenue expenditure. That the expenditure of R30 million cannot be said to have been a cost incurred in the actual performance of the taxpayer’s income-earning operations but it was a cost incurred in acquiring the right to perform those operations in this particular instance; the contract was “a source of profit” and the R30 million was spent to acquire it. That the taxpayer had first to pay to acquire the right to provide management services before it would be able to deploy its organisational structure to earn management fees; it was akin to expenditure incurred in the acquisition of a licence, which it was necessary to have in order to carry out a particular income-producing activity. That, accordingly, the cost of acquiring the management contract was not a revenue expenditure but a capital expenditure and hence the R30 million could not be deducted in terms of section 11(a) of the Income Tax Act.
Notes:

The major problem in deals such as these, especially in a group situation where the holding company directs the subsidiary, is that the income earned is revenue in nature while there is no deduction or write-off for the asset that created the income in the first place. This is very similar to the decision in the **GEORGE FOREST TIMBER** case (see above under capital and revenue gross income), but the legislation has intervened in the case of plantations.

Lesson:

If one structures deals in the same way as in the **RAND MINES** case it can only lead to problems. Perhaps it may have been possible to purchase the assets of the mining company rather than the shares in the company. In that case, the original management contract might have fallen away with very little cost incurred in respect thereof.

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4.1.3 **BP SOUTHERN AFRICA (PTY) LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICES**

69 SATC 79 (SCA) - 2007

**Importance classification:**

Important. This is the second **BP** case (see first case above) but deals with slightly different facts. It confirms the general principle that royalty payments made in terms of a licence agreement are revenue in nature and are therefore deductible in terms of section 11(a).

**Facts:**

The taxpayer, BPSA, was the manufacturer, supplier and marketer of fuel in South Africa. BPSA obtained the non-exclusive right to use certain licensed products and marketing material from its offshore holding company and, for these rights of use, paid an annual royalty, based on the amount of product supplied.

In the lower court it was found that the royalty expenditure incurred for the use of intellectual property (trademarks and other marketing material) was not comparable to rentals paid for business premises, but rather akin to expenditure incurred in setting up a business (like franchise fees). It found that the rights and obligations between BPSA and its holding company were of an enduring nature, although the parties had a clear right to terminate these obligations as provided for in their agreement.

**Issue:**

Was the lower court correct in holding that a licence agreement which could be terminated at short notice creates an asset of an enduring nature which should then be regarded as capital in nature and thus not be deductible in terms of section 11(a)?

**Held:**

That the **annual royalty payments, incurred in consideration for the right of use of intellectual property, were not of a capital nature and, accordingly were deductible** under the general deduction formula set out in the South African Income Tax Act.

The court referred to the argument by SARS that, although the agreement conferred a temporary right of use, it was unlikely that the offshore parent company would sever its “umbilical cord” to its South African subsidiary and so BPSA would “effectively garner a benefit.
of far greater magnitude than, at first blush, the agreement confers upon it”. The court stated categorically that “to engage in such speculation would be an act of grave folly”.

It also reconfirmed the principle that regard must principally be had to the agreement to determine the true rights and obligations between the parties. There was no evidence of a simulated transaction and thus the conclusion reached by the Special Court that the annual royalty was capital in nature was held to be unsustainable.

That the royalty was paid in consideration for the use – not ownership – of intellectual property and likened the expense to rentals paid by a tenant to a landlord in respect of immovable property. That the annual royalty fee is for all intents and purposes indistinguishable from recurrent rent paid for the use of another’s property.

Notes:

The decision of the Supreme Court of Appeal comes as a relief to taxpayers, especially to those who pay royalties to overseas holding companies. However, not every royalty payment is deductible. The principle that the purpose of each expense must be analysed in its own right and subject to its own specific circumstances, to determine the nature thereof, is of vital importance.

Lesson:

A licence to trade as opposed to a licence to distribute or a right to produce a product could be regarded as being capital in nature (more closely linked to the income-earning structure than the income-earning operations and thereby creating an asset of an enduring nature). Royalties paid for the right to produce or distribute a product are more likely to be revenue in nature (more closely linked to the income-earning operations and not creating an asset). However, to be safe, the royalty should not be paid “in perpetuity”. Rather, there should be provision for the termination of the agreement at the instance of the payer and the agreement should be renewable every five or so years to ensure the revenue nature of the royalty payments.

5 “TO THE EXTENT NOT LAID OUT FOR THE PURPOSES OF TRADE” – SECTION 23(g)

5.1 General

5.1.1 WARNER LAMBERT SA (PTY) LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
65 SATC 346 (SCA) - 2003

Importance classification:

Important as it clarifies the ambit of expenses which may be claimed as being in the production of income and the extent to which such expenses can be regarded as being laid out for the purposes of trade.

Facts:

The taxpayer, an American owned South African company operating in South Africa during the height of the Apartheid regime, had joined an association of local signatories of the Sullivan Code in 1978. Subsequently, America promulgated the Comprehensive Anti-Apartheid Act 1986, which compelled American companies and their subsidiaries operating in South Africa to comply with the Sullivan Code principles. If they did not comply, fines and even imprisonment
for the directors of the American holding company could be imposed. The Sullivan Code principles provided for the non-segregation of races in the workplace, equal and fair employment for all employees, equal pay, development of training programmes, increasing the number of disadvantaged persons in management and supervisory positions and improving the quality of employees' lives outside the work environment. The social responsibility expenses incurred in complying with the Sullivan Code principles, namely the expenses incurred in “Working to Eliminate Laws and Customs that Impede Social, Economic and Political Justice”, which was the seventh principle of the Sullivan Code, were claimed by the taxpayer as deductions. The taxpayer contended that it was instructed by its American parent to incur expenses that went with the performance of its Code obligations and if it did not it would almost certainly have suffered a loss of income. Such expenditure included participation in national conventions, peace initiatives, providing information technology support, adopting schools and helping small businesses start-up operations. The Commissioner disallowed the social responsibility expenses claimed on the basis that the expenditure had not been incurred in the production of taxpayer’s income and was expenditure of a capital nature since the purpose of the expenditure was to protect the taxpayer’s income-earning structure.

Issue:
Was the social responsibility expenditure which the taxpayer was by United States legislation obliged to incur in South Africa expenditure laid out for the purposes of trade and, if so, was it of a capital or a revenue nature?

Held:
That deductible expenditure has certain characteristics. It must be incurred in the production of income (section 11(a)) and will not be allowed as a deduction against gross income if it is not laid out or expended for the purposes of trade. That money spent by a taxpayer to advance the interests of the group of companies to which it belonged was not regarded as expenditure in the production of income. The link between the expenditure and the production of income was too tenuous; moneys expended by a taxpayer from motives of pure liberality also failed to qualify as expenditure in the production of income. The link between the expenditure and the production of income was not as close and obvious in the second category as in the first, but that did not mean that the connection was too remote. That a loss of the appellant’s subsidiary status might have brought about the loss of all kinds of trade advantages as it was unthinkable that the appellant should not comply with the Sullivan Code at all and it was not certain what would become of it if it complied but failed to do so adequately, but the appellant was not obliged and would not have been permitted, to take the risk of finding out. The Sullivan Code expenses were bona fide incurred for the performance of the appellant’s income-producing operation and formed part of the cost of performing it and, therefore, the social

...
responsibility expenditure was incurred for the purposes of trade and for no other. That in regard to whether the social responsibility expenses incurred by the appellant were to be regarded as capital expenditure, there was no question here of the creation or improvement of a capital asset in the hands of the appellant and although that is not conclusive in favour of such payment being a revenue expense, it is a consideration of considerable importance in assessing the “closeness of the connection between the expenditure and the income-earning operations” and where no new asset (for the enduring benefit of the trading operation) has been created, any questioned expenditure naturally tends to assume more of a revenue character. That the appellant’s income-earning structure had been erected long ago and it was now a question of protecting its earnings. Periodic payments were required to preserve it from harm, or at least to avert the risk of harm and these payments were similar to insurance premiums and if they were anything like that, they were payments of a revenue nature. That, accordingly, the expenditure in issue was deductible in terms of section 11(a) read with section 23(g) of the Income Tax Act.

Notes and lesson:

It is interesting to note that this matter only came before the court in 2003. It related to expenditure incurred in the 1980s and early 1990s at the behest of its American parent company. The Reverend Sullivan, an American citizen, was a critical activist against the Apartheid government then in power in South Africa. It is interesting to speculate whether the courts would have arrived at a different decision if this matter had come before the courts prior to 1990.

This decision categorically states that money spent by a taxpayer to advance the interests of the group of companies to which it belongs, is not regarded as expenditure in the production of income. The same can be said of moneys expended by a taxpayer from motives of pure liberality. However, the court found a link, which was not regarded as too remote, between the continued trade of the company and the expenditure. The social responsibility expenditure reduced the risk that the appellant might lose its privileged subsidiary status and it benefited the underprivileged and it pleased the American parent.

The court used the test as to whether a capital asset was created or improved by the Sullivan Code expenditure. This is a good test to use in such circumstances. It is in accordance with the tests for capital expenditure as set out in the NEW STATE AREAS decision.

5.1.2 COMMISSIONER, SOUTH AFRICAN REVENUE SERVICE v SCRIBANTE CONSTRUCTION (PTY) LTD
62 SATC 443 (SCA) - 2002

Importance classification:

Important. This case concerned the deductibility of interest incurred on loan accounts credited for the purpose of paying a dividend to holders of shares. The interest was held to be deductible for tax purposes. The distinguishing factor in this case was that the taxpayer company had sufficient funds available to pay dividends to its holders of shares, but for sound business reasons the taxpayer elected to, instead of paying out a dividend, credit a portion of the dividend to interest-bearing loan accounts. It was held that the purpose of paying the interest on the loan accounts was to secure for the company the benefit of the continued availability of the funds for use in its trading activities. In addition, borrowing money and relending it at a higher rate of interest, thereby making a profit, constitutes the carrying on of a trade.
Facts:

The taxpayer company (respondent in question) is a civil engineering construction company. Its holders of shares are three family trusts. During 1990 the taxpayer declared dividends of R6 573 076. Of this amount R3 199 834 was allocated (credited) to the loan accounts of the holders of shares with the understanding that no interest would be paid. The balance of R3 373 242 was likewise credited but on the basis that it would bear interest at an agreed rate. No cash changed hands. The arrangements were effected solely by book entries. The taxpayer claimed deductions in its 1991 to 1993 income tax returns of the interest that it had credited to its shareholders’ loan accounts in respect of the dividends as expenditure incurred in the production of income allowed by section 11(a) of the Income Tax Act. The Commissioner disallowed the deductions.

Issue:

Whether the interest paid by the company to the holders of shares for the years in question was expenditure incurred in the production of income as contemplated by section 11(a) of the Income Tax Act and whether the interest was laid out or expended by the company for the purposes of trade within the meaning of section 23(g)?

Held:

That the purpose of paying the interest on the loan accounts was to secure for the company the benefit of the continued availability of the funds for use in its trading activities. In addition, borrowing money and re-lending it at a higher rate of interest, thereby making a profit, constitutes the carrying on of a trade. The interest paid on the loans was therefore deductible.

Notes:

If the loan was incurred for the purpose of paying a dividend, the interest is not deductible in terms of section 11(a). Where, however, the taxpayer has funds available with which to pay a dividend, and then takes out a loan, the criterion for the deductibility of the interest remains whether the purpose of the loan was to pay the dividend. The existence of surplus funds was held to be the decisive factor in this case and the reason for retaining these funds was to increase the company’s competitiveness and, temporarily, its income in the form of the interest which it retained.

6 SPECIAL DEDUCTIONS

6.1 Repairs and maintenance – Section 11(d)

6.1.1 FLEMMING v KOMMISSARIS VAN BINNELANDSE INKOMSTE

57 SATC 73 (A) - 1994

Importance classification:

Not very important. This case explains what is not included in the meaning of “repairs” for the purposes of section 11(d) of the Income Tax Act, including what is not the subsidiary part of the whole.

23 Williams p 484.
Facts:
Because the existing borehole on the farm yielded less and less water to feed the existing dam, which water was vital for farming purposes, the taxpayer drilled a new borehole, erected a windmill for the borehole and installed piping to feed water from the borehole to a newly constructed dam. The taxpayer contended that all these expenses were repairs of property occupied to trade or in respect of which income is receivable and claimed a section 11(d) deduction. The basis of his claim was that the borehole and windmill had to be regarded as a subordinate part of the farm and that repairs of property as used in the section also included the replacement of a subordinate portion of property.

Issue:
Did the expenditure on the new borehole, windmill and dam constitute a “repair” for the purposes of section 11(d)?

Held:
There was no evidence that anything went wrong with the borehole itself requiring its replacement. Expenditure was therefore not incurred on the repair of the borehole as a subordinate and inseparable part of the farm. The availability of water from the original borehole had decreased because there was less water available underground at that place and on that ground the new borehole could not be regarded as a repair as a result of its replacement of the original. It was improving the water supply which had nothing to do with “repairs of property”.

Notes:
Not a very useful case as the taxpayer was trying to stretch the meaning of “repairs” for the purposes of section 11(d) to obtain a deduction. It was inevitable that he would lose his case. Although there is a precedent for the proposition that a “repair” includes a replacement of a subsidiary part of the whole, there was no way that the court could find that a new windmill replacing a borehole which was running dry, was the replacement of a subsidiary part of the farm. Perhaps the reasonable man test should prevail here.

Lesson:
This case illustrates what may not be regarded as a subsidiary part of the whole. Interpretation Note No. 74 (Issue 2): “Deduction and recoupment of expenditure incurred on repairs” has been issued by SARS on 14 December 2015. This interpretation note provides guidance on the interpretation and application of section 11(d) of the Income Tax Act.

6.1.2 COMMISSIONER FOR INLAND REVENUE v AFRICAN PRODUCTS MANUFACTURING CO LTD
13 SATC 164 (TPD) - 1944

Important classification:
Important, from the facts of the case and the principle, which emerge from the decision based on the facts. The case gives guidelines on the meaning of “repair” as opposed to a “restoration” or “renewal” for the purposes of section 11(d) of the Income Tax Act.

Facts:
The original roof of a factory was in a bad state of repair. The timber roof trusses had been
damaged and could not be replaced with the same timber as such timber was unprocurable owing to the war. The local wood was unsuitable. A new roof, made of reinforced concrete, was installed in its place.

**Issue:**

Would the expenditure incurred on the roof be regarded as a “repair” (qualifying for a deduction) or a “replacement” (capital expenditure for which no deduction was available other than perhaps an annual allowance)?

**Held:**

That the taxpayer had restored the roof to its original condition and the use of material other than that originally used was not for improvement but to restore the roof to its original condition. The expenditure thus fell in the term “repairs” as used in the Income Tax Act.

**Notes:**

Section 11(d) provides for the cost of “repairs” to be deducted from income. However, being able to distinguish between a repair and a reconstruction or renewal is difficult in practice. For example, the cost of waterproofing a concrete roof by providing a protective covering has been held not to be a repair. But putting right a defect which existed when a building was first completed, is regarded as a repair (ITC 1408, 48 SATC 21). ITC 617, 14 SATC 474 (neither of these two cases are prescribed by SAICA) is also informative on the matter of what constitutes a repair, namely

- Repair is restoration by renewal or replacement of subsidiary parts of the whole.
- In the case of repairs effected by renewal, it is not necessary that the materials used should be identical to the materials replaced.
- The test for distinguishing repairs from improvements is: Has a new asset been created resulting in an increase in the income-earning capacity, or does the work undertaken represent the cost of restoring the asset to a state in which it will earn income as before?

**Lesson:**

If a taxpayer intends modernising a building, two contracts should be entered into – one contract for legitimate repairs and the other contract for improvements or renewals. If a single contract is entered into for both items, the taxpayer runs the risk of the repairs being considered as part of the reconstruction for which no deduction is available.

Another important aspect in regard to obtaining a deduction for repairs is to ensure that the premises are occupied for the purposes of trade or that rental income is receivable for the property. Thus, a landlord must never incur expenses in respect of “repairs” where the building is vacant. Costs incurred (even if they can be regarded as repairs) in putting property into a condition to be leased while it is still vacant, will not be allowed to be claimed under section 11(d). Rather sign a lease with a lessee and then effect the repairs. It does not matter that the repairs were necessitated by damage caused by the previous tenant – if the premises are vacant or there is no lease agreement, there will probably be no deduction.24

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24 Broomberg pp 124, 125.
1 Income as a consequence of a donation, settlement or other disposition – Section 7 (study with TL 105)

1.1 COMMISSIONER FOR INLAND REVENUE v BEROLD
24 SATC 279 (A)

Importance classification:

Important. The principle that was laid down in the case of CIR v Widan, 19 SATC 341 (A), namely that there must be a causal connection between the taxpayer’s donation and the income in question, was taken a step further and it was held that it must be determined if there is an effective causal connection. If the donation was the efficient cause of the accumulation of income for the benefit of the minor children, such income is deemed to have been received by the taxpayer in terms of (the now) section 7(3) of the Income Tax Act and the forms of the company law should not cancel such effective causal connection.

Facts:

The taxpayer, a director of companies, established a company, Luzen Holdings (Pty) Ltd ("Luzen"), in 1951. The taxpayer was the sole beneficial holder of shares of ten issued shares in Luzen. The taxpayer then transferred certain of his assets to Luzen on credit and without charging any interest on the outstanding purchase price of the assets. The taxpayer then formed five trusts, a trust for each of his five children. He donated his ten shares in Luzen to the five trusts, each trust receiving two shares. The taxpayer further donated £2 000 of the purchase price owing to him by Luzen to each of the trusts. The taxpayer then formed five trusts, a trust for each of his five children. He donated his ten shares in Luzen to the five trusts, each trust receiving two shares. The taxpayer further donated £2 000 of the purchase price owing to him by Luzen to each of the trusts. In 1954 the taxpayer’s mother formed a trust for the benefit of the taxpayer’s sixth child, born in 1954. She donated £100 to this trust and the taxpayer donated £2 000 of the purchase price owing to him by Luzen to this trust. Luzen issued two shares to this trust in 1955. In short, in 1955 there were six trusts, each formed for the benefit of a child of the taxpayer. Each trust held two shares in Luzen and £2 000 of the debt owed by Luzen to the taxpayer. In 1955 the taxpayer’s mother incorporated a company, Zenlu Investments (Pty) Ltd (“Zenlu”), with a total issued share capital of twelve shares. She subsequently donated two shares each to the six trusts respectively. Zenlu subsequently purchased all the shares in Luzen from the six trusts, for £1 per share. Accordingly, all the shares in Luzen were held by Zenlu and the six trusts in turn held all the shares in Zenlu. During the taxpayer’s 1957 year of assessment Luzen declared two dividends of £6 500 and £5 520 respectively to Zenlu as the sole holder of shares. Zenlu in turn declared a dividend of £6 200 in equal shares to the six trusts. The trustees of the respective trusts did not pay or utilise any portion of the dividends received for the maintenance of any trust beneficiary during the year of assessment in question, but held the accumulated amounts for their benefit. The Commissioner included the amount of £5 167 in the taxpayer’s income, being the sum of the dividend amounts declared by Zenlu and received by the five trusts created by the taxpayer. It is this amount, included by the Commissioner in the taxpayer’s income in his 1957 year of assessment that was in dispute before the court.

Issue:

Whether the sum of £5 167 was deemed to be included in the taxpayer’s income in terms of section 9(3) of the Income Tax Act No. 31 of 1941 (now section 7(3) of the Income Tax Act)?
Held:

That for as long as the taxpayer failed to claim payment of the loan amount due to him in respect of the assets sold to Luzen, there was a **continuing donation by him to the company of the interest on the loan** (i.e. the interest not charged).

That, although in form the dividend in question is derived from Zenlu, in fact it is derived from the taxpayer's donation, and the Court should not allow the forms of the company law to cancel the **effective causal connection** between the taxpayer's donation and the income accumulated for the benefit of the children. That the taxpayer's donation was intended to have the result which was ultimately achieved, even though every step taken may not have been worked out beforehand.

That the **donation was the efficient cause of the income accumulated for the benefit of the taxpayer's children and the dividend was accordingly held to be income received by the taxpayer** in terms of section 9(3) of the Income Tax Act No. 31 of 1941 (**now section 7(3)**) of the Income Tax Act No. 58 of 1962).

Notes:

The Appellate Division in this case accepted the principle laid down in **CIR v Widan** that there must be a causal connection between the taxpayer’s donation and the income in question. The court, however, went a step further to look for the “effective cause” of the income. The court traced the causal chain of the dividend back through an intervening company and held that the effective cause of the dividend in question was the donation by the taxpayer, i.e. the father of the minor children for whose benefit the dividend had been accumulated.\(^{25}\)

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**1.2 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICES v WOULIDGE**  
63 SATC 483 (A) - 2002

**Importance classification:**

Important, as the principle that an apportionment needs to be made between the gratuitous disposition element and the non-gratuitous disposition element to determine the income to be attributable to the donor for the purposes of section 7(3), is also amplified in other cases dealing with trusts. The principle that an interest free loan is regarded as a continuing donation for the purposes of section 7 was not contested by the taxpayer on appeal. It was decided in the court **a quo** (lower court) that an interest-free loan was regarded as a "continuing donation" for the purposes of section 7. The principle decided in this case was that the **in duplum rule** (limitation of interest up to the capital sum lent) does not apply in tax cases.

**Facts:**

The taxpayer set up two similar trusts for his minor children who were income and capital beneficiaries under the terms of the trusts. The taxpayer sold the shares which he held in four companies, to the trusts. The purchase price was left on loan account and although the agreement of sale entitled the taxpayer to charge interest on the loan account, he did not do so. Half the shares were sold and income was generated from the proceeds. SARS contended that the original sale of the shares to the trusts was a simulation or, at the very least, contained a considerable element of gratuitousness and consequently all the income received or accrued by reason of that sale should have been taxed in the taxpayer's hands.

\(^{25}\) Williams p 168.
Issue:

Can the sale of shares at their true market value to a trust, be regarded as a simulation or sham? Furthermore, should all the income generated from the proceeds of the sale, be regarded as part of the income of the donor for the purposes of section 7(3)? Finally, does the in duplum rule (limitation of interest to the capital sum lent by the donor) apply in tax matters?

Held:

That as the sham aspect of the transaction was not included in the issue at the Special Court level, on appeal it was not permissible to raise a new point in circumstances where one’s opposing party did not have a proper opportunity to deal with the point at the earlier hearing. Thus SARS could not raise the sham transaction at this point.

Furthermore, that for its application, section 7(3) requires a disposition made wholly or to an appreciable extent gratuitously out of liberality or generosity and where the disposition contains appreciable elements of gratuitousness and of proper consideration, an apportionment may be made between the two elements to determine the income deemed to have accrued to, or received by, the parent under section 7(3). The taxpayer bears the burden of proof to show that such an apportionment is possible and how a court should give effect to the apportionment; in each case the possibility and extent of an apportionment for the purposes of section 7(3) is a matter of fact and the burden of proof in relation thereto rests on the taxpayer as a result of section 82 of the Income Tax Act (now regulated by section 102 of the Tax Administration Act). That there was indeed an appreciable degree of gratuitousness as far as the forbearance of interest was concerned, but the market-related purchase price, the terms of the deed of sale and the subsequent payment of that purchase price constituted due consideration in respect of the sale itself. So, the evidence in the present case established the case the taxpayer sought to make out, namely that only the forbearance of interest was gratuitous and not the sale itself.

That it was clear that the in duplum rule could only be applied in the real world of commerce and economic activity where it served considerations of public policy in the protection of borrowers against exploitation by lenders and the present matter was not such a case; moreover, there was neither such a lender nor such a borrower and to the extent that either one is absent, the result is a gratuitous disposition and that very element of gratuitousness cannot be said to trigger the working of the in duplum rule.

Notes:

Although an interest-free loan is regarded as a continuing donation for the purposes of section 7, it is not regarded as a donation for the purposes of section 54 and thus is not subject to donations tax.

The case recognises the principle of apportionment between the gratuitous portion of the disposition and the non-gratuitous portion of the disposition, the onus being on the taxpayer to show if and how the apportionment should be applied.

The in duplum rule only applies to commercial transactions – in section 7 it is not applicable.

Lesson:

To prevent an allegation that a transaction is a sham or a simulation, it is important that the underlying asset, at the very least, has been sold at its true market value. Proper market valuations of the assets should be obtained.
A further lesson is that all the issues must be discussed and argued at the Tax Court (previously the Special Court) level since at the appeal level, no further issues can be raised.\textsuperscript{26}

What SARS tends to forget when applying section 7 against the taxpayer, is that if the income on the donation is deemed to be that of the donor, that the donor, in paying the taxes and not recovering such taxes paid from the donee, is denuding his estate by the amount of the taxes paid. This is the very essence of tax planning.

2 Trading stock acquired for no consideration or not acquired for no consideration (section 22) (study with TL 106)

2.1 EVEREADY (PTY) LTD V COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
74 SATC 185 (SCA)

Importance classification:

Not so important. This case dealt with the issue of whether the taxpayer company (appellant) had acquired trading stock for no consideration, which would, as a result, entitle the taxpayer to claim a deduction for income tax purposes of the market value of the trading stock on the date of acquisition, as provided for in terms of section 22(4) of the Income Tax Act. Note that the deduction of the trading stock was not in dispute. It was the amount or value to be attributed to the deduction that was in dispute, i.e. whether the trading stock was acquired for no consideration, which would lead to a deduction of the market value of the trading stock (as contemplated by section 22(4)), or whether the trading stock was acquired for a consideration, which would lead to a (considerably lesser) deduction of the cost price of the trading stock (as contemplated by section 22(2)(b)).

Based on the facts and the sale of business agreement read and interpreted as a whole, it was evident that the trading stock was acquired for a consideration; the portion of the purchase price to be attributed to the trading stock was, however, not a matter before the Supreme Court of Appeal.

Facts:

The taxpayer company (appellant) was a shelf company when it acquired a business as a going concern on 1 March 2003. The taxpayer’s year of assessment ends on 30 June and in its income tax return for the 2004 year of assessment (ended 30 June 2004), the taxpayer claimed a deduction from its income of R103,532,179 for the trading stock that it had acquired based on the market value of the stock at the date of acquisition. The taxpayer claimed the deduction of the market value based on the provisions of section 22(4) of the Income Tax Act.

In an additional assessment issued to the taxpayer, the Commissioner for SARS at first disallowed the deduction of the trading stock in full, but later allowed a deduction of R21,562,918 and also levied section 89quat(2) interest on the allegedly unpaid tax.

The taxpayer objected to the disallowance of the deduction, as well as the levying of interest, which the Commissioner for SARS rejected. The taxpayer subsequently appealed to the Eastern Cape Tax Court (ITC 1851, 73 SATC 241 (not prescribed by SAICA)), which dismissed the taxpayer’s appeal against the disallowance of the deduction of the trading stock, but, however, upheld the taxpayer’s appeal against the levying of interest.

The taxpayer subsequently appealed to the Supreme Court of Appeal against the order of the Tax Court to disallow the deduction of the market value of the trading stock and the Commissioner, in turn, cross-appealed against the Tax Court’s decision of the non-levying of interest.

\textsuperscript{26} Williams p 179.
Issue:

Had the taxpayer acquired the trading stock “for no consideration” and was it entitled to deduct the market value of the stock as contemplated by section 22(4) of the Income Tax Act? Or had it been acquired for consideration and the trading stock thus fell to be deducted at its cost price as contemplated by section 22(2)(b) of the Income Tax Act?

Held:

As to the appeal

That whether or not the stock was acquired for no consideration was a question of fact that depended on what was agreed between the parties for the acquisition of the stock and the taxpayer wanted to present oral evidence in the Tax Court as to the meaning of the written agreement between the parties, but such oral evidence was rightly ruled to be inadmissible.

That the taxpayer’s case solely relied on the construction that it gave to Schedule 6 of the agreement of sale of the business as a going concern and the taxpayer’s submission that the schedule demonstrated that the parties intended that no part of the purchase price was to be paid for the trading stock and that it had been acquired “for no consideration”, had no merit, as not only did the submission ignore the context in which the schedule had to be read, but it was also inconsistent with the language of the schedule itself.

That it was apparent from the subject matter of the sale alone that the purchase price had been paid at least partly for the trading stock. In terms of the sale agreement, various matters still had to be dealt with, such as a stocktaking still had to be done on the day prior to the effective date; schedules had to be prepared reflecting the values of all inventory and such values were to be “used for the purposes of the Effective Date Accounts and the Working Capital Statement”. Schedule 6, on which the taxpayer relied, could not be seen to allocate a purchase price of R80 million, as the purchase price could only be determined at the time that the working capital at the effective date had been fixed.

That the only basis for the taxpayer’s contention that no consideration had been paid for the trading stock had been that the amount that the parties were said to have intended to allocate to inventory was nil, but seen in its context that was not what the schedule meant, indeed, it would be most extraordinary if the seller had given away trading stock for free to the taxpayer, which, as per the taxpayer’s contention, had a market value of over R100 million. That it was quite apparent from the agreement read as a whole that part of the purchase price was paid for the trading stock, but precisely what portion of the purchase price was paid for the stock, was not a matter for decision before the court in the appeal.

That, accordingly, the finding of the Tax Court on the issue could not be faulted and the appeal was accordingly dismissed.

As to the cross-appeal

That section 89quat(2) of the Income tax Act levied interest on unpaid tax in certain circumstances, but the Commissioner may, in terms of section 89quat(3), in his discretion waive that interest in whole or in part if he was satisfied that the taxpayer’s claim had been based on reasonable grounds and on appeal from the Commissioner’s decision, it was for the Tax Court to exercise such discretion. That it was open to the Supreme Court of Appeal to interfere only if the Tax court had failed properly to exercise its discretion.

That there were no grounds for finding that the Tax Court had failed to exercise its discretion properly and the cross-appeal was accordingly also dismissed.
3 Assessed losses (study with TL 106)

### 3.1 ROBIN CONSOLIDATED INDUSTRIES LTD v COMMISSIONER FOR INLAND REVENUE

59 SATC 199 (A) - 1997

**Importance classification:**

Important. The principle arising in this case is that the realization of stock or assets in the ordinary course of liquidation does not necessarily amount to carrying on a trade as required for the purposes of section 20(1) (set-off of assessed losses) of the Income Tax Act.

**Facts:**

After making huge losses and going into liquidation, the liquidators of the taxpayer company sold its business “lock, stock and barrel” except for the stock which was held in bond. The company then became inactive until the stock in bond was realised in two separate bulk sales.

**Issue:**

Did the realisation (sale) of the stock in bond constitute the “carrying on of a trade” for the purposes of section 20(1) of the Income Tax Act?

**Held:**

That while it may have been in the normal course of trading for a liquidator to sell off assets in bulk, trade and realisation are different and sometimes even opposing concepts. That the disposal of the stock in bond was designed to allow others to trade in that stock and release the taxpayer from the risks entailed in doing so itself. That the two bulk transactions in issue did not constitute the carrying on of a trade.

**Notes and lesson:**

This case is also authority for the meaning of “carrying on a trade” for the purposes of section 11(a) of the Income Tax Act. The cost of the stock was allowed as a deduction against the proceeds received on the bulk sale.

The taxpayer also requested the court to re-examine the principle laid down in the SA BAZAARS case that an assessed loss is lost if the company does not trade and earn income during the year of assessment on the basis that that case had been incorrectly decided. The court held that for forty-five years businessmen and the Commissioner have been ordering their affairs on the assumption that that case laid down the law and that there had been no material change in the context in which the rule in that case operates. Therefore, the court had to be especially slow to depart from its earlier decision.\(^{27}\)

\(^{27}\) Williams p 532.
Importance classification:

A very important principle arose, but the facts are not important. If a taxpayer, other than an individual, does not trade for an entire year of assessment, the balance of the assessed loss is forever lost in terms of section 20(1)(a).

Facts:

The taxpayer company closed down its active business operations but maintained its existence, continued its banking account, obtained a transfer of its trading licences to other premises and renewed them annually, paid its company tax and licence but it did not carry on any ordinary trading operations. Some five years later, the company resumed active business operations and in that year and the following year, it earned profits from those operations. The company claimed that it was entitled to carry forward year by year, the accumulated loss resulting from its trading operations prior to the closing down of those operations and to set such loss off against the profits earned by it on the resumption of active business.

Issue:

May the assessed loss of a company be carried forward if it does not trade for an entire year of assessment?

Held:

That, as in the year following the closing down of the business, the company had not carried on any trade, it had derived no income in that year from a trade against which a set-off of any loss carried forward could be made. Consequently, in the succeeding years there was no balance of assessed loss from the preceding year of assessment to rank for such set-off.

Notes:

This decision only applies to companies. It does not apply to individuals.

Lesson:

Usually when a company ceases business and sells its assets, there will be an assessed loss left in the company. This assessed loss is only worth something if it can be utilised. Sections 80A-L and 103(2) are major stumbling blocks to the use of the assessed loss, especially if the company is sold to a third party when section 103(2) can kick in. If income is diverted to the company and either sections 80A-L or section 103(2) applies, then such diverted income is regarded as “tainted” and will not be allowed to be set off against any assessed loss brought forward. This means that if the company does not or cannot earn any income from its own operations which do not fall foul of either sections 80A-L or section 103(2) for an entire year of assessment, the assessed loss brought forward is lost forever.

Thus, if there is an assessed loss in a company, it is worth something but only if the company can generate income from its own resources. One way to achieve this is for the company to retain some of its own assets to generate “untainted” income. If the company invests the proceeds on the sale of a business in a bank to earn interest, it is insufficient, as earning interest is not regarded as carrying on of a trade unless the person earning the interest is regarded as a money lender, for example, a bank.
But where a property is owned by a company, and letting ceases for a year while it is being renovated for six months and then is available on the market for the other six months for rental but no lessees are found, then any assessed loss brought forward from the previous year of assessment is not forever lost in terms of the decision in the **SUB-NIGEL** case (because the property was available for leasing).  

SARS’ view is stated in Interpretation Note No. 33 (Issue 4, issued on 22 July 2014), namely that section 20 contains a “trade” requirement and an “income from trade” requirement. Both requirements must be satisfied before an assessed loss may be carried forward by a company taxpayer. SARS will, however, accept that, as long as the company has proved that a trade has been carried on during the relevant (current) year of assessment, the company will be entitled to set off its balance of assessed loss from the prior year, even if no income accrued. This concession is limited to cases in which it is clear that a trade has been carried on. SARS will apply an objective test to determine the fact that a trade has been carried on. A mere intention to trade will not be sufficient.

4 **Value-Added Tax (study with TL 103)**

4.1 **SOUTH ATLANTIC JAZZ FESTIVAL (PTY) LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE**

77 SATC 254 (WCD)

**Importance classification:**

Not very important. This case deals with the situation where a taxpayer (vendor) in the absence of tax invoices, can rely on the provisions of section 20(7)(b) or section 16(2)(f) of the VAT Act to claim an input tax deduction. The transactions in question were barter transactions in terms of which the taxpayer acquired sponsorships in return for providing advertising. The sponsors failed to comply with their obligation to issue tax invoices to the taxpayer. However, the Commissioner assessed the taxpayer for output tax based on values and terms stipulated in the sponsorship agreements. It was held that the sponsorship agreements also serve as proof for the taxpayer’s entitlement to the input tax deductions. The court considered the character of the particular transactions (barter transactions) and held that if the documents (the agreements) were good enough for the Commissioner to raise an output tax liability, the agreements are also sufficient for the purpose of computing input tax.

**Facts:**

The taxpayer staged annual international jazz festivals in Cape Town. The taxpayer concluded sponsorship agreements with South African Airways, the City of Cape Town, the South African Broadcasting Corporation and Telkom in terms of which the sponsors paid money towards and provided goods and services for the festivals. The taxpayer in turn provided goods and services to the sponsors in the form of branding and marketing.

All parties were registered VAT vendors.

The taxpayer was liable to declare and pay output tax on the goods and services provided to the sponsors, but failed to do so. During a tax audit, the Commissioner raised additional assessments for output tax based on the information provided in the sponsorship agreements. However, the issue before the court was whether the taxpayer was entitled to offset the output tax against the input tax.

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28 Broomberg pp 89, 269.
tax liability with a deduction in respect of the input tax in respect of the 'supplies' made to it by the sponsors.

The Commissioner had declined to allow any deduction.

It was common ground between the parties that the transactions in issue were regarded as barter transactions and that the sponsors had not provided the taxpayer with tax invoices and no documents of the nature described in s 16(2)(b) of the VAT Act had been issued.

The Commissioner was aware of the sponsors' failure to comply with their obligation to issue tax invoices. However, the Commissioner had taken no steps to procure compliance, regardless of the Commissioner’s responsibility in terms of section 4(1) of the VAT Act to carry out the provisions of the VAT Act.

The court a quo had held that the taxpayer could not make the deductions in respect of the input tax for the reason that the taxpayer had to create its own documents in terms of section 20(2) of the VAT Act, which are deemed to have the status of tax invoices.

**Issue:**

Whether, in the context of the sponsors having failed to issue tax invoices to the taxpayer, despite demand, the provisions of either section 20(7)(b) or section 16(2)(f) of the VAT Act should have been applied to allow the taxpayer to claim input tax deductions?

**Held:**

That the barter transactions were at arm's length and the value of the goods and services provided by the taxpayer to the sponsors in each case could be taken as the same as that of the counter performance by the relevant sponsor.

That with regard to the provisions of section 20(7)(b) the Commissioner must be satisfied of two things: (i) the existence or availability of sufficient documentary records and (ii) the impracticability of requiring a full invoice to be issued. That with regard to (i), the sponsorship agreements constituted sufficient records. However, with regard to (ii), there was no basis for finding that it would be impractical to require the sponsors to issue full tax invoices.

That the sponsorship agreements served as “documentary proof” as provided for in section 16(2)(f), to substantiate the taxpayer’s entitlement to input tax deductions. In this regard, it was held that if the agreements were good enough for the Commissioner to assess the taxpayer’s output tax liability, they should have been sufficient for the purpose of determining the input tax that should have been deemed to have been levied by the sponsors.

That the Commissioner could not reasonably have decided that the information in the contracts did not in the circumstances provide sufficient proof substantiating the taxpayer’s entitlement to the deductions claimed.

That the taxpayer was exercising a right of appeal to the tax court against the assessments in question and was not seeking the review and setting aside of a decision in terms of section 16(2)(f) of the VAT Act.

Accordingly, the taxpayer was entitled to the input tax deductions.
Notes:
With regard to ordinary arm’s length barter transactions, the market value of the assets or services will, “in the absence of any contrary indication”, be the market value of the assets or services as agreed between the parties and would be of equal value. Normally these values are stipulated in the relevant agreement.

• Recoveries

4.2 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICES v BRITISH AIRWAYS PLC [2005] JOL 14066 (SCA)

Importance classification:
Important. The case deals with what constitutes a taxable service.

Facts:
The taxpayer was an airline (BA) whose supplying of a carrier service (transport of passengers) attracts VAT (zero-rated in terms of section 11(2)(a) and (b)). Certain charges were payable by the taxpayer (BA) to the Airports Company but were recovered from the passengers as part of the total cost (composite price but reflected separately) of the air ticket. The Commissioner contended that the taxpayer was liable to pay VAT on the element of its composite fare that was reflected separately but constituted the recovery of a passenger service charge levied on it by the Airports Company by applying section 8(15) of the VAT Act. The taxpayer argued that the recoverable element was part of its composite fare for its supply of international carriage, the whole of which is zero-rated.

Issue:
Was the recoverable portion (separately disclosed) of the composite fee subject to the standard rate of 14%?

Held:
Section 8(15) of the Value-added Tax Act 89 of 1991 does not purport to levy a tax on a vendor for a service that it does not supply. The tax is levied by section 7 on the supply of a service by a vendor, and not on the receipt by the vendor of moneys that arise in some way from the supply of a service by another. The passenger service charge relates to services supplied by the Airports Company and not the taxpayer and therefore VAT was not payable.

Notes:
It is interesting that the court did not decide on the points raised in argument by the parties. Rather the court came to its decision based on an entirely different premise, namely that, in effect the recovery of costs is not a supply.

• Zero-rated services

4.3 STELLENBOSCH FARMERS’ WINERY LTD V COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE 74 SATC 235 (SCA) – 2012

The facts of this case are discussed in paragraph 8.2.13 of this tutorial letter and will not be repeated.
Importance classification:

Not so important from a VAT perspective. This case dealt with the zero-rating of services supplied to a non-resident and such services were not directly related to movable property situated in South Africa, as envisaged in section 11(2)(l)(ii) of the VAT Act.

Issue:

Whether the compensation amount of R67 million received by the taxpayer related to the supply of “services” as defined in section 1 of the VAT Act and if affirmative, whether such supply is zero-rated in terms of section 11(2)(l)(ii) of the VAT Act.

Held:

The taxpayer had, in terms of the termination agreement (i.e. early termination of the exclusive distribution right), surrendered the remaining portion of the right and such surrender constituted the supply of services in the course of an enterprise by the taxpayer for VAT purposes. The exclusive distribution right held by the taxpayer could not constitute movable property as contemplated in section 11(2)(l). The exclusive distribution right, which was incorporeal property, was not situated in South Africa and the debtor's place of residence was the United Kingdom where the incorporeal right was registered. So, the supply fell in the scope of section 11(2)(l)(ii) and was subject to VAT at the rate of zero per cent.

4.4 MASTER CURRENCY (PTY) LTD V COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICES
[2013] 3 All SA 135 (SCA)

Importance classification:

Important. This case deals with the interpretation and the application of section 11(2)(l) of the VAT Act, i.e. the zero-rating of supplies made to non-residents.

Facts:

The taxpayer (vendor) operated two bureaux de change in the duty free area of a South African airport. The taxpayer rendered foreign exchange services to non-resident passengers. The passengers would present South African rand to the taxpayer either in cash, travellers’ cheques or cheques received from the VAT refund administrator at the airport. The taxpayer would then convert the rand into foreign currency. The taxpayer would calculate the exchange rate margin and charge a commission and transaction fee and then present the departing passengers with an invoice reflecting the relevant amounts.

The taxpayer assumed that these services rendered in the duty free area were not subject to VAT. SARS raised an assessment where VAT was charged. The taxpayer appealed to the Johannesburg Tax Court. The taxpayer's appeal was dismissed, leading to the appeal to the Supreme Court of Appeal.

Issue:

Whether the commissions and transaction fees charged to departing non-resident passengers qualified to be zero-rated?
Held:

That the taxpayer’s argument that the VAT Act did not apply to the supply of goods and services in the duty free area was not based on any particular provision. That for the taxpayer to escape liability for VAT it had to bring itself within one of the “exemptions, exceptions, deductions and adjustments” provided for in the VAT Act. The taxpayer also relied upon a ruling issued by the Commissioner (under section 72) in terms of which the supply of goods by duty free shops in the duty free areas are zero-rated. However, the ruling relates to the supply of goods and not the supply of services.

The appeal was mainly concerned with the interpretation of section 11(2)(l) of the VAT Act. Section 11(2)(l) provides for the zero-rating of services supplied to non-residents except where the services are supplied directly in connection with land in the Republic, movable property inside the Republic or where the person is situated in the Republic at the time the services are rendered. The taxpayer contended that the rendering of its services were zero-rated in terms of section 11(2)(l)(ii)(aa) because they were supplied in connection with movable property that was being "exported". The Commissioner (respondent), on the other hand, argued that section 11(2)(l)(iii) was not applicable since the persons were present in the Republic at the time the services were rendered and no zero-rating under section 11(2)(l)(ii) was possible. The taxpayer’s argument was rejected on the ground that to call the non-resident recipient an exporter in the circumstances of this case unduly strained the meaning of the word.

The taxpayer finally submitted that its services should be zero rated by virtue of the provisions of section 11(2)(g) which provides for a zero rating for services supplied in respect of movable property situated in an export country at the time the services are rendered. It was held that no evidence as to the nature of the bank notes exchanged at the appellant's bureaux de change was produced.

The appeal was dismissed and it was held that the taxpayer’s services rendered in the duty free area were subject to VAT at the standard rate.

Notes:

This judgement confirms that the duty free area of an international airport is not regarded as outside the Republic and goods or services supplied within the Republic are subject to VAT at the standard rate, unless a specific provision in the VAT Act for exemption or zero-rating applies. Also refer to Interpretation Note No. 85 (issued on 27 March 2015).

- Meaning of “imported services” and claiming of “input tax”

| 4.5 | COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE V DE BEERS CONSOLIDATED MINES LTD [2012] 3 All SA 367 (SCA), 74 SATC 330 |

Importance classification:

Important. This case dealt with two issues. The first issue was whether certain foreign advisory services were utilised or consumed in South Africa for “the purpose of making taxable supplies”. If the services were utilised or consumed in South Africa otherwise than to make taxable supplies, such services would constitute “imported services” as defined and would be subject to VAT in terms of section 7(1)(c) of the VAT Act. The second issue dealt with the definition of “input tax” and whether input tax could be claimed by the taxpayer in respect of the fees paid for services rendered in South Africa by South African service providers.
What is important to derive from the judgement in this case is that where a taxpayer generally carries on taxable activities, **not all expenses incurred by the taxpayer can be attributable to those taxable activities**. There must be a **direct or immediate link between the expense incurred and the taxable supply** made by the taxpayer (vendor). In this case, the fees in question, which were paid to a foreign advisor and to a number of South African service providers respectively, were held not to be directly linked to the “enterprise” of the taxpayer and so, the taxpayer had to pay VAT in respect of the fee paid to the foreign advisor. It was held that the services constituted “imported services” as defined. The taxpayer could not claim input tax on the fees paid to the local (South African) service providers.

**Facts:**

The taxpayer company (respondent), carrying on the business of mining for and selling diamonds internationally, was approached by a consortium which proposed a complex transaction in terms of which a new company was to be formed and this new company was to become the holding company of the taxpayer and a linked company. The taxpayer engaged the services of various advisors to assist and advise on the proposed transaction. A London-based company was appointed as the taxpayer’s independent financial advisors to advise the board of the taxpayer on whether the consortium’s offer was fair and reasonable. At the same time, the taxpayer appointed various local advisors and service providers, including attorneys, to assist in the finalisation of the proposed transaction.

The proposed transaction was implemented through a section 311 (of the Companies Act of 1973) scheme of arrangement. After finalisation of the transaction, the foreign advisor issued an invoice to the taxpayer for the services rendered. Between the period March 2001 to January 2002, the local suppliers of services in connection with the transaction issued their invoices. They included VAT and the taxpayer claimed this VAT as input tax in its own tax returns.

On assessment, the Commissioner for SARS determined that the foreign advisor’s services were “imported services” and assessed a sum of VAT to be payable by the taxpayer in terms of section 7(1)(c) of the VAT Act. Furthermore, the Commissioner for SARS disallowed the taxpayer’s input tax claim on the basis that the VAT charged by the local service providers did not qualify as input tax.

The taxpayer lodged an objection against the Commissioner’s assessments. The objection was disallowed by the Commissioner and the taxpayer lodged an appeal to the Cape Town Tax Court. The Tax Court upheld the taxpayer’s appeal and ordered that the foreign advisory services did not constitute imported services and that the VAT paid by the taxpayer in respect of the local services was not a deductible input tax, except as far as the services of one firm of attorneys was concerned.

The Commissioner appealed against the orders of the Tax Court to the Supreme Court of Appeal.

**Issue:**

Whether certain foreign advisory services had been utilised or consumed in the Republic for “the purpose of making taxable supplies” and

Whether tax on local advisory services qualified for deduction as “input tax”.

**Held:**

That the first issue for decision was whether the foreign advisor’s services were utilised or consumed by the taxpayer to make taxable supplies in the course or furtherance of the taxpayer’s enterprise of buying and selling diamonds. As the definition of “imported services” refers to the **supply of services by a supplier who is resident or carries on business outside South**
Africa to a recipient who is a resident of South Africa to the extent that such services are utilised or consumed in South Africa otherwise than to make taxable supplies, the primary question was whether the foreign advisor’s services were acquired to make taxable supplies. That the purpose in question was the purpose of the acquirer of the service and that, by its nature, the test is subjective. That the taxpayer’s “enterprise” consisted of mining, marketing and selling diamonds. That the answer to the question whether the foreign advisor’s services were acquired to make “taxable supplies” in that “enterprise” was clearly “no”. The foreign advisory services were unrelated to the taxpayer’s core activities, which was the mining and sale of diamonds. The foreign advisor was not providing services directed at making any of the taxpayer’s businesses better or more valuable. It was the interest of the taxpayer’s departing shareholders and investors, rather than the interest of the taxpayer itself that formed the focus of the foreign advisory services. The duty imposed on a public company that is the target of a take-over is too far removed from the advancement of the VAT enterprise to justify characterising services acquired in the discharge (fulfilment) of that duty as services acquired for purposes of making taxable supplies, especially in the circumstances of this case.

Another basis of objection to the Commissioner’s assessment was that of the place of consumption. The decision to acquire the foreign advisory services was made at the taxpayer’s head office in Johannesburg, South Africa. That the fact that some meetings were held with the foreign advisor outside South Africa, could not be used to justify the conclusion that the services were not consumed in South Africa. The conclusion was that the foreign advisory services were consumed in South Africa.

With regard to the second issue, the definition of “input tax” refers to tax charged on the supply of services where such services are acquired wholly for consumption, use or supply in the course of making taxable supplies. The same reasoning in relation to the foreign advisory services applied in respect of the providers of local (South African) services. The local services were also acquired for the purposes of dealing with the proposal by the consortium.

The Commissioner’s appeal was upheld, i.e. VAT had to be raised in respect of the imported services and the taxpayer was not entitled to claim input tax in respect of the fees paid to the South African service providers.
PART B

Note:

- These are the “teaching aid” cases, which will assist you to understand the context of the SAICA prescribed cases and apply the principles in those decisions to a real, practical, everyday situation.
- It is highly recommended that you familiarise yourself with the principles enunciated (expressed) in these cases.
- You may be tested on any of the principles in these cases in tests and the year-end examination.

CHAPTER 4

GROSS INCOME
(study with TL 104)

1  “CASH OR OTHERWISE”

1.1  General

1.1.1  LACE PROPRIETARY MINES LTD v COMMISSIONER FOR INLAND REVENUE
9 SATC 349 (A) - 1938

Importance classification:

Important. However, the facts leading to the decision by the Appellate Division that the deal was a scheme of profit-making and thus taxable, are unimportant. The decision does nevertheless clarify how a non-monetary consideration, which accrues to a taxpayer, is to be valued, namely by adopting some reasonable method of sale.

Facts:

The taxpayer company sold, what the Appellate Division had found to be trading stock (mineral mining rights), to another company. In the contract of sale, the purchase price was stated to be the sum of £250,000 to be paid and satisfied by the allotment of 1,000,000 fully paid up shares of the nominal value of 5s. in the purchasing company.

Issue:

What amount was received by the taxpayer - the £250,000 as stated in the contract or the value of the shares?

Held:

That the true intention of the contracting parties had to be established to determine what the contract consideration was. That the true consideration for the sale of the rights was 1,000,000 shares in the purchasing company, as no cash consideration could be demanded from the purchaser, who was entitled and obliged to deliver these shares in fulfilment of its obligation. That the market quotation on the date of sale and that of a later date were relevant to the question of the value of the shares constituting the consideration and were rightly admitted in evidence and applied by the Special Court.
Notes:

The date of receipt and thus the valuation date were held to be the date of the sale and not the last day of the year of assessment of the taxpayer. Also see the **BRUMMERIA RENAISSANCE** case in regard to the test to be used to value a right otherwise than in cash. However, be careful of this latter decision because the decision related only to the specific circumstances of that case where there has been a *quid pro quo* granted.

Lesson:

The contract must state specifically whether the receipt of a specific purchase price in cash is contemplated or whether the valuation of the non-monetary asset is the amount being received. This aspect is entirely in the hands of the person drawing up the contract.29

2 “ACCRUED TO”

2.1 General

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<tr>
<th>2.1.1</th>
<th>GUD HOLDINGS (PTY) LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE</th>
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<td>69 SATC 115 (N) - 2007</td>
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**Importance classification:**

Not very important. However, it illustrates the principle that the terms and conditions of the contract will determine whether an amount has accrued or not. This case concerned the granting of an automatic cash discount if payment was made in a stipulated time frame.

**Facts:**

The taxpayer's standard conditions of sale included a discount scheme in respect of its sales to wholesalers whereby they were entitled to a settlement discount if they made prompt payment in respect of each sale. Such wholesalers making prompt payment would pay the selling price less the settlement discount. The taxpayer’s return of income reflecting the amount accrued to be the sales figures less the “prompt payment discount” offered in terms of the scheme. The Commissioner increased gross income by the sum of the discounts for which the taxpayer had made provision and omitted from its accrued income at the relevant time.

**Issue:**

What had “accrued” to the taxpayer at the relevant time? Was what had accrued the total income reflected on the invoices issued up to midnight at the end of the year of assessment but not yet paid over to taxpayer by its customers or was what had accrued to the taxpayer only the amount to which it would be entitled in the event of the debt being paid in the time prescribed in the standard conditions of sale?

**Held:**

That what was aimed at by the taxpayer and its customer alike was that the customer will purchase the goods for the net price after deducting the discount provided for in the standard conditions of sale and the prescription that this price must be paid in the stipulated time was an

29 Broomberg p 68.
incentive, to the customer, to take advantage of the lower price; moreover, the customer only became indebted for the full invoice price if his payment was tardy. That, judged from this viewpoint, the “settlement discount” referred to in the standard conditions of sale was not so much a “discount” as it was a penalty which would be added for late payment and from this viewpoint also, the concept that an amount equivalent to the discount “accrues” to the appellant to determine the gross income was as illogical as saying that, where a contract of sale provides for the payment of interest if payment is made after a certain date, such interest “accrues” to the seller at the time of sale. That on the basis of Lategan v Commissioner for Inland Revenue 2 SATC 16 and Commissioner for Inland Revenue v People’s Stores (Walvis Bay) (Pty) Ltd 52 SATC 9 the question was “What was the value of the Taxpayer’s right at midnight on 30 June 2003?” and based on the approach of Watermeyer CJ in Lategan’s case, supra, it was erroneous to suggest that the full invoiced price had accrued to the appellant, as part of its gross income, at the close of the tax year.

Notes and lesson:

The terms of the standard conditions of the contract will determine whether an amount has accrued or not. It is interesting to note that the court “valued” the accrual as was done in the LATEGAN and the PEOPLE’S STORES cases. It is not, as was the case in the LATEGAN and PEOPLE’S STORES case, dealing with the granting of credit. It was the complete opposite, namely encouraging clients to settle a contract price in a certain timeframe. Thus, it is suggested that the valuing of the accrual in terms of the standard conditions of sale would not be prohibited by the statutory proviso to the definition of “gross income” relating to the amount to be included in “gross income”. See the commentary and lesson for the PEOPLE’S STORES case.

3 “EXCLUDING RECEIPTS OR ACCRUALS OF A CAPITAL NATURE”

3.1 General

3.1.1 MODDERFONTEIN B GOLD MINING CO, LTD v COMMISSIONER FOR INLAND REVENUE

32 SATC 202 (A) - 1922

Importance classification:

Important. It was an early case, which stated the principle that where a receipt takes the form of profits from a business or rental received, the receipt is inherently revenue in nature.

Facts:

The taxpayer who was the original “bewaarplaats” owner (owner of the right to mine certain immovable property), received in compensation for yielding this right to a third party, compensation in the form of a payment based on the annual profits of gold mining operations in the area.

Issue:

Was the compensation receipt capital or revenue in nature?

Held:

That the nature of the contract was neither for a sale nor for a lease – rather it was a contract sui generis (of its own kind). That the annual payment based on the profits and due to the taxpayer for an indefinite period, was analogous to a rental and had none of the charac-
teristics of a capital receipt and therefore fell in the wide definition of income as contained in section 6 of the Income Tax Act of 1917.

Notes and lesson:

Certain receipts are inherently revenue in nature, such as the share in the profits of a business, rental received, interest on money lent and a salary for services rendered and will be taxed as such. The trick is to change the nature of the receipt from being inherently revenue in nature to something that is regarded as being capital in nature. A lump sum payment together with the relinquishing of ownership of an asset or the outright sale of a right go a long way towards changing the nature of the receipt from being inherently revenue in nature to being capital in nature. \(^{30}\)

3.2 Subjective tests – Intention

• **Scheme of profit-making**

3.2.1 **COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v WYNER**

66 SATC 1 (A) - 2003

**Importance classification:**

Not very important but reiterates the principle that if you purchase an asset with the intention to immediately resell the asset at a profit, it can be regarded as a scheme of profit-making and as such be subject to tax.

**Facts:**

The taxpayer purchased a bungalow at Clifton beach with the intention of selling it in a year at a profit. Prior to its purchase, she had leased the property from the Cape Town municipality for 21 years. When the municipality offered the bungalow for purchase (at below its market value) or to lease for a further period, the taxpayer decided to purchase it. She did not have her own funds to finance its purchase but knowing that she could resell it at a profit, obtained a bridging loan for its purchase while she found a buyer for it. When she sold it, she made a profit of over R1,5 million on the deal.

**Issue:**

Was the purchase of the bungalow for immediate resale capital or revenue in nature taking into account the fact that the taxpayer had already been the lessee of the bungalow for 21 years?

**Held:**

That two factors which are always of great importance in deciding whether the proceeds of the sale of property are of a revenue or capital nature are the intention with which the taxpayer acquired the property and the circumstances in which the property was sold. That the acquisition of an asset to resell it at a profit – even if it is a single, isolated transaction – will usually be regarded as a profit-making scheme. That her rights in relation to the bungalow were determined by the terms of the lease agreement – she had the right to use and enjoy the property against payment of the rental and she was not the owner of the property and she had no other real rights in respect of the property. That the argument that the profit was not designedly sought for and worked for and was fortuitous cannot be accepted; a distinction must

\(^{30}\) Broomberg pp 58, 59.
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. That in the present case the facts show clearly and unambiguously that in buying and selling the property the taxpayer was indeed engaged in a scheme of profit-making and the court a quo’s reasoning and findings that the mix of private rights and public forbearance gave the taxpayer a sui generis claim to the property which was close to ownership had to be rejected as was the reasoning that she should notionally be put in the same category as someone who by force of circumstance was forced to sell her home.

Notes:

The principle espoused in the PICK ‘N PAY EMPLOYEE SHARE TRUST decision, namely to examine whether there had been a scheme of profit-making or not, was followed in this case. The original intention was critical. The history of the bungalow – its lease and subsequent right to purchase, was regarded as irrelevant in spite of the fact that it had been her home for more than 20 years and she could be regarded as something more than a mere lessee (as was found by the court a quo).

Lesson:

The juristic nature of the contract or deal must be examined. Perhaps the offering of the bungalow for purchase could be regarded as a novus actus interveniens (a new intervening factor).

3.2.2 SAMRIL INVESTMENTS (PTY) LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
65 SATC 1 (SCA) - 2002

Importance classification:

Not very important. It reiterates the “scheme of profit-making” principle.

Facts:

The taxpayer company owned a farm from which significant quantities of building sand were sold. The taxpayer entered into a written agreement with a contractor to excavate and remove such sand for a fixed sum per cubic metre of sand removed. The written agreement granted the contractor the right to acquire the entire deposit of sand on the farm.

Issue:

Had the taxpayer disposed of the right to acquire the sand on its farm in a single transaction which did not constitute the carrying on of a business or had it conducted the business of selling sand and had done so in carrying out a scheme of profit-making?

Held:

That while the agreement was one of purchase and sale, the subject-matter of the sale was the sand and not the right to acquire the sand on the farm. That income derived by the taxpayer from the sale of the sand fell to be classified as a gain made by the operation of a business for carrying out a scheme of profit-making. That in order to judge the true nature of the income from the sale of the sand, the enquiry should extend to all the dealings between the parties during the period of about two years over which the payments were received. Viewed in this manner, the multiplicity of the amounts received coupled with the fact that the income was generated by exploiting the resources on what was admittedly a capital asset and was plainly designedly sought and worked for, affords at least prima facie evidence that it was in the nature of revenue and not capital. Accordingly that the taxpayer
had not discharged the onus resting on it in terms of section 82 of the Income Tax Act (now governed by section 102 of the Tax Administration Act).

Notes and lesson:

Be careful of “crossing the Rubicon”. Perhaps the deal could have been structured in a way which would have made the proceeds capital in nature. For example, sold the sand for a lump-sum and in the contract recognising that the sand was part of the land and that by its removal, the value of the land would be decreased. The taxpayer should play a passive role in the extracting of the sand.

- **Sale of business - annuity**

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<th>3.2.3</th>
<th>DEARY v DEPUTY COMMISSIONER OF INLAND REVENUE</th>
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<td>32 SATC 92 (CPD) - 1920</td>
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**Importance classification:**

Important. It illustrates the principle that if a capital asset is sold, for example, goodwill, for an amount which is payable out of the profits of a business generated from the goodwill purchased, the amount payable to the seller is regarded as revenue in nature.

**Facts:**

The taxpayer, who had carried on the business as a general dealer for many years, entered into an agreement with three of his employees under which they, in partnership, would take over his business. The stock-in-trade, furniture and plant were to be taken over by the partnership at valuations to be ascertained. In terms of the agreement the partnership was further required to pay over to the taxpayer one-fourth of the annual profits of the business as consideration for his goodwill for so long as any sum of money was still due and owing to him under the bond. The Commissioner assessed to tax the one-fourth of the annual profits of the business paid over to the taxpayer.

**Issue:**

Was the taxpayer liable for tax on the one-fourth of the annual profits of the business paid to him for the disposal of the goodwill?

**Held:**

That legally, there could not be a valid contract of sale for the goodwill because the price determination was left to the discretion of one party to the transaction. The payment was, therefore, in the nature of income.

**Notes:**

This case is an old case, decided some three years after the introduction of income tax in South Africa in 1917. Nevertheless, it illustrates the importance of looking at the legal terms of a contract – in this case the validity of the sale – to determine the tax consequences. The purchase price must be ascertainable or determined at the time the agreement is made for there to be a valid contract of sale.

Additionally, the taxpayer lost his case, not because the sale of goodwill is not capital in nature but because he received an amount, which is inherently income in nature, namely a share of profits of the business.
Lesson:

The court treated the proceeds from the purported sale of the goodwill as partnership profits. Accordingly, the failure of the taxpayer to have the share of profits for the goodwill classified as capital in nature meant that the taxpayer received an amount in respect of the goodwill on which he had to pay tax while the purchasers paid for the goodwill out of pre-taxed income. This suited the purchasers more than the seller as the purchasers would not have been able to write off the goodwill for tax purposes if the proceeds had not been treated as an annuity in the hands of the seller. This case illustrates the point that negotiations between the contracting parties in regard to the tax consequences of the contract are imperative. The tax profile of each party to the agreement must be considered, for example whether one or both parties have an assessed loss and the negotiations must be conducted in the light of their tax profiles.31

Sale of shares

3.2.4 ANGLOVAAL MINING LIMITED v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE
71 SATC 293 (SCA) - 2009

Importance classification:

Not very important. It, however, reiterates the “scheme of profit-making” principle and applies the principle to share transactions.

Facts:

At the time of its inception, the taxpayer, Anglovaal Mining Limited (previously known as Anglovaal Limited), had two divisions, i.e. a mining division and an industrial division. The mining division consisted of various mining subsidiaries, whereas the industrial division consisted of a 60% shareholding in a JSE listed company called Anglovaal Industries Limited (“AVI”). AVI, in turn, had a number of subsidiaries, one of which was National Brands Limited (“NBL”). NBL housed all the fast moving consumer goods businesses of the group. Apart from the taxpayer’s mining and industrial interests, it traded in shares actively, particularly listed mining shares, thus with a speculative intent. In 1994, NBL purchased the “Willards Foods” snack food business. The taxpayer funded this transaction by way of acquiring a percentage shareholding in NBL for R300 million. The R300 million was in turn raised in the international market by way of a foreign equity placement of the taxpayer’s shares. The direct shareholding by the taxpayer in NBL was inconsistent with the group structure, where shares in an industrial subsidiary would normally be held via AVI. In early 1998, the taxpayer decided to separate its mining and industrial companies. It changed its name to the now known Anglovaal Mining Limited and transferred its shares in AVI to another holding company. At the same time, the taxpayer sold its shares in NBL to AVI and incurred a loss of R159.7 million on the sale of the shares in issue. This loss was incurred during the taxpayer’s 1999 year of assessment and deducted by the taxpayer in its 1999 income tax return. The Commissioner for SARS disallowed the deduction on the basis that the shareholding in issue was of a capital nature. The court a quo (Gauteng Tax Court) had held that the intention of the taxpayer in acquiring the shares in NBL was to hold the shares as a capital investment to derive income therefrom in the form of dividends and that the shares in issue never became trading stock.

Issue:

Was the loss incurred on the sale of the shares of a capital or revenue nature?

31 Broomberg pp 58, 59.
Held:

That to qualify for deduction, the taxpayer’s loss had to be a loss other than a loss of a capital nature. That it had been proved on a balance of probabilities that the shares in issue had been acquired by the taxpayer with the intention of disposing of them at a profit, i.e. such shares constituted trading stock in the hands of the taxpayer. So, it was held that the taxpayer was entitled to deduct the loss incurred on the sale of the shares from its taxable income and that the taxpayer, in computing its income tax liability, had acted in accordance with section 22 of the Income Tax Act.

Notes:

One should not only consider the number and frequency of the share transactions undertaken by a taxpayer. The intention of the taxpayer, supported by the underlying facts, is the cardinal factor.

Lesson:

Shares may be held either for investment purposes or as trading stock. The intention of the taxpayer at the time of acquiring the shares is important. If the shares were acquired with the intention of holding the shares for a long period and to earn dividend income, the proceeds on the sale of the shares will be capital in nature (provided there was no change in intention). If the taxpayer’s intention is to realise a profit from the sale of the shares, in other words, the shares were acquired by the taxpayer to resell at a profit, the profit resulting from the sale of the shares transaction will be revenue in nature. This will be subject to the fact that the taxpayer’s intention did not change from a speculative intent to holding the shares for investment purposes and earning dividends from the investment.

For certain shares (qualifying shares) held by a taxpayer for more than three years, the receipt on disposal of the shares is deemed to be capital in nature (in terms of section 9C of the Income Tax Act).

4 SPECIAL INCLUSIONS IN “GROSS INCOME”

4.1 Paragraph (a) of the definition of “gross income” – Annuities

4.1.1 SECRETARY FOR INLAND REVENUE v WATERMEYER

27 SATC 117 (A) - 1965

Importance classification:

Not very important as the principle decided in the case has been overtaken by legislation. However, the decision circumscribes the meaning of an annuity, which is important for the purposes of paragraph (a) of the definition of “gross income”.

Facts:

The taxpayer, the widow of a former professor of the University of the Witwatersrand, received from the University during the year of assessment under consideration the sum of R300. For some years prior to the death of the taxpayer’s husband, the Council of the University had decided that former members of the staff who had retired on pension should receive in addition to their pension from the University, an ex gratia amount equal to the cost of living allowance which they had been receiving before retirement. After the death of the taxpayer’s husband, the University voluntarily continued the ex gratia payments to her, in recognition of her late husband’s long service to the University. Some years later, the University decided that the amount
paid in the future would be fixed without reference to the cost of living allowance and it was laid down that the payment was subject to review each year and made entirely at the discretion of the Council. The amount paid to the taxpayer was determined at R300 per annum and the taxpayer was informed that the Council hoped to be able to continue this payment for her lifetime.

**Issue:**

Was the *ex gratia* payment made entirely at the discretion of the University an annuity?

**Held:**

That the amount had not been received by way of an annuity as the payments were made each year entirely at the discretion of the University Council and lacked the element of recurrence, based on a right of the beneficiary to receive more than one annual payment, which was an essential feature of an annuity; further, that where *ex gratia* payments are made yearly at the will of the payer, each payment constitutes an individual gift, and, as such, a receipt of a capital nature, unless it is attended by other features which would bring the amount in the character of income; further, that the receipt of the amount in question by the taxpayer was unattended by any features associating it with income and was therefore not taxable.

**Notes:**

These types of payments from employers to the spouses of former deceased employees are now regulated by paragraph (d) of the definition of “gross income”.

**Lesson:**

The award of an annuity, even if capital in nature, is taxable in terms of paragraph (a) of the definition of “gross income” if it is an amount that has been “received or accrued”. Rather structure a capital payment in a manner that does not constitute an annuity to circumvent paragraph (a). Also see the problems encountered in the DEARY case.32

4.2 **Paragraph (c) of the definition of “gross income”**

**COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v KOTZE**

64 SATC 447 (CPD) - 2002

**Importance classification:**

The facts and the principle arising are very important. This case gives us guidelines as to the ambit and application of paragraph (c) of the definition of “gross income”.

**Facts:**

The taxpayer had received the sum of R200 000 from the South African Police after giving them information in regard to the possibility of an illegal purchase of uncut diamonds. He had been approached by the accused to assist them in the perpetration of the crime. The crime was committed and the perpetrators were duly tried and convicted. The taxpayer was aware that “informers” are sometimes paid rewards by the police for information leading to the arrest and conviction of persons involved in illicit diamond buying. However, his reason for going to the police was to protect himself against any appearance of involvement in any criminal activity and

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32 Broomberg pp 153, 170.
to safeguard his name, his business and his standing in the community. It was agreed between the parties that the reward could not be taxed under the general definition of “gross income” because it was an amount of a capital nature. Additionally, because there was no relationship of employer and employee between the police and taxpayer, it followed that the said sum also did not fall into “gross income” in terms of paragraph (i) of the definition of “gross income” read together with the Seventh Schedule to the Income Tax Act.

**Issue:**

Had the reward been a receipt “in respect of services rendered” as provided for in paragraph (c) of the definition of “gross income”? In other words, were the services rendered the causa causans (the direct or proximate cause) of the reward?

**Held:**

The taxpayer had been rewarded for having provided information which led to the arrest and conviction of the accused. The decision in STANDER’S case (you are not required to study this case) was distinguishable as the reward there was from a third party and had the quality of a testimonial or accolade rather than a quality of remuneration for services rendered. In this case the reward was not one of the nature of a testimonial or accolade but as was said in MOORE V GRIFFITHS (INSPECTOR OF TAXES), [1972] 3AllER399(CH), one which had “the quality of remuneration for services rendered” and it was trite that “services need not be rendered by virtue of any contract, nor need the amount received or accrued be by reason of any contract or obligation: it can be a purely voluntary payment.” *(Meyerowitz on Income Tax, paragraph 9.13).* The court reached this conclusion because it was of the opinion that the taxpayer’s motive was to protect himself and that was not worthy of any kind of prize. Furthermore, the reward was paid, albeit after a discretion had been exercised by the Commissioner of Police, to the very person who had provided the police with the opportunity to convict criminals, confiscate a substantial sum of money and reward the taxpayer with a portion of the proceeds; moreover, the discretion could not have been exercised without the prior act of giving of information, which was directly linked to the receipt of the reward to the provider of that information and once the discretion had been exercised, the money was clearly paid in respect of services rendered and not as a reward for good conduct or the exercise of a civic duty.

**Notes:**

As in the STANDER case, there was no employer/employee relationship. Therefore, the Seventh Schedule (fringe benefit legislation) could not apply.

The parties agreed, mistakenly perhaps, that the reward did not fall in the general definition of “gross income” as it was regarded as of a capital nature. However, as with special inclusion paragraph (a) (annuities) of the definition of “gross income”, special inclusion paragraph (c), overrules the general definition and if the capital amount falls in the ambit of any special inclusion, such capital amount is taxable. A further example can be found in special inclusion paragraphs (cA) and (cB) regarding restraint of trade payments, where a restraint of trade is of a capital nature but is taxable in terms of the special inclusion.

This case also emphasises that there must be a sufficient link (“by virtue of”) between the payment received and the services rendered, namely a proximate or direct cause of the payment, or as expressed in Latin, a “causa causans”. If there are two or more causes, the only important cause is the direct or proximate cause. The other causes are disregarded.

Although it is not specifically mentioned in the judgement, the facts as presented to the court might have sunk the taxpayer. The court mentioned specifically that the taxpayer reported the
information to the police, not because he was doing his civic duty, but because he was afraid of being implicated in suspicious criminal activities. This was unlike the civic duty of rescuing a drowning child for which he may have received an accolade or testimonial. The implication is that in the latter case, any reward received would not fall in the ambit of the general definition of “gross income” or in the ambit of paragraph (c).

The case of MOORE v GRIFFITHS mentioned in the judgement, concerned an award given to a footballer (Sir Bobby Moore, the captain of the England team that won the 1966 World Cup) for his participation in the World Cup by his local community. The English court held that the accolade given to him did not constitute “income” and was therefore not taxable.

If one assumes that the case had been decided differently, namely that the amount received was not taxable because it depended on the discretion of the Commissioner of Police, the question to be asked is whether such receipt would be taxable in terms of the Eighth Schedule, that is, be subject to Capital Gains Tax? The answer to this question is difficult. It appears, however, that because the taxpayer would have no legally enforceable right to take the Commissioner to court to secure the reward, there is no asset which has been disposed of, which means there can be no Capital Gains Tax implications. But if the taxpayer had the right to sue the Commissioner, then the right to sue would be regarded as an incorporeal asset and the paying of the compensation would be regarded as a disposal of the asset. Because there is no specific exclusion in the Eighth Schedule for such reward, it would have been subject to Capital Gains Tax.

Lesson:

If an amount is capital in nature as a result of the general definition of “gross income”, the enquiry must not stop there. The special inclusion paragraphs of the definition of “gross income” must also be investigated to ensure that the capital payment amount is not inadvertently caught under one of those provisions. Some brilliant tax avoidance schemes fail this hurdle.

Furthermore, testimonials and accolades given to a person (who is not an employee) in recognition of good sportsmanship, bravery, et cetera would not fall foul of paragraph (c).33

4.3 Officer v employee – “in respect of services rendered”

4.3.1 SECRETARY FOR INLAND REVENUE v SOMERS VINE
29 SATC 179 (A) - 1967

Importance classification:

Important. The facts are not important but the principle established is that an attorney acting on behalf of someone else is not a holder of an office for the purposes of any section of the Income Tax Act where the holder of an office is mentioned.

Facts:

A contract was entered into between a company and a firm of attorneys appointing the partnership as the sole attorneys to the company for six years. The contract was terminated prematurely. The firm of attorneys received an amount in settlement for the early termination of the contract. The attorneys claimed an exemption for a portion of the amount received as compensation in terms of section 10(1)(x) of the Income Tax Act. To be able to claim the exemption, the attorneys had to be employees or the holder of an office of the company.

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33 Williams p 383; Broomberg pp 145, 179.
Issue:

Is an attorney a holder of any office in a company for the purposes of the Income Tax Act?

Held:

That the contract between the taxpayer’s firm and the company created the ordinary professional relationship between attorney and client and did not bring into existence an “office” which had been terminated by the breach of the contract. That in the absence of any payment of salary or remuneration other than the fees payable for professional services rendered and the lack of any right of control by the company over the conduct of the work performed by the taxpayers, the contract between the firm and the company did not constitute the members of the firm employees of the company or the position created by it one of employment.

Notes:

Note that section 10(1)(x) of the Income Tax Act has since been repealed. For the purposes of the other relevant sections of the Income Tax Act, an auditor is not an “officer” of a company and therefore will also not qualify as a holder of an office. A director is an “officer” for the purposes of the Income Tax Act.

Lesson:

An employer/employee relationship and the holder of an office can also result in several adverse and unwanted tax complications such as falling in the ambit of the fringe benefits legislation and consequently PAYE having to be deducted. These complications can be mitigated if the relationship between the contracting parties is described in a way that excludes the employee/employer relationship or holder of any office relationship. Refer to Interpretation Note No. 17 (Issue 3, issued on 31 March 2010)) for additional guidance.

4.4 Recoupments

4.4.1 OMNIA FERTILIZER LTD v COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE

65 SATC 159 (SCA) - 2003

Importance classification:

Very important. Recoupments do not fall under the general definition of “gross income”, but it constitutes gross income in terms of paragraph (n) of the definition of “gross income” in section 1 of the Income Tax Act. Unpaid liabilities are recouped when the taxpayer decides not to pay a liability, which has already been claimed as a deduction. This arises when the taxpayer, for example, decides to write back to profits the unpaid liability.

Facts:

The taxpayer had claimed and been allowed deductions in terms of section 11(a) of the Income Tax Act of expenditure incurred in the production of its income. Such deductions included the purchase price of raw materials bought on credit. Certain of the creditors concerned subsequently failed to claim payment and the taxpayer then allocated such unclaimed amounts to income, half of the purchase price one year later and the other half two years later.

34 Broomberg pp 142, 145, 212.
Issue:

Had the taxpayer effected a “recoupment” in the meaning of section 8(4)(a) of the Income Tax Act, that is, can expenditure, which by reason of the taxation provisions constitutes that which is legally owing but has not yet been paid out can, on these facts, be recouped in the meaning of the section?

Held:

Section 8(4)(a) had to do with the recoupment of amounts and not the extinction of liabilities. The legislature contemplated that a recoupment could occur despite the continuing chance that the taxpayer might after all be called on to pay. The taxpayer should not escape taxation if the alleged expenditure was not to be expenditure after all, whether or not the liability was legally terminated.

However, there may not be a recoupment until the taxpayer takes some or other step to recoup and the crucial enquiry therefore is whether the amount unpaid, but expended in the eyes of the tax law, has nevertheless, for all practical purposes, reverted to the taxpayer’s “pocket” and, in the circumstances, the taxpayer recouped those amounts. The writing back to income constituted an admission by the taxpayer that the amounts had been recouped, by which admission, in the absence of any consideration depriving it of binding effect, the taxpayer must be bound. The non-claiming of the payment by the creditor of amounts already deducted under section 11(a) was thus a recoupment.

Notes and lesson:

This situation of not paying a liability, which has already been claimed as a deduction in terms of section 11(a) must be distinguished from the situation where a taxpayer is paid twice for the same service or goods. If a taxpayer is paid twice for the same service or goods, there can be no recoupment. It can only be taxed in terms of the definition of “gross income”. In coming to a conclusion in this regard, you should refer to the cases on the meaning of “received by”. One can even refer to the theft cases, for example, MP FINANCE, to assist you to come to a conclusion.
CHAPTER 5
THE GENERAL DEDUCTION FORMULA
(study with TL 104 & TL 106)

1 “TRADE”

1.1 General

1.1.1 COMMISSIONER FOR INLAND REVENUE v STANDARD BANK OF SA LIMITED
47 SATC 179 (A) - 1985

Importance classification:
Very important. The principle flowing from this case is that in determining the deductibility of interest one must first determine the purpose of borrowing funds in the first place and whether the purpose was to earn income. If, as a result of borrowing the funds, non-income is produced, for example, local dividends, and the earning of such non-income is merely an incidental activity, then all the interest paid may be deducted. Section 23(f) is not applicable in these circumstances.

Facts:
Interest was paid by a bank on deposits made by the general public. The deposits were utilised to earn income by financing overdrafts and in other ways. The purpose of borrowing the funds was to earn “income” as defined but a relatively small portion of the borrowings were used, reluctantly, to fund “non-income” activities, namely the receipt of dividends on redeemable preference shares, which receipts were exempt in terms of section 10(1)(k) and therefore did not constitute “income” as defined.

Issue:
Should a portion of the interest paid on borrowed funds, which are used to produce non-income as an incidental activity, be disallowed in terms of section 23(f)?

Held:
That the general principles used in deciding whether expenditure is incurred in the production of the income (in terms of the general deduction formula), the important and sometimes over-riding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed. The same general test applies to the provisions of section 23(f) of the Income Tax Act. That a distinction may have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where the taxpayer borrows money generally and on a large scale to raise floating capital for use in his (or its) business. In the first type of case the purpose of the expenditure (in the form of interest) and what it actually affects can be determined and identified readily: a clear and close causal connection can be traced. Both these factors are therefore important considerations in determining the deductibility of the expenditure. In the last type of case, however, and more particularly in the case of institutions like the Bank, there are certain factors that prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that in a general sense the expenditure is incurred to provide the institution with the capital with which to run its business; but it is not possible to link particular expenditure with the
various ways in which the capital is in turn utilized, for example, it is imperative that the bank accepts all moneys tendered to it by depositors and that all moneys borrowed go into a common pool which constitutes a general fund used for all purposes. The borrowed moneys is not aimed at any particular form of utilization – it is rather dictated by the very nature of the institution's income-earning operations of cheaply borrowing all money offered and then dearly lending out as much thereof as it can possibly invest. That applying the above principles, that there was no sufficiently close connection between the Bank's payment of interest and its receipt of dividends on the redeemable preference shares to warrant the conclusion that such payment (or part thereof) constituted expenditure incurred in the production of exempt income inadmissible for deduction under section 11(a) or was an expense incurred in respect of amounts precluded from deduction by section 23(f) because of not constituting income as defined in section 1 of the Income Tax Act.

Notes:

The wording of section 23(f) appears strict and specific. However, the court applied the general test used for determining whether expenditure is in the production of income or not (see the PORT ELIZABETH ELECTRIC TRAMWAY case) and in this case, a liberal interpretation of the section resulted in the favour of the taxpayer.

However, a taxpayer must be aware of section 103(5)(a) which ignores the effect of a “cession” of taxable income for dividend income which is exempt from tax. The dividend income is regarded as ordinary income and a full deduction is available for any interest paid to fund the dividend income.

Lesson:

The section 103(5) anti-tax avoidance provisions only apply in the circumstances outlined in that section, i.e. where a taxpayer has, under a transaction, operation or scheme, ceded his right to taxable income for dividend income and as a result of the cession, his (or another party to the transaction) normal tax liability has been reduced or extinguished. It does not apply in cases that do not deal with the cession of taxable income for dividend income.

2 “EXPENDITURE AND LOSSES ACTUALLY INCURRED”

2.1 General

2.1.1 CALTEX OIL (SA) LIMITED v SECRETARY FOR INLAND REVENUE
37 SATC 1 (A) - 1974

Importance classification, facts and result:

The facts are not very important. The case dealt with a foreign exchange profit arising due to the devaluation of a foreign currency. Goods were purchased and the taxpayer claimed the spot rate of the currency when the goods were received and did not reduce the claim by the amount of the foreign exchange profit under section 11(a).

The court held that it is only at the end of a year of assessment that it is possible to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment. Thus, expenditure incurred during the year of assessment must be quantified and brought to account at the end of that year of assessment or at the date of the discharge of the liability during that year of assessment.
Notes and lesson:

Although the general principle espoused by the court is still relevant today in regard to actually incurred, the facts of that case would now be dealt with under section 24I.

3 "IN THE PRODUCTION OF INCOME"

3.1 Theft by employees

3.1.1 COT v RENDLE
1965(1) SA 59 (RAD) - 1964

Importance classification:

Not very important. It confirms already established principles. For illegal receipts and theft, refer to MP FINANCE GROUP CC in Part A of this tutorial letter.

Facts:

A clerk in an accountant's firm misappropriated trust funds belonging to two clients of the accountant as well as funds belonging to the firm. The Income Tax Special Court allowed a deduction for the misappropriation of amounts collected on behalf of the client companies but disallowed the deduction for the misappropriation of the firm's own funds, holding that "in the absence of evidence as to the circumstances under which the misappropriation had taken place the respondent had failed to discharge the onus of showing that the amount was deductible" (had failed to prove that the amount was deductible).

Issue:

Were the funds misappropriated by the clerk deductible as being a loss incurred in the production of income not of a capital nature?

Held:

That the expenditure "was sufficiently closely connected with the firm's business operations to be regarded as part of the cost of performing those operations". That the validity of the claim "was not affected by the fact that the misappropriation had been made by an employee of the firm and not by a third party" and that because "the expenditure was neither 'once and for all' .... nor made with a view to bringing into existence an asset for the enduring benefit of the firm's trade, it was not of a capital nature".

As regards the amount misappropriated from the firm's own funds, that in the absence of evidence as to the circumstances under which the misappropriation had taken place the respondent had failed to discharge the onus of showing (proving) that the amount was deductible.

Notes:

This decision, given by the then Rhodesian Appellate Division (and thus only of persuasive authority) did not establish that the misappropriation of trust funds by subordinate employees is always deductible and that the misappropriation of the firm's own funds is never deductible. This will depend on the facts of a particular case and the discharge of the onus. It did, however, examine the closeness of the connection of the expenditure with the firm's business operations in allowing the deduction and referred to the normal tests for the capital or revenue nature of the related expenditure.
There is still some academic debate around the question as to whether funds misappropriated by a senior employee will qualify as a deduction. In ITC 1221, 36 SATC 233, the court was of the opinion that theft losses by a managing director, a director or a manager in the position of a proprietor will not be deductible.

ITC 1242, 37 SATC 306, held that "as a prerequisite to deductibility the taxpayer must establish that the risk of the loss which he seeks to deduct from his income is inseparable from, or a necessary ingredient of, the carrying on of the particular business". This case also involved junior employees.

ITC 1383, 46 SATC 90, dealt with defalcations by a senior employee of a bank. It was held that

- the deductibility of fortuitous losses and expenditure depends on the facts of the particular case;
- with losses, the criterion is whether the risk of such loss is inseparable from or a necessary incident of the income producing operations of the particular business;
- there is no logical basis for restricting deductibility to the petty thefts of junior employees, and
- in the ordinary course of its business, a commercial bank must necessarily allow its employees to handle large sums of money; that the risk of theft is inherent in and an inseparable element of such business and that the loss in issue was therefore deductible.

The principles established in the cases discussed thus far are:

- the deduction of fortuitous losses and expenditure depends on the facts of the particular case;
- with losses by misappropriation, the onus is on the taxpayer to establish that the risk of the loss is inseparable from or a necessary incident of the income producing operations of the business;
- where misappropriation by employees is involved, deductibility is not limited to misappropriation by junior employees but that possibly in the case of senior employees, managers or directors, the taxpayer will have a heavier onus to establish the link between the risk and the ordinary operations of the business;
- expenditure arising from the repayment of trust funds misappropriated by employees of the "trustee" firm will be deductible, provided the link between the risk of misappropriation and the ordinary operations of the business is established;
- the nature of the asset misappropriated will determine the capital or revenue nature of the resulting loss.

The cases dealt with above have discussed misappropriations by employees. The position may differ in relation to proprietors, including sole traders, partners, members of close corporations and shareholders. A man cannot steal from himself, so there is no question of deducting thefts by a sole proprietor from his own business. In the case of a partnership, the partnership as such is not a legal entity. In terms of section 24H of the Income Tax Act, each partner will be taxed on his portion of the income of the partnership business and will be entitled to deduct his portion of the deductions or allowances related to that income. The partner misappropriating the assets (as with a sole trader) would not be entitled to deduct his share of the loss. He would instead be taxed on the amounts he had misappropriated (MP FINANCE).

Also, Interpretation Note No. 80 (issued on 5 November 2014) provides guidance on the deductibility of expenditure and losses incurred in a taxpayer’s trade when money is stolen through embezzlement, fraud or theft and the interpretation note confirms the principles established in case law. Each case must be considered on its merits having regard to the particular set of facts. Facts to be considered include, for example the nature of the taxpayer’s...
business, who perpetrated or is suspected to have perpetrated the embezzlement, fraud or theft, the perpetrator’s relationship to the taxpayer and the method used to perpetrate the embezzlement, fraud or theft. One also has to take a wider look than just the taxpayer’s business. In determining if a loss is a risk which is inherent in a taxpayer’s business, consideration must also be given to the general business environment and the industry and type of business in which the taxpayer operates.

4 “NOT OF A CAPITAL NATURE”

4.1 General

4.1.1 BURMAN v COMMISSIONER FOR INLAND REVENUE
53 SATC 63 (A) - 1990

Importance:

Not very important. It is submitted that the decision was incorrectly reached. The majority of the court distinguished between the loans made and the shares subscribed for in a scheme of profit-making. There is a legal difference between the two fundings but in the context of the scheme of profit-making, it is submitted that they should have not been treated differently.

Facts:

The taxpayer was part of syndicate composed of various members, which would acquire and sell properties thereby realising a profit and put them into property development companies in which the members took shares and to which they advanced loans in relation to their respective shareholdings. Various contracts of loan between the taxpayer and the property companies in the group were entered into. The purpose of the loans made was to finance such companies and enable them to purchase fixed property, that is, make provision of working capital. The scheme, however, failed and the taxpayer sought to deduct from taxable income the losses sustained by him on the loans by reason of the insolvency of the companies. The taxpayer’s intention had been that his shares and loan accounts would be sold to a public company as soon as possible. The purchase consideration was to be paid by way of an issue of shares in a public company to the taxpayer. The taxpayer would then have sold the shares in the public company on the market and thereby recouped his expenditure and realised a profit. It was agreed that whatever the taxpayer’s intention, the transactions between him and the property companies were genuine contracts of loan having the usual legal consequences and he became contractually entitled to receive back the capital sums lent.

The taxpayer contended that on the facts, the shares and the loan accounts which he held in the group of companies were held with the intention of reselling them at a profit and the losses incurred were accordingly not of a capital nature as intended by section 11(a). The taxpayer contended that the disposal of the loan accounts should be seen as part and parcel of the shares as they were linked together.

Issue:

Was capital lost fixed or floating (circulating) capital, that is, was the loss of a capital or revenue nature?

Held:

That the loans were made once and for all to the property companies and would have remained as such until purchased by the public company. That whatever the appellant’s intention was,
there was no question but that the transactions between appellant and the property companies were contracts of loan and as between them the appellant became contractually entitled to receive back the capital sums lent. There was no question of the taxpayer’s money “frequently changing its form”. Hence, the moneys lent by the taxpayer to the property companies constituted fixed capital and was thus a loss of capital amounts and not deductible in computation of the taxpayer’s taxable income.

Notes and lesson:

The taxpayer, it is submitted, was very unlucky to lose this appeal by a majority of 3 to 2. Perhaps, the taxpayer had not discharged the onus of proving to the court that the loan and the shares were part and parcel of the total scheme of profit-making. He merely contended that that was the case without proving it.

4.1.2 COMMISSIONER FOR INLAND REVENUE v GENN & CO (PTY) LTD
20 SATC 113 (A) - 1955

Importance classification:

Not very important. The decision followed the PORT ELIZABETH ELECTRIC TRAMWAY case in regard to the meaning of “in the production of income”. It is also authority for the proposition that interest paid on a loan is revenue expenditure and that raising fees are regarded as akin to interest.

Facts:

To facilitate the purchase of local and imported stock-in-trade, the taxpayer company entered into an arrangement with a financier whereby the financier obtained short term loans locally for it. The interest payable on the loans included the interest payable to the lenders and a commission or raising fee for the financier. The taxpayer sought to deduct the interest and the raising fees in the determination of its taxable income for that period. The Commissioner for Inland Revenue allowed the deduction of the interest paid on the moneys borrowed, but disallowed the deduction of the raising fees paid on the ground that such payments constituted expenditure of a capital nature. The Commissioner furthermore contended that as the raising fees were paid for procuring additional working capital (cash), they had been expended in respect of amounts received (cash) which were not included in the term “income” as defined in the Income Tax Act.

Issue:

Did the raising fees constitute capital expenditure? Furthermore, did the receipt of the cash loans constitute “income” as defined because if the loans did not constitute “income” as defined, then the expenditure incurred on raising such loan could not be deducted?

Held:

That no distinction in principle could be made between the interest paid to the actual lenders of the moneys borrowed and the raising fees paid to the company which arranged the loans. That interest paid on money borrowed and used for the purposes of a business constituted expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital. Furthermore, that the prohibition of the deduction of expenditure in respect of amounts not included in the term “income” referred to the outlay on those items of receipts or accruals which were by definition excluded from “gross income” by the exemptions provided under the Income Tax Act, and not generally to amounts falling outside the definition of “gross income”.

Notes:

The court also confirmed that amounts or articles borrowed for the use of a business do not constitute receipts or accruals to the borrower. They are not in the nature or character of income.

Subsequent Special Court cases found nebulous reasons for not following GENN’S case in regard to the decision that, in principle, there is no distinction between interest and raising fees paid.

Lesson:

At a time when money supplies were tight, a raising fee was often used to ensure that a loan was approved. This is not the problem currently and this method of raising a loan is hardly ever used in practice. However, in view of the Special Court’s reluctance to allow raising fees as a deduction in all circumstances, the taxpayer should rather prevent a dispute with SARS and build such fees into the interest charge.35

4.1.3 ITC 1322
42 SATC 272(Z) - 1980

Importance classification, facts, et cetera

Not important. However, the case highlights an important principle, namely that expenditure that is incurred in creating the business of the taxpayer is generally not deductible under section 11(a) as being of a capital nature. Nevertheless, there is statutory relief in such cases. In terms of section 11A, certain pre-trade expenses are allowed as a deduction in the year that trade commences. These include expenditure and losses:

(a) actually incurred prior to the commencement and in preparation of trade; and
(b) which would have been allowed as a deduction in terms of section 11 had the expenditure and losses been incurred after trade had commenced; and
(c) were not allowed as a deduction in that year or any previous year of assessment.

Interpretation Note 51 (Issue 3, issued on 22 July 2014) provides detailed guidance on the deductibility of pre-trade expenditure in terms of section 11A.

4.1.4 STONE v SECRETARY FOR INLAND REVENUE
36 SATC 117 (A) - 1974

Importance classification:

Important. It illustrates the principle that the deductibility of a loss incurred as a result of a loan being irrecoverable, depends on whether the capital lent constitutes the taxpayer’s fixed or floating capital. This is a question of fact. If the capital lost was fixed capital, then the loss would be of a capital nature; if, however, the capital lost constituted floating (circulating) capital, then the loss would be non-capital in nature.

Facts:

The taxpayer (a shareholder and director of a company whose main income consisted of a salary and some interest and dividends from investments) advanced two loans in separate transactions to the borrower for utilisation by the borrower in commercial transactions. Three

35 Broomberg pp 120, 122.
separate and distinct deeds of suretyship were also executed whereby the taxpayer, together with others, signed as sureties for loans to be raised by the borrower from third parties. In all these instances, the borrower undertook to pay the taxpayer a share of the profits to be realised from the proposed transactions that the loans were allegedly designed to finance. It subsequently transpired that the borrower had perpetrated a fraud in respect of all these transactions. Consequently, the taxpayer incurred losses in respect of the loans becoming irrecoverable, as well as in respect of his liability under the suretyship agreements. The taxpayer also incurred legal expenses in attempting to escape liability under these suretyship agreements.

**Issue:**

Were the losses the taxpayer had incurred in respect of the loans and the guarantees, as well as the legal costs incurred, deductible in terms of section 11(a) of the Income Tax Act or were they of a capital nature?

**Held:**

That the taxpayer had *neither been carrying on the business of a moneylender nor of giving guarantees* and that the capital he had risked, could not be regarded as *floating capital*, but formed part of his “fixed capital” and the losses were consequently of a *capital nature*. The *legal costs were incurred to avoid capital losses and were therefore also not deductible*.

**Notes and lesson:**

Where a taxpayer cannot recover a loan and suffers a loss as a result, the loss is only deductible if the loan constituted floating capital of the taxpayer, as opposed to fixed capital.

Where a taxpayer lends money otherwise than in the course of a money-lending business (or a bank), any loss sustained as a result of the loan becoming irrecoverable, will constitute fixed capital in the hands of the taxpayer and will thus be of a capital nature and not deductible for tax purposes.

### 4.1.5 SENTRA-OES KOÖPERATIEF BPK v KOMMISSARIS VAN BINNELANDSE INKOMSTE

57 SATC 109 (A) - 1995

**Importance classification:**

Not very important. It confirms the principle that was established in the *STONE* case, namely that where a taxpayer lends money otherwise than in the course of a banking or money-lending business, any loss suffered is a loss of a capital nature and not deductible under section 11(a) of the Income Tax Act.

**Facts:**

The taxpayer was a short-term insurer that invested the insurance premiums it received in short-term deposits, to ensure that it would always have available funds to pay claims as they arose. A deposit in an amount of R5 million became irrecoverable and the taxpayer claimed the loss as a deduction in terms of sections 11(a) and (the now deleted) 28(2)(c) of the Income Tax Act. The Commissioner disallowed the deduction and the taxpayer’s appeal to the Cape Special Court failed.
Issue:

The question for decision in the Appellate Division was whether the deduction of the R5 million claimed by the taxpayer was allowable in terms of the Income Tax Act.

Held:

That the general deduction formula contained in section 11(a) prevailed over the specific provision in section 28(2)(c) and there was no reason in terms of the legislation to exclude the application of the general deduction formula to a short-term insurer. That it was requisite that, to qualify for a deduction under section 11(a), the taxpayer had to prove that it was a money-lender and that whether a person is a money-lender, is a question of fact. That the business of money-lending required a certain degree of system and continuity about the transactions and a readiness and willingness to lend to all and sundry if they are acceptable to the taxpayer. That the taxpayer did not hold itself out as being prepared to lend money to any eligible borrower, but the initiative to lend always came from the taxpayer. That the taxpayer’s business was short-term insurance, not lending money and while the income it received by way of interest was considerable, the deposits were made in the course of carrying on its insurance business, as an incidental part of it. That the taxpayer did not carry on the business of a bank and did not deal with money as its stock-in-trade, as essentially its business consisted in receiving premiums and meeting claims and the fact that, as an incident of its business it performed some operations of a kind performed by a bank did not mean that it was a banker or analogous to a bank. That, accordingly, the money lost was fixed capital and the loss was of a capital nature and thus not deductible in terms of section 11(a) of the Income Tax Act.

Notes and lesson:

The principle laid down in the STONE case has been reapplied in this case, namely that if a taxpayer lends money, otherwise than in the course of a banking or money-lending business, any losses sustained from lending (for example, loss resulting from loan becoming irrecoverable or loss resulting from giving suretyship) are of a capital nature. The reason is that capital which is lent out is ordinarily fixed capital and not floating (circulating) capital; only where the taxpayer is in the business of banking or money-lending is it circulating capital. This is the case even if the main purpose of the loan was to earn income other than, or in addition to, interest.

Note that a loss resulting from a loan made by a taxpayer where loans form an integral part of the taxpayer’s business or an adjunct or ancillary part of the taxpayer’s business, would also be deductible on the basis that the loan constitutes floating capital of the taxpayer and would accordingly be of a revenue nature and thus deductible in terms of section 11(a) of the Income Tax Act.

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36 Williams p 561.
37 Williams p 561.
CHAPTER 6
OTHER MISCELLANEOUS CASES

1 TRUSTS: Conduit pipe principle (study with TL105)

1.1 ARMSTRONG v COMMISSIONER FOR INLAND REVENUE
10 SATC 1 (A) - 1938

Importance classification:
Important from the facts and the principle that emerges from the decision based on the facts. This case confirms the “conduit pipe” principle in regard to trusts, namely that income derived by a trust does not lose its identity when it is received by the beneficiary, for example local dividends normally retain their exempt tax status identity when received by the beneficiary from a trust.

Facts:
Under the will of her husband, the taxpayer was entitled to receive during her lifetime the whole of the net income of the residue of his estate. Shortly after his death, a family arrangement was entered into, under which the taxpayer’s interest was vested in a trust. The trustees were obliged to pay to the taxpayer £2,000 tax-free each year. The balance of the income, after providing for tax of £469 on the £2,000 and other expenses, was divided between the taxpayer’s daughters.

For the year of assessment, the taxpayer returned an income of £2,469 and her return indicated that of this sum £1,495 was derived from dividends and £974 from rents and interest. The Commissioner for Inland Revenue levied normal income tax on the whole amount of £2,469 returned by the taxpayer, disregarding the allocation made to dividends which were exempted from normal income tax by the provisions of section 10(1)(k) of the Income Tax Act, No 40 of 1925.

Issue:
Was the portion relating to the dividends received by the beneficiary exempt from tax?

Held:
That the intervention of a representative taxpayer to receive the dividend from the company for the benefit of the ultimate beneficiary did not deprive the beneficiary of the exemption provided for by section 10(1)(k) of the Income Tax Act, No 40 of 1925 because the dividend did not lose its character as a dividend when the trustees paid it over to the taxpayer. That the difficulties in applying the exemption in such a case as that of the taxpayer, where only a portion of the exempted amount was allocable to a certain taxpayer, were of an administration nature only and not of law and could be overcome by bookkeeping and arithmetical calculation.

Notes:
As can be seen from the facts of the case, the £2,000 per annum appears to be an annuity. Section 10(2)(b) provides that the exemption available for dividends in terms of section 10(1)(k) is not available in respect of any portion of an annuity. Thus, the ARMSTRONG decision would obviously be different if the same facts were to be presented today in the light of section 10(2)(b).
Lesson:

Be careful when advising a client about annuities, be it from a trust or other entity – the payment could lead to unexpected tax complications.\(^{38}\)

2 RECOUPLMENTS (\textit{study with TL106})

2.1 General

2.1.1 COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICES \textit{v} PINESTONE PROPERTIES CC

63 SATC 421 (NPD) - 2001

Importance classification:

Important. The decision illustrates the ambit of the recoupment provisions of section 8(4) in relation to repairs and maintenance on property, which was subsequently sold.

Facts:

The taxpayer purchased a commercial property and effected certain repairs after there had been a fire and the building was damaged. At the time of the fire repairs, it was found that, unrelated to the fire, the concrete slabs between floors had been weakened and needed to be reinforced. The taxpayer claimed and was allowed the deductions on the cost of the repairs in terms of section 11\((d)\) of the Income Tax Act. Within a year of completing such repairs, the taxpayer sold the property because it could not find any tenants. The property was sold at a profit.

Issue:

Did the sale of such property at a price greater than its cost represent a partial or total recoupment of such cost in the meaning of section 8(4)(a)?

Held:

That the onus was of no relevance to the enquiry in this case because unless the taxpayer could be shown to have “recovered or recouped” the cost of the repairs, the amount which the Commissioner sought to add back to the taxpayer’s income for tax purposes could not be taxable. That it was not an automatic consequence that repairs to a property necessarily improved its value and certainly not repairs which may have been done some time before its sale and that was the fundamental fallacy in the Commissioner’s stance. That if the taxpayer sells his property, is the Commissioner entitled, merely because he sells it at a profit, to claim that the taxpayer has recouped the cost of the repair in issue or, for that matter, other minor amounts expended on other kinds of maintenance? He cannot so claim unless it can be shown by facts other than the mere sale at a profit greater than the costs of the repairs and maintenance that there has in fact been a recoupment thereof. That, accordingly, the facts relied on by the Commissioner do not establish, even \textit{prima facie}, that the taxpayer had recouped the cost of the repairs merely by virtue of the sale of the property at a profit.

Notes:

It is interesting to note that the court put the onus on the Commissioner to show that an amount previously allowed to be deducted has been recovered or recouped by the

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\(^{38}\) Broomberg pp 18, 241.
taxpayer. This is one of the few exceptional instances where the onus, in terms of section 82 (now section 102 of the Tax Administration Act), is not placed on the taxpayer. The court had good reason for following this route – Feetham JA in the BUTCHER BROS case, had decided in similar circumstances that the onus is on the Commissioner to establish an amount. It is only after an amount has been established that the onus then rests on the taxpayer.

Lesson:

This decision, if not properly understood, may influence a seller, just prior to selling a property which is occupied for the purposes of trade, to effect repairs to the building and then sell the property at an enhanced value. The repairs would be claimed as a deduction in terms of section 11(d) and the enhanced proceeds on sale would be claimed as a capital profit.

However, the seller must be very circumspect because if the Commissioner is able to show that part of the sale proceeds relate to the cost of the repairs incurred by the seller, then such portion of the proceeds will probably become recoupable and thus taxable. In this case, the Commissioner determined the recoupment as the difference between the selling price and the historical cost of the building, limited to the amount of the cost of the repairs. This very simplistic basis of determining the recoupment was found by the court as being insufficient to establish if any amount had been recouped. If the Commissioner had used a more scientific method in an attempt to establish the amount of the recoupment, he may have been more successful in his endeavours.39

3 ASSESSED LOSSES (study with TL106)

3.1 ITC 1830
63 SATC 421 - 2007

Importance classification:

Not very important. The principle established in this case is that, not only is the trade requirement necessary for a company to be able to set off its balance of assessed loss incurred in the previous year of assessment, but income must also have been received by or accrued to the company in the current year of assessment, for the company to satisfy the set-off requirements of section 20(1) of the Income Tax Act. However, there are contradicting judgements and one must consider the provisions of Interpretation Note No. 33: Assessed losses: Companies: The “trade” and “income from trade” requirements (Issue 4, issued on 22 July 2014). Although not binding in law, SARS’ view is clear in this interpretation note, namely that, as long as a company has proved that a trade has been carried on during the relevant year of assessment, the company will be entitled to set off its balance of assessed loss from the preceding year of assessment, irrespective of the fact that income has not accrued during the year from the carrying on of that trade. Note that the company must discharge the onus (prove) that it did in fact trade during the year of assessment.

Facts:

The taxpayer company was primarily engaged in the business of awarding licences to the security industry for the use of a computer programme, which it had developed, known as the CT Programme. The taxpayer had an accumulated assessed loss of R3,338,742 brought forward from its 2003 year of assessment, which had been principally made up of development expenditure in respect of the CT Programme. In its 2004 year of assessment, it had incurred a

39 Broomberg pp 45, 126.
further loss of R424,057 and the only income for that year was R12,302 in respect of interest plus small amounts of sundry income, all of which was unrelated to trading. SARS disallowed the set off of the taxpayer’s balance of assessed loss brought forward from 2003 on the basis that no income was received by or accrued to the taxpayer during its 2004 year of assessment.

Issue:

Is a receipt or accrual of income a pre-requisite for the set-off of an assessed loss as provided for in terms of section 20(1) of the Income Tax Act?

Held:

That income must have been received by or accrued to the taxpayer in the relevant year of assessment for the taxpayer to satisfy the set-off requirements contained in section 20(1) of the Income Tax Act.

Notes and lesson:

The judgement in ITC 1830 seems to contradict the view expressed in Interpretation Note No. 33 (Issue 4, issued on 22 July 2014): “Assessed losses: Companies: The “trade” and “income from trade” requirements” and although interpretation notes are not binding in law, one must consider them, as they express SARS’ view, which should reflect the intention of the legislation. The status of the law as far as the set-off of a balance of an assessed loss is concerned, is as follows:

Section 20 of the Income Tax Act contains both a “trade” requirement and an “income from trade” requirement. However, if a company clearly trades during a year of assessment (the onus is on the taxpayer to prove this), the company will be entitled to set off its balance of assessed loss from the preceding year of assessment, irrespective of whether income has been received by or accrued to the company during the year of assessment from the carrying on of that trade. However, if it is not clear that the company has carried on the trade during the particular year of assessment, this concession will not apply and the company will have to meet both the “trade” requirement and the “income from trade” requirement.

In ITC 1830 the “trade” requirement was never argued before the court and it was assumed that this requirement had been satisfied. It is submitted that, if the “trade” requirement was the issue for determination by the court and the taxpayer discharged the onus of proving that it did carry on its trade during the year of assessment in question; SARS would not have invoked the second requirement of “income from trade”.

4 VALUE-ADDED TAX (study with TL103)

4.1 ITC 1852
73 SATC 253 - 2011

Importance classification:

Not very important. This case illustrates the application of the wide definition of “services” for the purposes of a taxable supply in terms of the Value-Added Tax Act, No 89 of 1991. Furthermore, the court looked at the meaning of the proviso under section 11(2)(f).
Facts:
The taxpayer (vendor) carried on an enterprise as a liquor wholesaler and had been awarded an exclusive distribution right to buy and sell certain defined whiskies in the designated territory for a fixed period. Before the expiry of the contract, however, the taxpayer had voluntarily entered into a termination agreement ending its distribution right. The taxpayer accordingly received a lump sum payment of R67 million as compensation for the premature termination of its distribution right.

Issue:
Had there been a taxable supply? If so, is such supply subject to VAT at the rate of 14% or zero per cent (section 11(2)(l) of the Income Tax Act)?

Held:
That by agreeing to the early termination of its distribution right, the vendor had surrendered its right to exclusively distribute the whiskies in issue and such surrender constituted “services” as defined in section 1 of the Value-Added Tax Act, No 89 of 1991 (“the VAT Act”), which had been voluntarily “supplied” as defined (the conclusion of the termination agreement constituting the “supply”) in section 1 of the VAT Act. The vendor had supplied services on which VAT was chargeable. In regard to the application of section 11(2)(l) of the VAT Act, that the services in issue were supplied to a person not resident in the Republic and that the services were not the acceptance by the vendor of a restraint against the carrying on of an enterprise in the Republic but the issue was whether the services supplied by the vendor were supplied directly in connection with movable property situated inside the Republic at the time the services were rendered. It was held that the services were not supplied directly in connection with movable property situated inside the Republic at the time the services were rendered and hence the supply of services was subject to VAT at the rate of zero per cent in terms of the provisions of section 11(2)(l) of the Act.

Notes and lesson:
Section 11(2)(l) of the VAT Act provides that services supplied to a person who is not a resident of the Republic are to be zero-rated provided that such services are not services which are supplied directly in connection with movable property situated inside the Republic at the time the services are rendered.

In ITC 1852 it was common cause that the services had been supplied to a non-resident in the Republic and that the services were not the acceptance by the appellant of a restraint against the carrying on of an enterprise in the Republic. The issue was whether the services were supplied directly in connection with movable property situated inside the Republic at the time the services were rendered.

The court’s decision that the supply of the services was not directly in connection with movable property situated in the Republic, was based on the following:
- The surrender of the exclusive distribution right, which constitutes the supply of the services, cannot at the same time constitute the movable property referred to in the proviso.
- The exclusive distribution right was predominantly exercised by the taxpayer in South Africa but on the evidence before the court, the contractual right surrendered by the taxpayer was not situated inside the Republic (the grantor of the right and the contractual debtor being a non-resident). There was therefore no proof for the submission that the right in question constituted “movable property situated inside the Republic at the time the services were rendered”.
TERMINOLOGY LIST

This tutorial letter contains some Latin terminology used by the courts. The following table contains an explanation of some of the terms used. The aim of this list is to assist you in reading the content and is not examinable.

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<th>Latin terminology</th>
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<td>in the case of doubt, benefit must be given to the person sought to be charged (“against treasury/fiscus”)</td>
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<td>quid pro quo</td>
<td>something given in return</td>
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<td>in duplum rule</td>
<td>limitation of interest up to capital sum of loan</td>
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<td>inter vivos trust</td>
<td>a trust created during the lifetime of the founder</td>
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<td>court a quo</td>
<td>the court (previous court)</td>
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<td>conduit pipe principle</td>
<td>in context of a trust being a conduit pipe through which income flows, i.e. the income retains its identity in the hands of the beneficiaries</td>
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<td>causa causans</td>
<td>proximate or direct cause</td>
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<td>novus actus interveniens</td>
<td>a new intervening factor</td>
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<td>obiter dicta</td>
<td>a judge's expression of opinion uttered in court or in a written judgement, but not essential to the decision and therefore not legally binding as a precedent; an incidental remark.</td>
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<td>ultra vires</td>
<td>beyond one's legal power or authority.</td>
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