

Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd: A practical problem of source

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ABSTRACT

Lever Brothers, the South African tax case that formed the basis of this research, was concerned with determining the source of interest income. In its time, this was one of the landmark cases and established tax principles that were valid for 54 years, until superseded by changes to legislation.

The research presented a critical analysis of the three judgments in the case, exposing weaknesses in each. It also provided a condensed account of the history of the company, the historical era in which the transactions giving rise to the case took place, a glimpse into the lives of the judges, as well as a discussion of the development in South Africa of the rules for determining source. The most important focus of the research was the discussion of the use and validity of the practical man principle, and it was concluded that this principle should be applied, not in lieu of legal theory, but to restrain its unbridled use when unjust results would ensue.

Key words: Lever Brothers and Unilever; South African income tax; source of income; interest; the “practical man”; the “reasonable man”; Chief Justice E.F. Watermeyer; Judge of Appeal O.D. Schreiner; Acting Judge of Appeal, R.P.B Davis

For the person whom Lord Atkin¹ had in mind was the practical man and not the legal theorist who, by resolutely shutting his eyes to all the facts, could prove that black was white.²

The *Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd* case (referred to as “the *Lever Brothers* case”) dealt with the question of determining the source

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¹ Lord Atkin was the Judge in *Rhodesian Metals Ltd (in Liquidation) v COT*, 1940 AD 432, 11 SATC 244.

² Davis AJA in *Lever Brothers* at 23.

of interest income and, in spite of the fact that most of the decision is no longer relevant, it is important for the opportunity it presents to criticise the “practical man” principle as applied in a number of cases dealing with the source of income. In the *Lever Brothers* case, each of the three judges referred to the practical man in his judgment but, just as the judgments of the three judges differed (Watermeyer JA, Schreiner JA and Davis AJA), so each described a different hypothetical conclusion that this practical man might have arrived at, based on the facts of the case.

In its time, the *Lever Brothers* case set a lasting precedent in South African income tax law that not only established the basis on which the source of income earned in the form of interest should be determined, but also, it is submitted, established a two-step test that can still be used when interrogating the source of other classes of income. But the *Lever Brothers* case also provided the opportunity to explore the extraordinary story behind the case: the company, the historical era and the personalities involved, and in this way to add colour to the facts of the case and the legal arguments.

The *Lever Brothers* case therefore provides the foundation for a discussion which aims to achieve the following goals:

- to discuss the facts of the case and analyse the judicial arguments presented in the case;
- to enhance the scholar’s interest in and understanding of the case by placing it within its historical context, sketching the history of one of the largest groups of companies in the world and providing a brief portrait of the judges involved in the case;
- to explain the development of the source rules in South African income tax law subsequent to the case; and
- to discuss the use of the practical man principle in tax law and compare its use with the “reasonable man” principle applied in civil and criminal law.

In addition to the pedagogical contribution referred to in the introduction to this series of articles, this article makes a significant contribution in the field of taxation. The discussion of the facts of the case and the in-depth analysis of the three judgments will, to a certain extent, challenge the established interpretation of the *ratio decidendi* of the judgment. While a great deal has been written on the source of income in various jurisdictions,³ no research could be identified that

3 For example: Dinnison, I. 1995. *Australia Relies on Residence*. International Tax Review. Volume 6, 34; Halyard, A.J. 1990. *Hong Kong Profits tax: The Source Concept: Part II*. Hong Kong Law Journal. Volume 20, 320; Liang, T.W. 1990. *Source of Interest: Section 10 and Section 12(6) of the Income Tax Act*. Malaya Law Review. Volume 30, 393; Hern Kuan, L. 1992. *Income Tax – Source Principal Refined?* Singapore Journal of Legal Studies, 566–578.

dealt specifically with the practical man principle in South African tax law.⁴ As this principle is frequently referred to in judgments, the critical analysis of its use makes an important contribution.

The article proceeds as follows: first a brief history of the company is presented; this is followed by an analysis of the facts of the case. The facts of the case are further explained by placing them in the context in which the case arose and was heard. Then a critical analysis of the judgment is conducted, together with a presentation of a “thumbnail” sketch of the judges involved. An exposition of the development of the source rules from the date of the *Lever Brothers* case follows and, finally, an analysis and critique of the practical man principle concludes the discussion.

Lever Brothers and Unilever: the company

William Hesketh Lever, a business giant, philanthropist and art collector, who died in 1925 as Viscount Leverhulme, was the founder of the *Lever Brothers* business empire.⁵ He started out in 1867 at the age of 15, working for his father in his grocery business, and became a partner five years later. With his prodigious energy and vision, he recognised the marketing opportunity in branding and packaging, and *Sunlight* soap was born in 1884 (it is still a popular brand today). His first business decision was to cut out the middleman, initially, by buying soap directly from the producers and then, in 1885, producing the soap himself in a rented factory in Warrington (England). Soon, owing to his astute use of advertising, demand quickly outstripped supply, and in 1887, he bought an open site at Bebington, the Wirral, which offered a river frontage for importing raw materials and a railway close by for transporting the finished product, and built a factory at what became known as Port Sunlight.

William Lever was not only a business pioneer, but a pioneer in recognising corporate social responsibility. He introduced a wide range of employment benefits, including pensions, sickness and unemployment insurance, shorter working weeks, holidays with pay, dining rooms for his employees and medical and recreational facilities, and he housed his employees in a model village of well-built homes on the factory site. The *Lever Brothers* product range and the production sites expanded rapidly (some of the brands are still in existence), and by 1910, there were factories

4 Other than: Grenville, D. 2014. *A Critical Analysis of the Practical Man Principle in Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd*. Unpublished master's degree thesis. Grahamstown, Rhodes University.

5 Wilson, C. 1954. *The History of Unilever. A Study in Economic Growth and Social Change*. London: Cassell & Company Ltd.

all over the world. The company diversified into making margarine, and in 1929, *Lever Brothers* merged with the *Margarine Union* (an amalgamation of mainly Dutch companies) and *Unilever* came into being.

This was the group of companies that shortly before the outbreak of the Second World War entered into the transactions that gave rise to the *Lever Brothers* case.

The facts of the *Lever Brothers* case⁶

Lever Brothers and Unilever Ltd and *Associated Enterprises Ltd*, two English companies, were assessed for South African income tax for the 1940 to 1942 years of assessment on money received by them from *Overseas Holdings (Pty) Ltd*, a South African company. As the parties had agreed that the position of *Lever Brothers and Unilever Ltd* and *Associated Enterprises Ltd* was similar and therefore one case would settle the dispute in both, the judgment referred to the two companies as “*Levers*” and the third company as “*Overseas Holdings*”.

On 31 December 1937, an agreement was entered into at Rotterdam, Holland, between *Levers*, an English company, *Mavibel (Maatschappij voor Internationale Beleggingen N.V.)*, a Dutch company (a subsidiary of *Lever Brothers and Unilever NV*, also a Dutch company), and a trustee company in England, *The Whitehall Trust Ltd*. The agreement was amended in April 1939 by a further agreement entered into at Rotterdam, and the effect of the two agreements was that *Levers* sold and transferred certain shares to *Mavibel* and ceded debts to *Mavibel*, in return for which *Mavibel* paid an amount in cash and became liable to *Levers* for the sum of £11 000 000, payable on or before 31 December 1961. *Mavibel* agreed to pay interest on this sum, and as security for the amount owing, transferred to or deposited with the trustee shares in an American company, *Lever Brothers Company of Boston*.

The agreement contained a number of clauses which gave *Levers* effective control over the shares. The trustee could not transfer or deal with the shares unless the debt had been fully paid, and if *Mavibel* failed to perform any of the obligations, the trustee would hold the shares on behalf of *Levers*, the debt would be cancelled and any excess of the value of the shares over the debt would be adjusted by a money payment. Another clause provided for circumstances in which the shares would be held by the trustee on behalf of *Levers*:⁷

In the event of any war, rebellion, civil commotion or political or constitutional disturbance or change affecting England the Netherlands or any country in which any of the Companies

6 14 SATC 1 at 3.

7 14 SATC 1 at 4.

or Corporate Bodies whose capital comprise any of the Shares are domiciled or any law being passed or any act being done as a result of which the property in the Shares or any benefits directly or indirectly receivable therefrom would . . . pass to any Government or to any third party or the rights . . . or the beneficial ownership of the Pledged Shares . . . being for any reason in jeopardy or likely to be jeopardised . . . "the emergency" . . . [the shares would be held by the Trustee on behalf of Levers].

Clearly the companies included this clause at a time when the outbreak of war was a distinct possibility. Then on 15 March 1939, on the instructions of *Levers*, *Overseas Holdings* was incorporated in the (then) Union of South Africa. On the same day, a second company, *Internationale Maatschappij voor Handel en Nywerheid Beperk*, was also incorporated in the Union. This second company held the shares in *Overseas Holdings*, and the effective control over the shares of this second company was in the hands of *Lever Brothers and Unilever Ltd N.V.* and *Associated Enterprises*. A number of agreements were entered into in March 1940, the effect of which was that *Overseas Holdings* bought from *Mavibel* their entire interest in the shares held as security by *The Whitehall Trust* and, subject to certain modifications, stepped into the shoes of *Mavibel*. One significant modification related to the place of payment, previously at *Mavibel's* registered office in Rotterdam, but then at *Levers'* registered office in England by sterling cheque in London. None of the agreements giving rise to the indebtedness and the liability to pay interest were entered into in South Africa (which Watermeyer CJ, in his judgment, considered to be relevant). The agreements were, however, assented to by the Union Treasury on condition that no payment of capital or interest would be made by *Overseas Holdings* from assets in the Union.

Overseas Holdings paid the interest due to *Levers* in London in each of the years 1940 to 1942 out of dividends received in the United States of America on the American shares they held. It was this interest that the Commissioner assessed to income tax in South Africa. The matter was finally brought on appeal to the Appellate Division of the Supreme Court (now the Supreme Court of Appeal). The Commissioner's claim was that the interest was not a capital receipt (irrelevant for the purposes of the present article), the interest was due on a loan made to a company incorporated in South Africa, the "source" of interest paid on a loan of money is the principal debt and the debt is regarded in law as being located where the debtor resides.

Lever Brothers and the Second World War: the historical context⁸

When the first agreement was entered into between *Lever Brothers* and *Mavibel* on 31 December 1937, it was clear to the directors of both companies that war was

⁸ Encyclopaedia Britannica. 1961. *World War II*. Volume 23. London: Encyclopaedia Britannica Ltd.

imminent. In March 1936, Hitler had marched into the Rhineland and shortly after had become involved in the Spanish Civil War as a proving ground for his military strength and weapons. In March 1938, German troops marched into Austria, and in September 1938, in terms of the Munich Agreement, Germany annexed the Sudetan region in Czechoslovakia. In March 1939, *Overseas Holdings* was incorporated in the Union of South Africa and a few months later, in September 1939, Germany attacked Poland. In the same month, Great Britain and France declared war on Germany. In March 1940, the agreements were entered into which substituted *Overseas Holdings* for the Dutch company, *Mavibel*, and on the 10 May 1940, Holland was invaded by Germany. In the *Lever Brothers* case, Watermeyer CJ speculated that “[p]robably the substitution of Overseas Holdings for Mavibel was effected in order to avert certain consequences which were foreseen if Holland were occupied by the enemy”⁹ It seems clear that this, and this only, was indeed the reason for its incorporation.

Watermeyer CJ’s judgment

Watermeyer CJ started his judgment by quoting the definition of gross income as it then read:¹⁰

“gross income” means the total amount which has been received by or which has accrued to a taxpayer from a source which is within the Union or which is deemed to be within the Union, other than receipts and accruals of a capital nature.

He went on to state that the word “source” is a metaphorical expression and “the sense in which it is used in the Act must be determined”.¹¹ In arriving at the meaning of “source” in the definition of “gross income”, he referred to the two problems (or questions) that arise:

- to determine what the source of “money” received by the taxpayer is (the originating cause); and
- to locate this source.

This is the two-step test that has, it is submitted, stood the test of time.

After relating the facts of the case, Watermeyer CJ proceeded to dismiss the Commissioner’s claim that the source of interest paid on a loan of money is the principal debt, which is located where the debtor resides, stating that¹²

9 14 SATC 1 at 7.

10 Income Tax Act No. 31 of 1941; s 7.

11 14 SATC 1 at 8.

12 14 SATC 1 at 8.

[p]rima facie, this contention appears to be somewhat artificial, because of the figurative language in which it is couched. A debt is a legal obligation, something having no corporeal existence; consequently it can have no real and actual situation in the material world. Metaphorically, however, by a legal fiction it may have a situation in a place, determined by accepted legal rules.

In his complex argument, Watermeyer CJ considered the two aspects of the Commissioner's claim – that the “source” of interest is the principal debt, and the source is located where the debtor resides. He compared the payment of interest on the loan of money to the payment of rent on the lease of fixed property and concluded by stating that a debt represented the legal obligation to repay the loan at the end of the period of the agreement and the claim that this obligation is the source of the interest on the debt is fallacious as, by parity of reasoning, the obligation on the lessee of property to return the property at the end of the period of lease would determine the source of the rent. He concluded:¹³ “Such a conclusion has only to be stated to refute itself and . . . shews to what surprising results the use of figurative language in a legal problem may lead.” He also referred¹⁴ to the fallacy of speaking of a debt carrying interest “as though interest were a sort of growth sprouting from the debt” (an echo of the tree and the fruit analogy used to differentiate capital and revenue income¹⁵).

He concluded¹⁶ that “[a]s a rule the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender”. Watermeyer CJ had therefore answered the first of his two questions: determining the source of the interest. In his discussion of cases dealing with the problem of source, he also noted the statement by Innes CJ¹⁷ that the word “source” denotes “origin” and not “location” and concluded¹⁸ that “‘source’ does not denote the quarter from which the money is received, but the originating cause of the receipt (i.e., the particular activity of the taxpayer which earns money)”.

In his typically thorough fashion, Watermeyer CJ went on to discuss what little precedent there was at the time in South Africa regarding the location of the source

13 *Supra* at 9.

14 *Supra*.

15 *CIR v Visser*, 1937 TPD 77, 8 SATC 271.

16 14 SATC 1 at 10.

17 *In Overseas Trust Co. Ltd. v CIR*, 1925 A.D. 444, 2 SATC 71.

18 14 SATC 1 at 12.

of income, and also referred to cases heard in other jurisdictions, in order to answer the second of his two questions: locating the source of the income. Although he discussed various cases dealing with the vexed question of locating the source of income that might have applied to the factual matrix of the *Lever Brothers* case, Watermeyer CJ did not reach a conclusion based on this discussion. These tests were, however, indirectly reflected in his final judgment.

In the case of *Liquidator, Rhodesia Metals Ltd. v Commissioner of Taxes*¹⁹ Lord Atkin referred with approval to an extract from the dissenting judgment of De Villiers JA in another case:²⁰ “source means not a legal concept but something which the practical man would regard as a real source of income. The ascertaining of the actual source is a practical hard matter of fact”. In locating the source of the interest in the *Lever Brothers* case, Watermeyer CJ accordingly went on to consider the facts of the case. He expressed some difficulty in differentiating the reasoning of the practical man from that of the theoretical lawyer, but nevertheless concluded²¹ that he could not think that “the practical man could ever come to the conclusion that the money came from a source in South Africa”. In reaching his conclusion that the interest was not from a source in the Union of South Africa, he gave the following reasons for his decision:²²

[N]o business was carried on by the respondent company [Levers] in South Africa, no contract was made by them in South Africa, no capital had been adventured by them in South Africa, no services were rendered by them in South Africa and no obligation resting on either party to the agreement had been performed or was to be performed in South Africa . . .

Watermeyer CJ did not conclude in positive terms that the location of the originating cause was where the service was provided (the credit that was made available in England), but in negative terms, with reference to the tests established in the case law that he had discussed.

The judgment of Davis AJA

Davis AJA concurred with Watermeyer CJ that the interest was not from a source within South Africa, but he did not specifically agree that the source was in England. Based purely on an application of the practical man test, he concluded²³ that the one

19 1938 AD 282, 9 SATC 363.

20 In *Overseas Trust Co. Ltd. v CIR*.

21 14 SATC 1 at 17.

22 *Supra* at 1.

23 14 SATC 1 at 21.

place that the practical man would not select as the source of income was South Africa.²⁴

Principles underlying the right of a country to levy tax

Certain countries levy tax on the basis of source, as South Africa did prior to 1 January 2001, while other countries levy tax on the basis of residence, as South Africa now does. In *Kergeulen Sealing and Whaling Co. Ltd. v Commissioner for Inland Revenue*²⁵ (referred to as “the *Kergeulen* case”), Stratford CJ referred to the two principles that must be borne in mind when trying to ascertain the intention of the Income Tax Act in relation to source, which he called the “equitable” principle and the “effective” principle. The *Kergeulen* case was heard in 1939 (prior to the *Lever Brothers* case), and also involved the determination of whether certain income was taxable in South Africa as being from a source within South Africa.

Neither the facts of the case nor the decision are relevant for the purposes of this article. In his judgment in the *Kergeulen* case, Stratford CJ referred²⁶ to the equitable principles “generally found to underlie liability for tax”. He stated that in the case of the residence basis of tax, this principle is²⁷ “that a resident, for the privilege and protection of residence, can justly be called upon to contribute to the cost of good order and government of the country that shelters him” and in the case of a source basis of tax, “the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live”.

In the *Lever Brothers* case, *Overseas Holdings*, incorporated in South Africa, produced no wealth and carried out no income-producing activities in South Africa; it merely paid, in London, the interest on the principal debt that was owing to *Lever Brothers*, using dividends that it had received in the United States of America. Watermeyer CJ could have used this equitable principle described by Stratford CJ in the *Kergeulen* case to strengthen his conclusion that the interest was not from a source within South Africa or deemed to be within South Africa. As he was one of the (concurring) judges in the case, it is surprising that he did not do so.

24 Refer to the discussion of the practical man principle later in this article, where the grounds for Davis AJA's judgment are elaborated on.

25 1939 AD 487, 10 SATC 363.

26 *Supra* at 381.

27 10 SATC 363 at 382.

The second principle that Stratford CJ referred to²⁸ in the *Kergeulen* case was the “effectiveness” principle, which is based on the assumption that the country has effective means to enforce the levy, that is, whether the country has control of the source and therefore the ability to collect the tax. This principle is less relevant in the *Lever Brothers* case, but the government of the Union of South Africa did not have control over the interest paid to *Lever Brothers* or the income used to pay the interest.

The dissenting judgment of Schreiner JA

In his judgment, Schreiner JA confirmed²⁹ that the source of income in general is either some personal activity of the taxpayer, or some property over which he or she has rights or a combination of both and he earns income from other persons because he or she renders services to them, provides them with the use of his or her property, or carries on profit-making activities in the world of commerce and industry. He stated³⁰ that “[i]n common parlance, by which it is a sound rule to judge definitions, the property itself, or . . . its use, is treated as the source of income”. He did not agree³¹ that “we are compelled by authority to find some activity of the taxpayer as in all cases the source of his income”. He then went on to conclude³² that, in his view, there was no good reason for treating the activities of letting property or providing the use of capital to earn interest or dividends as the source of income. He thus dismissed Watermeyer CJ’s use of the “activities” test and indirectly his analogy between granting the use of property and money. In his opinion, where the contract of loan was made and where the interest is payable are not relevant, and essentially the “interest is the “fruit” of the money and comes from where the money is”³³ (again the fruit and the tree analogy that was used in the *Visser* case but, with respect, used incorrectly as this was a test used to distinguish capital and non-capital income).

Schreiner JA went on to discuss³⁴ *Overseas Holdings* and the fact that, not only was the company registered in South Africa, but also the majority of its five directors resided in Durban, South Africa, where the head office of the company was situated. In his view, the place where the transactions were entered into was irrelevant. He

28 *Supra*.

29 14 SATC 1 at 16.

30 *Supra* at 17.

31 14 SATC 1 at 17.

32 *Supra* at 19.

33 *Supra*.

34 *Supra* at 20.

concluded that the source of *Lever's* interest income was the debt itself, or the money of *Levers* in the possession of *Overseas Holdings*.

Schreiner JA then went on to deal with the question of the location of the debt and, although he conceded³⁵ that “the location of an incorporeal in space by a rule of law carries a flavour of artificiality”, in his view “even the practical business man would realise, when the matter was explained to him, that for certain purposes it was unavoidable”. In concluding that a debt exists where the debtor resides, he respectfully agreed with the statement by Lord Buckmaster³⁶ that, “once it is assumed that a debt must have a local situation, it can only be where the debtor or creditor resides”, and the unanimous decision of the House of Lords in that case was that the debt exists where the debtor resides. Schreiner JA amplified this by remarking that if the locality of a debt depends on the place where it is recoverable, *Levers* could undoubtedly sue *Overseas Holdings* in South Africa to recover both the capital and the interest. Thus, while Watermeyer CJ, after carefully considering the decisions in various cases dealing with the source of income, went back to first principles to establish the source of interest in the *Lever Brothers* case, Schreiner JA based his judgment on one decision only, and that from a foreign jurisdiction.

Schreiner JA also dismissed two potential factors that may have had a bearing on the source of income: the place from which the interest came, or the place to which it would go. In his view,³⁷ it was “natural to suppose that [Parliament in the Union of South Africa] envisaged, as the source, the place from which the interest would ordinarily come and not the place to which it would go”, and that the argument was untenable that because most of the actual money used to pay the interest came from the United States of America (a small portion coming from London), the source was not in South Africa.

Watermeyer, Schreiner and Davis

Ernest Frederick Watermeyer obtained his first degree in Mathematics, Oliver Deneys Schreiner obtained a Bachelor of Arts (Honours), with a first in classics, and Reginald Percy Davis also obtained a Bachelor of Arts (Honours) in classics.³⁸ Watermeyer and Schreiner had both obtained their LLB at Cambridge University and Davis at Oxford.³⁹

35 *Supra*.

36 *In English, Scottish and Australian Bank Ltd. v Commissioner for Inland Revenue*, 1932 A.C. 238 at 256.

37 14 SATC 1 at 21.

38 Girvin, S.D. 1996. *The Architects of the Mixed Legal System*, in Zimmerman, R. and Visser, D. Southern Cross: Civil Law and Common Law in South Africa. Cape Town: Juta, at 129.

39 *Supra*.

While practising, Watermeyer was described as a clever lawyer and convincing advocate with the habit of winning cases, possessed of a clear and lucid mind. As Chairman of the Special Income Tax Court for the Cape, it was said⁴⁰ that “[h]is knowledge of mathematics stood him in good stead and his lucid judgment made clear many obscure points in this difficult branch of the Law”. He was also described⁴¹ as “an erudite Roman-Dutch lawyer”. In another article,⁴² he was described as “the youngest and handsomest of the Cape Judges by all members of the fair sex . . . [but this] has not affected his inherent modesty and quiet manners”. Popular and esteemed, to his friends, he was known as “Billy”.⁴³

Schreiner was equally highly esteemed. He had “an extraordinary intellect”, but was not an eloquent speaker.⁴⁴ Ellison Kahn said⁴⁵ of Schreiner that “he was the greatest Chief Justice South Africa did not have”. Schreiner jokingly recounted that he had attended only one lecture on Roman-Dutch law and it was said of him that he professed that he seldom conducted a deep search for the fountains of Roman-Dutch law.⁴⁶ Many instances of his wit and sense of humour have been described by Ellison Kahn.⁴⁷ He tells⁴⁸ of the remark made by Schreiner during the hearing of *Big Ben Soap Industries Ltd v CIR*:⁴⁹ “I thought that the business of this company was boiling soap, not cooking the books.” Kahn also describes⁵⁰ his one extravagance – fairly expensive cars that he was inclined to drive fast. Sir Alfred Denning, returning from a trip to the Kruger Park with Schreiner, said that “until his children were qualified in their careers he would prefer not to be driven by Oliver Schreiner”.

Ellison Kahn describes⁵¹ Davis as one of the two who must have “brought up the rear in the Handsomeness Stakes” (by vote of the Cape Bar in about 1912) and tells of⁵² his “impatient and at times irascible nature . . . [as] reflected in an anecdote according to which he so forgot his judicial dignity as to tackle with an umbrella a man in his reserved seat”.

40 *Mr Justice Watermeyer*. 1923. SALJ at 104.

41 *Supra*.

42 *Mr Justice Watermeyer*. 1933. 2 South African Law Times at 48.

43 *Mr Justice Watermeyer*. 1923. SALJ at 105.

44 *Oliver Deney Schreiner – The Man and his Judicial World*. 1980. 97 SALJ 566 at 591.

45 Kahn, E. 1991. *Law, Life and Laughter. Legal Anecdotes and Portraits*. Cape Town: Juta & Co Ltd, at 219.

46 *Oliver Deney Schreiner – The Man and his Judicial World* at 590.

47 *Law, Life and Laughter. Legal Anecdotes and Portraits*.

48 *Supra* at 220.

49 1949 (1) SA 740 (A).

50 *Law, Life and Laughter. Legal Anecdotes and Portraits* at 220.

51 *Supra* at 103.

52 *Supra* at 35.

In a letter to his wife,⁵³ Schreiner described working with Watermeyer in the following words, which seem to illustrate the respective approaches of these two judges in the *Lever Brothers* case:

The work is markedly more thoroughly done than when one sits in the Provincial Division . . . [Some] matters are heard . . . that one would be ready to dispose of in a rough and ready fashion without much delay, but we go over them with the utmost care and choose the words . . . that leave no room for mistake . . . The Chief, Billy, is a very wise judge with a big and well-stored brain. He guides our discussions with the artistry of a company chairman.

In another letter to his wife, Schreiner⁵⁴ mentions that Davis had told him that he “had never disagreed with his great friend Watermeyer in the decision of a case”, which Schreiner had found to be an “amazing statement”.

It was possibly also Watermeyer’s early training in mathematics that explains his preference in the *Lever Brothers* case for making his decision based on first principles and a set of normative tests to determine that the source of income was *not* within South Africa and to discount the value of the views of the practical man. Schreiner, who by his own admission had attended only one lecture in Roman-Dutch law, referred to only one earlier decision in support of his conclusion and placed greater weight on this practical man’s hypothetical viewpoint. Davis did not disagree with “his friend” Watermeyer.

The source principle, subsequent to the *Lever Brothers* case

The decision in *Lever Brothers* case has lost some of its relevance. One of the reasons for this is the amendments that were made to the Income Tax Act. At the time the case was heard, South Africa taxed on the basis of source – that is, income from a source within South Africa or deemed to be within South Africa (the definition of “gross income”⁵⁵). Section 9(1) of the Act⁵⁶ provided for certain categories of income that were deemed to be from a source in the Union, but this deeming provision did not include interest. The tests that Watermeyer CJ developed in the *Lever Brothers* case therefore applied for 54 years, from the date the case was heard until the introduction in 1998⁵⁷ of Sections (6) and (7) of Section 9 into the Act, which dealt, *inter alia*, with the source of interest.

53 Supra at 336.

54 *Law, Life and Laughter. Legal Anecdotes and Portraits* at 35.

55 Section 7 of the Income Tax Act No. 31 of 1941.

56 Income Tax Act No. 31 of 1941.

57 Section 25(1)(b) of the Taxation Laws Amendment Act No. 30 of 1998.

On 1 January 2001, South Africa changed the basis on which it levied tax to that of residence. The definition of “gross income”⁵⁸ was changed with the effect that residents are taxed on their worldwide income and non-residents on income from a source within or deemed to be within the Republic (the phrase “deemed to be within” was deleted with effect from 1 January 2012). Sections 9(6) and 9(7) remained unchanged until 1 January 2012, when Section 9 was substituted in its entirety and the definition of gross income amended. The new Section 9(2)(b) provides that an amount *is* received by or accrues to a person from a source within the Republic, if that amount constitutes interest that is attributable to an amount incurred by a person who is a resident (other than interest attributable to a permanent establishment outside the Republic), or is received or accrues in respect of the utilisation or application in the Republic by any person of any funds or any credit obtained in terms of any form of interest-bearing arrangement.

Double tax agreements entered into between countries also affect the source rules of the respective countries, as they allocate taxing rights to the countries, based on certain attribution rules. In South Africa, Section 108 of the Income Tax Act provides that the National Executive may enter into any agreement for the prevention of or relief from double taxation with the government of any other country. After approval by Parliament and publication in the *Government Gazette*, they have the same effect as if enacted in the Income Tax Act. The allocation of taxing rights in terms of a double tax agreement therefore takes precedence over the South African source rules. No double tax agreements had been entered into between the Union and the United Kingdom or the Netherlands at the time the *Lever Brothers* case was heard. The double tax agreement between South Africa and the United Kingdom only came into force from 20 January 1971, while the double tax agreement between South Africa and the Netherlands only came into force from 17 December 2002.

The income tax legislation as it now applies would have meant that, today, the interest paid by *Overseas Holdings* to *Lever Brothers* would have been taxed in South Africa, as the amount would have been incurred by a resident as defined. Nevertheless, Watermeyer CJ’s decision in the *Lever Brothers* case held sway from 1946 until 1998 and the test used to locate the source of the supply of credit (the originating cause), as “the place where the credit is made available”, was universally applied by tax academics and scholars, despite the fact that, based on the facts of the case, his decision was couched in negative terms. Part of Watermeyer CJ’s decision still stands today. In cases dealing with source, where there are no legislated provisions, the two-step test – identifying the originating cause and then locating it – is still relevant.

58 Section 1 of the Income Tax Act No. 58 of 1962.

The practical man principle⁵⁹

The practical man has made its appearance in a number of cases dealing with the source of income. In *Liquidator, Rhodesian Metals Ltd v Commissioner of Taxes*,⁶⁰ Stratford CJ quoted from the Australian Courts:

the question (as to the source) must be decided as a practical matter of fact . . . Source means, not a legal concept, but something which a practical man would regard as a real source of income; the ascertainment of the actual source is a practical hard matter of fact . . .

In *Rhodesian Metals Ltd (in Liquidation) v Commissioner of Taxes*,⁶¹ it was held that “the question of source must in every case be determined by the facts of that case as a hard matter of fact”. This statement was again quoted in *Liquidator, Rhodesian Metals*.⁶² In the *Lever Brothers* case, each of the three judges referred to the practical man, but each applied the principle in a different way in interpreting the facts of the case.

Watermeyer CJ, after referring⁶³ to Lord Atkin’s admonition that “the question be asked what would the practical man regard as the real source of income”, expressed some difficulty in differentiating the reasoning of the practical man from that of the theoretical lawyer. Schreiner JA had a different view of what the practical man would have concluded, based on the facts of the case. He first refers⁶⁴ to the “flavour of artificiality” that the law exhibits in locating an incorporeal in space, but concludes that “even the practical *business man* . . . would realize, *when the matter was explained to him*, that for certain purposes it is unavoidable” [emphasis added]. Later⁶⁵ he again refers to the “practical business man” whose “hypothetical views on these matters are said to be entitled to great weight”, and expresses the opinion that this practical business man, having been informed that the Statute made it necessary to fix the local situation of the interest-bearing debt, would have “expressed a *tentative layman’s view* in favour of placing it at the residence of the debtor [but that] he would indicate that the *obvious thing to do was to ask a lawyer*” [emphasis added]. His final word⁶⁶ on the value of the opinion of the practical man was that it would not provide much assistance. Schreiner JA, even when limiting the practical man’s opinion to that of a

59 This section of the article is based loosely on the discussion in *A Critical Analysis of the Practical Man Principle in Commissioner for Inland Revenue v Lever Brothers and Unilever Ltd*, written by one of the co-authors of the article.

60 1938 AD 282, 9 SATC 363 at 379.

61 1940 AD 432, 11 SATC 244 at 245.

62 At 249.

63 14 SATC 1 at 17.

64 14 SATC 1 at 21.

65 *Supra* at 23.

66 *Supra* at 23.

business man and after the matter had been explained to him, and having conceded that the view of the practical man carries great weight, considered that his opinion would be of little value in the present case.

Davis AJA,⁶⁷ while concurring with Watermeyer CJ's decision, appears to have based his entire judgment on what the practical man would have thought. He referred to the approval of the "practical man test" by the Privy Council in *Rhodesia Metals (in Liquidation) v CIR*, which he "felt bound to adopt" and concluded that he had "little doubt that the practical man would say that the source of Lever's income was the provision by it of assets in America and the giving of credit in England . . . [b]ut the one place he would not choose would be South Africa". Davis AJA emphasised the fact that Treasury had stipulated that no capital or interest could be paid from South African funds and that both Treasury and the practical man knew "as a practical hard matter of fact" that none had been so paid. Furthermore, the debtor possessed no assets in South Africa from which it could be paid. The one place that the practical man would not select as the source of the income, therefore, was South Africa.

The markedly different interpretations that these three judges placed on what the practical man would have decided, calls into question the value of the principle⁶⁸ that "source should not be seen as a legal concept; rather emphasis should be placed on what the 'practical man' would regard as the real source of income". This concept was reinforced in the judgment of Schreiner JA when he noted that the "hypothetical views" of the practical business man "are said to be entitled to great weight".⁶⁹ Similarly, Davis AJA adopted "the practical man" with the strongest favour and based his entire judgment on this concept.⁷⁰

The role of the practical man, as noted indirectly by Davis AJA,⁷¹ is to guard against the overzealous application of legal doctrine to issues that are heavily contingent on the factual matrix of a specific case.⁷² A similar sentiment can be found in the judgment of Schreiner JA⁷³ where he stresses the importance of defining terms according to "ordinary linguistic usage" or "common parlance".⁷⁴ The purpose of

67 *Supra* at 24.

68 As stated in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183.

69 14 SATC 1 at 22.

70 *Supra* at 23.

71 *Supra*.

72 Nourse, V. 2008. *After the Reasonable Man: Getting over the Subjectivity/Objectivity Question*. New Criminal Law Review. Volume 11(1) 33 at 38. Available at: <http://scholarship.law.georgetown.edu/facpub/1123>. (accessed 8 May 2012).

73 14 SATC 1 at 17.

74 *Supra*.

this is to prevent unnecessarily artificial operation of the law. Balazs⁷⁵ succinctly summarised this approach as follows:

What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law. For the word “source”, in this context, has no precise or technical reference. It expresses only a general conception of origin, leading the mind broadly, by analogy. The true meaning of the word evokes springs in grottos at Delphi, sooner than the incidence of taxes. So the exactness which the lawyer is prone to seek must be consciously set aside; indeed, with respect to a choice between various contributing factors, it cannot be attained.

This practical man principle therefore provides a lens through which Watermeyer CJ’s two-step test ought to be seen. Balazs⁷⁶ comments further that “[p]ractical reality is not a test so much as an attitude of mind in which the Court should approach the task of judgment”.

The striking feature of the judges’ application of the practical man principle is that they were all manifestly different. The primary distinction between all of the judgments was their interpretation and application of the practical man. Given that the construct of the practical man can be open to such a wide range of interpretations, its effectiveness as a tool for deciding cases is doubtful, and a number of problems arise when a notion such as the practical man is used in such a manner.

In order to accurately assess the impact of the practical man concept on judicial decisions, it is first important to understand the weight it is afforded in the process of coming to a conclusion. Although this is not decisively stated in the *Lever Brothers* case, there are a number of statements that point towards an answer. The most frank of these is the statement of Davis AJA in which he describes the practical man as a “test” that he is bound to adopt.⁷⁷ If this interpretation is followed, the use of the practical man concept is mandatory and must be a significant influencing factor in coming to a conclusion. Schreiner JA’s approach is similar when he states that the views of the practical man are, “entitled to great weight.”⁷⁸ The least prescriptive of the judges in the *Lever Brothers* case is Watermeyer CJ who merely calls this a suggestion that seemingly does not need to be followed.⁷⁹ It would seem that there is

75 Balazs, J. 2009. *An Introduction to Australia’s Tax System: How Source is Determined*, at 7. Available at: <http://www.blwllp.com/getattachment/a00ed84b-b7b8-429a-b39f-2e875a91e6a6/How-is-Source-Determined—.aspx> (accessed 8 May 2012).

76 *An Introduction to Australia’s Tax System: How Source is Determined*, at 7.

77 14 SATC 1 at 23.

78 *Supra* at 22.

79 *Supra* at 15.

therefore no unanimous conclusion in the *Lever Brothers* case on the question of how much weight should be placed on the practical man test.

Assistance in this regard can be gained from the case that initiated the concept of the practical man. In *Nathan v Federal Commissioner of Taxation*⁸⁰ it was held that the word “source” was intended by the legislature not to be “a legal concept, but something which a practical man would regard as a real source of income”. While the *Nathan* case was referring to the Australian legislation, there are sufficient similarities with the South African Income Tax Act as well as the acceptance of this dictum in a number of South African cases, to conclude that it has equal application in South Africa. It would seem therefore that the *primary question* of source is, as confirmed by De Villiers JA,⁸¹ Lord Atkin⁸² and Watermeyer CJ,⁸³ “a practical hard matter of fact”. The core of a source enquiry is therefore intended to be a factual analysis and that this is facilitated by the practical man in “practical reality”.⁸⁴

Although Watermeyer CJ does not expressly state that the view of the practical man is a mandatory consideration, it is submitted that there is sufficient agreement between Schreiner JA, Davis AJA and the judges of previous cases to conclude that it is. It necessarily follows that if the practical man is a mandatory consideration, it must have some weight in the outcome of the judgment. The best description of the weight that is to be given to the views of the practical man therefore, it is submitted, is to be found in Schreiner JA’s comment that it is to be accorded “great weight”.⁸⁵

The first problem that arises when requiring that a concept such as the practical man should be given great weight is that it is not well suited to dealing with, as Schreiner JA recognises,⁸⁶ complex legal issues. It is nevertheless stated that the question of source is not a legal issue but a factual question.⁸⁷ The relationship between factual and legal questions may, however, be blurred in difficult cases. It is clear that Watermeyer CJ’s two-step test is essentially two questions of fact. First, what is the originating cause of income, and second, where is it located? The issue, however, arises when, as Watermeyer CJ, recognises⁸⁸

[a] debt is a legal obligation, something having no corporeal existence; consequently it can have no real and actual situation in the material world. Metaphorically, however, by legal fiction, it may have a situation in a place, determined by accepted legal rules [emphasis added].

80 In *An Introduction to Australia’s Tax System: How Source is Determined*, at 6.

81 *Liquidator, Rhodesia Metals, Ltd v Commissioner of Taxes*, 1938 AD 282.

82 *Rhodesia Metals (in Liquidation), Ltd v Commissioner of Taxes*, 1940 AD 432.

83 14 SATC 1 at 15.

84 *An Introduction to Australia’s Tax System: How Source is Determined*.

85 14 SATC 1.

86 *Supra*.

87 *Nathan v Federal Commissioner of Taxation*.

88 14 SATC 1 at 8.

Therefore, while the determination of source is a question of fact at its core, this cannot be the end of the enquiry. There are legal questions that *must* be answered before the question of fact can be addressed. In the *Lever Brothers* case, these legal issues meant an adequate description of the incorporeal debt, which is created by the operation of the law and must therefore be fully described in legal terms. As Schreiner JA notes, “the location of an incorporeal in space by a *rule of law* carries a flavour of *artificiality* [emphasis added]”.⁸⁹ Accordingly, this implies that it is not an issue of practicality, which by its nature is not artificial. Furthermore, it is submitted that, if the practical man were permitted to engage in complex legal issues such as the artificiality of an incorporeal, the effect of this would be to dilute the practical man concept to such a degree that it can no longer perform the function for which it was introduced.

If the practical man is intended to serve an important function in the judicial process, one that is not easily reconciled with legal fictions, the second problem that arises is how is this tool to be used? An analogy can be found in the similar concept of the “reasonable man” from criminal law and the law of delict. This concept originated as a means with which to explain the law to lay people in a jury. This is summed up as follows in the case of *R v Smith*:⁹⁰

[T]he concept of the “reasonable man” has never been more than a way of explaining the law to a jury; an anthropomorphic image to convey to them, with suitable degree of vividness, the legal principle that even under provocation, people must conform to an objective standard of behaviour that society is entitled to expect.

The problem is essentially that, in criminal cases, for example, persons on trial must be tried according to their own characteristics. In other words, there must be a *subjective* approach. This approach would, however, lead to injustices where it is applied too strictly. As Nourse⁹¹ notes, “the defendant’s norms will acquit him”. This accordingly requires a call to *objectivity*. An overly objective approach, however, may be similarly unjust, as important factors such as the defendant’s age, mental capacity and physical characteristics, as examples, will be neglected.⁹² Many countries have accordingly adopted a hybrid approach: one that treats defendants subjectively, but then also requires that they comply with a certain standard expected by society. This standard is that of the reasonable man.⁹³

89 14 SATC 1 at 20.

90 *R v Smith (Morgan)* [2000] 4 A.E.R. 289 at 172 E–F.

91 *After the Reasonable Man: Getting over the Subjectivity/Objectivity Question*, at 36.

92 *After the Reasonable Man: Getting over the Subjectivity/Objectivity Question*.

93 Alternatively termed in various legal areas: the layman, prudent man or *bonus pater familias* (the good family father).

The reasonable man concept, while being applied widely, is not without difficulty. Nourse argues that, “we create [the fact/law] dilemma by placing the normative question [or legal question] within the guise of a human being [or factual question]”.⁹⁴ Furthermore, she contends that this dilemma may be removed by conceiving the concept differently. At the heart of the concept, Nourse argues, is that the reasonable man is a tool for preventing legal norms from being applied too strictly to particular cases. What it achieves therefore is an efficient way of *reflecting* the law as it stands, and then *restraining* its overzealous application by requiring that the factual matrix be considered.⁹⁵ This approach, it is submitted, is similar to that of using the practical man concept in questions of the source of income. There are legal concepts that must be applied, but it is submitted that the court, in the *Nathan* case, was aware that if a prescriptive body of law were to develop, this would lead to unjust results.⁹⁶ The approach by Nourse, it is submitted, provides a sound framework with which to understand the application of the reasonable man and practical man concepts. Hence legal rules that have been developed must be applied where their application is warranted but, realising the potentially harsh results of this, they should be mediated. The tool that criminal law, the law of delict and cases involving source have chosen to achieve this, is the practical/reasonable man. The role of the court is not to apply the law blindly, but to achieve justice.

Conclusion

Starting with an in-depth discussion of the *Lever Brothers* case, this article has traced a path through history, the lives of the judges involved in the case, the development of the source rules in South Africa and the problematic intrusion of the practical man into the world of the legal theorist. The difficult nature of the decision that the judges were called on to give in the case was the result of the complicated agreements entered into and the problem of determining the source of the interest on a loan from a company resident in England to a South African member of the same group of companies, where the interest was payable in London out of dividends received in the United States of America on shares in an American member of the group of companies. In the absence of legislative provisions dealing with the source of particular classes of income, and as South African case law had not yet developed clear guidelines for determining the source of interest, the judges had to determine

94 *After the Reasonable Man: Getting over the Subjectivity/Objectivity Question.*

95 *Supra* at 38.

96 *An Introduction to Australia's Tax System: How Source is Determined*, at 7.

the originating cause of the interest, which could have been the provision of the credit or the debt itself, and then had to locate this originating cause, which could have been South Africa, England or even the United States of America. It was no wonder that two judges concurred, but on different grounds, and the third dissented.

In a decision that stood unchallenged for 54 years, Watermeyer CJ established that a two-stage test had to be used to determine the source of interest income – finding the originating cause and then locating it. He held that the provision of credit was the originating cause and that it was situated where the credit was provided. Subsequent changes to the Income Tax Act have provided new rules for locating the source of interest income within South Africa, but nevertheless the two-step test Watermeyer CJ established still has application to other classes of income, where no specific legislative provisions determine their source.

The most difficult task for the three judges in the case was to locate the source of the interest that the Commissioner for Inland Revenue had assessed to tax in South Africa. In earlier cases, the location of the source of interest was referred to as “a hard practical matter of fact”, in which the place where the practical man would locate it was the determining factor. Unfortunately the three judges differed in their interpretation of their “practical man’s” reasoning and their view of the weight to be attributed to the principle of the practical man.

This lack of consensus by the three judges in applying the practical man principle prompted the research into the validity of this principle. After discussing the role of the practical man in tax law and the “reasonable man” in other branches of law, it was concluded that the principle should be applied, not in the place of legal theory and precedent, but to restrain their use when their application would lead to an unjust result.

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