

Capital Versus Revenue: Some Guidance

1 Introduction

For income tax purposes, the distinction between whether an amount or expenditure is of a capital nature or not is decisive. Receipts and accruals of a capital nature do not form part of the gross income definition (the definition in s 1 of the Income Tax Act 58 of 1962 (the ITA) reads: "... in the case of a resident, the total amount in cash or otherwise, received by or accrued to or in favour of such resident ... excluding receipts or accruals of a capital nature") and as such are not subject to income tax, but are subject to capital gains tax (CGT) (under par 10 Sch 8 ITA depending on the status of the taxpayer only 25% or 50% of a capital gain is included in the tax net – in the 2012 budget it was proposed that the inclusion rate be increased from 1 April 2012 for individuals to 33,3% and for other taxpayers to 66.6%). Similarly, expenditure of a capital nature is not deductible under the general deduction formula in s 11(a) of the ITA. Amounts that are not of a capital nature will be regarded as income, as no halfway house exists (*Pyott v CIR* 13 SATC 121 126). In light of this statement one would have expected that CGT would be levied on all receipts and accruals falling outside the "gross income" definition, would fall within the CGT net. However, this is not the basis on which capital gains tax is imposed, as CGT is imposed on the disposal of an asset for proceeds more than its base cost. The terms "disposal", "asset", "proceeds" and "base cost" are all defined for purposes of the Eighth Schedule.

One would have thought that clarity characterises such a basic principle. However, the most important distinction in the act has proven to be the most elusive. As the act itself does not give any indication as to when an amount or expenditure will generally be of a capital nature, it is left to the courts to define its meaning. Although several court cases on the topic do exist, Urquhart "Capital v revenue: Some light in the darkness?" 1979 *Acta Juridica* 299 is of the opinion that although "eminent counsel, distinguished judges" had over several years attempted to interpret the phrase, "the subject is still as murky as ever."

In this note an attempt will be made to provide guidance on the nature of an amount received by or accrued to the taxpayer. As the courts developed separate tests for the nature of expenditure, this will not be discussed here.

2 Tests applied by the Court

2 1 Introduction

The courts do not apply a single test to determine the nature of an amount. An analysis of case law indicates that at least three different tests are applied by the courts.

2 2 Profit-making Scheme

The current leading authority on the nature of an amount is *CIR v Pick-n-Pay Employee Share Purchase Trust* 54 SATC 271. The facts of the case were that a trust was formed to provide shares to company employees. Under the terms of the trust, the trust provided shares to company employees. The trust acquired shares at the market value and from the company and on-sold them, on a continuous basis, to the employees. Although the trust had no intention of making a profit, as it had to sell the shares to the employees at a certain price, it did indeed make a profit. The question the court had to adjudicate upon was whether this profit was of a capital nature. In a three-to-two decision it was held that the profits were of a capital nature (This “profit-making scheme” test was also applied in *CSARS v Wyner* 66 SATC 1).

The majority of the court reached its decision by first asking whether the taxpayer objectively conducted a business and secondly whether it was the objective of the taxpayer to conduct a business. It is clear that the first leg of the question should be objectively determined and the second leg purely subjectively.

The minority was of the view that the test to determine the nature of an amount should be a purely objective test. In other words, on the facts of each case it should be decided whether a business was carried on, and the amount was received in the ordinary course of business – then the amount was not of a capital nature.

It is thus clear that the majority applied a subjective test, whereas the minority applied an objective test. (It is interesting to note that both the majority and the minority were able to refer to previous cases by the Supreme Court of Appeal for their view. (The majority relied on *Natal Estates Ltd v SIR* 37 SATC 193 and *Elandsheuwel Farming (Edms)* 39 SATC 163 whereas the minority relied on *Overseas Trust corporation v CIR* 2 SATC 71 and *Stott v CIR* 3 SATC 253.)

2 3 Fruit Versus Tree Analogy

Where an amount represents income from the disposal of the income-producing asset (ie the tree), the amount is of a capital nature. However, where an amount represents the fruit of the tree, such amount is not of a capital nature. This was made clear in *Visser v CIR* SATC 271 in which it was held at 276 that:

‘Income’ is what ‘capital’ produces, or is something in the nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principle or tree in the hands of one man may be interest or fruit in the hands of another. Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset.

Although the principle is clear that the tree represents capital and the fruit revenue, as indicated in the quote it is not always easy to establish when an amount represents the tree and when it represents the fruit. In the context of deductions, this is illustrated by the decision in *BP Southern*

Africa (Pty) Ltd v CSARS 69 SATC 79 which dealt with the nature of expenditure. In the lower court it was decided that a payment for the right to operate under a certain name was of a capital nature. However, on appeal the Supreme Court of Appeal was of the opinion that the amount was not of a capital nature as it was more closely connected to the taxpayer's income-earning activities (ie the fruit) than it was to its income-earning structure (ie the tree).

2 4 Fixed Versus Floating Capital

Where an amount is received from the disposal of fixed capital it is regarded as of a capital nature whereas if it is received from the disposal of floating capital, is not of a capital nature. In *CIR v George Forest Timber Co Ltd* 1 SATC 20 23-24 it was held:

Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it remains intact. The distinction is relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed. But as pointed out by Mason J in *Stephan v CIR* (1919 WLD at 5) the two phrases have an ascertained meaning in accountancy as well as in economics. Ordinary merchandise in the hands of a trader would be floating capital. Its use involves its disappearance; and the money obtained for it is received as part of the ordinary revenue of the business. It could never have been intended that money received by a merchant in the course, and as the result of his trading, should not form part of his gross income.

(see also *SBI v Aveling* 40 SATC 1 17.)

2 5 Conclusion on Tests Applied by the Courts

Although over the years several tests have been applied by the courts to determine the nature of an amount, the impression is gained that, in recent years, the "profit-making scheme" test is the test most often applied. Although it is clear that the test is to determine whether a profit-making scheme was carried on, it is not clear that a subjective test has to be applied, and it is not clear which factors are taken into account.

3 Factors to be Taken into Account

Analyses of the relevant cases do not provide much clarity on whether a taxpayer's "object", "motive", "intention", "contemplation" or "*ipse dixit*" will be decisive in determining whether a profit-making scheme was carried on. These words are used interchangeably by the courts (Broomberg "Capital, Revenue, Intention, Motive and Contemplation" 1998 *Tax Planning* 69). In general terms the word "object" or "intention" refers to what a person does. In a tax context the word often refers to whether a taxpayer has disposed of or kept an asset. The word "motive" on the other hand refers to the reason why a person did something, and the word contemplation refers to whether a person foresees something (ie that he or she will make a profit).

On the one hand it was held in *CIR v Pick-n-Pay Employee Share Purchase Trust* 54 SATC 271 281 that:

Contemplation is not to be confused with intention ... In a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.

On the other hand, in *SIR v Trust Bank of Africa Ltd* 37 SATC 87 104, with reference to previous case law, it was held that in determining whether a profit-making scheme was carried on is "... fundamentally a question of intention', in other words, that the intention with which ... [assets] were acquired was of the utmost importance, but not necessarily decisive".

From the *Pick-n-Pay* and *Trust Bank* cases it does seem that the word "object" is synonymous with the words "intention" and "purpose" and that the test to determine the nature of an amount depends on whether it was derived as part of a profit-making scheme. It is also clear that the contemplation that a profit would be made is not taken into account. In this regard the word "contemplation" does not carry the same meaning as it does in criminal law. For example, in *Trust Bank* it was held (106) that:

[i]n an enquiry as to the intention with which a transaction was entered into for purposes of the law of income tax, a court of law is not concerned with the kind of subjective state of mind required for the purposes of criminal law, but rather with the purpose for which the transaction was entered into.

(See also *CIR v Paul* 1956 (3) SA 335 340-341.)

To determine this one has to establish the object (ie purpose or intention) with which the scheme was entered into. Although no cognisance is taken of the taxpayer's motive, his or her intention may be taken into account. However, a person's intention is not always equal to his or her *ipse dixit*.

Die rede waarom 'n belastingpligtige se woord nie noodwendig aanvaar word nie, hoef nie te beteken dat sy eerlikheid in twyfel getrek word nie. Mense se bedoelings is dikwels wisselend, ongevorm en ongeformuleer en hul ex post facto getuienis daaroor, hoewel eerlik, is dikwels onbetroubaar of bestaan uit 'n blote rekonstruksie.

(*Malan v KBI* 1981 2 SA 92 (KPA) 96F-O.)

The fact that a taxpayer's *ipse dixit* is not decisive in determining the nature of an amount was made clear in *CSARS v Heron Heights CC* 64 SATC 433, in which it was held (436) that

... the intention of the taxpayer ... is of great, sometimes decisive, importance ... the mere *ipse dixit* of the taxpayer in this regard cannot, in the nature of things, be conclusive; it must be tested against all other relevant considerations.

It is impossible to reconcile the above cases with the more recent decision in *CIR v Smith* 65 SATC 6. Although the *Smith* case does not deal with the nature of a receipt or accrual, in this case the taxpayer's *ipse dixit* was held to be decisive in determining whether he conducted a trade, notwithstanding that the objective factors did not support his *ipse dixit*.

4 Intention

4 1 Multiple intentions

Where a taxpayer has mixed intentions when an asset is acquired, for example he will rent the asset out and receive rental income (which is not of a capital nature), but dispose of it when he receives a good offer (which proceeds will be of a capital nature), the party who bears the onus of proof will lose the case. As section 82 of the Act places the onus on the taxpayer, he or she will always be the losing party.

4 2 Intention of a company.

It is particularly difficult to determine the intention of a *company* as it has “no body to kick and no soul to condemn” (*CIR v Richmond Estate (Pty) Ltd* 1956 1 SA 602 606F.) However, case law does give an indication of the factors to be taken into account.

In *Lace Proprietary Mines v CIR* 9 SATC 349 it was held that the name of the company, its policy, and its activities may be taken into account when the intention of a company is determined. In *SIR v Trust bank of Africa Ltd* 37 SATC 87 it was held (105) that the intention of a company should be determined by “the state of mind or intention of the persons in effective control of the company”.

The decision in *Elandsheuvel Farming (Edms) Bpk v SBI* 39 SATC 163 illustrates the dangers in attributing an intention to a company. In this case the majority of the court attributed the intention of new shareholders, who were speculators in their individual capacities, to the company.

4 3 Change of Intention

Although a taxpayer might have obtained an asset to keep it as an investment (ie as capital), it does not follow that when he or she disposes of it, the proceeds will always be of a capital nature. The reason is that a change of intention might have occurred, as was stated in *Natal Estates Ltd v SIR* 1975 4 SA 177 (A) 202-203:

From the totality of the facts one has to enquire whether it can be said that the owner had crossed the Rubicon and gone over to a business, or embarked upon a scheme, of selling such land for profit, *using the land as his stock-in-trade*.

However, an important caveat was added in *John Bell and Co (Pty) Ltd v SIR* 1976 4 SA 177 (A) where it was held (202-203) that:

the mere change of intention to dispose of an asset hitherto held as a capital does not *per se* subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and to render its proceeds gross income. For example, the taxpayer must already be trading in the same or similar kinds of asset and he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is used as his trade-in-stock.

The prospects of success are generally poor, as it may be as difficult to change from a trader into an investor for tax purposes as it is for a rope to pass through the eye of a needle. However, cases in which this did happen do exist. (See, for example, *CIR v Richmond Estates (Pty) Ltd* 20 SATC 355; *SIR v Rile Investments (Pty) Ltd* 40 SATC 135; *CSARS v Heron Heights CC* 64 SATC 433).

As intention is a subjective test, it is often very difficult to determine whether a change in intention has transpired. On the one hand it should be remembered that the mere fact that an asset is realised at the highest possible price does not turn an otherwise capital amount into an amount not of a capital nature. In *CIR v Stott* 3 SATC 253 263 it was held that:

... every person who invested surplus funds in land or stock or any other asset was entitled to realise such asset to the best advantage and to accommodate the asset to the exigencies of the market in which he was selling.

The decisive question is whether the taxpayer crossed the Rubicon in disposing of the asset.

Obviously no general rule can be laid down to determine whether the taxpayer crossed the Rubicon or whether the taxpayer merely realised a capital asset to his or her best advantage. The facts of each case have to be analysed to determine the answer, and in this regard previous case law cannot be decisive. (In *ITC 1299* 42 SATC 45 51 it was made clear that while guidelines enunciated in earlier cases “are useful aids in the process of arriving at a decision, each case falls for its determination on its own facts.” Just as it is possible to cross the Rubicon and change a capital asset into stock-in-trade, it is possible to back over the Rubicon and dispose of stock-in-trade as a capital asset.

5 Conclusion

Case law indicates that in the test to determine the nature of an amount received by or accrued to a taxpayer two questions have to be answered in the positive. Firstly, was the taxpayer objectively carrying on a profit-making scheme, and, secondly, was it his or her intention to carry on a profit-making scheme? It is less clear whether in answering the second question the taxpayer’s motive, intention or object is taken into account. However, it is clear that in this regard the taxpayer’s *ipse dixit* is not decisive. It is also clear that the intention with which an asset was obtained will not always be decisive, as a change of intention might have occurred between the time the asset was obtained and the time it was disposed of. The test to apply to determine whether a change of intention took place is to ask whether on the totality of the facts the taxpayer crossed the Rubicon.

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