

**STUDENT NO: SCTMEG001  
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DISSERTATION ON TAX LAW:**

**THE CLASSIFICATION OF THE NATURE OF  
SHARE PROCEED, CASE LAW VS S9C**

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**Research dissertation presented for the approval of Senate in fulfilment of the requirements of LLM in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.**

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## Introduction

The basis of a good tax system is driven by what is known to be the cannons of taxation; the aim is to keep a good system in progress by complying with these ideals as far as possible<sup>1</sup>. As a result, adjustments are made within a tax system in order to move towards having a more ideal tax system. Bearing in mind that these adjustments are changes in the law and are not expected to align with the previous manner in which the law is applied, it can be expected that such changes are effectively made to better favour the existence of a good tax system. An example of such an adjustment is the enactment of section 9C of the income tax act, dealing with the classification of the nature of share proceeds.

The South African Income tax act 58 of 1962 requires for the calculation of taxable income that income and expenditure be classified into one of two categories<sup>2</sup>. These categories are named capital nature and revenue nature, and there classification is necessary to determine whether amounts will be included in gross income or allowed as a general deduction. The nature into which the amount is classified then affects how these amounts are further treated in the calculation.

In the light of section 9C, the amount which needs to be classified for its treatment, is the proceeds from the disposal of shares giving nature to the share at its disposal. Over the years this classification has been influenced by multiple factors and applications of provisions. Initially being, this nature requires consideration to be made on a case by case basis. This is followed by the intervention of limited factor consideration legislature such as S9B, which the taxpayer could elect to apply or not. Section 9B provides a mechanism which gives guidance to the classification of such nature and more recently another such section has been enacted. The more recent provision, section 9C is a mandatory provision which further provides guidance and even more influence on the nature of proceeds on disposal of shares.

The classification of nature has to be made with all amounts considered for taxable income. It has very early been concluded that there is no one specific characteristic which classifies the nature of an amount and that many grey areas exist. So much so that the Income tax act does not define the terms *capital* and *revenue nature*. Given this inconclusiveness of nature, the courts have over the years assessed acts and considered a bundle of events in their entirety before making a decision about the nature of an amount. This was a norm for both the instance of share disposals and other asset disposals. This practice results in similar events being classified in one way in a certain instance and differently in another. The differentiation is driven each

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<sup>1</sup> The meade committee report

<sup>2</sup> Section 1 of the income tax act 58 of 1962

time by the substance of the cumulative factors of the event and not one factor in isolation. This is an approach which is still considered successful, however some conflict to this application exists by the provisions of the legislation such as S9B and S9C. Conflict in the sense that these provisions, though not required to align exactly with the law as previously applied, they are expected to be movements towards obtaining a better tax system and cut out considerations which were previously important. Introducing a new way of accounting for a transaction is expected to bring about differences in the classification of nature and the determination of taxable income, but a change like this, one would imagine is also expected to better achieve the ideals of a good tax system. Where the existence of the legislation (namely S9B and S9C) does result in amounts being classified and treated differently, grounds exist on which some or all of the ideals of a tax system are either better delivered or not. In the process, economic effects such as revenues can become greater or less than they would be for either of the tax parties in such a transaction, had the former been applied. Costs of applying can either be greater or less for either of the parties, basically allowing for the possibility of either tax parties to be more or less out of pocket<sup>3</sup>. Other than economic implications, a change could also result in the other ideals of a good tax system being better achieved or not.

This dissertation, while being mindful of the certainty and convenience ideals of a good tax system, aims to illustrate whether the change in the law to make a nature decision based on one factor (the S9C mandatory provision of the legislation rather than case law suggestion, both which are forms of law), not only creates room for differences in the classification of nature, but moves towards putting the taxpayers in a less out of pocket position while enhancing these ideals of a good tax system<sup>4</sup>. As previously mentioned, change(s) affect the quality of the tax system through affecting the taxable income calculation...this will be the starting point from which this analysis will be made...looking not only at how the nature decision differs before and after the existence of Section 9C, but what the knock on monetary effects are in ascertaining whether the taxpayer is in fact less out of pocket. This will then be used to ultimately conclude whether the approach of section 9C is an effective or ineffective enactment from what is envisioned in a good tax system. The manner, in which these issues will be addressed, is by looking to a few cases that were decided before the legislation was enacted, to set out and revise how the courts have decided the nature of these amounts. This will be done to show the significance of each factor in the final decision, so that in the event that this change in law is concluded to not be a better manner at achieving a good tax system, a suggestion can be made knowing the implications of the factors as to which other factor could potentially be suggested to better achieve this. Alternatively, to have a clear indication of what the impact of section 9C overlooks in its attempt to better regulate the tax system. Section 9C and all the appropriate legislation will then be applied as if it existed at the time of the cases, in an attempt to show how the outcomes of deciding nature

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<sup>3</sup> Adam Smith, *An Inquiry into the Nature and Causes of Wealth of Nations* (1776)

<sup>4</sup> Adam Smith, *An Inquiry into the Nature and Causes of Wealth of Nations* (1776)

would differ, and whether more or less tax is payable as a result of section 9C, ultimately showing who the legislation creates an opportunity for to be less out of pocket than before.

To begin this analogy, with regard to the proceeds on the disposal of shares, its effect depends on how it is included in gross income or not. For such amounts to be included in the gross income definition, the criteria of gross income is to be met which excludes 'receipts or accruals of a capital nature'<sup>5</sup>. Such amounts are potentially subject to the eighth schedule's capital gains tax<sup>6</sup>. This distinction is the main basis for financial effects and shows what is avoided by the enactment of section 9C.

#### The concept of Capital and Revenue nature

Capital and revenue nature testing is to be done for all amounts considered as gross income and general deductions. To the effect, that capital nature items are not included in gross income or deductible as a general deduction and revenue nature items are. As previously mentioned the tax act has no strict definitions or specific one criterion for the terms capital and revenue, it has instead been left to the courts to decide, for which courts have decided that the classification in terms of gross income was and is guided by the following tests:

#### Profit- making scheme

This test aims to ascertain whether the taxpayer demonstrably piloted a business and/or whether a business factually was or ended up being carried on by the taxpayer.

#### Fruit vs tree

This test requires distinction to be made between the income producing asset and the fruit of such an asset. The income producing asset because of its ability to provide for the carrying on of a trade is classified as a capital asset from which proceeds are likely to be capital in nature and the fruits thereof disposed of in the trade classified as revenue asset hence revenue nature<sup>7</sup>.

#### Fixed capital vs floating capital

This test it is to be established whether the capital disappears in the process of production, according to which it is floating capital and categorised as revenue

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<sup>5</sup> Section 1 of the income tax act 58 of 1962

<sup>6</sup> Eighth schedule of income tax act 58 of 1962

<sup>7</sup> Visser v CIR SATC 271

nature or the capital remains unbroken as it produces returns under which it is categorised as capital nature.<sup>8</sup>

In applying these tests the courts ultimately observe the intension of the transacting parties. Where intension was better defined as being the purpose for which the transaction is entered into<sup>9</sup>. Neither of these tests are taken on the grounds of a period of time but purpose. The establishment of this is essential to the conclusion of the nature as such purpose can either be to indulge in a scheme of profit-making i.e. speculating or carrying on a business or trade (defined below), or to dispose of the 'fruit'<sup>10</sup>, or as floating capital<sup>11</sup> for which the asset being disposed of being a revenue asset then becomes subject to the trading stock<sup>12</sup> (defined below) provisions in S22.

### Trade and trading stock

One of the most popular ways to examine the purpose for which shares are held is to make a call on whether those shares were intended to be disposed of in a business in other words carrying out in a trade.<sup>13</sup>

*'trade' includes every profession, trade, business employment, calling, occupation or venture including the letting of any property and the use.*

Where a trade is considered to be carried on the purpose is likely to be to acquire profits and hence the nature revenue rather than capital. The purpose is likely to be capital nature where it can be considered investing to hold as a long term investment and subject to Capital gains tax. This is the only real influence a long time period is known to have on the determination of nature as this means the asset is held for returns other than for maximum sale proceed. Where the share proceeds are considered to be of a revenue nature, the share itself is a revenue asset and better could be categorised as trading stock<sup>14</sup>, both for which there are additional tax treatments. The above set out considerations are what drive the courts decision of whether an amount of proceeds is of a capital nature or not, in the absence of the section 9C provision. None of these considerations made by the courts in deciding the nature are specifically time frame orientated, the main measure in deciding this instance in a court scenario is whether a trade i.e. scheme of profit making<sup>15</sup> can be considered to be conducted in which case the shares are to be classified as trading stock and treated in line with those provisions.

<sup>8</sup> CIR v George forest timbr CO Ltd 1924 AD 516,1 SATC 20

<sup>9</sup> CIR vs Paul 1956 (3) SA 335 340-341.)

<sup>10</sup> Visser v CIR SATC 271

<sup>11</sup> CIR v George forest timber Co LTD 1924 AD 516,1 SATC

<sup>12</sup> Section 22 of the income tax act 58 of 1962

<sup>13</sup> Section 1 of the income tax act 58 of 1962

<sup>14</sup> Section 22 of the income tax act 58 of 1962

<sup>15</sup> CIR v Stott 1928 AD 252,3 SATC 253

The act defines trading stock as anything which is purchased or in any other manner acquired for the purpose of sale including shares held by a share dealer.<sup>16</sup>

The tax treatment for trading stock, including shares as trading stock, is dealt with in section 22 of the income tax act which aims to match the cost of the stock with the income from the sale by deferring the deduction until sale occurs and matches the deduction with the income. Section 22 to achieve this requires that the closing balance of trading stock<sup>17</sup>, in this capacity, shares of a sharedealer be added to income in the calculation of taxable income, and the opening balance of a period be deducted in the calculation<sup>18</sup>. This has here been established as it represents a potential effect of the nature classification of shares being revenue in which case it is required to apply section 22 and where the shares are not revenue nature they are potentially subject to the eighth schedule of the income tax act 58 of 1962, capital gains tax.

### Capital Gains Tax

Capital gains tax is a tax implemented to account for taxes on the items which are excluded from the gross income definition because they are not revenue nature. Capital gains tax is accounted for on disposals made on or after 2001<sup>19</sup>, which is prior to the date of the S9C enactment (1 October 2007) since Capital Gains Tax existed before S9C was enacted to account for the overall effect of S9C in the present and going forward *cetris paribus* this analysis has to be done with with Capital Gains tax in mind.

S26A of the Income tax act requires that taxable capital gains be included in taxable income and how this taxable capital gain is determined in terms of the eighth schedule. The deemed disposals to which S9C are subject. A deemed disposal is an action which is not a disposal as such but per the tax act is an equivalent. Examples of deemed disposals will be made below as they are a section 9C condition too.

Para 12 of the eighth schedule:

Section 2(a) when a person or a permanent establishment residing in the republic no longer meets the respective residence criteria in the republic, all the assets held by such a person, including his or her share just prior to ceasing to be a resident is deemed to be disposed of by such a tax payer inline with the nature which that share was said to have, except where these share being equity were held for less than 5 years prior to change in residence.<sup>20</sup>

The eighth schedule further contains the following deemed disposals ,when shares are held by a taxpayer as trading stock, in the production of income, and are no

<sup>16</sup> Section 22 of the income tax act 58 of 1962

<sup>17</sup> Section 22(1)

<sup>18</sup> Section 22(2)

<sup>19</sup> Eighth schedule of the income tax act 58 of 1962

<sup>20</sup> Para 12(ii), eighth schedule

longer to be disposed of in the business operation, in other words ceases to have the intension of trading with them<sup>21</sup>. Hence a share can be considered disposed of in accordance with this section by the taxpayer ceasing residence or the taxpayer changing the trading intension with which the stock was previously held.

These deemed disposals are deemed to have been made at market value at the date of the deeming act on which date the classification is required to be known.

The eighth schedule specifically excludes the issue or cancellation of shares by a company as a disposal, where an issue is defined as new shares in a company being made available to the public.

#### The implications of applying the eighth schedule

Capital gains tax is accounted for on the aggregate net gains from the disposals of the capital assets which is determined by deducting what the Income Tax Act refers to as the base cost( a depiction of the cost) from the proceeds , this gain is included in taxable income as what is referred to as the inclusion rate which for an individual is 33.3% and for companies and trusts are 66.6% which is less than the 100% inclusion rate of proceeds from other revenue assets, this can be expected to be the most significant driver of who will, if any party, be more out of pocketed by the provision resulting in different outcomes than it previously would. Capital gains tax as previously mentioned only included a fraction of the gain after which it is only subject to the applicable tax rate; hence the tax that is ultimately charged on an item being capital nature is less.

For example if an entity were to sell shares at a profit of R1000 , assuming the share proceeds are of a revenue nature the entire R1000 would be subject to the applicable tax rate 28% the tax payable would be R280. If however the same profit, R1000, were to be made by a different company whose disposal resulted in proceeds being of a capital nature, the proceeds would not meet the gross income definition and the gain assuming it is equivalent to the profit of R1000, would only be inclusive at the inclusion rate of 66.6% for companies, in other words R666 to which the tax rate is still to be applied , 28%, resulting in a tax payable of R186.48, which is less than if the amount were revenue in nature, and was even less before the change in the inclusion rate in 2012, favouring the taxpayer if there transactions result in amounts being classified as revenue rather than capital.

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<sup>21</sup> Para 3, eighth schedule

### Comparing the outcomes of case law and section 9C

Having set out what the various disposal of shares can be subject to, cases will now be used to show how nature is established in the event of a share disposal prior to the enactment of section 9 C and then as if section 9 C existed to make comparisons and identify exactly what is different and use these difference to comment on how these difference contribute to the standard of the tax system. These cases are :

#### African Life Investment Company (Pty) Ltd v SIR

In this case the taxpayer was a subsidiary specifically formed to act as a share investment vehicle for its parent in 1963 after having invested in shares in 1961. The object of the taxpayers company was to administer the share portfolios and acquire shares with a view to receiving income there from. However, the company followed an active investment policy, meaning 'seeking a portfolio', which would show rising dividends over the years ,watching each share carefully ,effecting realisations whether profit or loss, and affected realisation whenever reasons existed for switching to another share. The court considered what the purpose for initially acquiring the shares were then decided the nature.

#### Deciding the nature of the amount of proceeds:

In determining the nature of the proceeds in this case the courts aimed to establish whether a dual purpose existed and if so what the dominant one was.

The taxpayer declared obtaining a suitable dividend as its intension for holding the shares, the special court on the other hand was of the opinion that the taxpayers intension was to obtain the best possible return from the shares. Two possibilities were therefore considered, being either that the shares were held for dividends or for the profitable disposal thereof.

The decision was concluded to be revenue nature via the consideration that a dual purpose existed which was so found to be by reference to the company memorandum and the manner in which the activities were conducted. The memorandum was analysed by way of provisions both present and absent, making very little reference to any duration of time. In the case conflicting conclusions were reached on a factor by factor basis, in other words on the one hand the provision that the shares could not be classified as 'stock-in-trade'<sup>22</sup> implies that the shares should be capital assets and hence not included in gross income but subject to the Capital Gains Tax<sup>23</sup> inclusion. However, this was an insufficient and inconclusive fact and more factors were to be considered<sup>24</sup>. The court looked to other factors such as ,the non-existence of a provision restricting the distribution of profits, this left room for profits to be distributed at any time , which the courts considered to be a deliberate act

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<sup>22</sup> Steyn CJ

<sup>23</sup> Eighth schedule Income Tax Act 58 1962

<sup>24</sup> STRATHMORE CASE1959 (1) SA 469 (AD)

contributing to the intension not being that of an investment holding company. The courts further considered the motives and manner in which the entire set of activities were conducted. Like to observation of portfolio, to sustain its initial proposal of being an investment holding company the portfolio's would need to be watched, and hence from the outset the likelihood of profits could be anticipated. The fact that profit could be anticipated by the observation abandons the notion that the amounts could be 'fortuitous'.<sup>25</sup> The manner in which the authority was exercised in this case more than just aimed to ensure the best dividend yield but had to have accounted for profitable sales presenting a secondary object, part of business operations and hence in a scheme of profit making/ trade.

In summary the following factors from this case contribute to nature in the following ways:

- Intension to obtain sustainable dividends:

This implies that the shares are a capital investment from which returns in the form of dividend are expected instead of profit.

- The shares not classified as stock-in-trade provision:

This provision means that shares are not to be trading stock in the business, favouring the likelihood of capital nature. The absence of this provision means that the shares the business does not prohibit shares from being trading stock, and it is more likely that shares can so be employed.

The absence of a provision limiting distribution of profit- means that the distribution of profits from shares are permissible in very much the same way as the profits earned from trade in the business hence favouring the likelihood of such profits being of a revenue nature.

- Observation of the portfolio:

This implies that the share prices were being monitored a lot like in a share speculation scenario targeting the best profit to be made. This is an indication of a scheme of profit making and hence favours revenue nature.

#### Section 9C application to African Life Investment Company

Court decided that the proceeds from the disposal (actual disposal not one per the eighth schedule) of shares were of a revenue nature as the company was factually carrying on a business i.e scheme of profit making. To apply S9c the time frame for which the shares were held prior to the disposal are of utmost importance, the duration of time for which the shares which were held per the facts are not very specific as the courts did not give much consideration to this. The facts however say that the company started investing in equity in 1961 and formed the vehicle which

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<sup>25</sup> Overseas Trust corporation Ltd v CIR 1926 AD 444

started dealing in shares in 1963. Given that section 9C assumes a first-in-first-out basis, the first disposal can be assumed to be of the equity invested in 1961, creating for that batch disposed of a period held of two years. These two years mean that the shares disposed of in 1963 would not be capital nature as per the mandatory provision of section 9C. In the instance of this batch disposed of, section 9C would not result in a different nature. If the court were to consider the factors exactly as they have in their judgement, a once off call would be able to be made at the time of the trial for the proceeds received or accrued to date.

In the African life Investment case, 3 years profits from proceeds are questioned. 1963's disposal would not be deemed capital nature per section 9C as it has just been applied above. The disposals of the other years need to be considered in two circumstances for the application of section 9C: (a) that these were share disposals part of the initial acquisition in 1961 and (b) these were share disposals part of the acquisitions made from 1963 on.

In the event of (a) for the years 1964 and 1965, these shares would have been held for 3 years at the time of disposal. Since the sales were not carried out with connected persons<sup>26</sup> of African Life Investment after this duration, the provision in the instance of the given facts would result in the disposals being deemed to be of a capital nature purely based on the time frame. As a result of this nature classification, these profits would not be taxable in terms of the gross income definition which is opposite to how the courts decided. From the court decision in African Life Investment i.e. declaring these proceeds (all proceeds under question) revenue in nature looking at multiple facts and factors of the disposals and the company, section 9C based just on a period of time deems the proceeds capital nature effectively ignore the number of transactions which were performed, the clauses and absence thereof in the memorandum.

As a result of the difference in the classification of the nature of the shares the following would be different from a taxable income perspective, where the shares are considered to be revenue in nature. The proceeds will be included in the gross income and since a trade is effectively carried on as the courts decided the shares are to be accounted for as trading stock and the section 22 provisions would apply, in other words the cost element will be matched to the proceeds each time by adding back each year end closing balance and deducting the opening, leaving the entire excess above the cost as a taxable portion in the taxable income calculation. To add an image to this interpretation an example is provided below.

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<sup>26</sup> SECTION 1 OF THE INCOME TAX ACT 58 OF 1962 'connected person' defined

Example:

Current year revenues amount to R100. The stock on hand at the beginning of the year amounted to R 80 and the stock on hand at the end of the year amounted to R20( assuming not additional shares were acquired R60 shares were disposed for)

Gross income :

Proceeds on disposal of shares                      R100

S22 trading stock

-opening balance    ( R80 )

-closing balance    R20

effective profit inclusion                                  R40

The effective inclusion is 100% taxable at the applicable rate.

Where the shares are capital nature or so deemed per section 9C which would have potentially been the case for the portion of shares which could have been held for more than 3 years, the proceeds being deemed capital nature would be subject to the eighth schedule capital gains tax provision which as established in the capital gains tax portion (page 7) of this dissertation and existed prior to the enactment of s9C. This would include 33.3% of the effective profit (assuming all else remains the same) in the taxable income calculation which will be subject to the applicable tax rate and effectively less than the entire proceed being taxed. In this occurrence the use of case law looking to all the factors which influenced the decision to be revenue nature, results in more tax being payable by the taxpayer, i.e the taxpayer will be less out of pocket when the single factor approach of section 9C is used.

In event (b) the acquisitions are all considered to have taken place in 1963 which is one and two years consecutively before the disposals made in 1964 and 1965 which is both case then held for less than 3 years and not deemed Capital nature per S9C and given the facts as they are the outcome with or without s9c would be the same as the courts initially decided, hence section 9C presents no differences in this occurrence and the cumulative factors which the court considered are effective what the decision aligns with, not that this is an expectation of a change in the law but this means that in comparison to the application of case law, section 9 C does not result in more or less tax being collectible from the disposal of these specific shares.

SIR v The Trust bank of Africa case:

Brief summary of the facts:

The taxpayer was a commercial bank who did some additional 'subsidiary'<sup>27</sup> trades. In 1965 its management committee who had been seeking to diversify the taxpayer's activities suggested the taxpayer invest in the management company of a growth fund set to result in indemnity advantages in the form of additional banking business.

Deciding the nature of the amount of proceeds:

In determining the nature of the proceeds in this case the courts aimed to establish whether the shares were acquired with the intention of extending the permanent structure of the business or whether the shares were acquired with the intention of sharedealing. Given that this question was an initial issue which could reasonably be answered, a subsequent question needed to be considered. This question being whether there had been an adjustment to whichever the intention was with which the shares were acquired in the decision of the nature<sup>28</sup>. The need to reconsider the same factor is evidence of the indecisiveness of the intention which leaves plenty of room for uncertainty.

The initial intention question was considered by the tax payer to be that of extending its capital structure. The enhancement of capital structure deems the shares to be fixed capital. On the other hand however, '... where the company would use in its business operations, which it would deal or hold as a prospect of profitable user dictated; that would be its floating capital'<sup>29</sup>.

The shares were without a doubt either of the above. Knowing what the taxpayer had claimed it to be the courts then needed to confirm this by looking to controlling elements of the business which had in this case been granted to the management committee. The initial intention per the courts was hence obtainable from this committee as to be extension of the permanent establishment. The expectation was that the investment would result in advantages in the form of additional banking business. The initial intention from this was accepted as not having profitable resale i.e trade in mind, not as an immediate intention at least. Having its initial intention so established further consideration needed to be made, the courts needed to progress to see whether the initial intention had changed prior to the sale before deciding on the nature of the shares. In the event that it was so found the previous establishment would no longer be as effective. This was done in this case by careful consideration to objective factors and subsequent actions which none constituted a special act sufficient enough of changing the initial intention, resulting in the nature fairly being concluded as capital nature which it initially intended and did not alter. The initial intention resulted in the determination of nature in this case.

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<sup>27</sup> Section 22 of the income tax act 58 of 1962

<sup>28</sup> CIR V stott 1928 AD 252, 3 SATC 253

<sup>29</sup> (CIR VS RICHMOND(PTY) LTD 1956 (1) SA 602 (A) .

In summary the following factors are said to contribute to nature in the following ways:

- The intension to extend the permanent structure:

This being considered a fixed capital , favour capital nature which was further supported by no change in initial intension.

#### Section 9c application to the Trust Bank of Africa Ltd

From the selected sample of cases this case is the first for which the courts decided that the nature of the proceeds on disposal of shares were of a capital nature, to do this the courts looked to the objective factors , memorandum, nature of the companies business, nature of transactions etc. The duration of time is made very little reference to hence the outcome as capital nature was predominantly dependent on the other factors the courts examined. Since S9c is a time based provision the time frame needs to be attended to.

The facts of the case say that the shares were acquired per the instruction of the effective management in 1965 the shares were later disposed of by the taxpayer. The taxpayer here acquired the shares in the management company of a growth fund (NFH), creating an interest and connection to the company and later the disposals were made to other members in the company. This disposal would in terms of the Income tax act 58 of 1962 constitute a connected person transaction as it is made to a company which is part of the same group of companies of the management company. Connected person transactions have specific treatment when section 9C applies.

On applying S9C to this case even in the absence of further information only a few possibilities exist which will now be considered .

The outcome possibilities:

- a) The connected persons exception as set out in the act applies:

Section 9C is applicable to this possibility, section 9C(3) which limits the application of the provisions of section 9C. The application is limited with an ‘and ‘ constraint by stating that section 9C ‘s deeming ability does not apply to any qualifying share which at the time of it’s disposal, the taxpayer is/was a connected person in relation to the company<sup>30</sup>. In addition to that the majority of the market value of the equity shares in that company is attributable directly or indirectly to immovable property, other than immovable property not held directly or indirectly by a connected person or held for more than 3 year prior to the disposal of shares. This means that when the transacting parties to a share disposal are connected persons and

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<sup>30</sup> Section 9C (3) income tax act 58 of 1962

the market value of most of the shares in that company are in some way attributable to the immovable property of that company that has been held by such a company for less than 3 years will not fall subject to this provision.

Where “connected person” means –

(d) in relation to a company-

(i) any other company that would be part of the same group of companies as that company ,

(iv) any person other than a company as defined in the companies act 2008 , who individually or jointly with any connected person in relation to himself holds directly or indirectly at least 20 per cent of (a) the company’s equity shares : or (b) the voting rights of the company.

(v) any other company if at least 20 per cent of the equity shares of or voting rights in the company are held by that other company and no shareholder holds the majority voting rights of the company.

(vA) any other company if such other company is managed or controlled by –

(aa) any person who or which is a connected person in relation to such a company; or

(bb) any person who or which is a connected person in relation to a person who or which is a connected person in relation to a person contemplated in (aa) .

The section excludes such disposals with connected person<sup>31</sup> to prevent the tax implications from being avoided by a taxpayer/taxpayers colluding. The existence of either one of these will render the parties ‘connected persons’ and section 9C will not be applicable.

As previously mentioned the two nature options that exist do favour the parties involved differently. Therefore the deeming of the nature of proceeds on disposal of shares after holding them for three years is not applicable to shares held in companies under the above mentioned conditions and both criteria are met.

In this event the provision of Section 9C will not be applicable as the conditions will be specifically excluded from applying the provisions of the section .In this case the courts would be left to decide the of which the outcome could go either way again but assuming that all the other facts align with the reality of how the case was set out, its reasonable to expect that the outcome would not differ i.e the nature of proceeds will be concluded as capital nature as it so was in 1978 after making all the consideration.

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<sup>31</sup> Section 1 Income tax act 58 1962

The second possibility:

- b) The connected person's exception does not apply, and the shares are held for three or more years prior to disposal. The deeming nature of S9C giving attention only to a duration of time to declare the nature of the proceeds capital, the outcome would in this case be the same from applying section 9C or the rules and tests which the courts have applied however this would be achieved with much more convenience and certainty. Where shares were held for less than the 3 years the courts would have been left to decide if the nature was not obvious and again with the facts remaining exactly the same the courts would likely decide as it has been decided in that case.

University of Cape Town

Barnato Holdings:

Brief summary of the facts:

Taxpayer was a subsidiary that was established as a vehicle for acquiring and holding most of the parent's industrial investments. The taxpayer made significant profits from selling investments in later years claiming that the changing of investments was part of business and unavoidable.

Deciding the nature of the amount of proceeds:

The question the courts aimed to answer in this case with regard to deciding the nature of the share proceeds was what the initial intension was, whether this intension later changed or if a secondary purpose existed. The taxpayer claimed that the intension was capital retention to which the courts then made consideration of the factors as follows.

The taxpayer had certain conditions under which shares would usually be disposed of these contributed to what the court considered being not for keeps, these conditions were a usual badge for capital investment as the shares were intended for retention but only under these very specific conditions were disposed of. In order to know when these conditions were met the taxpayer closely keep watch over its portfolio a factor the courts considered to favour the likelihood of the shares being a revenue asset together with the gap the memorandum left for trading. The permission which the memorandum left for trade further enhanced the likelihood of revenue nature by looking to the ratio of profit from share disposals to annual profit of the taxpayer. The percentage being as large as it was implied that the taxpayer could be indulging in a scheme of profit making as one does not just incidentally make such profits regardless of the fact that the taxpayer did make certain disposals at a loss. The existence of occasional losses was not given much influence it does however have the potential of creating uncertainty.

The disposals which were made included shares not held for a very long duration. The majority of the factors here indicating that the shares in fact were a revenue asset with which the taxpayer was dealing with in secondary purpose. If the taxpayer so believed otherwise the onus was on him or her to declare that these conditions were not as they so appeared after which if it was successfully done the decision could be subject to adjustment. This a further measure to ensure that the classification of shares is appropriate. In the absence of such a declaration by the taxpayer the shares were classified as a revenue asset.

In summary the following factors contribute to nature in the following ways :

- Intension of retention with disposal under certain conditions:

The nature of the conditions under which shares were to be disposed in the instance meant that the shares were not acquired 'for keeps' however this didn't

impair that the share were capital in nature, it was considered a reasonable part of the criteria.

- Absence of a provision in the memorandum prohibiting trade:

This means that the company was allowed to trade in its capacity, which favoured the likelihood that shares could be revenue in nature.

- The duration of time for which share held:

The longer the shares were held the more likely that the investment was capital nature. ( This factor carried very little weight in the courts final decision )

### Applying s9C to Barnato

From the facts of the case, the longest the shares were held in this case was since 1962 ..

‘appellant did indulge in share-dealing during the tax years of 1967, 1968 and 1969. That appears from ...the fact that they had not been held for very long (some at the longest since 1962, others for shorter periods).’<sup>32</sup>

The years which were questionable under this case were 1967, 1968 and 1969 and from the extract for the judgement above the courts have accepted that the longest of the shares disposed have been held since 1962. With regard to section 9C which makes the assumption that share disposals are done on the first-in-first-out basis, means that since the facts say that the longest of the share disposed subject to this case were held since 1962 the longest duration shares held that were disposed of in that first year under question 1967 were held for greater than 3 years.

In applying section 9C, since the facts are not such that the disposals were made to a connected person the duration for which these shares disposed in 1967 were held would entail that the proceeds from the disposals are of a capital nature. This would result in its presence taxable income being different to that which the courts have decided. This is a reasonable expectation from the change in the law. Per the court findings, after giving much consideration these shares will be classified as trading stock subject to the conditions of section 22, but section 9C would require that the eighth schedule be applicable to the shares disposed of in 1967 which meant that less of the profits would have been taxed under section 9C than by applying case law.

If any of the shares disposed in 1968 were of that which was acquired in 1962 the duration for which they were held would also exceed 3 years and in line with section 9C, without any further consideration these would also be classified as capital nature. These disposals would also be in line with the section 9C be subject to

<sup>32</sup> Barnato holdings LTD v SIR 1978(2) SA 440(A), 40 SATC 75, 1978

Capital gains tax can not be included in gross income or subject to the section 22 provisions. This would result in less of the proceeds being included in the taxable income calculation for this period hence the taxpayer is less out of pocketed by this conclusion. The facts state that during the period /s under question i.e 1967,1968,1969, additional acquisitions were made and in the event that these shares were the shares which were disposed of during these same periods and the rest of the facts the same the nature assigned to the proceeds of these shares would probably be decided the same as in the cases, deciding them as revenue nature to which section 22 would apply and a greater portion of the profits would be taxable. This approach would require more consideration than the time frame.

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Nussbaum:

This case deals with an individual.

Brief summary of the facts:

The taxpayer was a retired employee who had inherited portfolios of listed shares over a number of years first 1946 resulting in what was referred to as a substantial portfolio over which he kept constant watch and exercised investment strategies and had concluded numerous share sales and purchases.

The commissioner classified it as scheme of profit-making and hence revenue in nature.

Deciding the nature of the amount of proceeds:

Of the selected cases this is the only case where the taxpayer is an individual and in very much the same way it was considered appropriate to determine whether the share disposals were a mechanism of capital asset realisation, which the taxpayer was of the opinion of, or of trading stock. The courts looked to the circumstances under which the taxpayer found it appropriate to dispose of its shares these were similar to that in Barnato which classified the shares as not being held for keeps but still an appropriate condition to be a capital investment. For these conditions to be acted on it was required that portfolio be observed and given the nature of the share markets fluctuations were foreseeable. This here meant that in addition to observing when disposals in line with disposal conditions were appropriate the taxpayer could also anticipate profits reasonably, which allowed indulgence in profitable trades. The percentage of profits made from the disposal of shares, in the years of trade were an indication that the latter had been indulged in. Although the conditions under which the taxpayer found it appropriate to dispose of its shares were usually capital investment norms, portfolio observation together the accompanied profit anticipation and continuity of the trades the courts concluded that the taxpayer was in fact indulging in realisation of trading stock as a secondary purpose hence was revenue nature.

In summary the following factors were considered to contribute to nature in the following ways:

- Disposals under specific conditions:

Meaning shares were not held 'for keeps' however this is not against the capital investment criteria.

- Observing portfolio:

This means that the value of the shares were being monitored and its more likely that disposals would occur at times when profit was higher i.e in scheme of profit making hence favouring revenue nature.

- Continuity of trade:

This means that trades occurred often and this favoured the likelihood of revenue nature.

Applying S9C to Nussbaum

From the facts the duration for which the shares were held , were stated in the judgement that most of these shares were held for more than 5 years. Section 9C would render these share disposals to be of a capital nature having been held for more than 3 years. The classification which the courts have decided requires that the shares be trading stock and subject to section 22 of the income tax act as well as the full proceeds are included in gross income. Section 9C will result in the proceeds being subject to the eighth schedule where less of the profits would be taxable, an even lesser percentage than in the above cases as the inclusion rate for capital gains is less for an individual than for a company.

## Outcome differences from the application of section 9C the case law

### African Life Investments

The final court decision was that the amount of proceeds from the disposal of shares was Revenue in nature<sup>33</sup>. Whereas section 9C existing at that time would have resulted in the nature of the share proceeds being Capital in nature. The tax payable for the taxpayer will be less than it was had case law decided.

### Trust bank of Africa

The final court decision was that the amounts of proceeds from disposal were capital in nature<sup>34</sup>. If section 9C applied at the time, the court decision would more likely have been arrived at if the connected persons full exception applied or if it didn't and the duration for which shares were held was less than 3 years. Where the connected person's exception did not apply and the duration was greater than 3 years the nature would be capital. These outcomes are more or less the same, not having much effect on tax payable by the taxpayer, however arriving at this conclusion using section 9C is much more convenient and certain.

### Barnato

The final court decision was that the amount of proceeds from the disposal of shares was Revenue in nature<sup>35</sup>. If section 9C was applicable at the time of the transactions the shares disposed of first assuming the first-in-first-out method as section 9C does would have been capital in nature, resulting in less tax being payable. Only those shares acquired after the very first acquisition would have been subject to the court's decision in the event that the nature is not obvious. All the factors which are set out in the cases analysis above will require consideration to arrive at a conclusion, which will likely be like the courts previously decided.

### Nussbaum

The final court decision was that the proceeds from the disposal of shares were Revenue in nature<sup>36</sup>, had section 9C applied at the time of the disposal however transactions proceed amounts would be Capital in nature. The taxpayer would here be liable for less tax than when case law was used.

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<sup>33</sup> African life investment Corporation (Pty) Ltd v SIR 1969 (4) SA 2559 (A)

<sup>34</sup> SIR V The trust bank of Africa LTD 1975 (2) SA 652 (A)

<sup>35</sup> Barnato Holdings Ltd v SIR 1978 (2) SA 440 (A)

<sup>36</sup> CIR V Nussbaum 1996 (4) SA 1156 (A)

Having analysed the cases this dissertation will now set out the observations made in the process of reviewing the cases.

#### How section 9C impacts the ideal of a good tax system

From the above comparison and analysis it is clear that the introduction of section 9C provision has brought about change as can reasonably be expected. As set out in the introduction, section 9C is not expected to be in line with the previous court findings as it only makes reference to one factor. The factor being a duration of time results in instances where other factors would all indicate that the taxpayer in fact was holding the shares as a revenue asset but the existence of section 9C and a time frame of greater than three years has the power to convert that nature in the instance of shares. Section 9C being time based achieves this, which is evident by almost all of the cases considered in this dissertation. This is the first indication that the enactment of section 9C is effective in bringing about change as one can reasonably expect to be the change of this enactment.

Most capital and revenue distinctions are said not to be conclusively defined, with regard to share proceeds and the enactment of section 9C however, some form of definition has in fact been added. This results in nature not being as indecisive in the case of shares which can be considered to provide a form of certainty. In each of the other case considerations where a share was held for greater than 3 years the share was so deemed to be capital in nature regardless of the other factors which usually contradict each other and require the courts to go back and forth on the matter. (see above number of considerations taken into account for the decision) The provision can hence be said to provide a better form of certainty than in the case of the decision being influenced by so many different effects, as a set period is attached. Considering different factors create room for debate and can in most instances be very time consuming which by looking to the time period the provision can be considered to a more convenient way of accounting for the taxes on share disposal. The idea of a tax system is that it not overly complex which by contribution to convenience and certainty section 9C enhances the existence of a good system.

With regard to the financial difference in applying section 9C rather than case law to decide nature, having nature more often decided as capital results in the taxpayer being less out of pocket<sup>37</sup>. This reduced tax payable comes mainly as a result of the capital gains tax which was brought into enactment prior to section 9C. The eighth schedule results in the inclusion rate for such sales are less than other providing financial advantage to the taxpayer (refer to example in African Life Investment case above, page 12).

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<sup>37</sup> Adam Smith, an inquiry into the nature and causes of the wealth of nations

This form of financial advantage is beneficial to both taxpayers and the economy. Taxpayers are benefitted by less of their income being taxable. The economy is favoured by more disposable income being in circulation on a national platform, at the same time also on an international platform. The provisions of section 9C regardless of other factors will result in share proceeds being capital nature after a 3 year duration is fulfilled. Subject to capital gains tax, this reduces the taxes which investors who dispose of shares after 3 years, both local and international. The latter also being liable for taxes related to their domestic investments also are subject to the implications of section 9C. Effectively by section 9C looking only to a 3 year time period to classify proceeds as capital nature, subject to capital gains tax, acts as a booster to investor confidence<sup>38</sup>. The financial implications of section 9C indeed favour the taxpayer, both domestic and international.

#### Misusing section 9c

As can reasonably be expected where financial advantages exist there is a probability of the in inappropriate attempt to obtain the advantage.

For example if a taxpayer has every intention to trade its shares, makes provisions for it in its memorandum given that it is a company, the taxpayer can just not trade in its shares claim to be holding them for dividend yield and after three years dispose as often it wants. The taxpayer would deduct and add the trading stock in terms of section 22. Given that the shares will still be on hand however the inclusion and deduction will result in a zero effect. This zero effect will result each year up until the disposal and where it is greater than 3 years the disposal will only be subject to capital gains tax. This act would equate to obtaining the best of both, and a potential loophole. Section 9c however is set out such that if shares are previously regarded as trading stock in terms of tax and subsequently meet the section 9C capital nature condition that all prior deductions be recouped, almost eliminating the unfair benefit of applying both revenue nature and capital nature principles.

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<sup>38</sup>Shares and Capital Gains tax (2013). Available at [www.hmrc.gov](http://www.hmrc.gov)

### Conclusion

Section 9C and case law are both practices of the law. The switch from one to the other is expected to come with much change, which was evident in the comparison of the outcome of the application. In the application of case law the courts considered many factors which would be sufficient enough to influence the outcome in some instances and not in others, much like the indecisiveness of the concept of nature<sup>39</sup>.

Section 9C attaches a single factor giving a criterion to capital nature of shares. In the instance of shares this better achieves the certainty ideal of a good tax system than the multiple varying factors which case law would consider, of which uncertainty was a major downfall. Some examples from the cases looked at, are whether the portfolios are observed, what the intensions are and consideration of the company's memorandum, where neither of the factors alone provides a conclusion. Section 9C removes a lot of this uncertainty, creating a convenience which previously didn't exist.

In addition to contributing to certainty and convenience of the tax implications for share proceeds, section 9C, even in the presence of conclusions which would result in the amount being one hundred percent taxable, reduces the tax payable by the taxpayer<sup>40</sup>. The taxpayer is placed in a less out of pocket<sup>41</sup> position than it would be if the decisions were based on the court considerations. This applies to domestic and international taxpayers, increasing the income available for the taxpayers disposal as well as enhancing the favourability of international investment<sup>42</sup>.

Possibility is created by section 9C for advantage to be improperly obtained, however by requiring previous deduction to be recouped on disposal, which should not have been allowed, the provision restricts the favour of such practice<sup>43</sup>.

Looking at the possibilities and considerations to which the court was required to resort prior to section 9C, in almost every uncertain situation, one can reasonably say that the enactment of section 9C eliminates a lot of the complexity while it provides much advantage such as favouring the parties a good tax system aims to favour, more certainty and convenience. A better tax system is effectively achieved than with the use of case law, in relation to share proceeds.

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<sup>39</sup> CIR v Stott 1928 AD 252, 3 SATC

<sup>40</sup> Eighth schedule, Income Tax act 58 of 1962

<sup>41</sup> Adam Smith, An inquiry into the nature and causes of the wealth of nations

<sup>42</sup> Shares and Capital Gains tax (2013). Available at [www.hmrc.gov](http://www.hmrc.gov)

<sup>43</sup> Interpretation note 43(issue 4) (2012). Available at [www.jutalaw.co.za](http://www.jutalaw.co.za)

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