WAS THE SUPREME COURT OF APPEAL CORRECT IN ITS JUDGEMENT OF THE STELLENBOSCH FARMER’S WINERY CASE?

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INTRODUCTION

A contract requires two or more people to come to an agreement with regards to the requirements of such a contract with the intention of following the practice of whatever is set out in the contract, the main intention being to deliver a performance by both parties. When two parties sign a contract they are thus agreeing to stick to the terms of the contract that they are signing, as it becomes effective upon signature. The contract is then rendered to be in place and binding from that moment thereon. This implies that any condition that is not complied with in the contract that might take place after signing the contract will have penalty imputed on the guilty party as per stipulated in the contract. The contract must also provide the detailed measures that will be taken in the case of either party failing to honour the necessary conditions that were stated at the inception of the contract. Failure to adhere to the conditions in the contract is called breaching the terms of the contract and thus the company found guilty of breaching the contract will be liable to pay the penalties agreed to by the parties that have entered into that contract. If a company or individual signs a contract that will provide that particular company or individual with benefits for a certain period, but for whatever reasons the contract gets cancelled, it makes sense that the company or individual should receive compensation for the damages of the loss of the income that it would have received had the contract run its full course as intended without any party repudiating the specific contract in question. This brings me to the concept of damages and compensation.

CHAPTER 1.

DAMAGES AND COMPENSATION DEFINITIONS.

Damages and compensation are a form of payment to a person or a company that has suffered a loss resulting from a breach of contract, injury or failure to deliver what was promised.

The debate whether an amount is revenue or capital in nature has been going on for decades. The question therein lies with what actually determines whether an amount will be of a revenue or capital to the recipient. How do we then explain that there are similar cases which get to be decided differently even when the facts are more or less the same? What is the determining factor that leads to a conclusion of a different treatment of a receipt? In this research, I aim to elaborate on the treatment of damages and compensation in the hands of the recipient, looking mainly at an amount received by the recipient as a result of a cancellation of contract.
I am focusing on this topic dealing with the tax implication of an amount received as compensation of an early termination of a contract as to evaluate whether the Supreme Court of Appeal was right in coming to its conclusion.

The South African Income Tax Act 58 of 1962\(^1\) (herein referred to as ‘the Act’) does not provide a decisive guide of the classification of an amount that is received by way of compensation, case law principles and decisions that have been taken by earlier courts thus have to be used as a guide. These cases also, do not indicate how an amount should be treated but rather explore styles and directions of how an amount is likely to be treated. In other words, whether the compensation that is received is to be treated as capital or revenue in nature and why.

There have been many cases dealing with what makes an amount revenue and capital in nature. The guide of how to classify an amount as revenue or capital have been correctly interpreted in \textit{WJ Fourie Beleggings CC vs CSARS}\(^2\) passed by Judge Leach AJA that when an amount that is received is considered to be of revenue in nature that means that it adds to the income producing activity of the business, and that amount which is found to be revenue in nature will be included in the taxpayer’s gross income and is therefore taxable. Similarly, when an amount is received for the income earning structure of the business, it will be rendered capital in nature. By income producing activity in my own understanding means the regular manner in which the taxpayer derives his income, either by buying goods and selling them for a profit and these goods are known as trading stock, or, by way of providing services. For the capital nature, an example would be a company which does not trade in property and the company engage in a once off sale of an apartment, that income that is received from the sale will not be included in gross income but it will be liable to Capital Gains Tax under s26A of the Act, another example would be what was decided in the \textit{Stander vs CIR}\(^3\) case about an employee earning prize reward outside his employment description. Amounts that are found to be capital in nature are excluded specifically from the definition of gross income.

I will demonstrate my points with the aid of case law from South Africa as well as Foreign case law. The reason I will be applying foreign case law is because the decisions arrived to in

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\(^1\) Income Tax Act s1: Definitions.
\(^2\) \textit{WJ Fourie Beleggings CC vs CSARS} 2003(5) SA 344 (SCA), 71 SATC 125 2009 Taxpayer 74.
\(^3\) \textit{Stander vs CIR} 1997 (3)SA 617 (C), 59 SATC 212, 1997 Taxpayer 174.
regards to this issue are the same as the Tax Court used some of the foreign authority to arrive to its decisions. Foreign tax law also seem to have an emphasis which I would like to substantiate my points on, as it provides the relevant discussion and treatments of court when dealing with a particular case. It appears that for decisions of the examples that I will be elaborating on, similar court decisions have been arrived at. I am therefore convinced that is why the treatment of the cases is more or less the same. I will then move on the factors that could give a lead and guide of how to treat an amount that is received as a compensation or damage from a premature termination of a contract. There is no section of the Act that provides guidance as to how to treat the amount of compensation received, thus we rely on case law to have a guide. Lord Macmillan stated that the decisions taken by the tax courts are not decisive for each case as we look at the merits of every case on their own facts and then take a decision from there. To elaborate, the decisions taken by the courts only give an informative guide to ensure that we apply the appropriate principle to each case based on the facts and circumstances that existed on the times of the payment. I will also make mention of a few cases where a different decision was reached relating to same facts of information in order to substantiate my points.

In this dissertation, I will be using The Stellenbosch Farmer’s Winery case as my leading case of reference (hereinafter referred to as The SFW case) in order to show what should be established in order to justify the classification of an amount that is received as a compensation. I am choosing to use this case as it is a South African case dealing with an early termination of contract, and I concur with the judgement that was passed on by the Supreme Court of Appeal, the decision was decided excellently in my opinion and it would be injustice to further add or subtract to the words of the judgement that was concluded. It is close to perfect, and thus the reason I chose to use it more than other cases. It is suited for this case because it deals with a contract that was terminated before its maturity date was reached, most cases deal with assets that were sold and are therefore inappropriate to be used as a leading case for the purpose of this particular dissertation.

As mentioned earlier, the Act does not contain sections that defines or deems an amount to being revenue or capital in nature, thus we look to relevant case law and inspect thoroughly the important factors that render an amount to be of a capital in nature. Even in the cases, there is no single, straight principle that says if an amount is this way, then it should be

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treated in a certain manner but we look carefully into the facts and characters of each case. Although, the most dominant factors might direct the manner in which an amount then gets treated, nevertheless it is not so obvious.

When compensation is received, in order for the amount to be taxable, it must be included in the gross income. This goes without saying that the amount must then meet every requirement of the gross income definition set out in section 1 of the Act. The amount should be included if, and only if, certain criterion is met. Should any point given fail, the amount then comes short of the requirements and will not meet the definition of gross income and can therefore not be included in gross income. In order for an amount to be included in gross income, these are the requirements that have to be satisfied: section 1 of the Act states that:

\[
\text{In any year or period of assessment, means –}
\]
\[
\begin{align*}
\text{In the case of any resident, the total amount, in cash or otherwise, received or accrued to or in favour of such resident; or} \\
\text{In the case of any person other than a resident, the total amount, in cash or otherwise, received or accrued to or in favour of such person from a source within the Republic, during such a year or period of assessment, excluding receipts or accruals of a capital nature.}
\end{align*}
\]

One of the vital requirements for an amount to be included in gross income is that the amount must not be of a capital in nature. The Act does not give a definition of a capital amount, therefore in order to come to a right conclusion of the whether an amount is capital would have to be evaluated by means of relevant case law.

There has been case law that was established on the requirements of the gross income definition and it shall be assumed, for the purpose of this dissertation that the other requirements of the gross income definition have been met. Those requirements are there must be a total amount, received by or accrued to and that the amount is made to a resident.
CHAPTER 2

Description of the case: The Stellenbosch Farmers Winery

Facts of the case

The SFW case deals with a contract that was signed between a United Kingdom company called Distillers and a South African company (the Stellenbosch Farmer’s Winery). The contract was entered into on the 1st February 1991. The contract was for Distillers to use the SFW as a distributor of their liquor products because the SFW was gaining prominence in the liquor market. The SFW was a wholly owned subsidiary of Stellenbosch Farmers Winery Group. The Group did not participate in any other income earning activity, it just acted merely on being a holding company. SFW was in the business of distributing liquor products, and the market that the SFW was in proved to be a successful business venture until the termination of the contract that was signed between the two companies took place. These two companies came to an agreement in which Distillers gave The SFW a sole right to distribute liquor goods such as whiskey and spirits. The whiskey product was Bells.

The agreement that was entered into was for a fixed period of ten years, and the contract did give an option of termination before the period could end, however, a notice of six months would have to be given before the termination takes place, and of course the party that terminates the contract before the stipulated period would be liable for some sort of compensation. The contract continued for a period of six and a half years, at that point there emerged a global financial unrest that forced Distillers to terminate the contract three years before the full ten years was reached. Distillers planned to go out of the contract with The SFW and enter into a new one with an international company that establishing itself in South Africa. As a result, Distillers was obliged to pay the appellant for the breach of failing to run the course of the contract as stipulated at the inception of the contract. The term that was used for this payment in the clause was “Payment received for the loss of right to distribute Whiskey products”.

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The Commissioner then went on to include the amount received as compensation for the breach in the appellant’s gross income. This receipt as a result, is the core argument of this case, whether the Commissioner rightfully included the amount in gross income, or if this amount was capital in nature and should therefore be excluded.

**Judgement**

The taxpayer appealed to the Special Tax Court where the decision was taken by the Tax Court based on their findings that the amount that was received was received for future loss of profits that the SFW will no longer be receiving after this termination of contract. A conclusion was then reached that this amount must then be included in gross income.

Secondly, the Tax Court concluded that the compensation that was made was a gain made from schemes of profit making relying heavily on the *Pick ‘n Pay Share Purchase Trust vs CIR*\(^5\). This is a complicated process to accept as scheme of profit making relates to an asset that is acquired and then subsequently sold with a different intention than when it was obtained for the first time. This argument I can therefore not agree with as this is not what happened in the SFW case and thus the decision of the Tax Court based on this judgement was incorrect.

The taxpayer appealed to the Supreme Court of Appeal (hereinafter referred to as SCA) for the treatment of the amount that was received by way of compensation because the taxpayer was dissatisfied that the amount was included by the Commissioner in the appellant gross income. This was upheld by the SCA and the onus was on the taxpayer to prove that the amount of the sixty seven million that was received was of capital in nature. This is in line with the requirements of section 82 of the Act.

The SCA was not satisfied with the Special Tax Court decision on the basis that the Tax Court only focuses on the physical side of the payment that was received, that is, payment for the loss of profits which is not so. The appeal was dismissed with costs

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\(^5\) *Pick ‘n Pay Employee Share Purchase Trust v CIR*, 1992(4) SA 39(A), 54 SATC.
As mentioned, I will be using The SFW case as my main point of reference. Applying the gross income definition to this case:

*The amount must not be of a capital nature*

This is the root of the argument, to determine whether the amount that a recipient receives from premature termination of a contract is revenue or capital in nature. It is a bit challenging to come to a conclusion of the right treatment when dealing with cases of this category since the Act does not define what determines a receipt to be of a capital in nature. It appears that the first three requirements of the gross income have been met without question, the uncertainty seems to lie in the fourth requirement of the definition, and this is by far the largest body of case law. In assessing what determines whether an amount of compensation is to be included in gross income or not, the research will also be to evaluate the nature of the amount of the compensation that was received by The SFW. Comparisons will be made to other cases.

**Factors that help to determine whether an amount is of a revenue or capital in nature.**

It is of utmost importance to establish the reason behind the compensation that is received. This is because when a purpose has been established, it simplifies the process of determining whether an amount is received for revenue or capital purposes. Therefore we have to scrutinise if the compensation being received is received in order to remunerate loss of the utilisation of an asset to produce income or whether the compensation is looking to pay the recipient in order to compensate for the loss of the profits that the taxpayer will no longer earn as a result of that termination\(^6\). In other words, the test here is to determine if the compensation that is received is aimed at filling the hole in the taxpayer’s assets or filling in the hole in the taxpayer’s profits’ This was interpreted comprehensively in the case of *Burmah Steam Ship Co Ltd*. A statement was made by Judge Hoexter, which explained in my understanding, that filling a hole in the taxpayer’s assets is to make a compensation in order to remunerate a loss of an asset that the taxpayer can no longer use to earn income as a result of the termination of the contract, and on the other hand filling in a hole in the taxpayer’s

\(^6\) *Burmah Steam Ship Co Ltd v Inland Revenue Commissioners* (1931) SC 156, 16 TC 67.
profits is to pay the taxpayer an amount of compensation that the taxpayer would have received as income had the termination not happened.

Applying this principle to the case of *WJ Fourie Beleggings vs Sars*\(^7\), where the appellant was in the business of letting his property, this was the appellant nature of business operations and as a result, amounts earned by the appellant will be included in gross income as they are amounts that enable involved in day to day operation of his business, and are taxable, even when he is letting items that are of a capital nature, that is, the buildings. In addition to letting his property as part of his normal trade, he entered into a lease contract to let the property to an Army, of which the Army terminated the contract before it has run its full course. The appellant was compensated the amount of income he would have made had the Army not terminated the contract. However, the appellant thought of this amount to be of a capital in nature as it is a termination of a contract, a right to receive money from the people that the appellant is letting the property to. The Commissioner then proceeded to include this amount in gross income, deciding on this case to be an amount of revenue in nature. The Tax court also concurred with this decision stating that there must be a clear distinction between a means of producing income as well as a contract that depends on the performance of the business to make profit. The service that was provided by the hotelier was accommodation which formed part of the appellant income earning activities. Thus the amount that was received by the hotelier was to plug in a hole to the appellant’s income. This decision in my opinion was decided fairly, the cancellation of the lease was incidental to earning income in the business because of the nature of trade of the appellant. There was no difference in letting of the property by means of a lease contract as the nature of the appellant’s business was to let property in any form.

Identification of whether the business activity can still continue after a termination of contract is a basic point to consider when assessing the treatment of whether an amount received is capital or revenue. The case of *Inland Revenue v. Flemming* lays this principle correctly, it states that:

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\(^7\) *WJ Fourie Beleggings CC vs CSARS 2003(5) SA 344 (SCA), 71 SATC 125 2009 Taxpayer 74.*
‘If a receipt of compensation is received and that receipt was to remunerate an appellant for the deprivation of utilising an asset to earn income as a result of premature termination of a contract, then that amount must be of a capital in nature.’

I will contrast the case of The SFW with the WJ Fourie Beleggings in order to show that the statement mentioned in the Inland Revenue case did not apply to the case of WJ Fourie Beleggings. The latter’s compensation that was received for the cancellation of letting property to one of the clients did not impose severe effects on the nature of the appellant’s income structure, it did not drive the taxpayer out of business, because the nature of the business was the letting of property. The taxpayer could still conclude contracts to let to other companies without being jeopardised by the termination resulting from the Army Company. The Army Company duly paid for the premature termination of the contract and the appellant still rented out the properties without suffering any loss brought by the Army Company. There was never a threat of the appellant business closing down as a result of the termination resulting from the aforementioned companies. Whereas with the SFW case, the compensation was given to remunerate the company for divesting SFW from distributing liquors, to which SFW cannot continue business thereafter.

We can then come to a conclusion that when a receipt is made out to a company that relates to activities that form part of the income earning apparatus of the company, it is more likely than not that the amount will be revenue in nature and therefore included in the recipient gross income. It makes no sense at all to have the amount that is received as a compensation as part of the trading operations to be capital in nature, because even if the contract was not terminated, taxpayer would still receive the income as a product of the taxpayer’s income-earning activities. Thus, the amount must be revenue in nature and taxable. Receiving a termination amount at once does not change a classification that a compensation receipt might take.

On the analysis of the SWF case however, termination of that contract meant that the taxpayer could no longer trade in distributing the liquors as that right had been taken from taxpayer. From my understanding, the right was a basis on which the taxpayer received income; the right basically enabled The SWF Company to derive income from the distribution of the liquors.

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8 *Flemming vs KBI 1995 (1) SA 574 (A), 57 SATC 73.*
Without the right, SWF cannot sell the liquors, without sale of the liquors, SFW cannot generate income, without the generation of income SFW cannot stay in the business. This implied that SFW Company could no longer enter into other contracts without having that sole right of distribution. The success of SFW could be said to have been majorly dependent on the distribution right.

The SFW needed the distribution right to carry on business, and by losing the right the distribution cannot be possible. This unfortunately, implied losing a major proportion of the income that was brought by the sale of the liquors. The compensation that was paid for this consequence can be said to be a payment to compensate for the impairment of the SFW business, that is, the receipt to SFW was to compensate for the closure of the liquor business due to the loss of the distribution right.

Another contributing factor in determining what makes an amount to be classified as revenue or capital in nature is to look at the nature of taxpayer’s business. This was comprehensively explained by Mahalingham⁹. When a taxpayer buys items for resale, that constitutes trading stock and the proceeds will be included in his gross income, even if that trading stock is a capital asset, for example a company that operates in the selling and buying of machinery. If then a taxpayer sells items that are not in the ordinary course of business the items will then be treated as a capital items and not be included in the taxpayer’s gross income. In the case of SFW the taxpayer was a producer, seller and an importer of liquor goods. This was an income earning activity of the business.

On the analysis of this dissertation I will use a statement by Judge Wessels JA that was decided in the *CIR v Stott* case, that

> “when deciding whether a person’s intention has changed over time, we must investigate the intention that a company holds when they acquire an asset as well as the intention when that particular asset is disposed”⁷⁰.

In my opinion, this statement does apply to a termination of a contract and not only on an asset that is bought and subsequently sold because this principle can have an effect on the classification of whether a compensation will be revenue or capital in nature.

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¹⁰ *CIR vs Stott*, 1928 AD252, 3 SATC 253.
At the inception of the contract, the SFW’s main aim was to acquire this distribution right to be able to distribute the products that the company specialised in, and not treat this as part of their trading stock. Even to the end of this contract, the SFW was still in the business of distributing liquor products, and not distribution of rights.

The amount received for the compensation constitute an amount of capital in nature because it was solely paid to remunerate SFW from divesting the company in using the distribution right (which is an asset) to produce income. In other words, it was made because the taxpayer will no longer be trading in the Bells whiskey that the taxpayer imported as the contract has come to an end. In this regard, the taxpayer cannot distribute any product outside of the contract as he has lost the distribution right to do so. This is what the amount received was intended for. Upon termination date, this intention was still in existence and nothing has changed. Thus on the application of the Stott case, original intention remains, there appears to be no proof of an amount being revenue in nature. The SFW was not in the market of buying and selling rights to distribute the liquors, and the company did not enter into this agreement with Distillers to buy the right of distribution in order to sell it at a profit. SFW intention at the very beginning of the contract was to obtain the right in order to be able to sell the products that specialises in, and his intention has subsequently not changed over time

The SCA has differed with the decision of the Tax Court on a basis that when one is looking at the factors that might contribute to an amount of compensation being classified otherwise, one must look at the frequency of the taxpayer’s dealings in such instances, in the judgement that was handed down by the SCA, there has been a point raised to justify how SFW did not appear to be involved in any other activities that might prove that SFW is now in the business of trading in the distribution of right. This makes sense, the payment that was received was a one off payment that was never going to be received again and a similar contract was not to be entered into. On a close examination by Coetzee, it was stated that “the Tax Court has looked more at a physical asset and not analysed the underlying reason for the compensation of this loss of right”11. The physical asset in this case is the money that is paid for this compensation, but what the Tax Court did not take into account was the purpose for which the money was paid. In my own opinion, what the Tax Court should have done was to look at the incorporeal right that Distillers Company was looking to compensate SFW for.

There was an adverse effect on the continuity of SFW after the payment of this termination was completed, and this can only mean that SFW profits was embedded in that distribution right.

I will use a definition that was decided in the case of *British Insulated and Helsby Cables* which went to defined an asset as an ‘item that should not only be cramped down to a material thing’, as intangible assets do exist and in this case that happens to be the distribution right. The court in the case of *British Insulated* further mentioned that ‘if a right that is in fact a major portion of an asset that will be used to generate profits is brought to a halt by way of termination then that amount cannot be of revenue in nature’. Thus the amount that was received by SFW as compensation for stopping the liquor distributing right could have not been an amount of revenue in nature.

Another compelling decision was made in the decision of the *Inland Revenue v Flemming* that decided an amount to be of capital in nature, which related to a receipt of compensation that was to remunerate an appellant for the deprivation of utilising an asset to earn income as a result of premature termination of a contract.

Applying the principle of this case in my own words, it stated that an amount of damages or compensation that is received for the loss, giving up or forcing one to stop using a fixed capital asset of a taxpayer’s income-producing activities is receipt of a capital nature. Looking at the SFW case, the company was deprived of using an asset, that asset being the distribution right to make profits by distributing the liquors, and that deprivation led to the company being driven out of the liquor market after the compensation was received. This goes to prove without question to be filling in the taxpayer’s hole in assets, and not the profits as there were no more contracts were entered into relating to SFW and the distribution of liquors.

To elaborate further on this principle that states that there could be a suggestion of an amount being classified as capital in nature if a business comes to a complete halt due to an early termination of a contract, I will use the Canadian case of *HA Roberts vs Minister of National*

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12 *British Insulated and Helsby Cables Ltd* [1925] 10TC155.
13 *Flemming vs KBI 1995 (1) SA 574 (A), 57 SATC 73.*
to support this claim. In this case, a judgement was delivered in the Supreme Court of Appeal by Spence J where the appellant who was HA Roberts had a business which was divided into five departments, namely the real estate, mortgage, insurance, property management and appraisals.

HA Roberts had different clients from all the services that it offered. It came to pass that the clients from the mortgage department felt the need to go and start their own business, so they had to terminate with HA Roberts. The revenue from this mortgage department came from agency contracts. The agency clients terminated the contracts that they had signed with the appellant and duly paid the compensation that was expected. The amount that was received as compensation was then included by the Minister of Revenue in the appellant gross income because the Minister argued that the amount was received from normal operations of the enterprise and therefore the amount that was received was taxable. The Tax Court supported this claim by stating that that the department actually represented a separate line of business even though it seemed as if the mortgage business was in line with the main operations of the company, thus becoming incidental to the income earning operations of the company. With due respect, I beg to differ with the decision that was made. First, the amount that was received as compensation was received for the closure of the department as no more agency clients were held. This was paid to compensate for that closure of the separate line and I hold the opinion that the amount then was actually paid for the capital that has been invested to ensure the success of the mortgage department, building it up and maintaining it until the day of termination. Secondly, the entire line of the mortgage division came to an end, there were no longer clients held in that particular division and it was closed down. Had the company resumed operating in mortgages without being affected by the change that took place then that might have been a different case. If the taxpayer could still secure contracts and other clients after losing those major clients then it would make sense to include the amount that was received as compensation in the appellant gross income. For this reasons mentioned above, I therefore deem the amount that was received as a compensation that is of capital in nature and should not be included in gross income.

Judge Franklin JA supports my point in ITC 1259\textsuperscript{15} by mentioning that a ‘company does not have to be materially crippled by the termination of a contract in order for an amount to be classified as capital in nature’ but as long as there is a substantial part of the business that is affected by this termination then it may qualify to be classified as capital in nature. It appears that there were thirteen employees in the mortgage department that were employed by HA Roberts to manage the three different agencies that they have secured over the years.

After the termination of these contracts, nine of the thirteen employees from HA Roberts resigned and, two more employees resigned and went to other different companies, one then followed and one remaining last employee from HA Roberts resigned. There were no more employees left for the mortgage department because there were no longer clients to deal with. The employees I understand that they represent goodwill of the business, and losing them is part of losing an asset that has been built along since the incorporation of the mortgage department, being the skills and qualifications that the employees acquired over the years. This is what led to the closure of the aforementioned division and the money of the compensation was received for this very reason, the closing down of the mortgage division. The three agencies that had terminated their contracts were paying the loss that HA Roberts would suffer as a result of the closing down of that particular department. That is similar to what The SFW was compensated for, losing a capital right which led The SFW not to distribute the liquor that needed the right from Distillers. It was not for future revenue that was lost, but rather the incorporeal right that the company can no longer use to earn their profits. I will then come to a conclusion that when a contract comes to an end due to early termination, and a business suffers substantially as a result, the amount of the compensation received should be classified as capital in nature because the main intention of that payment is to pay for the embedded right in the asset.

I will contrast this to the Kelsall Parsons & Co vs CIR \textsuperscript{16} case, which was decided in the United Kingdom as an example to clearly distinguish why the facts are the same but the case was decided upon differently. In this case, Kelsall was an agency dealing company which had about thirteen contracts with specific agencies. It happened that one of the thirteen agencies terminated the contract before the stipulated period and was therefore liable to compensate

\textsuperscript{15} ITC 1259 39 SATC 65. 1981 Taxpayer 136.
\textsuperscript{16} Kelsall, Parsons & Co. v CIR (1938) 21 TC 608.
Kersall for the unforeseen change in the contract. The amount was decided to be of revenue in nature due to the fact that Kersall Company’s main stream of income came from agencies. I fully agree with the decision that was taken by the Commissioner to include this amount in the appellant’s gross income, because Kelsall was a company that made profits from dealing in agencies. Any amount of income that is earned will be taxable as that is their main stream of income. Losing one contract of the total thirteen that the company held would not affect the company, its goal or its policies.

The company can still operate as normal as they did before with no disastrous effects and change in their business structure, and it appears that after this termination, Kelsall continued to operate as before. Kelsall did not close down, entered into other contracts without being at a disadvantage of the cancelled contract and still made profits from the agency business. It makes much more sense that the compensation that was received was in fact received to remunerate Kelsall for the future amounts of profits that they would suffer as a result of that early termination and thus the Commissioner was right to include this amount in the appellant’s gross income.

Similarly, a quote that was used in a case of Van Den Berghs vs Commissioner, The Supreme Court panel quoted that “when compensation is received for a termination that materially cripples the business of the appellant, that amount should be capital in nature”\(^{17}\). This case related to an agreement that was between Company A (hereinafter referred to as A), and Company B (‘B’), where B was required to manufacture goods and sell to other companies. B was required not to manufacture any competing products for as long as A was still signed with B. Together these two companies agreed to form Company C (‘C’). C was a company that would distribute the products to their final destination. B then added another product to their product list outside the scope of the contract that it had signed with A, which was still distributed by C to another company, Company D (‘D’). Later, D stopped the contract and no longer purchased their product from B. The machines that were used to produce that additional product were also used to produce the products that A and B agreed upon.

\(^{17}\) Van den Berghs Ltd v Clark ([1935] 19 TC 390).
The compensation that was received from this cancellation was decided to be revenue in nature by the Tax Courts siting their reason being because stopping the distribution of the product of company D did not stop the production of the many products that the machines were producing for A and B. This decision I fully agree with as the machines were not sterilised after dropping that product for D. The companies still made profits without being at the disadvantage of losing a substantial part of their incomes as a result of a termination from D, and the termination did not preclude the companies from entering into other contracts or completely changing their income earning activity structure. It makes much sense, that the compensation that was received was classified as revenue in nature and was therefore taxable.

The sixty seven million that was received by The SFW was argued by the Tax Courts to be an amount if revenue in nature by virtue of how it was termed in the financial statements for that period in which it was received.

The terminology used for it was ‘exceptional amount received’ in the company’s Statement of Cash Flows, and South African Revenue Services attempted to include it based on that fact. With utmost respect, the term that an amount is given has never and will never be used to decide the nature that the amount should follow. In most instances, if not all, taxation principles and laws always precede accounting rules that are used. That is, the manner in which an amount is treated for accounting purpose cannot overrule the taxation treatment. This was demonstrated in the article of South African Institute of Tax Practitioners by Silke\(^\text{18}\) and it was said in this article that if an amount has been classified using the Generally Accepted Accounting Principle, and a conclusion is reached to treat that item as an income, that does not apply to taxation rules. When it comes to the taxation treatment we have to examine the facts of that particular amount that has been received before coming to a conclusion. In my opinion, the main point that was being emphasised here was that how the compensation is derived and classified does not determine the nature of that particular compensation. For example, in order to come to an amount that should be received as compensation, future predictions of profits that a company would make is evaluated, and based on that, a final amount would then be determined. The mere fact that future profits are used as a basis to determine an amount for the damages/compensation has no effect on the nature that the compensation so received will be classified. That is how a company gets to

predict a value that it could be worth. It shows in The SFW financial statements of the year ended 1992 that the amount of sixty seven million that was received for the compensation of the termination was termed ‘an exceptional amount’, nevertheless, this does not change the nature of the amount received because of the way it has been treated in the accounting financial statements. Therefore the compensation cannot be automatically classified as revenue in nature. “A test would have to be applied to see what the taxpayer is actually losing as a consequence of the cancellation”\(^\text{19}\). In the agreement contract of termination regarding

The SFW case, it makes no mention of the loss to compensate for future profits, but clearly states that the loss is for the distribution right.

The one thing that makes SFW case different from all the other cases that I have dealt with is that the distribution of SFW was the only means to earning profits. When the right to distribute liquor was stopped, then the ability to make profits followed suit. This goes to show, that SFW was sterilised as a result of the premature cancellation that took place. Had it not been for the termination, the company would have still continued to use that right as a basis of realising profits. The entity was thus crippled by the action of the termination. The general principle here is then, when a company comes to a complete stop, and the fixed asset by which it would have earn profits is terminated, in so doing the consequence of the cancellation “destroys and considerably cripples the asset that is used in order to earn profits. The amount received from that cancellation must then be treated as a receipt of a capital nature as the aim is to fill in a hole in the taxpayer’s assets”\(^\text{20}\).

To set a firm basis of how to treat an amount received by means of compensation, the explanation also given in a contract plays a major role. Does the compensation received denote an amount that is received for a temporary termination? Or does it relate to a condition that is of a permanent nature? For example, a restraint of trade received by a company not to

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trade in a certain product for a stipulated period would be of a temporary basis, this type of compensation was perfectly dealt with in the *Tauber* case\(^{21}\), which I cannot add anything more as I fully concur with the reasons given. If an amount is received for a temporary shutdown of business or restraint of trade, when the temporary time lapses, the company can go back and specialise in the product that it has always produced without hanging the structure of that company. When the years come to a full course, then the recipient is relieved from the restraint, he now has the freedom to go and continue in business. Compensation received in this manner will mostly be treated as revenue in nature, as it would be for loss of income unless it relates to a capital asset or closing down the entire business then depending on the merit of the case then that would be rendered capital in nature.

On the case of SFW, the compensation that was received was received for a loss of right that was of a permanent nature. After the compensation has been received, the distribution right is lost and there is no renewal or coming back into the business. There is nothing further that can be done, if SFW wants to continue then the company will have to go get another right to distribute (which did not happen again) or go into a completely new set of an income operating activity. SFW option was to close down on the liquor distribution as a result of losing the distribution right and closure of the liquor business implies that this amount was of a capital in nature.

A critical assessment of the compensation received in place should be thoroughly investigated to determine the nature of the compensation received. This idea was elaborated by Bowles that if a receipt is received and that receipt relates to a once off amount that will not be paid again, it is more likely than not that such an amount will prove to be of a capital in nature. However, if an amount is received for recurring periods then that suggest that such an amount is received in the nature of the taxpayer’s business and might render such an amount to be of revenue in nature\(^{22}\). The amount of sixty seven million that was received by SFW was a once off receipt which was paid by Distillers to the SFW as compensation for signing out of the contract earlier than stipulated, after which the deal was closed and SFW was to receive nothing more of Distillers. There was no recurring benefit that would accrue to

\(^{21}\) *Tauber & Corsen (Pty) Ltd v SIR* 1975 (3) SA 649 (A), 37 SATC 129, 1975 *Taxpayer* 192.

SFW. The deal was signed off and done with. Distillers Company was relieved from the obligation and there was nothing binding them to enter into another contract or keep on paying SFW for the loss that was suffered.

Tyler J. Bowles and W. Cris Lewis further stated that when assessing such cases, one must pay attention to the duration of the contract. When an enterprise enters into a contract that appears to be of a short term, realising profits quickly and seemingly appearing as if the enterprise is in the scheme of profit making, then the amount received will be considered revenue in nature because that is what the enterprise is dealing in. My understanding of this is that the company will be speculating and engaging in activities that maximise their profits.

However, when an enterprise enters into a contract for a longer fixed period that goes to show that the enterprise concerned does not seek to maximise profits to an advantage, this will be indicated by the longer period that the business stays in the contract. SFW entered into the contract with Distillers for a distribution right and did not seek to dispose the right to gain an advantage; they did not dispose of the right at all. A termination was proposed by Distillers and that is when SFW could not distribute the liquors any longer. This was after a period of six years into the contract. Six years is a long term, it is enough to know that an entity is not speculating. The compensation received by SFW shows in many ways than one that it could not have related to a receipt that was of revenue in nature.

In the case of Van Den Berghs vs Clark23, there was a contract entered into between Van den Berghs and another company. The two companies were in the business of selling margarine. One company went into liquidation before the contract came to an end and compensated Van Den Berghs; later Van den Berghs lost the business. The amount was decided by this court and judge to be if capital in nature because it destroyed the whole income earning apparatus of the enterprise. Now, when we take a look of how the business (SFW) did after the premature termination of the contract that was entered in with Distillers. The company did not continue in the sale of liquor products. It was left completely crippled as nothing could be done without the distribution right that allows it to sell the liquor. The trade structure of the business after the termination took place helps to direct the manner of how a judgement is decided upon concerning the treatment of the damages/compensation received. In addition, the termination contract that was signed does not appear to have been a commercial contract.

The loss that was suffered as a result of the termination constituted a major portion of the structure of the business. In other words, the right to distribute that was lost controlled the whole structure of the taxpayer’s business.

Mahalingham also demonstrated a considerable point in mentioning that ‘one would need to also assess if the company receiving the compensation has signed other contracts with the other companies that can keep the income earning activity going’\textsuperscript{24}. The SFW group did not engage in operating activities, it was a holding company that left all of the operations to the subsidiaries, there were no other contracts entered into from the group.

SFW seems to have just had the distribution right as the highest contributor to their profits. As I mentioned in the WJ Fourie Beleggings, the company had other contracts that it entered into and could still enter into without affecting the company’s business structure, even after the Army had terminated the contract. In fact, they could enter into multiple contracts at once for it would be relating to different rentals of different properties being let out as that is where their stream of income came from. They could let the very same property that the Army just cancelled the contract on without compromising the structure of their main business activity or totally having to redefine their main business operation as a result of the termination. The reason I mention this is to compare the case again with SFW. SFW had the contract only with Distillers, without the contract with Distillers nothing else happened. SFW relied on the contract as it possessed the sole right to distribute the liquors. Again, at the time of receiving the compensation this was still the only contract that was in place. This suggests furthermore that SFW did not deal in sale of distribution rights and the amount of compensation received should therefore be capital in nature. The other income of SFW comprised of, which is of a small percentage compared to what the Bells whiskey and spirits were bringing in.

When an early termination of a contract takes place, and the appellant loses business in entirety which brings trade to a discontinuation, then an amount is said to be of a capital in nature. In Barr Crombie case, the fundamental principle was to:

*assess whether the change in the contract fundamentally affects the whole business of the taxpayer. And if the answer to that is yes, then this an amount received for the related compensation will be capital in nature*\(^\text{25}\).

The international case of *Barr Crombie ltd vs Inland Revenue* was a case between two shipping companies, that agreed to come together and operate as one to realise profits to best advantage considering the synergies that they would have had together working as one than working as competitors. The business constituted about 80% of Barr Crombie’s income. Disputes arose and the main cause was the distribution of profits. Failing to find a way to resolve this issue, the other company opted out and remunerated Barr Crombie for the early termination of the contract.

The repudiation badly affected Barr Crombie as the amount of income it got form the deal constituted a majority of their main income of income earning activity and the loss of that contract implied that they would need to redefine their whole business structure as a company that they relied on could not be of support any longer. The amount that was received was decided to be an amount of capital in nature and the Court based this on the fact that when Barr Crombie got liquidated, there was nothing left in the business and this let to its closure.

When the consequences of an amount that is received by way of compensation drives a business out of the market or causes the business to redefine their aims and goals or constitute a majority of how a business earns its profits, Any amount that is received in relation to that cannot be an amount of revenue in nature. For it compensates for the loss of a right embedded in a contract to receive money, and not for the loss of the profits that a company will earn as a result of that cancellation.

If an amount is received for compensation relating to utilisation of an asset that can no longer be used upon termination of a contract, that amount without dispute will be a receipt of capital in nature, save when the taxpayer’s income earning activity is by way of that asset. When mechanisms are brought to a stop and when a machine that is used to produce the company’s products can no longer be used, the amount thereof is capital in nature.

\(^{25}\) *Barr, Crombie & Co v CIR* ([1945] 26 TC 406).
The machines do not produce profits but they are the means that has to be used to produce income.

A similar case was *ITC 1279*[^26], in summary the facts of the case were that there was an agreement between a lessor and a lessee. The lessor was renting out a property that was in a shopping complex. The lessee was an owner of a liquor bottle store. The two parties entered into a contract and one disguising feature in that contract was that the lessee was not supposed to move out to another complex without the prior and written consent of the lessor. The lease was intended to run for a period of 20 years. When the lease was in its seventh year, the lessee no longer wanted to trade in that particular complex and thus gave notice to the lessor about the intentions to terminate the contract earlier. The amount of this compensation would be payment to the lessor for the changes that might need to be made in order for the lessor to get other tenants.

In other words, that would be the costs that the lessor would bear as a result of the premature termination. The lessor classified as an amount that was received for property and the licence that was given for the lessee to run the liquor store.

I agree with that decision from the Commissioner that the amount that was received for the compensation should have been involved in the lessor’s taxable income for that particular year. First, the lessor main business activity was renting out properties to customers and this means any income earned from the rentals would be taxable. Secondly and most importantly, the amount that was received was for the lessor to effect any changes that would need to be done in order for other new tenants to move in, provided that they did not deal with liquor (to remove the designs and the manner in which the store was structured as a bottle store).

This amount was received in pursuance of business. Furthermore, the facts of the case states that the amount that the lessor incurred to effect the changes in order to accommodate new tenants, he sought to deduct them and had done so successfully. If a receipt is received, and it is argued to be capital in nature, any associated costs that are incurred with in relation to the

[^26]: *ITC 1279 (1997) 40 SATC 254 at 258.*
receipt should follow the manner of the treatment of the aforementioned receipt. From my understanding, a receipt cannot be capital in nature but the associated costs be in the ordinary course of business and then be deducted. Both the receipt and the costs associated should be treated the same. If the receipt is capital, it will not be included in gross income and the associated costs will follow the same treatment, if the receipt is revenue it will be included in the gross income of the lessor and the costs can be deducted under the requirements of s11(a).

There was discrepancy in the treatment of the two amounts and that should not be so. The rental amount that was paid by the lessee was paid to compensate for the alterations that the lessor might need to go through to secure new tenants and this is without questioned an aim in the furtherance of the lessors ordinary business activity and this amount is revenue in nature and should have been included in the lessor’s gross income for the particular year in question.

When an early termination takes place and a taxpayer is unaffected by that, this could suggest that an amount received is in the ordinary course of the business activity and that compensation could be revenue in nature.

I will demonstrate this with the case *D12/90*[^27], which was decided in Canada. The appellant in this case was an insurance agent, the appellant entered into a contract with an insurance company whereby the appellant will introduce clients to the aforementioned company in return for receiving a commission from the insurance company. The appellant was to manage and guide the clients that the appellant introduced to this insurance company. The appellant had seven clients in total, but due to personal reasons, the appellant could not continue with the seven clients. The appellant then went on to sell out two of the contract to the insurance company so that the clients would now be managed and guided by the insurance company and not the appellant himself. The appellant got compensated for the loss of the two contracts by the insurance company. And the taxpayer argued receipt of this receipt to be of a capital in nature as he claimed that it related to a goodwill gesture, part of selling his business.

With respect, in my opinion this cannot stand to be true because the appellant was an insurance agent, this was the nature of the appellant business therefore amounts of income earned from the insurance related activities are income as defined and will be included in his gross income and are taxable. The amount that the appellant received related to the two was

[^27]: Inland Revenue board of review decisions, March 1990.
earned in the production of his income. He dealt in this business as an agent and this proved to be receipt of revenue in nature. The decision that was given emphasised that just because an amount is unusual, that does not determine that nature that will follow the compensation that is received. Any amount that is received in the course of pursuing a business will most likely than not be rendered a receipt of revenue in nature. Furthermore, there was a continuation of the appellant business with the remaining five clients, the cancellation of the two clients did not affect the appellant main operating income activity as she could still manage and enter into other contract. The appellant’s business structure was not brought to an end by the cut down of the two contracts that have been disposed off to the insurance company. This amount shows to be a receipt of revenue in nature. This case clearly defines that an amount that is received in order to make business grow, rather, with the aim of maximising profits will be an amount of revenue in nature.

Similarly, an amount that is received and there is no continuation might not be of a revenue in nature. In fact, if the appellant could no longer manage any contracts at all after surrendering the two contracts to the insurance company, and was driven out of business, then the compensation received would have been classified otherwise.

It would have been classified as capital in nature because it would be relating to the complete disposal of the business that materially crippled the insurance agent from continuing any further. In the light of the above mentioned the SFW Company fell into the no continuation mishap. Loss of a distribution right meant loss of the whole income earning apparatus of the enterprise, and that is what the compensation that was received sought to remunerate SFW Company for. Furthermore, if the staff or some of the staff has to be laid off resulting from the termination this could be because there is no activity that goes on. If less people or no people at all can no longer do their job because the right to distribute the liquors have been terminated, then that leads to a receipt being of a capital in nature.

There were employees that were laid off in the SFW as a result of the loss of the distribution right and this also suggests in many ways than one that the inclusion of the compensation received in question, should not have been taxed by the commissioner.
“One of the fundamental requirements for an amount to be of revenue in nature is that it must arise out of normal trade operations of the business”\textsuperscript{28}. This was again analysed in the article Mahalingham and from my understanding stated that if an amount is received as compensation or for damages and that amount does not relate to the daily activities and operations of the business then that amount cannot be of revenue in nature, it does not matter the material significance of the amount being received or the classification that it is categorised into when received. The case that demonstrated this was Kersall vs Parsons\textsuperscript{29}, which also related to an agency company and there was an early termination. Since the appellant’s nature of business activity was dealing in agencies, the amount received as compensation for that termination was also deemed to have arisen out of trade purposes and treated as revenue for tax purposes, even if an amount is received in lump sum. Purpose for which they compensation in place is received plays a vital role. The decision that was handed down gave a profound statement, that when there is a contract and that contract happens to be terminated earlier than the stipulated date, emphasis should be placed on the structure of the business. We would have to look at whether the business changes its main goals and policies, whether the business goes into compete structuring, does the business start to drop in profits significantly, do factors of bankruptcy start to emerge, is there any form of suffering that occurs in the business after the termination takes place.

If none of these factors are seem to be changed and the business carries on trade like they normally did before the early termination took place then those factors highly suggest that the contract was done in the course of trade as there is little or no impact at all from the termination of the contract. The amount received as compensation with regards to the termination will then be an amount of revenue in nature and thus included in the taxable income of the appellant.

There should be much emphasis on whether an asset or income is being lost. I will illustrate this by a way of this example, if a company (‘A’) signs a contract with another company (‘B’), which enables it to use machines to make products and sell them but for unforeseen circumstances the contract comes to an end before it has run its full course. The factors that should be critically examined are whether the machine forms part of the income operating


\textsuperscript{29} Kelsall, Parsons & Co. v CIR (1938) 21 TC 608.
apparatus of the business, meaning that are the machines a vital part of making the profits themselves or are they incidental to the working of the of profit making. When a machine is incidental to the profit making of the enterprise it means that the machines are used to make profits but they themselves cannot make profit. Furthermore, it means that the machines have to be used to produce those products or else the products cannot be produced if not put on those machines. And if findings show that the products cannot be produced without the machines, that indicates the machines are part of the income producing structure of the business and receipt received for the termination of the contract will be rendered capital in nature. That is exactly what happened in The SFW case. The distribution right that was acquired by SFW from distillers did not make profit itself, but it produced means to which the profits were made and it was very vital to the profit making structure of the business for without that right there was nothing to be done that could be done. This suggests that the intangible right of distribution was capital in nature and should have never been included in the taxable income by the Commissioner.

Finally, using the critical analysis of Silke to determine if an amount should be classified as revenue or capital in nature, ‘the contents of the contract that is signed for the termination should also be critically analysed’\textsuperscript{30}. I would elaborate to say that the contract should be inspected if the company receiving the compensation, in this case The SFW, is obliged to perform anything currently or in the future for Distillers.

If an amount of compensation for early termination is received and there appears to be further conditions attached to it in terms of performance, then the amount could be suggesting that the receipt of compensation is received in the pursuance of trade and would therefore be liable for taxation. This termination contract between Distillers and SFW however, did not appear to have any conditions attached to it. There was no part payments that SFW had to pay Distillers in the future or presently or a distribution right that would be granted again in the future. Distillers was to pay SFW an amount of sixty seven million and cut ties completely with SFW.

From the facts I have mentioned, the amount that The SFW received for an early termination of a contract, in my opinion relates to the intangible right of distribution of a contract proving to be of a capital nature. It then makes sense to not be included in the SFW gross income, although the compensation will be subject to Capital Gains Tax, which applies to proceeds received of all assets that are used in the production of income, except if the assets are personal use assets or specifically prohibited in terms of section 26 of The Act.
CONCLUSION

In closing, it is not as easy to look at an amount and conclude the nature and the classification that the amount will follow. It will be noticed that on this dissertation relied heavily on case law principles and the reason for this is because The Act does not define what an amount of capital nature constitutes. I will use a favoured line from the United Kingdom case of Wiseburgh v Domville Stated by Birkett LJ which stated that

‘there is no precise rule or standard by which one can lay it down that “You have come within it or without it”. It is all a matter of degree and all the facts of the case must be considered’\(^{31}\).

Certain principles have to be applied to each case and be assessed individually without looking at one case and decide that an amount will be classified as revenue or capital. It has been shown in the cases mentioned above that there could be similar situations but gets a different treatment depending on the circumstances surrounding each case.

There are certain factors that one needs to keep in mind while working to determine a nature of an amount. Some of those factors are the number of years that a taxpayer has been in business, the nature of the taxpayer’s business, the bargaining position of the taxpayer, the terminology used around the amount that was received and the actual reasons why the amount for compensation has been received in gross income.

In this research I elaborated with aid of case law on factors that should be evaluated when attempting to classify an amount that is received as compensation for early termination of a contract. Based on my understanding, I gave my view of whether I feel the cases have been rightly decided or not and why. I have analysed The SFW in detail, and in my view the Tax Court should have not included the compensation that was received.

I then went to compare and contrast The SFW with other cases because I believe without a shadow of doubt that the Commissioner erroneously included this amount in the appellant’s gross income. I have demonstrated that the termination related to the closure of that business,

\(^{31}\) Wiseburgh v Domville (1956) 1 All ER 754 (CA) at 759.
the closure due to the distribution right that was lost with Distillers opting out of the contract earlier than the date that was stipulated. The amount of sixty seven million that was received should have not been include in the appellant gross income as it related to an compensation of capital in nature and that is specifically excluded from the gross income definition. With all the facts I have mentioned above, the supporting cases and a few journals I am convinced and can therefore fairly conclude that the amount of compensation that was received was for the distribution right, and a right is an item of capital nature. The appellant was right and the Commissioner was erroneous to include this amount in the taxpayer’s taxable income. The Act however does state that amounts that are received regarding assets of the business may be capital in nature but that does not preclude them fully from escaping some sort of tax. Such amounts will be taxed in terms of the capital gains rules and be included in the appellant’s income at 66.6%, as opposed to the 100% that the Commissioner has included. This amount was without arguments received for the capital value of this distribution asset, which I am persuaded that is a capital asset.

I therefore disagree with the treatment from the Special Tax Court and the reasons provided and I agree with how the SCA arrived to their decision, this is also because the SCA is higher in ranking as compared to the Tax Courts. And the decisions of the SCA are binding on the lower courts. The reasons were logical and in accordance with the understanding of how amounts should be treated in order to determine rightfully if they are revenue or capital in nature.

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