TAX AVOIDANCE AND TAX REDUCTION

WITHIN THE FRAMEWORK OF THE SOUTH AFRICAN INCOME TAX LEGISLATION, WITH SPECIAL REFERENCE TO THE EFFECT ON THE *FISCUS* AND TO CURRENT ANOMALIES AND INEQUITIES

[A thesis submitted for approval to the University of Cape Town in fulfilment of the requirements for the degree of Doctor of Philosophy.]

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PREFACE

The subject of tax avoidance and tax reduction within the framework of the income tax legislation has so far not been dealt with in any work in South Africa and this is, therefore, the first work of its kind.

My approach in this work has generally been, firstly, to set out the effect of the law in the light of the court decisions, the departmental practice and my own interpretations; secondly, to consider and discuss the extent to which taxpayers can arrange their affairs within the letter of the law in order to avoid or reduce tax and the prejudicial effect on the public revenue, and finally to offer my criticisms, suggestions and recommendations.

It was inevitable that during the course of my studies and investigation into the workings of the Income Tax Act and the incidence of the taxes levied, various anomalies, inequities and obscurities would present themselves. Although some of these bear no or little relation to the problem of tax avoidance and tax reduction, I have nevertheless considered it necessary to deal with them in this work. Often they lead to results quite opposed to well-established commercial and accountancy practice. I have attempted to show how this conflict that exists between the Income Tax Act and the accountant's and business man's approach frequently results in the taxable income not coinciding with the profits as ascertained on the basis of ordinary commercial and accountancy principles. Many of these aspects have up till now received very scant thought, and I have, therefore, felt that they should be clarified with a view to making both the taxpaying public and the *fiscus* fully conscious of them. The legislator and the taxpayer should be ever mindful of anomalies, inequities and obscurities in the law, because only by continual discussion and criticism can one hope for their ultimate eradication and hence for a better and fairer tax system.

After setting out the accepted distinction between tax avoidance and tax evasion and describing broadly the Union's present tax structure, Chapter One deals with the present anti-avoidance provisions in the Income Tax Act. Chapter Two discusses the principle of source as a test of liability to tax and its contribution to tax avoidance. Tax avoidance through the medium of companies and the avoidance of super tax on company dividends are considered in Chapters Three and Four. In Chapter Five, various income-splitting devices are dealt with, viz. partnerships, arrangements between parent and child, and trusts. The position of the non-Union resident is considered in Chapter Six, and the taxation of husband and wife in

Chapter Seven. The various exemptions from income tax and the present system of granting rebates are examined in Chapter Eight. Chapter Nine deals with the allowable deduction provisions of the Act, and in Chapter Ten the taxation of benefits from employment and services is considered. Chapter Eleven is devoted to the special statutory provisions affecting particular classes of taxpayers, viz. farmers, insurers, mining and co-operative concerns and land dealers. Various special aspects and topics are considered in Chapter Twelve, and finally, the general problem of tax avoidance is discussed in Chapter Thirteen.

My researches into the fiscal laws of other countries have convinced me that in the solution to many of our tax problems in South Africa much can be learned from the methods adopted in the United Kingdom and other Commonwealth countries particularly in regard to the manner in which these countries have attempted to solve the problem of tax avoidance and to overcome anomalies and inequities thereby nipping possible future controversies in the bud. I have, therefore, not hesitated to refer on a number of points to the tax laws of the United Kingdom, Australia, Canada, New Zealand and the Federation of Rhodesia and Nyasaland.

There has been no attempt to undertake discussion on the general and administrative provisions of the Income Tax Act except where they directly concern the subject-matter under consideration. In general, the details of the administrative machinery have been omitted as being outside the scope of this work. The work is based on the law and the rates of tax in force in respect of the year of assessment ending 30th June, 1958, and on the practice of the Department of Inland Revenue as known to me at the time of writing.

I have submitted this thesis for approval to the University of Cape Town in fulfilment of the requirements for the degree of Doctor of Philosophy. I am indeed grateful to my supervisors, Professor W. H. Hutt, Professor of Commerce and Dean of the Faculty of Commerce, and Professor H. Greenwood, Professor of Accounting, at the University of Cape Town, for their guidance and encouragement.

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Cape Town,
September, 1958.

A. S. Silke.

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Abbreviations

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A.D.	Reports of the Appellate Division of the Supreme Court of South Africa.
(A.D.)	Appellate Division of the Supreme Court of South Africa.
All E.R.	All England Law Reports.
Ch. D.	Law Reports, Chancery Division.
C.I.R.	Commissioner for Inland Revenue.
C.O.T.	Commissioner of Taxes.
C.P.D.	Reports of the Cape Provincial Division of the Supreme Court of South Africa.
(C)	Cape Provincial Division of the Supreme Court of South Africa.
F.C.	Federal Supreme Court of the Federation of Rhodesia and Nyasaland.
I.R.C.	Inland Revenue Commissioners.
I.T.C.	Income Tax Case (Special Court).
K.B.	King's Bench Division.
L.J.Ex.	Law Journal Exchequer.
L.T.	Law Times Reports.
N.P.D.	Reports of the Natal Provincial Division of the Supreme Court of South Africa.
(N)	Natal Provincial Division of the Supreme Court of South Africa.
O.P.D.	Reports of the Orange Free State Provincial Division of the Supreme Court of South Africa.
(O)	Orange Free State Provincial Division of the Supreme Court of South Africa.
S.A.	South African Law Reports.
S.A.T.C.	South African Tax Cases
Sc.L.R.	Scottish Law Reports.
S.C.	Court of Session Scotland Reports.
S.R.	Southern Rhodesia Law Reports.
(S.R.)	High Court of Southern Rhodesia.
T.C.	Reports of Tax Cases (United Kingdom).
T.H.	Reports of Witwatersrand High Court (1902-1910).
T.L.R.	Times Law Reports.
T.P.D.	Reports of the Transvaal Provincial Division of the Supreme Court of South Africa.
(T)	Transvaal Provincial Division of the Supreme Court of South Africa.
W.L.D.	Reports of the Witwatersrand Local Division of the Supreme Court of South Africa.
(W)	Witwatersrand Local Division of the Supreme Court of South Africa.
T.S.	Transvaal Supreme Court Reports.

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CHAPTER ONE

INTRODUCTION

I. Tax Avoidance and Tax Evasion

§ 1. The distinction between tax avoidance and tax evasion

The purpose of this treatise is to consider the extent to which taxpayers can arrange their affairs within the framework of the South African income tax laws in order to avoid or reduce tax and the consequential prejudicial effect on the public revenue. The accepted distinction between tax avoidance and tax evasion will be observed.

Tax evasion refers to all those activities deliberately undertaken by a taxpayer to free himself from tax which the law charges upon his income, e.g. the falsification of returns, books or accounts, sham transactions or transactions in *fraudem legis*, etc. The usual methods of tax evasion are to arrange for receipts of income to go into the taxpayer's pocket rather than through his books and to claim as a deduction expenditure which is of a personal nature or not in fact laid out at all. No special provision is necessary in a taxing Act to prevent the nullification of these schemes, which are illegal and which are subject to very heavy and severe penalties.[1] As regards disguised transactions entered into for the purpose of tax evasion, the *fiscus* is sufficiently protected by common law in that the court will not hesitate to strip the transaction of its disguise and expose the true nature or substance of the contract.[2]

Tax avoidance, on the other hand, denotes that the taxpayer has arranged his affairs in such a perfectly legal manner that he has either reduced his income or that he has no income on which tax is payable. In other words, tax avoidance is lawful whereas tax evasion is illegal. This treatise is not concerned with tax evasion. Fraudulent devices employed to escape tax do not fall within its scope. It considers only transactions, operations or schemes which do not constitute a breach of the law.

No obligation rests upon a taxpayer to pay a greater tax than is legally due under the taxing Act and a taxpayer is not debarred from entering into a genuine or *bona fide* transaction which, when carried out, has the effect of avoiding or reducing liability to tax. This is clearly brought out by the following *dicta* expressed in various court decisions:

[1] See sec. 65 and sec. 91 of Act 31 of 1941.
[2] See, for example, *C.I.R.* v. *Saner*, 1927 T.P.D. 162; 2 S.A.T.C. 199, and *Bailey* v. *C.I.R.*, 1933 A.D. 204; 6 S.A.T.C. 69.

'It is trite law that His Majesty's subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure, if, having considered the lines drawn by the Legislature for the imposition of taxes, they make it their business to walk outside them.'[3]

'No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow — and quite rightly — to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, as far as he honestly can, the depletion of his means by the Revenue.'[4]

'Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.'[5]

§ 2. The rule of interpretation of fiscal legislation

The courts have, therefore, held that it is open to any taxpayer to avoid or reduce tax by preferring the kind of transaction that is not taxed. Tax liability is fixed by law, so that if the taxpayer has been able to arrange his affairs in a way that he falls outside the taxing net, he is free. The remote intentions of the Treasury to collect as much tax revenue as possible are immaterial. On the other hand, if the taxpayer has organized his affairs in a way so as to attract tax liability in terms of the clear letter of the law, he is liable to pay — no matter what hardships result. In *Partington* v. *Attorney-General*[6] Lord Cairns stated the rule of interpretation of fiscal legislation as follows:

'If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'

This *dictum* has been approved of[7] and repeatedly referred to by the South African courts.

3 Per Viscount Sumner in *Levene* v. *I.R.C.*, [1928] A.C. 217; 13 T.C. 486.
4 Per The Lord President (Clyde) in *Ayrshire Pullman Motor Services and D. M. Ritchie* v. *I.R.C.*, 14 T.C. 754.
5 Per Lord Tomlin in *Duke of Westminster* v. *I.R.C.*, 51 T.L.R. 467; 19 T.C. 490.
6 21 L.T. 370.
7 See *C.I.R.* v. *George Forest Timber Co., Ltd.*, 1924 A.D. 516; 1 S.A.T.C. 20, and *C.I.R.* v. *Delfos*, 1933 A.D. 242; 6 S.A.T.C. 92.

Another often quoted passage which has been referred to by the courts[8] is the following *dictum* of Rowlatt, J., in *Cape Brandy Syndicate* v. *I.R.C.*:[9]

> '. . . in taxation you have to look simply at what is clearly said. There is no room for any intendment; there is no equity about a tax; there is no presumption as to a tax; you read nothing in; you imply nothing; but you look fairly at what is said and at what is said clearly and that is the tax.'

In applying the provisions of a taxing measure, therefore, justice and equity can have little significance. The court must administer the Act according to its plain language and if the language is plain it must be given effect to even if the result to the taxpayer is harsh and unfair.

II. An Outline of the Present Tax Structure

§ 3. Nature of the taxes levied

Both the Union Government and the four Provincial Administrations impose taxes on income.

Taxes levied by the Union Government

The Income Tax Act (Act 31 of 1941, as amended) imposes a normal tax, a super tax, a non-resident shareholders' tax, an undistributed profits tax and a donations tax.

Taxes levied by the Provincial Administrations

Each of the four Provinces imposes a personal tax and an income tax by means of an Ordinance passed by the Provincial Councils which are empowered to levy these taxes by the Financial Relations Consolidation and Amendment Act, 1945, as amended.

Normal tax

Normal tax is imposed upon all persons, whether individuals or companies or other taxable entities, e.g. trusts, estates, clubs, etc. The tax is payable on the *taxable income* (which does not include company dividends since the company itself pays the normal tax on its profits), as defined in the Act, and is imposed at progressive rates upon individuals and other taxable entities, i.e. the proportion of tax paid to total income increases as the income increases, but at a flat rate upon companies. Unmarried persons pay a higher rate than married persons and different rates are prescribed for mining companies. All persons other than companies are entitled to deduct from the tax payable a primary rebate. In addition, individuals are entitled to rebates in respect of children, insurance and dependants. Companies are, however, not entitled to any rebate. After deducting the various rebates, a surcharge is added to the tax payable in the case of persons other than companies. Normal tax rates must be fixed annually by Parliament.

[8] See, for example, *Dibowitz* v. *C.I.R.*, 1952 (1) S.A. 55 (A.D.); 18 S.A.T.C. 11.
[9] [1921] 1 K.B. 64; 12 T.C. 358.

Super tax

Super tax is imposed upon all persons other than companies whose *income subject to super tax*, as defined in the Act, exceeds £2,300. The income subject to super tax comprises taxable income *plus* company dividends. Companies are not liable to super tax as shareholders pay the tax on dividends received. The rate of super tax, which is progressive, is the same for all taxpayers, whether married or not. Certain rebates are deductible, and, after making this deduction from the tax payable, a surcharge is added. Individuals not ordinarily resident nor carrying on business in the Union, are exempt from super tax on company dividends. Super tax rates must be fixed annually by Parliament. The object of super tax is, firstly, to increase the tax burden in respect of the higher income groups and so achieve the principle of levying tax according to ability to pay. Secondly, by the inclusion of company dividends in the income subject to super tax, the super tax enables additional tax to be imposed in respect of the income earned by companies which are subject only to normal tax on such income.

Non-resident shareholders' tax

Non-resident shareholders' tax is payable in the main by persons not ordinarily resident nor carrying on business in the Union who receive dividends from South African companies on which super tax is not payable. The tax is also payable by Union private companies on such proportion of their income subject to super tax as pertains to the interest of shareholders who are foreign companies. In such circumstances, the tax is not payable again when the Union private company declares a dividend in favour of the foreign company. The non-resident shareholders' tax is imposed at a flat rate which is the same for all persons.

Undistributed profits tax

Undistributed profits tax is payable by companies registered or carrying on business in the Union. It is imposed solely in order to discourage avoidance of the payment of super tax through companies not distributing dividends to shareholders. The tax is calculated at a flat rate on that part of the income of a company which has not been distributed but which in terms of the Act ought to have been paid to shareholders in the form of a dividend.

Donations tax

In order to prevent avoidance of income tax and estate duty by the distribution of gifts, a donations tax has been imposed in respect of the value of all gifts (other than those gifts which are specially exempted from tax) made by a donor ordinarily resident in the Union. All persons, including companies, are liable for this tax. The tax, which is at a progressive rate, is calculated on the cumulative value of donations made on or after 24th March, 1955. Donations tax is a tax on capital but for administrative convenience it has been incorporated into the Income Tax Act.

Provincial personal tax

Personal tax, the rate of which varies in each Province, is payable only by individuals over 21 residing in one of the four Provinces for at least ninety consecutive days during the tax year. It is calculater at a graduated rate on taxable income *plus* company dividends. Unmarried persons pay a higher rate than married persons. The tax is payable to the Province in which the taxpayer was last resident for at least ninety consecutive days during the tax year.

Provincial income tax

Provincial income tax is payable at varying rates in the different Provinces by persons other than companies residing in any of the Provinces for at least ninety consecutive days during the tax year. It is calculated as a percentage of the amounts payable by way of normal tax and super tax before the addition of any surcharge. The tax is payable to the Province in which the taxpayer was last resident for at least ninety consecutive days during the tax year. In some of the Provinces the rates vary as between married and unmarried persons.

Compulsory savings levy

Except in the case of incomes derived from gold-mining, a certain portion of the normal and super tax payable must be regarded as a savings levy repayable to the taxpayer after five years. The savings levy bears interest at the rate of 4½ per cent per annum free of income tax.

§ 4. Determination of taxable income — the pivot of tax liability

The determination of the taxable income is a vital step in the calculation of the taxes payable; it is the pivot of tax liability. No matter the type of tax to be calculated, the first essential requirement is to arrive at taxable income. Normal tax is calculated on taxable income; super tax requires, as the starting-point, the taxable income, and the non-resident shareholders' tax on private companies, undistributed profits tax and the provincial taxes all require as a prerequisite the determination of taxable income.

The method of arriving at the taxable income is set out in section 7. The first step involves the determination of *gross income* which is the total of all receipts and accruals (other than those of a capital nature) from any source within the Union or deemed to be within the Union. The second step is the determination of *income* which is the balance remaining of the gross income after excluding all amounts exempt from normal tax in terms of section 10 of the Act. *Taxable income* is the amount remaining after deducting from the income all the amounts allowed to be deducted or set off in terms purpose of section 9(4) is to ensure that parents do not avoid the provisions of section 9(3) by each making a donation to the minor child of the other. In terms of section 9(5), income under a donation, which is withheld from the beneficiary, is deemed to be the income of the donor, and, under section 9(6), income under a donation is deemed to be the donor's income if he has the right to revoke or to confer the income upon another.

The undistributed profits tax provisions (sections 49 to 54 in Part V of the Act) have been designed to protect the Revenue in that if a company does not distribute each year a specified proportion of its profits by way of dividends on which shareholders will be subject to super tax, it has to pay the undistributed profits tax.

The donations tax provisions (section 54 *bis* to 54 *duodec* in Part VI of the Act) were introduced to serve a double purpose, namely to prevent the avoidance of estate duty and the reduction of income tax by the making of gifts.

Section 90(1)(*b*) is another special provision designed to counter the trafficking in assessed losses of companies.

The effect of these special provisions, as well as certain others, will be considered in this treatise in their appropriate places.

§ 7. General provision against tax avoidance — section 90(1)(*a*)

Section 90(1)(*a*) provides that if the Commissioner is satisfied that any transaction, operation or scheme has been entered into by a taxpayer for the purpose of avoiding or reducing liability for the payment of tax, he may determine the income of the taxpayer as though the transaction, operation or scheme had not been entered into. In this respect, the decision of the Commissioner is subject to objection and appeal but it is provided that whenever it is proved that tax avoidance would result from any such transaction, operation or scheme, it will be presumed, until the taxpayer proves the contrary, that the transaction, operation or scheme was entered into for the purpose of avoiding tax. The section is couched in the following terms:

> '*Transactions, operations or schemes for purpose of avoiding liability for or reducing amounts of taxes on income*
>
> 90. (1) Whenever the Commissioner is satisfied —
>
> (*a*) that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act) has been entered into or carried out for the purpose of avoiding liability for the payment of any tax, duty or levy on income (including any such tax, duty or levy imposed by a previous Act) or reducing the amount thereof, and has the effect of avoiding liability for the payment of any tax, duty or levy on income or of reducing the amount thereof, the liability for any tax, duty or levy on income and the amount thereof may be determined as if the transaction, operation or scheme had not been entered into or carried out;

of the Act. Practically all the permissible deductions are to be found in section 11 of the Act.

The Union Act does not, therefore, impose tax on 'profits or gains' as such but in respect of the *taxable income*, as defined. In this respect, the taxation system differs from others, notably that of the United Kingdom. Unlike many other countries also, e.g. the United Kingdom, Australia and Canada, the Act does not seek to impose tax upon residents in respect of their entire income from all sources. The Act imposes tax in respect of income from sources within the Union. Only in exceptional cases is income from foreign sources taxed in the hands of a Union resident or is the residence of the taxpayer relevant.

Like most other taxing systems, the Union Act does not tax capital gains nor does it permit the deduction of capital losses. In certain cases (usually by way of an amortization allowance), capital expenditure is deductible.

The taxable income does not include company dividends since the company itself pays the normal tax on its profits. Shareholders resident or carrying on business in the Union are, however, subject to super tax on dividends received.

In the Union, no adjustment of tax is made (as, for example, in the United Kingdom and in the Federation of Rhodesia and Nyasaland) in order to grant relief to those shareholders receiving dividends whose personal rate of tax is less than the rate of tax payable by companies.

III. Statutory Provisions against Tax Avoidance

§ 5. Introduction

A study of the income tax laws of most modern taxation systems reveals the inclusion of specific provisions designed to prevent tax avoidance and reduction. In addition, there is usually a general provision against tax avoidance whereby the tax gatherer is entitled to ignore the legal effect of transactions, operations or schemes entered into for the purpose of avoiding tax although they do not affect the validity of such transactions for other purposes. Such general provisions are to be found, for example, in the income tax laws of Australia,[11] Canada[12] and South Africa.[13]

§ 6. Specific provisions against tax avoidance in the South African Income Tax Act

The Union Income Tax Act contains a number of sections which are designed to prevent specific and known schemes of tax avoidance. For example, under section 9(3), income is deemed to be that of the parent if, by reason of any donation made by the parent, income is received by his minor child or is expended for the benefit of the child or has been accumulated for the benefit of the child. The

[11] Sec. 260 of the Income Tax and Social Services Contribution Assessment Act.
[12] Sec. 138 of the Income Tax Act.
[13] Sec. 90(1)(*a*) of Act 31 of 1941.

(*b*) . . .

(2) Any decision of the Commissioner under sub-section (1) shall be subject to objection and appeal, and in proceedings relating thereto, whenever it is proved that the transaction, operation, scheme, . . . in question would result in the avoidance of liability for payment of any tax, duty or levy on income or in the reduction of the amount thereof, it shall be presumed, until the contrary is proved —

(*a*) in the case of any such transaction, operation or scheme, that it was entered into or carried out for the purpose of avoiding such liability or of reducing the amount thereof; and

(*b*) . . .'

The Appellate Division, in *C.I.R.* v. *King*,[14] interpreted section 90 and held that it only applied if the income was in reality the income of the taxpayer concerned, i.e. if as a result of the transaction, operation or scheme, the taxpayer has parted with income which is in reality his income being the product of his capital or labour. It would seem, therefore, that the section cannot be invoked in the case of any transaction involving the alienation of income-producing assets. In *King's* case it was also held that section 90 is limited to those transactions, operations or schemes in which tax avoidance or reduction was the dominant motive. If the person entering into the transaction, operation or scheme does so not for the purpose of avoiding income tax but for other purposes, e.g. in order to avoid death duties, it must follow that section 90 does not operate. It was further held by the Court that in section 90 the word *may* imports a duty on the Commissioner to exercise the powers conferred upon him if he is satisfied as to the nature of any such transaction as is specified in the section.

The meaning of section 90(1)(*a*) is well brought out in the following extracts from the judgment of *King's* case:

Per Watermeyer, C.J.:

'Liability for the payment of some expected tax can, in a wide general sense, be avoided by a taxpayer if he abstains from earning any income and acquires none in any other way. This abstention from earning an income can be brought about by many kinds of operations or transactions. A man can for instance simply close down his business or resign from his employment but it is absurd to suppose that the Legislature intended to impose a tax upon a man who enters into such a transaction or operation as if he had an income, which in fact he has not got, merely because his purpose was to avoid exposing himself to liability for taxation by having an income.

'In a wide sense also the amount of a man's income tax can be reduced from what it was in previous years if he earns less income than in previous years, but here again it is absurd to suppose that the Legislature intended to impose a penalty upon a man who enters into a transaction which reduces the amount of his income from what it was in previous years merely because his purpose was to reduce the amount of his income and consequently of his tax. These two types of cases

[14] 1947 (2) S.A. 196 (A.D.); 14 S.A.T.C. 184. The Court was concerned with sec. 90 prior to its amendment by the Income Tax Amendment Act, 1946 (Act No. 55 of 1946). This section was identical with the present sec. 90(1)(*a*).

may be uncommon but there are many other ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or of freeing himself from taxation on some part of his future income. For example, a man can sell investments which produce income subject to tax and in their place make no investments at all, or he can spend the proceeds in buying a house to live in, or in buying shares which produce no income but may increase in value, or he may invest the proceeds outside of the Union, or make investments which produce income not subject to normal tax in his hands, e.g. Union Loan Certificates, deposits in the Post Office Savings Bank or shares in public companies. He can also sell shares in private companies, the holding of which may subject him to heavy taxation in his hands although he does not receive the income which is taxed, or he can sell shares in companies which pay high dividends and invest in securities which return him a lower but safer and more certain income. He might even have conceived such a dislike for the taxation under the Act that he sells all his investments and lives on his capital or gives it away to the poor in order not to have to pay such taxation. If he is a professional man he may reduce his fees or work for nothing; if he is a trader he may reduce his rate of profit or sell his goods at a loss in order to earn a smaller income. He can also secure deductions from the amount of his gross income, for example by insuring his life. He can carry out such operations for the avowed purpose of reducing the amount of tax he has to pay, yet it cannot be imagined that Parliament intended by the provisions of section 90 to do such an absurd thing as to levy a tax upon persons who carry out such operations as if they had not carried them out. Moreover the problem of deciding what the income of such persons for the tax year would have been if they had not carried out such operations would appear to be insoluble in some cases, if the countless possibilities of what they might otherwise have done with their capital or their labour are borne in mind. . . . It is necessary, therefore, to search for some other meaning of section 90 which will not lead to such unsatisfactory results and, as I shall show, such a meaning can be found. What type of transaction or operation was the Legislature intending to nullify for taxation purposes? Obviously it must be one which has the effect of avoiding liability for a tax or of reducing its amounts. But in what sense is the word " avoid " used and from what amount is a reduction contemplated? In order to answer these questions it should be realized that there is a real distinction between the case of a man who so orders his affairs that he has no income which would expose him to liability for income tax, and the case of a man who so orders his affairs that he escapes from liability for taxation which he ought to pay upon the income which is in reality his. Similarly there is a distinction between reducing the amount of tax from what it would have been if he had not entered into the transaction and reducing the amount of tax from what it ought to be in the tax year under consideration. . . . I shall now endeavour to illustrate the distinction which I have drawn between the two meanings. The taxes imposed by the Act are intended to be taxes upon persons, assessed in various ways upon the amounts of their incomes and upon amounts which are deemed to be part of their incomes. Now income, in the ordinary sense of the word, is the product or fruit of a man's labour or of his capital or of both. I use the words labour and capital in their widest sense, labour to include all his activities which result in producing income and capital to include, *inter alia*, legal rights such as usufructs or annuities. The tax is not, however, imposed *simpliciter* upon a person's income; instead of that being done the Act provides for a series of steps being taken which constitute the calculation whereby the taxable amount of a person's income is arrived at. The starting point is "gross income", i.e. the total amount received by or accrued to a person from a source within the Union, less certain receipts of a capital nature. From " gross income " receipts and accruals which are exempt from normal tax are deducted and the result is called " income ". From " income " the deductions which are permissible in terms of the Act, consisting mainly of the expenditure incurred in earning the income are subtracted, the result is called " taxable income ". From " taxable income " abatements permissible in terms of the Act are deducted and the result is called " taxable amount ".

'This scheme for calculating the taxable amount affords several opportunities for the ingenious person to put into operation a transaction which is designed to free himself from taxation in respect of moneys which should be taxable in his hands because they are in reality his income for the year. (By the words " in reality his income " I mean that they are the product of his capital or his labour or of both.) For example, seeing that the " gross income " of a person is defined as the total amount " received by or accrued to or in favour of that person ", a taxpayer can, while retaining the ownership of his capital, arrange for the fruits of that capital, which are in reality part of his income, to be received by someone else and thus he can free himself from taxation in respect of these moneys. (Compare *Hiddingh's* case.[15]) Section 90 of Act No. 31 of 1941 was enacted immediately after the decision in *Hiddingh's* case and this suggests that it was introduced into the Act to prevent a taxpayer from avoiding liability by means of assignments of income such as were made in that case. Again a taxpayer may go further and cause the equivalent of his income to be received by himself as a benefit in a non-taxable form, e.g. as a capital accrual. (Compare *Latilla* v. *Inland Revenue Commissioner*,[16] subsequently affirmed in the Court of Appeal and in the House of Lords; *Gratus* v. *Commissioner for Inland Revenue*.[17]) There may also be many other ways in which a taxpayer can contrive, by a transaction or operation, to free himself from taxation in respect of moneys which in reality form portion of his income.

'It may indeed sometimes be difficult to decide whether or not a particular sum of money is in reality portion of a taxpayer's income. If the word income be given the narrow meaning which it bears in the Act, then nothing which is not already within the net of the taxing provisions could be brought within it by the operation of section 90; but if the word be given its natural meaning, i.e. the fruits derived from a man's labour, capital or from both, then many schemes for avoiding payment of tax will be brought within the operation of section 90.'

Per Schreiner, J.A.:

'I do not read section 90 as a penalty section or as widening the net beyond the general scope of the Act. It seems to aim at a truer or fairer determination of the liability to the taxes imposed by the Act

[15] *Hiddingh* v. *C.I.R.*, 1941 A.D. 111; 11 S.A.T.C. 205.
[16] [1943] A.C. 377; 25 T.C. 107.
[17] 1933 W.L.D. 100; 6 S.A.T.C. 159.

and at their due payment when so determined. It is intended, I think, to deal with cases in which the Commissioner, as representing the *fiscus*, is properly aggrieved by a transaction or operation designed to enable one of the parties thereto to escape tax. The Commissioner is not properly aggrieved merely because at a stage before income has accrued to a taxpayer it might have been predicted with confidence amounting even to certainty, that if the taxpayer took no steps in the matter such income would accrue to him and because he then takes the avoiding steps. But the Commissioner would be properly aggrieved if a transaction or operation were entered into which prevented income from accruing to the taxpayer, while leaving him in the position of one to whom the income would normally and naturally accrue. The section is not, in my opinion, designed to implement the expectations, however reasonable, of the Commissioner that there will be no change in the taxpayer's affairs which will result in his getting less income; it is designed to meet the Commissioner's objections to the creation of abnormal or unnatural situations, to the detriment of the *fiscus*. Now normally and naturally the owner of an income-producing asset receives the income and the labourer receives the reward of his labour. Any departure from this order of things, if done with the object of prejudicing the *fiscus*, is the subject of legitimate objection by the Commissioner, which is met by the machinery of the section. In such cases, and in my view in such cases alone, it can be said that the Commissioner is seeking to tax the taxpayer on what is "in reality his income", to use the expression employed by the Chief Justice. It is in reality his income because it should have accrued to him and it can only be said that it should have accrued to him if it was the fruit of his capital or of his labour or of both.'

§ 8. Consequences of '*King's*' case

The decision in *King's* case has resulted in the scope of section 90(1)(*a*) being limited to such transactions, operations or schemes as result in the fruits of a taxpayer's capital or labour accruing to another. It cannot be invoked in cases where a taxpayer has parted with his income-producing asset, whether by way of sale or donation, in such a manner that the income now accrues to the new owner since the income is in reality the product of the capital of the new owner. Thus, schemes to avoid tax by the transfer of income-producing assets to a company, e.g. a taxpayer may sell his business to a company for the express purpose of avoiding tax, are not hit by the section as the income derived from the assets after the sale is in reality the income of the company since it is the provider of its own capital. Similarly, a scheme to avoid tax by the donation of an income-producing asset to another so that the income now accrues to the donee is not hit by the section. The creation of a servitude, such as a usufruct, would also not fall within the section. Although the donor is not parting with the whole of his asset, he is disposing of a portion thereof, i.e. the right to the use and enjoyment thereof. This is an income-bearing asset, the disposal of which falls outside section 90, in terms of *King's* case.

It is submitted that if a person who possesses a right to claim payment of income under a trust deed cedes that right so that the income in future accrues to the cessionary, the cession falls outside the ambit of section 90 since he will have disposed of an income-bearing asset, i.e. a right to claim income under a trust. It cannot be argued, it is submitted, that the cedent has disposed of income which is in reality his, being the product of his capital. The income-bearing asset, in this instance, being the right to receive income, has not been retained. Thus, the income accruing to the cessionary in the future is not the product of the capital of the cedent but the product of his own capital, i.e. the right to receive the income under the trust. Watermeyer, C.J., in *King's* case held that because section 90 was enacted immediately after the decision in *Hiddingh* v. *C.I.R.*[15] this suggested that it was introduced into the Act to prevent a taxpayer from avoiding liability by means of assignments of income such as were made in that case. In *Hiddingh's* case it was held that because the taxpayer had divested himself of portion of his right to claim income under a trust, the income flowing therefrom accrued to and was taxable in the hands of the donees. *Hiddingh's* case clearly involved a disposal of an income-bearing asset, i.e. a right to receive income, and it is, therefore, submitted that section 90(1)(*a*) would not apply to a transaction similar to that which occurred in *Hiddingh's* case assuming that the main or dominant purpose of the transaction was the avoidance or reduction of tax liability. It is contended that the remarks of Watermeyer, C.J., were only in the nature of a *dictum* in regard to the reason for the introduction of section 90, and were not intended to convey that the section applies to a transaction similar to that which occurred in *Hiddingh's* case.

The case of *C.I.R.* v. *King* is so far the only case of the superior courts of the Union on section 90 of the Act. In practice, the Commissioner seldom applies section 90, no doubt because of the very restricted interpretation accorded to the section by *King's* case. In a Special Court case decided before *King's* case, the Court applied section 90 to a partnership agreement and refused to recognize it.[18] In another case, the Special Court refused to apply section 90 having regard to the principles laid down in *King's* case.[19]

§ 9. Recommendations of the Committee of Enquiry in regard to section 90(1)(*a*)

The Committee of Enquiry into the Income Tax Act, while realizing that the judgment in *King's* case had the effect of severely limiting the scope of section 90(1)(*a*), felt that there was every justification for the existence of a provision giving the Commissioner the necessary machinery to attack transactions resulting in the creation of abnormal or unnatural situations to the detriment of the *fiscus*, notwithstanding that such a provision might represent an encroachment on the rights of a person to order his affairs for the purpose of avoiding or reducing his liability for the payment of tax. The deterrent effect of such a provision was, in the view of the Com-

[18] I.T.C. No. 581, 14 S.A.T.C. 105.
[19] I.T.C. No. 642, 15 S.A.T.C. 238.

mittee, considerable, and the Committee had no doubt that without such a general clause it would be impossible to counter effectively all the schemes for the avoidance of tax that may be devised. In making its recommendations, the Committee expressed itself as follows:[20]

'The decision in the *King* case has resulted in the scope of section 90 as presently worded being limited to such transactions as result in the fruits of a taxpayer's capital or labour accruing to another. In these circumstances the present section would probably be held not to be capable of being invoked in the case of any transaction involving the alienation of income-producing assets. The application of the present section is furthermore, as a result of the decision in the *King* case, limited to those cases in which tax avoidance or reduction was the *dominant* motive of the transaction.

'While we feel that it should not be the object of the section to render any or all transactions of a taxpayer open to attack under its provisions, as in its present form the section purports to do, we are of opinion that the total exclusion of transactions involving the alienation of assets would preclude the application of the section to certain cases to which it is proper that it should apply. The transfer by alienation, of assets from a company to another company under the same control, for example, may well be resorted to for no other reason than the avoidance or reduction of tax, for the ultimate benefit of those in control of the companies concerned.

'As regards the question of the degree of the tax avoidance purpose which should be present to bring a transaction within the ambit of the section, we feel that it is only where the tax avoidance motive is the sole or main purpose of a transaction that the transaction should be subject to attack under its provisions.

'Under the present provisions of section 90 the Commissioner's powers to effect adjustments in pursuance of the section are confined to determining the tax liability of the persons concerned "as if the transaction, operation or scheme had not been entered into or carried out". Circumstances may arise, however, in which adjustments effected on that basis would not provide an appropriate or practicable means of counteracting the tax avoidance motive of a transaction. We feel, therefore, that the Commissioner should be vested with alternative powers to effect the necessary adjustments, where it is expedient to do so, by other appropriate means.

'To give effect to our view that the present section should be modified as to the scope of the transactions to which it should be applied, as to the degree of tax avoidance motive that should be present to bring the section into operation, and to extend the Commissioner's powers of effecting adjustments to counteract the tax avoidance motives of transactions falling within its provisions, *we recommend* that the present provisions of sub-section (1) (*a*) of section 90 be amended to read as follows:

"90 (1) (*a*) Where any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act and including a transaction, operation or scheme involving the alienation of property) has been entered into or carried out, which has the effect of avoiding liability for any tax, duty or levy on income (including any such tax, duty or

[20] *Second and Final Report*, p. 32, paras. 21-6.

levy imposed by a previous Act), or of reducing the amount thereof, and which the Commissioner, having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out, is of opinion —

(i) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question,

and the Commissioner is not satisfied that some purpose other than the avoidance of such liability, or the reduction of the amount of such liability, was the sole or main purpose of the transaction, operation or scheme, the Commissioner shall determine the liability for any tax, duty or levy on income and the amount thereof as if the transaction, operation or scheme had not been entered into or carried out or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance or reduction."'

The Income Tax Commission, 1953, accepted this recommendation in principle.[21]

§ 10. Conclusions on section 90(1)(*a*)

With respect, the writer is doubtful whether the Committee's recommended wording will affect the range of the section at all, except in regard to the Commissioner's powers to effect adjustments when he does apply the section. At present, if the Commissioner seeks to apply the section, he may encounter practical difficulties which may be insoluble since the basis for the assessment must of necessity be a hypothetical state of affairs because the transaction, operation or scheme, although disregarded for tax purposes, is in fact operative between the parties. As was held in *King's* case, the section seems to seize upon departures from the normal and natural result that the owner of an income-producing asset receives the income and the labourer receives the reward of his labour. The mere alienation of capital or of an income-producing asset has not the effect of avoiding payment of or reducing income tax since the new owner is entitled to the income. If the income is in reality that of the purchaser and not of the vendor, section 90 cannot be invoked. That is why the Commissioner failed in *King's* case and why he must fail in all transactions, operations or schemes involving the alienation of income-producing assets.

Section 90(1)(*a*) is of little assistance to the Commissioner in effectively countering many of the loopholes in the law since the tax avoider either arranges for the income-producing asset to belong to another so that the income is in reality the income of the new owner or orders his affairs in such a way that he has no income which would expose him to liability for income tax. The section applies only if the

[21] See *First and Final Report*, para. 66, p. 35.

income is in reality the income of the taxpayer concerned. The scope of the section is, therefore, extremely limited, particularly when there is borne in mind that well-established principle of taxation law that the disposal of income does not affect the incidence of tax which means that disposals of income after it has accrued also do not fall within the section. To conclude, it is hard to conceive of many cases in practice which could fall within the scope of the section. No wonder the Commissioner resorts so sparingly to the section. As will be shown in the ensuing chapters, there are many tax avoidance schemes and devices which cannot be stopped by section 90(1)(*a*). Such devices can only be effectively countered by specific anti-avoidance provisions rather than by some general provision which must of necessity introduce an element of uncertainty as to the liability for tax thereby violating a canon of taxation that a tax must be certain in its effect. The lesson of *King's* case is that an anti-avoidance section which is cast in the widest and most general possible language will not work in practice. In the writer's view, a wise tax legislator should concentrate rather on specific provisions to counter obvious avoidance devices and loopholes in the law (see § 306).

CHAPTER TWO

THE SOURCE CONCEPT AND TAX AVOIDANCE

§ 11. THE SOURCE PRINCIPLE

Meaning of source

The principle of source of income as a test of liability for tax, which the Union Treasury has consistently followed ever since income tax was first imposed, has resulted in the creation of a number of tax avoidance and tax reduction devices.

In terms of the definition of 'gross income' in section 7 of the Income Tax Act, only receipts and accruals of income derived from a source within the Union or from a source deemed to be within the Union[1] are subject to tax. Presumably the reason for adopting source as the basis of liability to tax is that if the natural resources of a country or the activities of its inhabitants produce wealth, that country is entitled to a share in that wealth wherever the recipient of it may live.[2]

The fact of residence in or without the Union does not generally determine a person's liability to tax. Whether he resides in Cape Town or Timbuktu, as soon as a person receives income from a source within the Union or from a source deemed to be within the Union, such income is taxable no matter where the recipient resides. In certain exceptional cases, residence is laid down as a test of liability for tax, irrespective of the source of the income. Thus, in terms of section 7 (*g*) *bis*, persons, other than companies, ordinarily resident in the Union are subject to super tax on all dividends irrespective of the source of such dividends. In terms of section 9 (1) (*a*) *ter*, ship-owners or aircraft-owners resident in the Union are taxable on all their profits notwithstanding the source and in terms of section 9 (1) (*c*) *bis*, Union residents receiving remuneration as officers or members of the crew of ships or aircraft belonging to Union shipping or aircraft concerns are taxed thereon as being from a Union source irrespective of whether the services are rendered in or outside the Union. In regard to certain specified types of income, non-residents are exempt from tax in respect thereof, even though such income is derived from a Union source (see chapter six).

There is no definition in the Act of 'source' because it is not possible to define satisfactorily the qualities which will determine the source of income for all cases. As was pointed out by Watermeyer,

[1] Income deemed to be from a source within the Union is set out in secs. 9 (1), 7 (*g*) *bis* and 7 (*h*) of the Act.

[2] *Kerguelen Sealing and Whaling Co., Ltd.* v. *C.I.R.*, 1939 A.D. 487; 10 S.A.T.C. 363.

C.J., in *C.I.R.* v. *Lever Bros. & Unilever, Ltd.*,[3] it was probably an impossible task to formulate a definition which would furnish a universal test for determining when an amount is received from a source within the Union. Centlivres, C.J., in *C.I.R.* v. *Epstein*,[4] pointed out that the legislator was probably aware of the difficulty in defining the phrase 'source within the Union' and therefore gave no definition. Consequently, it is for the courts to decide on the particular facts of each case whether income has or has not been received from a source within the Union.

In *C.I.R.* v. *Black*[5] it was held that the source of income is in the Union if 'the dominant, or main, or substantial or real and basic cause of the accrual of the income is to be found in the Union'.

In the *Lever Brothers* case, Watermeyer, C.J., stated:

> 'When the question has to be decided whether or not money received by a taxpayer is "gross income" within the meaning of the definition referred to above, two problems arise which have not always been differentiated from one another in decided cases. The first problem is to determine what is the source from which it has been received and when that has been determined the second problem is to locate it in order to decide whether it is or is not within the Union.
>
> 'The word "source" has several possible meanings. In this section it is used figuratively, and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipt of the money, another possible meaning is the quarter from which it is received. A series of decisions of this Court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Acts elsewhere have dealt with the meaning of the word "source" and the inference, which, I think, should be drawn from those decisions is that the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.'

The *Lever Brothers* case, therefore, authoritatively lays down that by 'source' is meant 'the originating cause' and that the problem involves an inquiry into two matters, namely: What is the originating cause of the income? Is the originating cause in the Union?

Determination of source

Ordinarily it is not difficult to determine and locate the originating cause of income. The court decisions show, however, that difficult cases may arise. It is very difficult and sometimes an impos-

[3] 1946 A.D. 441; 14 S.A.T.C. 1.
[4] 1954 (3) S.A. 689 (A.D.); 19 S.A.T.C. 221.
[5] 1957 (3) S.A. 536 (A.D.); 21 S.A.T.C. 226.

sible task to extract general principles from these cases, because as the courts have frequently pointed out, it is dangerous to generalize in regard to source. Each case has to be decided on its own facts. In *Black's* case[5] it was held that 'the decisions do give some indication of the kind of tests, factors, or considerations that should, according to the circumstances, be used when deciding where the source of income was'.

Where it is necessary to determine the situation of the source of income arising from the employment of capital, the place where the capital is employed will generally be regarded as an important factor.[6]

Although there is no decision of the courts which provides a clear and an authoritative test for determining the source of income derived from the sale of trading commodities[7] the inference which, it is submitted, should be drawn from the various court decisions appertaining to source is that the source of income derived from trading or manufacturing operations is in the Union if the trader or manufacturer productively employs his capital in the Union and exercises his activities in the Union. The source of income derived from mining is situate at the mine and the source of income from farming is situate at the farm where the taxpayer's activities are exercised including the productive employment of his capital. The fact that the products derived from mining or farming are consigned to an agent of an oversea country for sale there, has no bearing, it is submitted, on the question of source. The originating cause is the activities of the producer and if these are exercised in the Union, the source is located in the Union. Thus, the proceeds derived from the sale of coal mined in the Union under a contract of sale concluded in America are from a source within the Union. In taxing the taxpayer, the legislator looks at his activities and ascertains whether these activities were exercised within the Union; if they were, then he is taxable in respect of any profits resulting from such activities.[8]

Where the income consists of remuneration for services, the courts have held that the source of the income is the services and the situation of the source is the place where the services are rendered (see *infra*, § 16).

Recommendations of the Committee of Enquiry

The Committee of Enquiry into the Income Tax Act was of the following view[9] in regard to the principle of source of income as a test of liability for tax:

> 'The submissions received by us on this subject were largely in favour of a continuance of the general principle of taxing income arising from Union sources only and we see no reason to suggest any change

[6] *Rhodesia Metals, Ltd.* v. *C.O.T.*, 1938 A.D. 282; 9 S.A.T.C. 363; *Overseas Trust Corporation, Ltd.* v. *C.I.R.*, 1926 A.D. 444; 2 S.A.T.C. 71.
[7] See the remarks of Lord Atkin in *Rhodesia Metals, Ltd.* v. *C.O.T.* (On appeal to the Privy Council) 1940 A.D. 432; 11 S.A.T.C. 244.
[8] *C.I.R.* v. *Epstein*, 1954 (3) S.A. 689 (A.D.); 19 S.A.T.C. 221.
[9] *First Report*, p. 19, para. 68.

in this respect. It is true that adherence to this principle makes it possible for a person whose income is derived entirely from abroad to reside in the Union and enjoy the protection of the State without making any direct contribution by way of income tax to the Fiscus. If the scope of the Union Income Tax Act were to be extended to tax income derived by residents of the Union from abroad it would obviously be necessary for provisions to be introduced to grant some form of relief in respect of the taxes which would generally have been paid on such income in the country from which it was derived. The usual form of relief which is granted by these countries which tax their residents on income from abroad is relief by way of a credit against the taxes of the country of residence, for the taxes paid in the country of origin of the income. Such arrangements, if they are to be effective and equitable, inevitably introduce considerable complication into the law. Moreover, unless a considerable volume of income were to be derived from sources abroad by persons residing in the Union, and the taxes paid abroad on such income were paid at substantially lower rates than the rates in force in the Union, there would be no material gain to the Union Treasury from extending the scope of the Act in this manner. We have no reason to believe that at present any large volume of income is so derived by Union residents from abroad or that the rates of tax of the countries from which such income may be derived are likely to be substantially lower than those in force in the Union. We do not, therefore, favour any change in the principle which has been consistently followed since income tax was first imposed in the Union of limiting the scope of the charge to income derived from sources within the Union or deemed to be derived from within the Union.'

It would appear to the writer that the Committee of Enquiry was probably more concerned with oversea countries such as the United Kingdom, Canada and Australia in coming to its conclusion that the rates of tax of the countries from which foreign income may be derived were not likely to be substantially lower than those in force in the Union. Having regard to the present restrictions of exchange control in South Africa and the high rates of tax in force in those countries, as compared with the rates applicable in the Union, there is not likely to be any serious prejudice to the *fiscus*, since Union residents will be deterred from deriving income from these foreign sources to any great extent. But the same cannot be said of our neighbours South West Africa, the Federation of Rhodesia and Nyasaland and the Native Territories.

§ 12. Source creation in South West Africa

The South West African Income Tax Ordinance[10] has adopted all the important principles embodied in the South African Income Tax Act including the principle of source as a test of liability for tax. Its normal and super tax rates in regard to individuals are less than those in the Union. Super tax commences once an income subject to super tax of £2,500 has been reached. On small incomes, the tax is much lower in South West Africa than in the Union. Companies pay normal tax at the rate of 4*s.* 6*d.* per £ of taxable income as com-

[10] Ordinance No. 15 of 1942 (as amended).

pared with 6*s*. per £ in the Union and there is, therefore, not a sufficient incentive for Union companies to transfer investment capital to South West Africa in order to benefit from a lower tax rate.

Ample opportunity is afforded to the individual taxpayer in the Union to avoid South African tax by investing his capital in South West Africa and deriving his income from sources in the Territory. This can be achieved either by investment in trading operations or in securities. The tax lost to the Union Treasury can be substantial. This does not necessarily mean that South West Africa gains by what is lost to the Union *fiscus*. The Territory may gain nothing; or it may gain only a small amount of tax as compared with what is lost to the Union Treasury. The following example attempts to explain the position (based on 1958 rates of tax):

Illustration 1

Mr. A, a married Cape resident, enjoys a taxable income of £6,000 from South African sources. He has surplus funds which require investment. Both in South Africa and in South West Africa, the income derived from this investment would amount to £1,500. From the tax point of view, it will clearly pay Mr. A to make his investment in South West Africa. If he invests in the Union, his taxable income will be increased from £6,000 to £7,500. The marginal tax payable on this increment of income, viz. £1,500, amounts to £782 0*s*. 0*d*. If he invests in South West Africa and earns £1,500 there, the tax payable will be only £41 0*s*. 0*d*. The saving to Mr. A is substantial; the loss to the Union *fiscus* is equally substantial.

From the tax point of view, therefore, the investment of surplus funds is no problem to the taxpayer in South Africa who finds himself in the higher-income groups and who is subject to the maximum tax rate of some 12*s*. 6*d*. in the £. All he need do is to seek investment of his funds in the Territory where the initial tax-free abatements and rebates granted allow a taxpayer to enjoy investment income free of all taxes up to a certain amount. The investment could take the form of loans, mortgage bonds, the acquisition of rental-producing properties, or deposits with building societies. As long as the Union taxpayer has created a source of income in the Territory, the tax, if any, is payable there and not in the Union.

Special mention should be made of the opportunity open to Union residents to make investments with established building societies whose head offices are in the Union but which operate full scale branches in the Territory. The taxation authorities of both the Union and South West Africa have agreed as follows in regard to income derived from such investments, viz.:

Interest on savings bank accounts

The source of the interest is the branch where the account was opened. Where an account is transferred, the source of the interest will be the place to which the account is transferred.

Interest on fixed deposits

The source of the interest is regarded as the place where the fixed deposit is made. If a fixed deposit is transferred during the currency of the fixed period, the source of the interest will be the place to which the deposit is transferred. This will apply to the full amount of interest payable.

Fully paid-up shares

The source of the dividend is the head office of the society paying the dividend.

The above arrangements between the Union and South West Africa offer considerable scope for large-scale avoidance of tax with the minimum of trouble to the taxpayer. Overnight, all South African investors with deposits in the building societies concerned can arrange for their savings accounts and fixed deposits to be transferred to the respective branches in South West Africa with the resulting effect that from then onwards all interest accruing is subject to tax in South West Africa and not in the Union. The result for the Union *fiscus* will be alarming indeed. The taxpayer, who is subject to a marginal tax rate of, say, 6*s.* 8*d.* in the £ on his present investment income from the building societies concerned, can at a moment's notice transfer his savings account or fixed deposit to Windhoek and if the interest concerned is, say, £300 per annum, by doing so he will free himself from Union tax to the extent of £100. It is true that the £300 interest will now be subject to tax in South West Africa but no tax is payable on this amount. Only the taxpayer stands to gain. In terms of the ruling above, if a fixed deposit is transferred during the currency of the fixed period, the full amount of the interest payable at maturity will have its source in the country to which the deposit is transferred. Thus, in the case of a twelve-month fixed deposit maturing on 31st December, the investor can a few days before the end of the year request his building society which happens to have a branch in South West Africa to transfer his deposit to the Territory. The effect will be that the full year's interest will be subject to tax in the Territory and not in the Union in spite of the fact that the investment was situated in the Union for practically the whole year. If the interest in question amounted to, say, £640 and the Union investor was in the higher-income group and subject to maximum tax rates (some 12*s.* 6*d.* in the £), such a simple request a few days prior to maturity date would save him £400 in Union tax! No tax would be payable in the Territory so that the taxpayer has gained £400 at the expense of the Union Treasury. Unfortunately, figures are not available as to what the *fiscus* is likely to suffer if all Union investors took advantage of the loophole and transferred their present investments (excluding paid-up shares in respect of which the ruling does not apply) to South West Africa. But, in the view of the writer, the loss will be considerable particularly when it is borne in mind that interest on savings accounts and fixed deposits is subject to both normal tax and super tax. Moreover, if all new investments are made with the branches in South West Africa, the loss to the *fiscus* will be even greater.

As regards the tax advantages of the investment in shares in companies incorporated in South West Africa, this aspect is dealt with in § 42.

The source principle also encourages tax avoidance and reduction without the necessity of the Union resident having to make new investments in South West Africa. It may not be possible for the Union taxpayer to transfer funds for investment to South West Africa. He may have existing investments in the Union which cannot be realized, but the income in respect of which is subject to heavy tax. For example, there may be a mortgage bond over Union property which cannot be called up for some years still. Or, on the other hand, he may possess investments in a Union building society, which does not operate through a branch in South West Africa or he may own fully paid-up shares in a Union building society which operates in the Territory but in respect of which the dividends are subject to Union tax as being from a South African source. There is nothing to prevent the Union taxpayer from selling these investments to a company incorporated and resident in the Territory by virtue of a contract concluded in the Territory. Either he or members of his family can be the sole beneficial shareholder in the company. It is true that the income earned by the company will be derived from a source in the Union but by charging the company with interest on the balance of the purchase price due in respect of the sale of the assets, the net income of the company can be kept small with a negligible tax liability. In the writer's view, the interest payable on the purchase price would be derived from a South West African source but, as explained earlier, the tax payable in the Territory would be negligible.

Illustration II

Mr. Y, a married Transvaal resident, enjoys a taxable income of £5,000 from South African sources. Included therein is £3,000 derived from dividends on fully paid-up shares in a Union building society. Mr. Y proceeds to form a company in South West Africa in which either he or members of his family are the sole beneficial shareholders. He sells his building society shares to the new company. He charges the company interest amounting to £2,500 per annum on the outstanding purchase price:

Taxes payable in South West Africa

By the company ..	Nil	(income derived from a South African source)
By Mr. Y	£120	(on interest income of £2,500)
Total	£120	

Taxes payable in South Africa

By the company ..	£150	6*s.* per £ on £500 (£3,000 dividends less £2,500 interest payable to Mr. Y)
By Mr. Y	163	(on a taxable income of £2,000)
Total	£313	

If Mr. Y had done nothing in the matter, Union taxes would have been payable on a taxable income of £5,000, namely £1,229 0*s.* 0*d.* The effect of carrying out the scheme is that the total tax payable in both countries is £433 (£120 + £313). There is thus a saving of tax amounting to £796 (£1,229 *less* £433) (based on 1958 rates of tax).

§ 13. Source creation in the Federation of Rhodesia and Nyasaland

Like South West Africa, the Income Tax Act of the Federation of Rhodesia and Nyasaland[11] contains many of the principles to be found in the Union tax law. The principle of source of income as a test of liability for tax has also been adopted. On small incomes, the tax for individuals is lower in the Federation than in the Union. Companies pay income tax and territorial surcharge at the rate of 7*s.* 6*d.* in the £ as compared with 6*s.* in the pound in the Union and there is, therefore, no incentive for Union companies to transfer capital to the Federation in order to take advantage of a lower rate of tax.

The individual taxpayer in the Union, however, is able to effect a substantial saving in his South African taxes by investing his capital in the Federation and thereby deriving his income from sources in that country. As in the case of South West Africa, the loss to the Union Treasury can be substantial. In view of the initial tax-free abatements and the attractive rebates granted in the Federation, the taxpayer in South Africa can enjoy income free of tax up to quite a substantial sum. For example, a married Union resident who derives a taxable income of £1,500 from Federal sources is subject to £62 tax in the Federation, whereas on a taxable income of £1,800 he pays £107 and on a taxable income of £2,500 he pays £250. Moreover, if he is entitled to the child rebate in respect of, say, three children and pays life insurance amounting to, say, £150 per annum, the Federal tax payable on £1,500 is Nil; on £1,800 the tax is £17 and on £2,500 it is £160.

Prior to the introduction of the present exchange control restrictions, there was a substantial transfer of Union capital to the Federation in order to effect a tax reduction for the Union taxpayer and today there are a number of Union residents receiving income from Federal sources which is free of South African tax. Although exchange control restrictions presently in force prohibit Union

[11] Act No. 16 of 1954 (as amended).

residents from freely exporting capital to other countries, they are permitted to retain investments previously made in the Federation of Rhodesia and Nyasaland, and are thus entitled to enjoy income free of South African tax. In this manner a number of Union residents are effecting a substantial reduction in their taxation liability as the following illustration proves (based on 1958 rates of tax):

Illustration III

Mr. Z, an unmarried Durban resident, had an existing taxable income of £10,000 from Union sources when he invested his surplus capital in rental-producing property in the Federation which brings him in a net income of £1,500 per annum.

If he acquired the property in the Union, the tax payable on the additional £1,500 taxable income would be about £937 (the maximum rate of 12*s*. 6*d*. per £ will be applicable). As he acquired the property in the Federation, the tax payable on a taxable income of £1,500 (this being his sole source of income in the Federation) is only £131. The advantage of investment in the Federation from the tax point of view is a substantial one.

The source principle also encourages the Union resident to effect a considerable saving of Union tax by transferring portion of his Union income-producing investments to a company incorporated and resident in the Federation and in respect of which company he is the sole beneficial shareholder. The income earned by the Federal company from the investments transferred to it is derived from a Union source but by charging the company with interest on the balance of the purchase price due in respect of the sale of the investments, the net income of the company can be minimized with a resultant small tax liability. The interest received by the Union resident would be from a Federal source but the tax payable would either be nil or very small compared with the tax which would otherwise be payable to the Union *fiscus* on the investment income. The Union Government has committed itself not to subject to tax the interest received by the Union resident from the Federal company in terms of Article XII 4 of the reciprocal tax agreement between the Union and the Federation which provides as follows:

> 'Where interest is derived by any person from a person (hereinafter referred to as the debtor) who is ordinarily resident in one of the territories and the interest would, but for the provisions of this paragraph, be subject to tax in both territories, that interest shall be subject to tax only in the territory in which the debtor is ordinarily resident: Provided that if the debtor is ordinarily resident in both territories, the interest shall be subject to tax only in the territory in which that interest is allowable as a deduction in the determination of the debtor's taxable income.'

Such interest is deemed to be from a Federal source in terms of section 10(3) of the Federal Income Tax Act which means that if ever it was made subject to Union tax, the Union Government would have to forfeit its right to claim the tax. In terms of Article XII, the interest would be subject to tax in the Federation where the debtor is ordinarily resident.

Illustration IV

Mr. O, a married Cape resident, enjoys a taxable income of £8,000 from Union sources including £2,500 interest derived from a mortgage bond over property situated in the Union. Mr. O forms a company resident in Rhodesia, in which he is the sole beneficial shareholder. He sells the mortgage bond to the company and on the purchase price he charges interest amounting to £2,000 per annum.

Taxes Payable in the Federation

By the company ..	Nil	(Income derived from a South African source. Although deemed to be from a Federal source in terms of section 10(2), it is subject to Union tax only in terms of Article XII 4 — see *supra*.)
By Mr. O	£137	(on interest income of £2,000)
Total	£137	

Taxes Payable in South Africa

By the company	6s. per £ = £150	on £500 (£2,500 interest *less* £2,000 interest payable to Mr. O)
By Mr. O ..	1,487	(on a taxable income of £5,500)
Total ..	£1,637	

If Mr. O had done nothing in the matter, Union taxes would have been payable on a taxable income of £8,000, namely £2,790. The effect of carrying out the scheme is that the total tax payable in both countries is £1,774 (£1,637 + £137). There is thus a saving of tax amounting to £1,016 (£2,790 *less* £1,774) (based on 1958 rates of tax).

§ 14. The Native Territories

At present there is very little scope for investment by Union residents in the Native Territories bordering on the Union, i.e. Bechuanaland, Basutoland and Swaziland. Each Territory has its own fiscal laws and income derived from the Territories is not subject to Union tax being from a non-Union source. The Income Tax Ordinances are essentially similar to the South African Income Tax Act. Each Territory has adopted the principle of source of income as a test of liability for tax. As is the case with South West Africa and the Federation of Rhodesia and Nyasaland, the taxes payable on small incomes is low. Although investment facilities are very limited, the source principle could encourage Union residents to transfer their income-producing investments to companies incorporated and resident in the Territories. The income earned by the company from the investments transferred to it is derived from a Union source but by charging the company with interest on the balance of the purchase price due in respect of the sale of the investments, the net income of the company can be minimized with a resultant small tax liability. The interest received by the Union resident would be from a source in the Territory but the tax payable would either be nil or a very small amount compared with the tax which would otherwise be payable to the Union *fiscus* on the investment income (see Illustrations II and IV *supra* for the principles involved). There is a company law in force in Swaziland and Bechuanaland and companies may be registered in these Territories. As regards Basutoland, under the company laws presently in force only public companies and not private companies can be registered. It is believed that a modern companies' proclamation is in the draft stage.

§ 15. Interest on foreign government securities

A number of foreign countries have issued securities, the interest in respect of which is free of tax in the country of issue by reason of the non-residence of the owner of the securities. For example, as regards the United Kingdom, interest in respect of the following securities are exempt from United Kingdom tax where the securities are in the beneficial ownership of a non-resident person:

4% Funding Loan 1960-90
4% Victory Bonds, 1920-76
3% War Loan, 1955-59
3½% War Loan, 1952 or after
3% Savings Bonds 1955-65
3% Savings Bonds 1960-70.

Examples of other countries which have issued tax-free bonds are Canada (e.g. Canadian 4½% Bonds, 1958), Australia (3¼% Registered Stock 1965-69), Kenya (e.g. Kenya £3,400,000 1930 Loan 1961-71) and Southern Rhodesia (e.g. 4½% Inscribed Stock 1958-68).

It must follow that if a Union resident is the owner of any of the above securities, no tax whatsoever is leviable on the interest since the income is from a source outside the Union. Thus, a Union resident whose sole source of income consists of £3,000 British War Loan interest is altogether free of tax whereas his next-door neighbour who may be earning £3,000 per annum from the conduct of a business in the Union is liable for some £500 worth of tax.

Up to and including the 1955 tax year, section 9(7) of the Income Tax Act provided that an amount derived by any person ordinarily resident or carrying on business in the Union by way of interest on securities issued by the Government of any other country was deemed to have been derived from a Union source if that interest was exempt from tax in the country of origin by reason of the recipient not being domiciled or resident therein. The Committee of Enquiry into the Income Tax Act[12] was of the view that this provision was in direct conflict with the principle of taxing income derived from a Union source only and recommended the repeal of section 9(7). The recommendation was accepted by the Income Tax Commission, 1953.[13] Section 9(7) was repealed with effect from the 1956 tax year.

The above illustrates another case of where the source principle has created a loophole for tax avoidance.

§ 16. EMPLOYMENT AND SERVICES RENDERED

Location of source from employment and services

Although there are no superior court decisions on the point, the Special Court has consistently laid down that the source or originating cause of income from employment and other services rendered is the services irrespective of where the contract is made or the remuneration paid.[13a] Thus the source of the remuneration would be located where the services are rendered.[14] If an employee is stationed outside the Union to render services there on behalf of a Union employer, his salary is not taxable in the Union, being from a source outside the Union, and this would be the case even though the contract of employment was concluded in the Union or the salary is payable in the Union.[15] Conversely, if an oversea employer sends his employee to the Union to buy wool and such an employee is stationed here for that purpose, the salary he received is from a Union source, the services being rendered in the Union. It matters not that the employer is oversea or that the employee's salary is not remitted to the Union.

In a very early decision of the Special Court,[16] the general principles relating to source of income from employment were very well set out in the form of practical illustrations:

'1. An attorney who practised in the Free State employed a clerk at a salary of £500: the source of the clerk's income of £500 would be the Union, for his services were located there.

2. An attorney who practised both in the Free State and in Basutoland, employed a clerk to work in both businesses at a salary of £500: the locality of the services which earned the £500 would be partly in the Free State and partly in Basutoland. An allocation would have to be made, probably on a time basis, of the £500, partly to a Union source, and partly to a Basutoland source.

[12] See p. 22, para. 97 of its *First Report*.

[13] See p. 6, para. 13 of its *First and Final Report*.

[13a] See, however, *C.O.T.* v. *Schein*, 1958 (3) S.A. 14 (F.C.); 22 S.A.T.C. 12, where the Federal Supreme Court of the Federation of Rhodesia and Nyasaland held that it may be accepted that, prima facie, the test of the source of a payment for services rendered is the place where those services are rendered.

[14] I.T.C. No. 100, 3 S.A.T.C. 250; I.T.C. No. 396, 10 S.A.T.C. 87; I.T.C. No. 266, 7 S.A.T.C. 151.

[15] I.T.C. No. 182, 5 S.A.T.C. 260.

[16] I.T.C. No. 77, 3 S.A.T.C. 72.

3. An attorney who practised in the Free State near the Basutoland border employed a clerk at £500 per annum to serve him in his Free State business. The clerk, however, occasionally crossed the border to perform casual work for his employer in Basutoland. The locality of the services which earned the £500 would be the Free State, because the contract stated that the services for which he is paid £500 was in the Free State. The acts of service performed by the clerk in Basutoland were casual and accidental in their nature, and were not remunerated as such. If, however, the attorney remunerated him specially for the acts of service he performed in Basutoland, then the locality of the service which produced that special remuneration would be Basutoland, and the source of the special remuneration would be Basutoland.'

In the application of these tests, therefore, regard must be had to the contract of employment in order to ascertain whether or not the employee had contracted to render services both within and outside the Union. If he had so contracted, then to the extent to which services were rendered outside the Union, the remuneration applicable thereto would be from a source outside the Union.[17] If he had not contracted to render services outside the Union, the full remuneration must be from a Union source even though occasional or casual services are performed outside the Union. In such cases, regard must be had to the contract as a whole and not to incidents connected therewith.[18] Where, however, a director or other employee is in the course of his duties called upon to proceed oversea on a special mission for which he receives an additional remuneration, the income so received may, in the special circumstances of the case, not be from a Union source. Thus, in the case where a director of a Union company was approached by his company to undertake a trip to a foreign country in an endeavour to negotiate for the removal of the difficulties which were impeding the company's business and received a special fee for this service, the Court held that as the taxpayer had established as a fact that he was employed in this service not as a director but by virtue of his special knowledge of the conditions of the foreign country, the fee was not from a Union source.[19]

The above tests in relation to the source of income from services offer scope for tax avoidance and reduction. Employees of Union companies could arrange to insert special provisions in their service agreements in terms of which they contract to render services in and outside the Union in the hope that they can claim an apportionment of their salaries in any tax year in which they proceed overseas on the company's business. They may even go further and enter into two contracts, one to render services in the Union for an agreed remuneration and another contract, whereby for a fixed remuneration also, they agree to render services outside the Union. Directors of Union companies, particularly those who control such companies by means of shareholding, could arrange to award themselves special

[17] I.T.C. No. 97, 3 S.A.T.C. 245; I.T.C. No. 396, 10 S.A.T.C. 87.
[18] See I.T.C. No 445, 11 S.A.T.C. 86; I.T.C. No. 738, 18 S.A.T.C. 213.
[19] I.T.C. No. 266, 7 SA.T.C. 151; see, however, I.T.C. No. 235, 6 S.A.T.C. 262.

remuneration for the undertaking of trips overseas on behalf of the company in the hope that such a special salary would, in terms of the court decisions, be from a source outside the Union.

Effect of section 9(1)(b)

The provisions of section 9(1)(*b*) may prove an effective counter to the above devices in that they provide that income from work or labour or services whether rendered in or outside the Union, is deemed to be from a source within the Union provided the work or labour or services are rendered in the carrying on in the Union of any trade. *Trade* is defined in section 7 and includes any employment. The exact scope of section 9(1)(*b*) is, however, obscure.

In the case of a person who is employed in the Union but who, in terms of his contract of employment, has to render services outside the Union as well, it does not necessarily follow that the whole salary must be deemed to be from a Union source in terms of section 9(1)(*b*) and is not apportionable between the Union and the extra-Union services in accordance with the general concept. The Special Court has held[20] that to justify the application of section 9(1)(*b*), there must be some close link between the work done outside the Union and the carrying on of a trade within the Union, a link closer than the mere fact that the taxpayer is carrying on a trade in the Union and that the work done outside the Union is in the way of such trade or of the same nature as the work done by the taxpayer in the Union. The degree of closeness of the link between the work done outside the Union and the carrying on of a trade in the Union necessary to justify the application of the section, is a determination which may be indeed difficult to resolve. The Court refused to apply the section to a case of an employee who derived a salary from a Union company and who in the course of his duties was required to render services outside the Union for the benefit of certain non-Union subsidiary companies. The portion of his salary attributable to the non-Union services was not taxable since it was derived from a source outside the Union.[21]

There are many employees, including directors and managing directors of Union companies, who periodically proceed overseas to undertake work on behalf of their companies, whether for the benefit of the company which employs them or for the benefit of associate companies. In view of the narrow scope accorded to section 9(1)(*b*), these employees may well be within their legal rights to take advantage of the general test for the determination of source of income from services rendered and split their salaries according to services rendered in or outside the Union or claim an apportionment of their salaries so that only a portion thereof is taxable in the Union. It is felt that section 9(1)(*b*) should be clarified and should set out clearly the circumstances under which income from labour or services is deemed to be from a Union source.

[20] I.T.C. No. 749, 18 S.A.T.C. 319.
[21] I.T.C. No. 837, 21 S.A.T.C. 413.

§ 17. Interest on borrowed moneys

Location of source of interest on a loan

In the case of *C.I.R.* v. *Lever Bros. & Unilever, Ltd.*,[22] it was held that the source or originating cause of interest in the case of a loan of money was not the debt but the services which the lender performs for the borrower, viz. the supply of credit, in return for which the borrower pays him interest. Per Watermeyer, C.J.:

> 'In the case of a loan of money the lender gives the money to the borrower, who in return incurs an obligation to repay the same amount of money at some future time and, if the loan is one which bears interest, he also incurs an obligation to pay that interest. . . . As a rule the lender either gives credit to the borrower or transfers to him certain rights of obtaining credit which had previously belonged to the lender, and this supply of credit is the service which the lender performs for the borrower, in return for which the borrower pays him interest. Consequently this provision of credit is the originating cause or source of the interest received by the lender.'

In the case cited, interest was received by an English company from a South African company in respect of a debt owing to the English company by a Dutch company and which liability was taken over by the Union company. The Court held that inasmuch as no business was carried on by the English company in South Africa, no contract had been made by it in South Africa, no capital had been ventured by it in South Africa, no services were rendered by it in South Africa and no obligation resting on either party to the agreements had been performed or was to be performed in South Africa, the source of the interest received was not to be located in South Africa.

Having regard to the principles laid down in the *Lever Bros.* case it is submitted that —

(*a*) the place where the debt is payable is not a factor for determining the location of the source of the interest on such debt;

(*b*) the place where the borrower productively employs the money is not a factor for determining the location of the source of the interest;

(*c*) the loan agreement is not the source so that the place where the agreement is concluded does not localize the source of the interest.

The true source of interest on a loan in terms of the *Lever Bros.* case is the provision of credit so that if the supply of credit takes place in the Union, the source of the interest is in the Union. If the loan creditor has made the money available to the debtor in the Union, it is submitted that the source of the interest is in the Union, irrespective of where the debtor resides, the debtor productively employs the capital, the interest is payable or the loan contract is concluded.[23] Thus, if A in South Africa agrees to lend money to B

[22] 1946 A.D. 441; 14 S.A.T.C. 1.
[23] See also I.T.C. No. 283, 7 S.A.T.C. 264.

for use in his business in Basutoland and A makes the money available to B in South Africa, it is submitted that as the provision of credit has taken place in South Africa, the source is in the Union even though B may have transferred the capital to Basutoland for use in his business there. The position, it is submitted, would be different if A remitted the loan through his bankers to B in Basutoland. In such a case, the credit has been provided in Basutoland and not in the Union. Consequently, the source of the interest is to be found in Basutoland and not South Africa.

Effect of the Lever Bros. *case*

There is a grave danger of the principle established in the *Lever Bros.* case being so applied by taxpayers as to cause considerable loss of revenue to the *fiscus*. For example, a Union resident, by making the money available to a Union borrower in South West Africa, on the principle established in the *Lever Bros.* case, is subject to tax on the interest in South West Africa and not in the Union since the provision of credit has taken place in the Territory. The lender can simply remit the money through his bankers to the borrower or his agent in South West Africa. Thereafter the money can be transferred back to the borrower for use in his business. It is submitted that in terms of the *Lever Bros.* case the interest is taxable in South West Africa where the credit has been provided. The Union must forfeit its right to tax on such interest. On the other hand, the borrower is entitled to claim the interest paid as an allowable deduction from his income in South Africa if the borrowed capital is used for business purposes. Both the Committee of Enquiry into the Income Tax Act and the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland realized the possible dangers of tax avoidance caused by the application of the *Lever Bros.* principle and made recommendations to counteract the avoidance of tax.[24] The Committee of Enquiry recommended that provision be made in the Act as follows:

> 'an amount shall be deemed to have accrued to any person from a source within the Union whenever it has been received by or has accrued to such person by virtue of any contract under which interest is payable on any amount owing by a person ordinarily resident or carrying on business in the Union, wheresoever the contract was entered into, wheresoever payment of the interest is made or is to be made and wheresoever the funds from which payment is made or is to be made are situate, except to the extent that the Commissioner is satisfied that, during the year of assessment in respect of which the interest is payable, the funds loaned were employed outside the Union'.

The Commission of Inquiry recommended that provision be made in the Act

> 'that interest receivable under or in respect of a loan be deemed to be from a source within the Federation if the borrower is a person ordinarily resident in the Federation, wheresoever the contract was made,

[24] See p. 19, para. 72 et seq. of the *First Report* of the Committee of Enquiry, and p. 11, para. 59, of the *Report of the Commission of Inquiry*.

wheresoever the money lent was actually paid over, wheresoever such money is used by the borrower, wheresoever the interest is paid or payable and wheresoever the funds from which the interest is paid or payable are situate '.

Both recommendations will be an effective counter to the device of a Union lender making the loan money available to a Union borrower by providing the credit outside the Union. The Rhodesian recommendation, however, goes further than the Union one since the interest is taxable as long as the borrower is a resident irrespective of where the money is used by the borrower. It must be mentioned, however, that the Income Tax Commission, 1953, rejected the recommendation of the Committee of Enquiry. It was of the opinion that the recommended provision would, in many cases, be difficult to apply and would give rise to administrative difficulties. Furthermore, it thought that such a provision might prove detrimental to the flow of capital into the Union.[25]

§ 18. Royalty income

In *Millin* v. *C.I.R.*[26] it was held that the source of royalties accruing to a novelist was his wits, labour and intellect so that if these are employed in the Union, the source is in the Union. Mrs. Millin had written a book in the Union but the right to publish was granted to an English publisher under a contract concluded in England. It was held that the source of the income accruing to Mrs. Millin was not the grant of the publishing rights in England but the place where she employed her skill and time in the business of writing books, i.e. the Union. Although no capital was employed by Mrs. Millin in the sense of a cash investment, her wits and labour could be regarded as her capital, and, as these were productively employed in the Union, the whole amount received in the form of royalties was from a Union source, even though the publishing rights were granted in England. The Court was of the view that an author's copyright is not a capital asset but represents income derived from the exercise of his labour and wits in the business of writing novels. It must follow, therefore, from the *Millin* case that if a novelist ordinarily following his vocation in the Union decides to write one or more of his books in a country outside the Union, the income derived therefrom is not taxable in South Africa. The provisions of section 9 (1) (*a*) *bis*, however, must be borne in mind since if the author permits a Union publisher to exploit the copyright in the Union, the royalties will be deemed to be from a Union source.

Section 9 (1) (*a*) *bis* provides that an amount is deemed to be from a source within the Union if it accrues to a person by virtue of the use in the Union of or the grant of permission to use in the Union any patent, design, trade mark or copyright as defined in the Patents, Designs, Trade Marks and Copyright Act, 1916 (Act No. 9 of

[25] See p. 5, para. 9, of its *First and Final Report*.
[26] 1928 A.D. 207; 3 S.A.T.C. 170.

1916), or any other property which, in the opinion of the Commissioner, is of a similar nature no matter where such property has been produced or such permission has been granted and irrespective of where payment is to be made and by whom it is to be made.

The author or inventor may perform all the work in the creation of his copyright or patent outside the Union, yet because he allows the use of his rights in the Union, the income derived is deemed to be from a Union source. Thus, if a novelist oversea permits a South African publisher to publish his book in return for a royalty, the income is deemed to be from a Union source in terms of section 9(1)(*a*)*bis*. The position would be different if the novelist sells his copyright out and out to the South African publisher since in that event the payment would not be received for the 'use' of the right but for its complete alienation so that section 9(1)(*a*)*bis* is not applicable. If, however, the novelist is chargeable with tax on royalties in the oversea country, he will be exempt from Union tax in terms of section 10(1)(*r*) which exempts from tax any amount received by or accrued to an author of a work in respect of the assignment of or grant of an interest in a copyright in such work if such amount is chargeable with income tax in a country other than the Union. It is, however, provided that this exemption shall not apply to any person who is not the first owner of a copyright in terms of Chapter IV of the Patents, Designs, Trade Marks and Copyright Act, 1916 (Act No. 9 of 1916), or to a company.

The Committee of Enquiry into the Income Tax Act held that no evidence was placed before it to indicate that taxation questions are in fact influencing the grant of patent rights to users in the Union or that section 9(1)(*a*)*bis* was a deterrent to the use in the Union of valuable patents held by residents abroad. Accordingly, it was not prepared to recommend any amendment of the present law.[27] It does, however, seem wrong that whereas an author abroad who permits the use of his copyright in the Union is free from Union tax in terms of section 10(1)(*r*) on the royalties received if they are also chargeable with tax in the country of his residence, an owner of valuable patent rights abroad is not entitled to the benefit of this exemption. In principle there is no justification for this differentiation. No doubt patent royalties payable to non-residents for the use of their patents in the Union by far exceed copyright royalties payable to persons abroad for the use in the Union of their copyrights and the loss of revenue which would be involved in exempting patent royalties paid to persons abroad might, therefore, be considerable.

§ 19. Contracts for the sale of goods

In terms of section 9(1)(*a*), an amount is deemed to be from a source within the Union if it accrues to a person by virtue of any contract made by such person within the Union for the sale of goods,

[27] *First Report*, p. 21, paras. 83 and 84.

whether such goods have been delivered or are to be delivered in or out of the Union.

The goods may be produced outside the Union where the taxpayer's capital is productively employed and all his activities are carried out, yet because the contract for the sale of the goods is made in the Union, the proceeds of the sale are stamped with a Union source.[28] If an Australian, who happens to be on holiday in the Union, concludes a contract for the sale of produce grown on his farm in Australia, the proceeds are deemed to be from a Union source.

A contract is made where it is completed by acceptance.[29] Difficulty may, however, be experienced in locating the place of completion of a contract. In this respect, the following principles, referred to in the judgment of the *Kerguelen Sealing & Whaling* case,[28] afford a useful guide:

> 'When a written offer is made by letter through the post the offer becomes a contract in the absence of a different intention by the offeror on the posting of the letter of acceptance.
>
> 'In the case of a contract made between parties, some of whom are resident in one country and some in another, the contract must be held to be made in the country in which the signature of the last necessary party is affixed.'

It should be pointed out, however, that in terms of double taxation agreements negotiated with certain other countries,[30] residents of such countries are exempt from Union tax on trading profits unless derived from a permanent establishment in the Union. In such cases, the mere conclusion of a contract of sale in the Union is not sufficient to attract a tax liability on the part of the non-resident.

The place of the signing of a contract is not a satisfactory test on which to base liability as it lies within the power of the parties to the contract to determine the place where the contract is concluded and thus the source of the income. Consequently, liability for or freedom from taxation rests with the parties to the agreement. The Committee of Enquiry into the Income Tax Act was not disposed to recommend that section 9(1)(*a*) be repealed.[31] It is interesting to record, however, that the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland recommended that the comparable section in the Federal Income Tax Act (section 10(1)(*a*)) be repealed.[32]

§ 20. Annuities

There is no authoritative decision as to the source of a purchased annuity, e.g. an annuity bought from an insurance company. In practice, the Commissioner regards the situation of the source as the

[28] *Kerguelen Sealing & Whaling Co., Ltd.* v. *C.I.R.*, 1939 A.D. 487; 10 S.A.T.C. 363; see also I.T.C. No. 454, 11 S.A.T.C. 165.
[29] I.T.C. No. 560, 13 S.A.T.C. 308.
[30] At present there are agreements with the United Kingdom, United States of America, Sweden, Canada and the Federation of Rhodesia and Nyasaland.
[31] See p. 20, paras. 80-82, of its *First Report*.
[32] See p. 10, para. 52, of the *Report of the Commission of Inquiry*.

place where the contract under which the company undertakes to pay the annuity is entered into. The place where the proposal is accepted by the company is held to be the situation of the source. With respect, the writer cannot agree with this decision. It is considered that the originating cause of a purchased annuity is the employment of the capital with which the annuity is acquired so that if the capital is employed in the Union, the source of the annuity is in the Union irrespective of the place where the proposal is accepted by the company. On the Departmental interpretation, all annuities payable under contracts taken out with Union branches of oversea companies are not taxable in the Union where it is a condition that the proposal must be accepted at the oversea head office. This gives rise to a loophole for tax avoidance.

As regards contractual annuities, e.g. annuities by way of donation and testamentary annuities, the Special Court has held[33] that in both cases the source is the same. In the case of a contractual annuity the source would be within the Union where the contract is made within the Union, and where, before the amount is paid, the debtor is a *persona* resident in the Union, the debtor is a separate *persona* distinct from the *persona* who is the creditor and the *fons et origo* of the debt is a formal act performed in the Union. In the case of a testamentary annuity, the source would be within the Union where before the amount is paid the debtor is a *persona* resident in the Union, the debtor is a separate *persona* from the *persona* who is a creditor and the *fons et origo* of the debt is a formal act performed in the Union (the formal act being the execution of the last will within the Union).

The Court referred to the case of *Boyd* v. *C.I.R.*[34] where Centlivres, C.J., said:

> 'If a resident of the Union whose sole source of income is South West Africa pays in terms of a contract made in the Union an annuity to another person, it seems to me that the source of that other person's income is in the Union. It might be said that the ultimate source of the annuity is in South West Africa but I do not think that on a proper interpretation of the word " source " in the definition of " gross income " one is required to go back to the remote source.'

It would appear that all the requirements must be complied with before the source of an annuity can be within the Union. In the Special Court case referred to, counsel for the taxpayer referred to the case of a person resident in England coming to the Union on holiday and executing his last will in this country and creating an annuity to be paid out of the assets of his estate in England. The Court was of the view that in such a case the source would not be in the Union since the debtor would not be resident within the Union nor would any action to enforce the annuity be brought within the Union. It would seem, therefore, that if a Union resident, while on holiday in Salisbury, by a contract concluded in Salisbury

[33] I.T.C. No. 826, 21 S.A.T.C. 189.
[34] 1951 (3) S.A. 525 (A.D.); 17 S.A.T.C. 366.

creates an annuity to be paid to a Union resident out of the assets of his estate in the Union, the source of the annuity would not be within the Union since the *fons et origo* of the debt is a formal act performed outside the Union (the formal act being the conclusion of the agreement in Salisbury).

The test of source of annuities may, therefore, create loopholes for tax avoidance because of the relative ease with which a contract or last will can be executed outside the Union thereby causing the annuity to be derived from a source in a country other than the Union with a possible resulting loss of tax to the Union Treasury.

§ 21. The problem of multiple source

Difficulties may arise in locating the source of income if the activities which result in the income being received occur in the Union and in one or more other countries. In such a case, the whole of the receipt or no part thereof or part thereof might be regarded as constituting income from a source within the Union. The courts have discussed the problem but have not yet been called upon to solve it.[35] In *C.I.R.* v. *Lever Bros. & Unilever, Ltd.*[36] the Court held that:

> '. . . it is obvious that a taxpayer's activities, which are the originating cause of a particular receipt, need not all occur in the same place and may even occur in different countries, and consequently, after the activities which are the source of the particular "gross income" have been identified the problem of locating them may present considerable difficulties, and it may be necessary to come to the conclusion that the "source" of a particular receipt is located partly in one country and partly in another. . . . Such a state of affairs may lead to the conclusion that the whole of a receipt, or part of it, or none of it, is taxable as income from a source within the Union, according to the particular circumstances of the case, but I am not aware of any decision which has laid down clearly what would be the governing consideration in such a case.'

Apart from the case of income from services (the Special Court has authorized the apportionment of the source of such income), it is doubtful whether the courts will readily resort to the splitting of a particular amount of income according to the various sources from which it may have been derived. In such a case regard may be had to the dominant or main source so that the source may lie in the country in which the main activities have taken place.

On the other hand, if a taxpayer's activities in different countries are of such a nature that his business in the Union may be regarded as having extended to such other countries, the problem of apportionment of source does not exist as the provisions of section 17, which lay down a formula for the determination of taxable income from Union sources in such circumstances, come into play.

Broadly it is provided in section 17 that the taxable income shall be a proportion of the total net profits of the business derived

[35] *C.I.R.* v. *Lever Bros. & Unilever, Ltd.*, 1946 A.D. 441; 14 S.A.T.C. 1; *Millin* v. *C.I.R.*, 1928 A.D. 207; 3 S.A.T.C. 170.

[36] 1946 A.D. 441; 14 S.A.T.C. 1.

from all sources calculated in the ratio which the assets of the business in the Union bear to the total assets of the business. There is a proviso, however, that if accounts satisfactory to the Commissioner are furnished disclosing the actual taxable income derived from Union sources, the assessment may then be based on such accounts.

The basis of assessment laid down in section 17 is not satisfactory. It lies within the power of the taxpayer to choose the basis which attracts the smallest tax liability. In the case of a business the bulk of the operations of which is conducted in the Union but having the greater portion of its assets in another country, the taxpayer may well choose the 'assets to assets' basis laid down in the section with resulting prejudice to the Union *fiscus*. On the other hand, if the bulk of the assets is in the Union but the greater portion of the activities is conducted outside the Union, the taxpayer will probably not choose the basis of apportionment provided for in section 17 but will attempt to submit accounts disclosing the actual taxable income derived from Union sources.

The provisions of section 17 clearly call for modification. The Committee of Enquiry into the Income Tax Act considered that the Act should be amended so as to provide that the Commissioner should have the power to estimate the income of taxpayers engaged in business which extends beyond the Union if the taxpayers refuse to make a return disclosing the income of such business derived from Union sources or if the nature of the business is such as to make it impracticable for the income from Union sources to be computed accurately, and the power so to be vested in the Commissioner should be subject to objection and appeal.[37] The Income Tax Commission, 1953, accepted this recommendation.[38] The writer is of the view, however, that the whole problem of multiple source should be expressly dealt with in the Act and not merely the case of taxpayers whose business extends beyond the Union. It should be provided that in cases where the source is not wholly in the Union the source should be apportioned between the Union and any other country in a fair and reasonable way. Any determination by the Commissioner in this regard should be subject to objection and appeal. Precedent for such a provision is to be found in the Australian Act (see sections 38 to 43) and also in the New Zealand Act (section 169).

§ 22. Recommendations

The writer is of the view that the source of income as the sole test of liability for tax is out of place in a modern taxing system in that the source concept is the creator of too many tax avoidance devices. As has been shown above, the relative ease with which a source of income can be created outside the country of residence by the transfer of capital to neighbouring countries or by the conclusion of contracts in countries outside the Union can lead to large-scale

[37] See *First Report*, p. 20, para. 76 et seq.
[38] See *First and Final Report*, p. 5, para. 10.

avoidance and reduction of tax. Certain residents will, therefore, not be contributing to the cost of government in accordance with their means. For this reason alone, the source principle cannot be maintained. Liability to tax should be based upon the domicile or residence of the taxpayer. Residents should be taxed not only in respect of their local incomes but also in respect of their foreign incomes. Non-residents should be taxed only on income derived from a source within the Union. In other words, the tax system should seek to levy the tax on all income arising in the Union no matter to whom it belongs and it should also tax all residents in South Africa no matter from where their income arises. If these principles are adopted, the Union will be brought into line with the United Kingdom and other Commonwealth countries such as Australia and Canada which have made residence or domicile the test of liability for the reason, presumably, that a resident, for the privilege and protection of residence can justly be called upon to contribute towards the cost of government of the country that shelters him.[39]

A taxing authority is able to enforce its demand for tax either because the taxpayer is resident within its jurisdiction or because the income or the capital employed to produce such income is situate within its jurisdiction. The adoption, therefore, of either the test of 'residence' or 'source' is satisfactory from the point of view of the capacity of the taxing authority to enforce its demand for the tax. When, however, the adoption of the test of 'source' leaves the door wide open for large-scale avoidance of tax, it is clear that the test is no longer a satisfactory one. It is a much simpler problem to transfer a source of income to another country where tax conditions are favourable than to transfer a residence.

In certain exceptional cases income is taxed in the hands of persons ordinarily resident in the Union irrespective of its source. Thus, shipping concerns resident in the Union are taxable on all their profits (section 9 (1) (*a*) *ter*) and persons who work on their boats are taxable on the remuneration received, wherever they may render the services, as long as they are ordinarily resident in the Union (section 9 (1) (*c*) *bis*). Dividends from all sources are taxable in the hands of persons ordinarily resident in the Union (section 7 (*g*) *bis*). This provision was necessary in order to prevent the deliberate avoidance of super tax on the part of Union residents (see § 39). In the writer's view there is no justification for distinguishing between dividends and other forms of income, e.g. interest. Where a tax system is based on source it is anomalous that in certain instances liability should depend on residence. This results in a differentiation between one type of income and another which, on principle, cannot be justified. All foreign income or none should be taxed. In order to prevent the large-scale avoidance of tax, the Treasury may in the near future find it necessary to have a similar provision in respect of

[39] *Kerguelen Sealing & Whaling Co., Ltd.* v. *C.I.R.*, 1939 A.D. 487; 10 S.A.T.C. 363.

other types of income, e.g. interest income. Once the source principle is abandoned in regard to investment income, there will be no justification for retaining it in regard to trading profits and other forms of earned income.

The Committee of Enquiry into the Income Tax Act was of the view that if the principle of residence was adopted as the test of liability for tax it might be necessary to insert complex double taxation relief provisions into the Act.[40] Most taxation systems which have adopted residence as the basis of liability have found it necessary to insert such provisions. Some sacrifice must be made if it is desired to prevent tax avoidance on a large scale and its resultant inequity as between various taxpayers. As has been shown earlier on, the way is open for Union residents to derive income from other neighbouring countries where the tax payable is negligible compared with the marginal rate of tax for which they would otherwise be liable in respect of such income in the Union. What is more, as explained above, by the simple process of company formation in these foreign countries, Union income can be diverted to these companies with consequential prejudice to the Union *fiscus*. The necessity of additional double taxation relief provisions should not be a deterrent. Relief will have to be given to the Union resident by way of a credit against the taxes payable in the Union for the tax paid in the country of origin of the income. Many of the hardships arising from double taxation will be alleviated by reciprocal agreements between the Union and other countries. Experience in other Commonwealth and European countries has shown that the basis of residence can work reasonably well and that by suitable double taxation relief provisions, the anomaly and unfairness of double taxation by different Legislatures can be avoided in cases where both the tests of 'residence' and 'source' are relied on as a basis of liability to tax. It is true that intricate and difficult questions may also arise as regards whether a taxpayer is resident or not and thus whether he is chargeable or not. Fortunately, in the United Kingdom, where the fundamental basis of the incidence of income tax is the residence of the taxpayer, some useful tests have been evolved from a long series of decided cases (see § 90) and the Union is thus able to benefit from the experience obtained in the United Kingdom.

There is no data available as to the extent of the foreign income earned by Union residents. It is reasonable to suggest that the majority of such residents derive their income from sources in the Commonwealth. As regards those residents who derive income from countries like the United Kingdom, Canada and Australia, it is possible that owing to the higher taxes payable in those countries very little additional tax would be leviable in the Union if all the foreign income were taxable. On the other hand, as regards those residents who derive income from South West Africa and the Federation of Rhodesia and Nyasaland, the additional tax may be substantial as the illustrations clearly show.

[40] *First Report*, p. 19, para. 68.

Union residents are not required to include details of foreign income in the annual return of income to be rendered by them. This is an unsatisfactory feature of the present system. The effect of excluding receipts and accruals from sources outside the Union is to permit the taxpayer to decide what is income from a source within or outside the Union. Where, in submitting his return, the taxpayer excludes an amount which he regards as from a foreign source, the Commissioner is prevented from examining the source and possibly challenging the taxpayer's view of the matter. The annual return of income which taxpayers are called upon to complete should require disclosure of the taxpayer's income from all sources so that the details of foreign income are brought to the notice of the taxation authorities who will have the opportunity of examining their source. Apart from this advantage, data will become available as to the extent of the foreign income earned by Union residents and its resulting effect on the *fiscus*.

Both the Committee of Enquiry into the South African Act[40] and the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland[41] were of the view that source of income should be retained as the basis of income tax liability and that such liability should not be based upon the domicile or residence of the taxpayer. With the greatest respect, the writer is of the view that insufficient attention was given to the tax avoidance devices resulting from the adoption of the source principle. In the interests of the public revenue, and, if it is desired that justice and equity among the tax-paying public be achieved, it is imperative that the principle of source be abandoned or, if this is not possible, that special provisions be inserted into the Act to ensure that Union residents should be subject to tax on income derived from sources in the neighbouring territories such as South-West Africa, the Federation of Rhodesia and Nyasaland and the Native Territories. It is wrong that a Union resident, who has invested at 5 per cent per annum in gilt-edged securities £40,000 of his capital in the Union, £40,000 in South West Africa and £40,000 in the Federation of Rhodesia and Nyasaland, pays in the aggregate taxes amounting to £387 only on his total income of £6,000,[42] whereas another resident has to pay £1,726 if he earns the whole £6,000 in South Africa. A system of taxation that encourages this kind of practice violates the acknowledged principle of 'ability to pay' and is bad law.

Apart from the important consideration of the attainment of justice and equity among the tax-paying public, it is also not in the national interests that the source principle be retained in the Union's taxation system. Because of the present demand for capital to develop industries and other projects in South Africa, the taxation system should not be such as to encourage Union residents to retain their

[41] *Report of the Commission of Inquiry*, p. 9, para. 48.

[42] In South Africa, a married Cape resident pays £170 on a taxable income of £2,000; in South-West Africa, £80 is payable and in the Federation of Rhodesia and Nyasaland, £137 is payable. Aggregate tax liability £387.

investment capital in countries outside the Union, e.g. the Federation of Rhodesia and Nyasaland. Although exchange control restrictions presently in force prohibit Union residents from freely exporting capital to other countries, they are permitted to retain investments previously made in the Federation of Rhodesia and Nyasaland. If the present restrictions are removed in the future, there is no doubt that the source principle will again stimulate the export of capital to other countries for the purpose of effecting a saving in tax. In the interests of the national economy, therefore, it is desirable that we abandon a principle that encourages the retention of investment capital in or the export of capital to other countries.

Union residents are not required to include details of foreign income in the annual return of income to be rendered by them. This is an unsatisfactory feature of the present system. The effect of excluding receipts and accruals from sources outside the Union is to permit the taxpayer to decide what is income from a source within or outside the Union. Where, in submitting his return, the taxpayer excludes an amount which he regards as from a foreign source, the Commissioner is prevented from examining the source and possibly challenging the taxpayer's view of the matter. The annual return of income which taxpayers are called upon to complete should require disclosure of the taxpayer's income from all sources so that the details of foreign income are brought to the notice of the taxation authorities who will have the opportunity of examining their source. Apart from this advantage, data will become available as to the extent of the foreign income earned by Union residents and its resulting effect on the *fiscus.*

Both the Committee of Enquiry into the South African Act[40] and the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland[41] were of the view that source of income should be retained as the basis of income tax liability and that such liability should not be based upon the domicile or residence of the taxpayer. With the greatest respect, the writer is of the view that insufficient attention was given to the tax avoidance devices resulting from the adoption of the source principle. In the interests of the public revenue, and, if it is desired that justice and equity among the tax-paying public be achieved, it is imperative that the principle of source be abandoned or, if this is not possible, that special provisions be inserted into the Act to ensure that Union residents should be subject to tax on income derived from sources in the neighbouring territories such as South-West Africa, the Federation of Rhodesia and Nyasaland and the Native Territories. It is wrong that a Union resident, who has invested at 5 per cent per annum in gilt-edged securities £40,000 of his capital in the Union, £40,000 in South West Africa and £40,000 in the Federation of Rhodesia and Nyasaland, pays in the aggregate taxes amounting to £387 only on his total income of £6,000,[42] whereas another resident has to pay £1,726 if he earns the whole £6,000 in South Africa. A system of taxation that encourages this kind of practice violates the acknowledged principle of 'ability to pay' and is bad law.

Apart from the important consideration of the attainment of justice and equity among the tax-paying public, it is also not in the national interests that the source principle be retained in the Union's taxation system. Because of the present demand for capital to develop industries and other projects in South Africa, the taxation system should not be such as to encourage Union residents to retain their

[41] *Report of the Commission of Inquiry*, p. 9, para. 48.
[42] In South Africa, a married Cape resident pays £170 on a taxable income of £2,000; in South-West Africa, £80 is payable and in the Federation of Rhodesia and Nyasaland, £137 is payable. Aggregate tax liability £387.

investment capital in countries outside the Union, e.g. the Federation of Rhodesia and Nyasaland. Although exchange control restrictions presently in force prohibit Union residents from freely exporting capital to other countries, they are permitted to retain investments previously made in the Federation of Rhodesia and Nyasaland. If the present restrictions are removed in the future, there is no doubt that the source principle will again stimulate the export of capital to other countries for the purpose of effecting a saving in tax. In the interests of the national economy, therefore, it is desirable that we abandon a principle that encourages the retention of investment capital in or the export of capital to other countries.

CHAPTER THREE

TAX AVOIDANCE THROUGH THE MEDIUM OF COMPANIES

§ 23. Introduction

Probably the most difficult problem of income tax is the taxation of the income of companies and the dividends derived therefrom. The experience of most countries has been that due to the fact that a company is a legal *persona* and because of the relative ease with which it may be formed, manipulated and controlled within the framework of the company law, it is very frequently made the medium for the avoidance and reduction of tax. Company formation becomes very attractive indeed when it secures not only the benefit of limited liability but also a tax saving while enabling the promoter to retain both the control of his assets and the income derived therefrom. It is, therefore, imperative for any Treasury to devise a system of taxation for companies which cannot readily be exploited by the tax avoider.

Tax avoidance through company formation is facilitated and encouraged by the concept in company law that a company is an artificial legal person separate and distinct from its members, and, unless the income tax law provides otherwise, it must be treated as such for taxation purposes. One cannot simply brush aside the separate legal existence of a company when it comes to taxation matters, whether the company is a public company with numerous shareholders or a private company with one sole beneficial shareholder, i.e. a one-man company. In *Ochberg* v. *C.I.R.*[1] de Villiers, C.J., stated as follows:

> 'The law endows a company with a fictitious personality. The wisdom of allowing a person to escape the natural consequences of his commercial sins under the ordinary law, and for his own private purposes virtually to turn himself into a corporation with limited liability may well be open to doubt. But as long as the law allows it the Court has to recognize the position. But then too the person himself must abide by that. A company, being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter. To say that a company sustains a separate *persona* and yet in the same breath to argue that in substance the person holding all the shares is the company is an attempt to have it both ways, which cannot be allowed.'

In the same case, Wessels, J.A., declared:

> 'We know from our experience in the law courts that juggling with shares of a private company is a favourite method adopted by certain

[1] 1931 A.D. 215; 5 S.A.T.C. 93.

persons who control such companies in order to seek to evade the income tax laws, and therefore the courts must be careful to analyse transactions of this nature and to insist on the principle that the individual who controls the private company is not to be regarded as if he were the company. Juridically the controlling individual and the company itself must be kept apart and distinct, even if he be the sole shareholder.'

The benefits of limited liability are so great that the majority of business today is conducted through companies. Apart from the case of the professions whose rules prohibit incorporation, the individual proprietor or partnership business is fast disappearing and what is left of them indeed play a relatively unimportant role in the economic life of the Union. Most business and industry is nowadays carried on through the medium of companies and no modern taxing system can afford to ignore the aspect of company taxation. Great care is required to ensure that the system devised for the taxation of company profits is such that it will not stifle the formation of companies and yet at the same time ensure that it does not create a loophole for tax avoidance and reduction. The aim must be to achieve a reasonable balance between these two important requirements.

No country today can afford to refrain from taxing the profits of companies until such income is distributed among the shareholders by way of dividend. All modern taxing systems impose tax directly upon the profits earned by companies. (In respect of the 1957/58 financial year, the Union Government collected normal tax from companies (other than mining companies) amounting to £58,551,550 out of total collections of income tax from all taxpayers amounting to £145,562,496.) From experience Treasuries have learnt that the rate of tax upon corporate profits must be a flat rate otherwise the system can readily be exploited for the benefit of the tax avoider.

The present system of taxation of the incomes of companies in the Union, although practicable of administration, has failed to ensure that it does not create a loophole for tax avoidance. As the writer will show, the system encourages a widespread avoidance of tax. In many cases, the savings which can be effected by the formation of companies to run businesses can be quite startling with a corresponding loss of revenue to the Treasury.

§ 24. DEFINITION OF 'COMPANY'

Company, in terms of section 1, includes:

(*a*) Any association incorporated or registered under any law in force in the Union; or

(*b*) any association incorporated or registered outside the Union which carries on business or has an office or place of business in the Union or in which any person ordinarily resident or carrying on business in the Union is interested as a shareholder or member; or

(*c*) any association which is incorporated or registered outside the Union and is a shareholder in or member of any company as defined in paragraph (*a*) or (*b*) *supra*, either directly, or indirectly by reason of the fact that it is a shareholder in or member of any other company; or

(*d*) any association (not being an association referred to in paragraph (*a*) *supra* or an association to which the provisions of section 10(1)(*e*) apply) formed in the Union to serve a specified purpose, beneficial to the public or a section of the public. Thus, for example, racing clubs and stock exchanges are treated as companies for tax purposes.

In terms of the present practice of the Commissioner, the enumeration of the various types of companies to which the provisions of the Income Tax Act apply is not exclusive — hence the use of the word *includes* in the definition — and it is unlikely that any company could fall outside the scope of the definition. As a consequence of this, a company which is neither registered nor carrying on business in the Union and has no Union shareholders, falls within the definition even though it does not specifically fall within paragraphs (*a*) to (*d*). If this were not so, it would mean that such a company is exempt from tax on investment income derived from Union sources, for example, interest or royalties. This could never have been the intention of the legislator.

In *Estate Brownstein* v. *C.I.R.*,[2] Schreiner, J.A., considered the meaning of the word *includes* in a definition section and held that this word is sometimes the equivalent of *means*, i.e. it operates to exclude everything else, while in other cases it merely adds unusual or less usual meanings to the one usually borne by the word defined. The learned Judge referred to the case of *Jones & Co., Ltd.* v. *C.I.R.*[3] where it was held that the definition of *company* appearing in the Income Tax Act of 1917 was not exhaustive.[4] It was not necessary for the learned Judge to decide whether the conclusion reached in that case was correct. It may, however, be pointed out that the definition of *company* in the 1917 Income Tax Act was not the same as the present definition in the 1941 Act,[5] and it may well be that the word *includes* in the present definition is the equivalent of *means*, i.e. it operates to exclude all other companies. In view of the remarks of Schreiner, J.A., it is felt that the definition of *company* in section 1 should be further widened to make it quite clear that it includes all associations incorporated or registered outside the Union whether they carry on business or have an office or place of business in the Union or not.

[2] 1957 (3) S.A. 512 (A.D.); 21 S.A.T.C. 262.
[3] 1926 C.P.D. 1; 2 S.A.T.C. 7.
[4] See also *Guernsey & Foreign Investment Trust, Ltd.* v. *C.I.R.*, 1938 C.P.D. 158; 9 S.A.T.C. 390.
[5] Definition of *company* in sec. 100 of Act 41 of 1917:
'"Company" includes any association incorporated or registered under any law in force in any part of the Union relating to companies, banking companies or insurance companies, or under a special law, and further includes any such association, which though incorporated or registered outside the Union, carries on business or has an office or place of business therein.'

§ 25. PRESENT SYSTEM OF COMPANY TAXATION IN SOUTH AFRICA

The scheme of company taxation

The taxable income and the income subject to super tax of a company are determined in accordance with the ordinary rules applicable to individuals. Normal tax at a flat rate of 6*s.* 6*d.* per £ is imposed in respect of its taxable income.[6] Special rates of normal tax are prescribed for mining companies. No rebate is deductible from the tax payable by the company, i.e. liability commences from the first pound of taxable income received or accrued. If a company incurs an assessed loss, this loss is carried forward and, as in the case of individual taxpayers, can be set off against any income derived from the company's trade in the next succeeding year of assessment. Companies are exempt from the payment of super tax (section 30(2)(*a*)). As regards the normal tax rate of 6*s.* 6*d.* per £ it is provided that 1/13th thereof, or 6*d.* per £, represents a savings levy repayable to the company after five years. (Companies not registered nor carrying on business in the Union are exempt from the payment of the savings levy.) The net effect is that the normal tax liability has been fixed at 6*s.* per £ of taxable income.

In regard to a company in liquidation, any income derived is taxable in the ordinary way notwithstanding the fact of liquidation. Liability for the savings levy falls away upon the liquidation of a company and a company in liquidation is not liable for the levy on income earned during liquidation.

Dividends distributed by companies, whether in cash or in kind, or by the issue of bonus shares (other than bonus shares specifically exempted from tax — see § 44), although exempt from normal tax (section 10(1)(*k*)) are subject to super tax in the hands of shareholders ordinarily resident or carrying on business in the Union (section 27(*b*) and section 30(1)(*a*)) and are liable to non-resident shareholders' tax in the hands of non-resident shareholders other than foreign companies receiving dividends from private companies (section 42(*a*) and (*a*)*bis*). There are no provisions for adjusting the rate of tax payable by companies to the rate of tax payable by the shareholder who receives a dividend, in order that, if his personal rate of tax be less than the company rate, he should be credited with the excess by the *fiscus* (as, for example, in the United Kingdom and the Federation of Rhodesia and Nyasaland where there are provisions which take into account the fact that the tax payable by the company is indirectly borne by the shareholders which may individually pay different rates of tax). The rich and the poor shareholder are, therefore, put on the same basis under the system of company taxation in force in the Union.

Section 42(*e*), read with section 37 *bis*, provides for the imposition of a non-resident shareholders' tax of 7½ per cent on the income subject to super tax of a private company registered or carrying on business in the Union and whose income is apportioned to any share-

[6] The rate in force in respect of the year of assessment ending 30th June, 1958.

holder which is a company not registered nor carrying on business in the Union.

Foreign companies which receive dividends from Union public companies are liable for the non-resident shareholders' tax thereon (section 42 (*a*)). This is not so in the case of foreign companies which hold shares in Union private companies (section 42 (*a*) *bis*) since it is the Union private company itself which is liable for the non-resident shareholders' tax on its income that is apportioned to the foreign company in terms of section 42 (*e*).

If companies do not distribute their profits, although the tax payable by them will not be diminished, the super tax payable by shareholders will be. To protect the revenue, the Legislature has, therefore, sought by the introduction of an undistributed profits tax to encourage a distribution of dividends by companies that will ensure a satisfactory flow of super tax from shareholders. If the company does not distribute a specified proportion of its profits by way of dividends each year, it has to pay the undistributed profits tax, which it has the power to avoid by making the distribution and rendering shareholders subject to super tax.

The undistributed profits tax, being a penal tax, is not designed to produce revenue directly: its primary aim appears to be to increase the super tax payable by shareholders of companies. If it is working effectively, the less revenue the tax produces the more successful will its object be. As will be shown in this chapter, the tax is not working effectively and this is also borne out by the large collections of the tax in recent years. In the 1956/57 financial year, the amount of undistributed profits tax collected was some £600,000, whereas in the 1957/58 financial year collections were about £240,000.

The undistributed profits tax provisions

All companies, whether private or public companies, are subject to the undistributed profits tax as long as they are registered or carrying on business in the Union (section 49). Certain companies are, however, exempt from the undistributed profits tax in terms of section 51.

The tax is payable at 5*s.* in the £ on the amount by which the *distributable income* of the company for the year of assessment exceeds the *dividends distributed* by such company *during the specified period* (section 49).

In order, therefore, to determine a company's liability for undistributed profits tax in respect of any year of assessment, one must determine —

(*a*) its distributable income for such year of assessment; and

(*b*) the dividends distributed by it during the specified period applicable to such year of assessment. The specified period is the period of twelve months which begins six months before the end of the company's financial year and which ends six months after the end of the financial year. Thus, dividends declared during the last six months of the company's financial year and the first six months of the following year are taken into account, thereby normally ensuring that the dividends to be taken into account reflect more correctly the distribution of the profits for the tax year than the dividends declared during the tax year.

If (*a*) exceeds (*b*), the excess amount is subject to the tax at 5*s.* in the £.

On the other hand, if (*b*) exceeds (*a*), no tax is payable and the company is not permitted to carry forward such excess to a subsequent year for set-off against any distributable income in that year.

The distributable income in respect of any year of assessment is broadly speaking determined as follows (section 50).

Total net profits of the company as defined in the Act. This includes all the profits of the company, including dividends, irrespective of whether derived from a source within or without the Union. Profits or losses of a capital nature are, however, excluded	£0000
Less all income taxes payable in respect of the profits (local as well as foreign) including the savings levy portion ..	0000
Less a 'plough-back' allowance of 40 per cent of the *total net profits.* [This allowance is not granted on any dividends included in the total net profits unless the company is a public company in terms of section 33(2), and whose total net profits are derived solely or mainly from dividends. The writer understands that the Departmental practice is to grant the 40 per cent 'plough-back' on dividends to any public company recognized as such in terms of section 33(2) whose dividends for the year exceed 50 per cent of the total net profits. All other companies are required to distribute the total amount of any dividends accruing to them (without the grant of the 40 per cent 'plough-back' in respect thereof) if they desire to avoid the undistributed profits tax]	0000
Less the cost incurred on any new machinery used in a process of production. [The allowance is granted in addition to the new machinery allowance in terms of section 11(2)(*d*)*bis* and the wear-and-tear allowances in terms of section 11(2)(*d*) made for normal tax purposes and hence taken into account in the determination of the total net profits. It would seem, therefore, that for undistributed profits tax purposes a company may claim as a deduction in the determination of the distributable income an amount greater than the actual cost of the new machinery acquired. Thus, if a company brought into use in the 1958 tax year producing machinery costing £10,000, the total net profits for such year would be reduced by the new machinery allowance of £1,000 (10 per cent of £10,000) as well as by the wear-and-tear allowance calculated on the balance of £9,000. In addition to these allowances, the total net profits will be reduced by a further amount of £10,000 being the cost price of	

the machinery brought into use during the 1958 tax year. This anomaly could not have been intended by the Legislature]	0000
DISTRIBUTABLE INCOME[7] ..	£0000

Thus, in the case of a company which has derived a trading income of £10,000 and a dividend income of £2,250 during the 1958 tax year, i.e. the year of assessment ending 30th June, 1958, the following calculation shows that a dividend of £5,000 must be distributed during the specified period (1st January, 1958, to 31st December, 1958) in order to avoid the undistributed profits tax in respect of the 1958 tax year.

Total net profits (trading income plus dividend income) ..	£12,250
Less normal tax payable (only on trading income) (6*s.* 6*d.* per £ on £10,000)	3,250
	£9,000
Less 'plough-back' allowance (only on trading income) 40% of £10,000	4,000
DISTRIBUTABLE INCOME ..	£5,000

If a dividend of only £4,000 is distributed to the shareholders, undistributed profits tax at 5*s.* per £ is payable on £1,000, i.e. £250. The shareholders are subject to super tax on the dividend of £4,000 in the year in which it accrues for tax purposes.

It may, therefore, be generally stated that if companies wish to avoid the payment of undistributed profits tax they are required to distribute by way of dividend 27½% of their taxable income and 100% of dividend income received. In the case of a public company, however, it is required to distribute 27½% of the taxable income and 60% of any dividends received as long as its total net profits have been derived solely or mainly from dividends.

The Act does not lay down when a dividend is to be regarded as distributed. As long as a company has during the specified period so dealt with certain of its profits as to render those of its shareholders who are super tax payers liable to super tax on their share of those profits, such profits do not form part of the amount subject to the undistributed profits tax since they have been distributed by way of dividend within the specified period. *Dividend distributed*, it is submitted, means that a company has so declared the dividend as to cause an accrual of the dividend among the shareholders within the specified period with the result that those of them who were super tax payers

[7] Other items which are deductible in the determination of distributable income but which are not of relevance for present purposes are:
(i) any expenditure not of a capital nature incurred in the course of and by reason of the company's ordinary business operations and which has not been allowed as a deduction in the determining of the company's total net profits, e.g. donations;
(ii) in the case of companies carrying on farming, 30% of any amount subject to tax under para. 11 of the Third Schedule.

became liable to pay super tax on the dividend which thus accrued to them in the specified period.[7a] Unfortunately, the law is not clear as to whether income accrues for tax purposes when the taxpayer obtains an enforceable right to claim payment of it or when it is due and payable (see § 237).

The Departmental practice is to allow a company to choose either the date on which shareholders were required to be registered in order to participate in the dividend or the date of actual payment as the date of distribution as best suits its purpose but once having chosen it is required in subsequent years to adhere to whichever date it has elected as the date of distribution of a dividend. In view of the uncertainty of the meaning of *accrued*, the Commissioner's practice is understandable, although, until the meaning of the word 'accrued' is clarified, the Act should embody the practice.

'Dividend', to qualify as a deduction from the total net profits, must be given the meaning it bears in section 1. Bonus share issues which fall outside the definition of dividend (see § 44), are not deductible from total net profits.

Classification of companies

No distinction is drawn between private and public companies except in regard to the non-resident shareholders' tax imposed on private companies in terms of section 42(*e*) read with section 37 *bis* and in regard to certain undistributed profits tax concessions granted to public companies. The distinction may also be of importance in regard to the taxability of bonus shares (see § 44). Companies recognized as public are set out in section 33(2) (see § 85). All other companies are regarded as private companies.

§ 26. Tax benefits derived from operating through companies

It will be observed that the rate of normal tax imposed upon companies, i.e. 6*s*. per £, bears no relation whatsoever to the maximum progressive rate of normal tax (including the provincial income tax superimposed thereon) payable by individuals which varies in the four Provinces and also between married and unmarried persons. The lowest maximum rate of normal tax is 3*s*. 11¼*d*. payable by married Transvaal residents. The highest rate is 4*s*. 9½*d*. and is payable by unmarried Orange Free State residents. On the other hand, it must not be overlooked that whereas the individual is subject to super tax on the whole of his taxable income, the shareholder in a company is generally required to declare a dividend of only 27½ per cent of the company's taxable income on which super tax is payable. In other words, in respect of every £100 of taxable income earned by a company, £32½ goes in normal tax and savings levy (6*s*. 6*d*. per £), £40 constitutes the 'plough-back' allowance (40 per cent) and, in order to avoid the undistributed profits tax, a dividend of £27½ (27

[7a] See *New Union Goldfields, Ltd.* v. *C.I.R.*, 1950 (3) S.A. 392 (A.D.); 17 S.A.T.C. 1.

per cent) is required to be declared. In the case of manufacturing companies the amount of the dividend required to be paid may be further reduced by the cost incurred on any new machinery.

Holding companies recognized as public companies in terms of section 33 are in an even more favoured position than other companies as regards the minimum dividend required to be declared to avoid the undistributed profits tax. As regards dividends received from their subsidiary companies, as long as these constitute their sole or main source of income, they are entitled to the 40 per cent 'plough-back' allowance in respect of such dividends. The net effect is that public holding companies are only required to distribute 16½ per cent of the income derived by their subsidiaries as the following calculation shows:

	Public Holding Company	*Subsidiary Company*
Trading Profit	—	£100,000
Dividend received from subsidiary ..	£27,500	
Less normal tax at *6s. 6d.* per £ (including the savings levy)	—	32,500
	£27,500	£67,500
Less 40 per cent 'plough-back' allowance..	11,000	40,000
Dividend to be distributed in order to avoid undistributed profits tax	£16,500	£27,500

It will be observed from this illustration that the holding company, in order to avoid the undistributed profits tax, need pay out by way of dividend only 16½ per cent of the trading profits derived by the subsidiary company in order to avoid the undistributed profits tax. If the holding company did all the trading in its own name instead of through a subsidiary company, it would have to pay out by way of dividend 27½ per cent of the taxable income. It is thus better from the undistributed profits tax point of view for a public holding company not to undertake the trading operations in its own name but to form a subsidiary company to conduct the operations. The combined 'plough-back' allowance will be 51 per cent of the taxable income instead of the ordinary 40 per cent granted to other companies.

The following table shows the taxes payable by a company at selected levels of income. It also shows what taxes would have been payable if the profits were not earned by a company but in an individual capacity (based on 1958 rates of tax).

Data

(*a*) Transvaal private company X (Pty.) Ltd. with sole shareholder X, a married Transvaal resident. Apart from a dividend he receives from the company, X has no other income.

(*b*) X (Pty.) Ltd., to avoid payment of the undistributed profits tax, declares a dividend sufficient to absorb the available profits after providing for the 40 per cent 'plough-back' allowance.

TABLE I

	£	£	£	£	£	£
Taxable income of company (at selected levels)	1,000	3,000	6,000	10,000	15,000	20,000
Less normal tax (including savings levy, 6*s*. 6*d*. per £)	325	975	1,950	3,250	4,875	6,500
	675	2,025	4,050	6,750	10,125	13,500
Less 'plough-back' allowance (40% of taxable income) ..	400	1,200	2,400	4,000	6,000	8,000
Dividend to be declared in order to avoid the undistributed profits tax	275	825	1,650	2,750	4,125	5,500
Taxes payable by X on dividend received (excluding savings levy)	2	9	9	109	444	843
Taxes payable by company (excluding savings levy, i.e. 6*s*. per £)	300	900	1,800	3,000	4,500	6,000
Total taxes payable by X and his company	302	909	1,809	3,109	4,944	6,843
Total taxes payable by X if not trading through a company	59	435	1,688	3,929	7,013	10,096
Result of operating through a company	Additional tax 243	Additional tax 474	Additional tax 121	Saving in tax 820	Saving in tax 2,069	Saving in tax 3,253
Contingent liability for super tax on undistributed profits (40% 'plough-back' allowance *plus* recoverable savings levy)	£425	£1,275	£2,550	£4,250	£6,375	£8,500

§ 27. EFFECT OF CREDITING MANAGERIAL REMUNERATION

The above table shows that operating through a company under the postulated conditions, there is a very substantial increase in tax liability in the case of the lower income groups of taxpayers whereas substantial savings accrue to the higher income groups. It is true that by drawing a salary X may be able to shift the tax burden from the company to himself and thus receive the advantage of the lower rate of tax. This door is, however, not open to minority shareholders or shareholders who do not take an active part in the business of the company. Not every shareholder of a private company is a director or employee of the company. Assuming, however, that it can be done by virtue of X being a full-time employee of the company, it will be observed from Table II that the lower income groups of taxpayers will be virtually completely relieved from the additional taxes as shown in Table I.

TABLE II

	£	£	£	£	£	£
Profits of company (at selected levels) (before crediting remuneration)	1,000	3,000	6,000	10,000	15,000	20,000
Less remuneration (say) ..	1,000	2,300	3,000	3,000	3,000	3,000
Taxable income of company	—	700	3,000	7,000	12,000	17,000
Less normal tax (including savings levy, 6*s.* 6*d.* per £)	—	228	975	2,275	3,900	5,525
	—	472	2,025	4,725	8,100	11,475
Less 'plough-back' allowance (40% of taxable income)..	—	280	1,200	2,800	4,800	6,800
Dividend to be declared in order to avoid undistributed profits tax	—	192	825	1,925	3,300	4,675
Taxes payable by X on salary and dividend received (excluding savings levy) ..	59	238	639	941	1,370	1,855
Taxes payable by company (excluding savings levy, i.e. 6*s.* per £)	—	210	900	2,100	3,600	5,100
Total taxes payable by X and his company	59	448	1,539	3,041	4,970	6,955
Total taxes payable by X if not trading through a company	59	435	1,688	3,929	7,013	10,096
Result of operating through a company	—	Additional tax 13	Saving in tax 149	Saving in tax 888	Saving in tax 2,043	Saving in tax 3,141
Contingent liability for super tax on undistributed profits (40% 'plough-back' allowance *plus* recoverable savings levy)	NIL	£298	£1,275	£2,975	£5,100	£7,225

It must be remembered that until the super tax exemption limit is reached, i.e. £2,300, an individual is subject only to normal tax (plus the provincial income tax superimposed thereon) at rates considerably below the company rate of normal tax, i.e. 6*s.* per £. However, every additional pound of income earned after £2,300 attracts tax at a rate exceeding the company rate. As long as a taxpayer has no other income, it is, therefore, most favourable for him to credit himself with remuneration at an amount not exceeding £2,300, although the extra tax payable by taking a slightly higher remuneration, say £2,500 or even £3,000 is not substantial. If a taxpayer has other income, it does not always follow that he will save by taking remuneration up to £2,300. Everything will depend upon the extent of his income and his marginal rate of tax. Each case has to be considered on its own merits, and a company and its shareholders may have to 'juggle' with such remuneration in order to achieve the maximum benefit. In the process of 'juggling', however, the taxpayer must bear in mind the question as to how far this can be done under the allowable deduction provisions of the Income Tax Act.

There are numerous cases of the Special Court in which it was held that the Commissioner is entitled to disallow expenditure to the extent to which it is excessive on the grounds that the expenditure is not actually incurred in the production of the income in terms of section 11 (2) (*a*) or is not wholly or exclusively laid out or expended for the purposes of trade as required by section 12 (*g*) but is inspired by some other motive.

The temptation may arise particularly in the case of the one-man company to absorb the profits of the company in wholly exaggerated directors' fees or remuneration with the result that the incidence of tax on the company either disappears or is comparatively negligible and now falls on the individual whose personal rate of tax may be smaller than the company rate. The Court has held that, in terms of section 11 (2) (*a*), the Commissioner may challenge the remuneration awarded to directors if in his opinion it is unreasonable.[8]

In one case[9] the Special Court stated:

> 'Now, when it is said that remuneration is excessive, and accordingly must be regarded as not expended in the production of the income, this Court, in determining the question under section 11 (2) (*a*) is not exercising discretionary powers, nor must it necessarily look to the direct effect of the remuneration which is said to be excessive. Accordingly, when it is sought to rule out remuneration under section 11 (2) (*a*) it would seem that the considerations that should influence the Court would be — (*a*) that the remuneration is so grossly excessive that it could not possibly be regarded in its total amount as producing income, and (*b*) that it had been awarded from some ulterior motive, such as, for example, tax evasion or favouritism or the like. For apart from such motives, any award, however high, only results in the liability for tax being transferred from the shoulders of one taxpayer to another.'

There are a number of cases where the Special Court had to decide whether alleged excessive remuneration was or was not paid in the production of income. In these cases the Court took into account various factors, e.g. the value and nature of the services rendered, the nature of the business, the relationship between the employer and the employee, the amount of the remuneration in relation to the net profit earned by the employer and the dependence of the remuneration paid on the profits earned, the presence of motives other than ordinary commercial ones, e.g. tax avoidance, family feeling, etc.[10]

In cases where the Commissioner disallows portion of a remuneration payable by a company to its shareholders as being excessive and

[8] *Ben Richards (Pty.), Ltd.* v. *C.I.R.*, 1940 T.P.D. 321; 11 S.A.T.C. 116.

[9] I.T.C. No. 569, 13 S.A.T.C. 447.

[10] I.T.C. No. 781, 19 S.A.T.C. 407; I.T.C. No. 577, 13 S.A.T.C. 486; I.T.C. No. 335, 8 S.A.T.C. 338; I.T.C. No. 345, 9 S.A.T.C. 46; I.T.C. No. 348, 9 S.A.T.C. 59; I.T.C. No. 397, 10 S.A.T.C. 91; I.T.C. No. 428, 10 S.A.T.C. 350; I.T.C. No. 473, 11 S.A.T.C. 269; I.T.C. No. 502, 12 S.A.T.C. 153; I.T.C. No. 610, 14 S.A.T.C. 377; *Verrinder, Ltd.* v. *C.I.R.*, 1949 (2) S.A. 147 (T); 16 S.A.T.C. 48.

not incurred in the production of income, the recipient is taxable on the full amount received being in respect of services rendered.[11] It does not follow that because any particular amount is not allowed as a deduction from the income of the payer, it is not taxable in the hands of the recipient.[12]

This is a pitfall which a company and its shareholders must watch very carefully for, if a portion of the remuneration payable by a company is disallowed as not having been incurred in the production of income and yet the whole of such remuneration is taxed in the hands of the recipient as being in respect of services rendered, this is tantamount to tax being levied twice on the same amount — once in the hands of the company and for a second time in the hands of the recipient. The result may prove to be quite startling. For example, if A through his company A (Pty.) Ltd. credits himself with an excessive remuneration of, say, £8,000 but the Receiver is prepared to allow only £4,000 as a deduction to the company, the consequence will be that the company will pay normal tax at 6*s.* in the £ on the remuneration disallowed of £4,000 making a liability of £1,200. In addition, A will be liable to both normal tax and super tax on the remuneration of £8,000 and if this is his only income, the total tax payable will be £2,789 (assuming he is a married Cape resident). If A had voted himself remuneration to the extent of only £4,000, which the Receiver is prepared to allow, his tax liability can only be on £4,000, viz. £832. As far as the company is concerned, it is no better off or worse off, whether it claims £4,000 or £8,000 as having been paid by way of director's remuneration. However, A is decidedly worse off since the taxation of the full remuneration in his hands will cost him an extra £1,957 in tax (£2,789 *less* £832).

As regards the lower-income groups of taxpayers operating through companies, if they are not able to alter the tax liability by adjustments in managerial remuneration, a solution may be to go into liquidation and for the business to revert to individual ownership. But it is not every shareholder who has this chance open to him. The answer is, of course, that our legislation should recognize the fact that in truth the tax payable by a company is indirectly borne by its shareholders who may individually be paying different rates of tax. Thus, a shareholder earning £10,000 per annum indirectly bears the same rate of company tax as the shareholder earning £1,000 per annum. The Union system, therefore, entails a grave injustice to small shareholders and it may discourage the investment of foreign capital in South Africa. The Committee of Enquiry into the Income Tax Act considered the application to the Union of the system of dividend adjustment in countries like the United Kingdom and the Federation of Rhodesia and Nyasaland but came to the conclusion that whereas the system had admirable features they were outweighed by certain practical considerations and administrative difficulties.[13]

[11] I.T.C. No. 792, 20 S.A.T.C. 98.
[12] *W. F. Johnstone & Co., Ltd.* v. *C.I.R.*, 1951 (2) S.A. 283 (A.D.); 17 S.A.T.C. 235.
[13] *First Report*, p. 52, para. 14.

The present system of company taxation in the Union has the great merits of simplicity and ease of administration but these advantages may be purchased at too high a price if equity is to be achieved among all classes of the tax-paying public.

§ 28. Contingent liability for super tax on undistributed profits

As regards the higher income groups of taxpayers operating through companies, they are at a distinct advantage as compared with individuals falling in the same category. As Table I reflects, a person operating through a company earning £20,000 per annum, pays some £3,250 less than his counterpart who does not operate through a company. If the earnings are £15,000, the saving is some £2,000 through the operation of a company and if the earnings are £10,000, the saving is about £800. It may be effectively argued that whereas the company does pay that less tax as compared with the individual, the latter has the great advantage of not having to pay any further tax on his earnings whereas the individual who trades through a company is always faced with a contingent liability for super tax, which must grow with the years, in respect of undistributed profits. For if and when these undistributed profits are distributed by way of dividend among the shareholders, liability to super tax arises. For example, Table I shows that where the earnings are £20,000, the contingent liability for super tax in respect of undistributed profits is £8,500. In ten years time the contingent liability may well be nearly £100,000. If these profits are ever declared by way of dividend, liability for super tax will arise, or should the company go into liquidation the distribution of these accumulated profits in the form of a liquidation dividend will be subject to super tax. The heavy super tax payable in these circumstances may well be considerably in excess of the saving of tax over all the previous years. It is also argued that the contingent liability for super tax in respect of undistributed profits may hamper the shareholder in the negotiations with a prospective purchaser for the acquisition of his shares in the company. The prospective purchaser may insist, as a condition of purchase, that the seller declare all the undistributed profits by way of a dividend to himself thereby subjecting him to a super tax liability which may well prove to be disastrous or, as an alternative, the seller may be required to furnish an indemnity against any tax that may be payable in the future in respect of the undistributed profits. The contingent liability for super tax in respect of undistributed profits may, therefore, prove to be a serious problem to a shareholder in a company and it could, therefore, be argued that there is no certainty that the immediate saving which the higher income groups of taxpayers operating through companies achieve will not be swallowed up in the future by a liability for tax in respect of the undistributed profits.

On further examination, however, it is doubtful whether the contingent liability for super tax in respect of undistributed profits is a real problem because there is no compulsion on a shareholder to declare dividends except for the minimum requirement for undistributed profits tax purposes. There is also no compulsion to put the company into liquidation.

If the presence of large undistributed profits in a company is likely to hamper a sale of shares in such company, all the selling shareholder need do is to let the company sell the business assets to the purchaser rather than let the transaction take the form of a sale of shares. The seller will, therefore, remain with the company with the large undistributed profits. One must also consider the relative ease with which the undistributed profits can be made to disappear, free of all taxes, within the framework of the taxing laws. For example, assume that A is the sole beneficial shareholder in A (Pty.) Ltd. whose balance sheet reads as follows:

Issued Capital	£1,000	Net Assets	£50,000
Undistributed Profits ..	49,000		
	£50,000		£50,000

One method may be for A to sell his shares for £50,000 (the question of goodwill is ignored) to a new investment holding company incorporated in the territory of South West Africa. He could be the sole beneficial shareholder in the foreign company. Thereafter, A (Pty.) Ltd. would declare a dividend of the entire undistributed profits of £49,000 in favour of the foreign holding company. A (Pty.) Ltd. would, therefore, be free of undistributed profits. The foreign holding company cannot treat this dividend of £49,000 as income since the purchase price it has paid A for the shares took into account the undistributed profits of A (Pty.) Ltd. Prudent accounting procedure dictates that the holding company must utilize the dividend to write down the cost of the shares. Thus, its balance sheet may read something like this:

Issued Capital	£1,000	Cost of Shares in A (Pty.) Ltd.	£50,000
Amount owing to A (for purchase price of shares £50,000 *less* subscription price of issued capital £1,000)	49,000	*Less* dividend used to write down cost	49,000
			£1,000
		Amount owing by A (Pty.) Ltd. (in respect of dividend declared)	49,000
	£50,000		£50,000

It will be observed that the undistributed profits of £49,000 have completely disappeared and A can now dispose of his interests in A (Pty.) Ltd. by letting the foreign company sell its shareholding in A (Pty.) Ltd. worth £1,000 to the prospective shareholder who will also pay the foreign company £49,000 for the cession of the debt owed to it by A (Pty.), Ltd. The foreign company will thus receive £50,000 for the sale of the debt and the shares and in this way A will receive the £49,000 owing to him. The foreign company may now be liquidated. It would appear that the above procedure will not involve A (Pty.) Ltd. or the foreign holding company in any tax liability. The dividend of £49,000 passing from A (Pty.) Ltd. to the foreign holding company is not liable for any South African taxes. Non-resident shareholders' tax is not payable since it constitutes a dividend passing from a Union private company in favour of a company and not a person other than a company. As regards the foreign holding company, it is also exempt from tax on the dividend. In South West Africa, as in the Union, no normal or super tax is payable on the dividend. Furthermore, there is no undistributed profits tax operating in South West Africa.

It will not be advantageous to form the new holding company in the Federation of Rhodesia and Nyasaland. Although the dividend received from the South African company is not subject to income tax or supertax in the Federation, it will form part of the company's distributable income for undistributed profits tax purposes. The Federation has imposed an undistributed profits tax and with effect from the year of assessment ending 31st March, 1958, the law regards dividends from sources outside the Federation as forming part of the company's distributable income. Since the dividend of £49,000 from A (Pty.) Ltd. is clearly from a Union source, and bearing in mind that the foreign holding company cannot treat this dividend as income available for distribution, liability for undistributed profits tax must arise unless advantage is taken of the present loopholes in the Federation law for the avoidance of the tax (see § 39).

The above method of legally causing the disappearance of the undistributed profits of a company will not give the same tax advantages if the holding company is formed in South Africa since the dividend of £49,000 declared by A (Pty.) Ltd. will form part of the distributable income of the holding company in South Africa even though, from the accounting point of view, no real income has accrued to the holding company by the declaration of the dividend. Thus, liability for undistributed profits tax must arise in respect of this dividend unless the holding company can be made an exempt company for undistributed profits tax purposes in terms of section 51. It will be shown that under the exemption provisions of section 51 presently in force, it may not be too difficult a problem to make a company exempt from the undistributed profits tax.

§ 29. Defects in the undistributed profits tax exemption provisions

In Tables I and II *supra*, it has been shown that even after declaring the minimum dividend required by law to avoid undistributed profits tax, i.e. 27½ per cent of the taxable income, substantial savings accrue to the higher income groups who conduct their business through companies rather than as a sole proprietorship business or in the form of a partnership business. An analysis of the present exemptions from undistributed profits tax in terms of section 51 will show that these exemptions are very wide indeed and leave loopholes of such a nature that a company by taking advantage of one or other of these exemption provisions can avoid the necessity of having to declare any dividends to shareholders and also be free of the undistributed profits tax. In other words, by making use of certain avoidance devices which the law permits, a company can limit its tax liability to normal tax at 6*s.* per £ and the Treasury's efforts to collect super tax from shareholders on a reasonable portion of the taxable income derived by the company would have failed completely. The benefit to such companies which take advantage of the avoidance devices is obvious if a comparison is made with the marginal rates of tax applicable to persons not operating through companies. It will be observed from the table below, applicable to married Cape residents, that after an income of £2,300 has been reached, the lowest marginal rate is 6*s.* 9*d.* — already 9*d.* more than the company rate of 6*s.* — whereas the maximum marginal rate for income exceeding £9,300 is about 12*s.* 6*d.* — some 6*s.* 6*d.* more than the company rate. For income levels between £2,300 and £9,300 the marginal rate increases rapidly from 6*s.* 9*d.* until it reaches the maximum of 12*s.* 6*d.* To take a simple illustration, a company which is entitled to exemption from undistributed profits tax and which earns £20,000 a year, is liable only for normal tax at 6*s.* per £ on its entire income, whereas an individual earning this sum will in respect of the income after the first £2,300 pay a rate of tax fluctuating between 6*s.* 9*d.* and 12*s.* 6*d.* in the £, viz.:

On the increase from	£2,300	to	£2,500	the rate is	6*s.* 9*d.*
,, ,, ,, ,,	£2,500	to	£3,000	,, ,, ,,	7*s.* 1*d.*
,, ,, ,, ,,	£3,000	to	£3,500	,, ,, ,,	7*s.* 5*d.*
,, ,, ,, ,,	£3,500	to	£4,000	,, ,, ,,	7*s.* 11*d.*
,, ,, ,, ,,	£4,000	to	£4,500	,, ,, ,,	8*s.* 4*d.*
,, ,, ,, ,,	£4,500	to	£5,000	,, ,, ,,	8*s.* 9*d.*
,, ,, ,, ,,	£5,000	to	£5,500	,, ,, ,,	9*s.* 2*d.*
,, ,, ,, ,,	£5,500	to	£6,000	,, ,, ,,	9*s.* 7*d.*
,, ,, ,, ,,	£6,000	to	£6,500	,, ,, ,,	10*s.* 0*d.*
,, ,, ,, ,,	£6,500	to	£7,000	,, ,, ,,	10*s.* 5*d.*
,, ,, ,, ,,	£7,000	to	£7,500	,, ,, ,,	10*s.* 10*d.*
,, ,, ,, ,,	£7,500	to	£8,000	,, ,, ,,	11*s.* 3*d.*
,, ,, ,, ,,	£8,000	to	£8,500	,, ,, ,,	11*s.* 8*d.*
,, ,, ,, ,,	£8,500	to	£9,000	,, ,, ,,	12*s.* 1*d.*
,, ,, ,, ,,	£9,000	to	£20,000	,, ,, ,,	12*s.* 6*d.*

Thus, on the last £11,000 of the income, whereas the company will pay £3,300 (6*s.* per £ on £11,000) the individual will pay £6,875 (12*s.* 6*d.* per £ on £11,000). The difference is considerable. The above schedule of marginal tax rates provides the clue as to the time for an individual trader or partner to form a company. Considering only the tax aspect, one can say as a broad general rule that as long as the owner of the business can justify an annual director's remuneration of at least £2,300 — the figure at which super tax liability commences — a tax savings can be effected by the formation of a company as soon as the income exceeds £2,300. For example, if the profits of the business total £3,000 and the owner can justify a remuneration of £2,300, company tax at 6*s.* in the £ will be payable on £700. The marginal rate schedule above shows that an individual would pay, in respect of the last £700 of the income of £3,000, 6*s.* 9*d.* per £ on the first £200 and 7*s.* 1*d.* per £ on the last £500. However, the saving is so small that it is not likely to encourage the trader to effect the change. He is more likely to consider a change to a company when the profits approach the £5,000 or £6,000 mark, even though the tax saving is not very substantial at this level of income, since it will be borne in mind that the saving will grow as the business prospers. If the individual, who is contemplating the formation of a company, cannot justify a remuneration of £2,300, great care will have to be exercised in deciding whether incorporation is desirable from the tax point of view. In the example given, if only £500 director's remuneration can be justified as a deduction against the £3,000 profits, the formation of a company will obviously have a boomerang effect. The company will pay normal tax at 6*s.* per £ on £2,500 taxable income whereas the shareholder will pay tax on £500 income only. It must be borne in mind that the rate of normal tax payable by an individual is considerably less than 6*s.* per £ in respect of the first £2,300 of his income. The writer would like to emphasize that he is stating very general rules since each case must be dealt with on its own merits and according to the special circumstances of the business.

Table II has been reconstructed to show the results if the company can claim exemption from the undistributed profits tax and is thereby not required to declare the minimum dividend of 27½ per cent of the taxable income.

TABLE III

	£	£	£	£	£	£
Profits (before crediting remuneration)	1,000	3,000	6,000	10,000	15,000	20,000
Less remuneration (say) ..	1,000	2,300	3,000	3,000	3,000	3,000
Taxable income of company	—	700	3,000	7,000	12,000	17,000
Less normal tax (excluding savings levy, 6*s.* per £) ..	—	210	900	2,100	3,600	5,100
Contingent liability for super tax on	—	490	2,100	4,900	8,400	11,900
Taxes payable by X on salary (excluding savings levy) ..	59	196	435	435	435	435
Taxes payable by company (as above)	—	210	900	2,100	3,600	5,100
Total taxes payable by X and his company	59	406	1,335	2,535	4,035	5,535
Total taxes payable by X if not trading through a company	59	435	1,688	3,929	7,013	10,096
Saving resulting from operating through a company ..	—	£29	£353	£1,394	£2,978	£4,561

It seems manifestly unjust that taxpayers in the higher income groups can maximize tax liability at 6*s*. per £ by operating through corporations whereas certain individuals who for some reason or another cannot do so, e.g. professional men, have to pay considerably higher rates of tax even though they fall into the lower income groups. The married Cape resident who increases his income from £2,500 to £3,000, has to pay a rate of 7*s*. 1*d*. in the £ on the increment of £500 whereas an individual trading through a company and earning £30,000 per annum pays a maximum rate of 6*s*. in the £. This is a flagrant violation of the principle of 'ability to pay'. Taxpayers who are subject to maximum rates of tax in their individual capacity, i.e. some 12*s*. 6*d*. in the £, are naturally tempted to transfer all income-producing assets to one or more companies so that tax is payable at 6*s*. per £ on such income. This accounts for the spate of companies formed in recent years to take transfer of rental-producing properties and other forms of income-producing investments.

An analysis must now be made of the present undistributed profits tax exemptions which permit companies to refrain from declaring dividends to shareholders and thus to limit the tax liability to 6*s*. per £ of the taxable income.

The various companies which are exempt from the payment of undistributed profits tax in terms of section 51 may be conveniently classified under the following heads:

(1) Special types of companies, e.g. co-operative companies, insurance companies and public utility companies.

(2) Companies whose reserves do not exceed £50,000 or 40 per cent of their capital.

(3) Companies whose profits for year do not exceed 5 per cent of their capital.

(4) Wholly owned subsidiary companies.

(5) Companies with foreign shareholders.

(6) Banking institutions.

(7) Companies whose shares are held by the Union Government.

(8) Foreign companies carrying on business in the Union.

(9) Companies whose shares are held by mining companies to the extent of 75 per cent.

It is the shareholders of companies which fall within the exemptions set out in (2), (3), (4) and (5) who are able to arrange their affairs in such a way that their companies fall within the exemptions so that it is not necessary for them to declare dividends. In this way, they are able to maximize tax liability at 6*s*. per £.

§ 30. Companies whose reserves do not exceed £50,000 or 40 per cent of capital

Statutory provisions

A company is exempt from undistributed profits tax in terms of section 51 (*f*) if it can satisfy the Commissioner that the sum of its reserves and balance of profits unappropriated, arrived at in the following manner, does not exceed £50,000 or 40 per cent of its paid-up capital at the specified date (as defined),[14] whichever is the greater.

(*a*) Take all the company's reserves (including any share premium account) at the specified date		£0,000
(*b*) *Add* the balance of profits unappropriated at the specified date		0,000
Sum of (*a*) + (*b*)		£0,000
(*c*) *Deduct*		
(i) All dividends distributed by the company during the last six months of the specified period, i.e. the period of six months following the end of the financial year	£0,000	
(ii) Taxes payable on total net profits for year of assessment	0,000	0,000
Sum of reserves and unappropriated profits (*a*) + (*b*) — (*c*)		£0,000

This exemption does not apply to private companies whose total net profits are derived solely or mainly from dividends. Companies recognized as public in terms of section 33 are entitled to exemption in terms of section 51 (*f*) even though their total net profits are derived solely or mainly from dividends. The writer understands that it is the Departmental practice *not* to grant this exemption to a private company whose dividend income for the year exceeds 50 per cent of the total net profits for that year. In such circumstances, the company's total net profits will be regarded as derived mainly from dividends. The reason for excluding private companies whose total net profits are derived solely or mainly from dividends was to prevent avoidance of super tax by Union shareholders by the operation of transferring their dividend-producing investments to holding companies and then claiming the exemption in terms of section 51 (*f*).

Any decision of the Commissioner in the exercise of his discretionary power under this exemption is subject to objection and appeal in terms of section 54.

Paid-up capital includes both ordinary share capital (equity share capital) and preference share capital. If the issued capital of a company has been reduced, the reduced amount must be regarded as the paid-up capital.

[14] *Specified date*, in terms of sec. 33 (4), is, broadly speaking, the last day of the company's financial year.

If the company's reserves and balance of unappropriated profits have been reduced by the issue of bonus shares which did not rank as a 'dividend' within the meaning of the definition in section 1 (see § 44), it is provided that the reserves and unappropriated profits must be increased by the nominal value of the bonus shares so awarded. This does not apply in the case of bonus shares awarded out of a share premium account.

Paid-up capital is defined in section 50 to exclude so much of the nominal value of any bonus shares awarded as did not rank as a dividend in terms of the definition in section 1 (see § 44), but includes any such bonus shares awarded out of a share premium account.

In order to prevent the inflation of paid-up capital by the issue of shares as consideration for the purchase of assets where the fair value of the assets purchased is less than the nominal value of the shares issued, it is provided in section 53 (2) that where a company resorts to such a practice its paid-up capital must be reduced by the amount by which, in the opinion of the Commissioner, the nominal value of such shares exceeded the fair value of the assets. *Fair value* is defined in section 50 to mean the fair market value, regard being had, *inter alia*, to —

(*a*) any sworn valuation furnished by the company;

(*b*) any valuation made by a competent and disinterested person appointed by the Commissioner.

Any decision by the Commissioner as regards the application of section 53 (2) is subject to objection and appeal — section 54.

Meaning of reserves and balance of profits unappropriated

Reserves and balance of profits unappropriated are not defined in the Act. The fact that the Legislature sought to grant a special deduction therefrom in respect of taxation liability might be an indication that the intention was to regard as reserves all amounts provided out of profits to meet liabilities or losses not actually incurred at the specified date, and that unrealized profits credited to the profit and loss account should be excluded from the balance of unappropriated profits.

The writer understands that at present the Commissioner acts as follows in regard to the meaning of *reserves and balance of profits unappropriated*:

(i) Realized capital profits and losses on the sale of fixed assets go to increase or reduce the balance of profits unappropriated.

(ii) Unrealized losses on assets whose cost price is in excess of the market value and which have been written off in the profit and loss account, although these will reduce the balance of profits unappropriated, will not be regarded as reserves, e.g. an unrealized loss on shares written off will not be treated as a reserve. If a company establishes that a reduction in the value of an asset has taken place, the Commissioner insists that all assets of the same type must be revalued. Thus, if a company claims that a provision for an unrealized loss on one share investment must be excluded from the reserves, the Commissioner will want evidence as to the value of all share investments and he will take into account any unrealized appreciations in the value of other share investments. On the overall position it may be found that there has been no reduction in the value of the company's share investments.

(iii) If the profit and loss account is credited with an unrealized profit on an asset whose market value is in excess of the book value, this amount will be excluded from the reserves and balance of profits unappropriated except in the case of unrealized enhancements referred to in (ii) *supra.*

(iv) Reasonable provisions to meet known or proved liabilities on revenue account in respect of which the company is actually committed, the exact amount of which cannot be properly ascertained at the date when the accounts are made up, will go to reduce the balance of unappropriated profits and will not be regarded as reserves. On the other hand, provisions to meet potential or anticipated losses or liabilities will be regarded as reserves.

(v) In practice the Department does not regard as reserves any bad debts and discount reserves provided these reserves have been admitted as a deduction for normal tax purposes. Thus, if a company has created a bad debt reserve of £8,000 at 30th June, 1958, and the Commissioner allows only £2,000 thereof for normal tax purposes in terms of section 11 (2) (*h*), the portion not allowed, viz. £6,000, will be included with the reserves and balance of profits unappropriated for the purposes of section 51 (*f*).

(vi) As regards hire-purchase reserves allowed as a deduction from income in terms of the proviso to section 22, in practice these are not treated as reserves for purposes of section 51 (*f*).

(vii) Wear-and-tear allowances, to the extent to which they are admissible as deductions for normal tax purposes, are not regarded as reserves. Where, however, a company has claimed in its accounts wear and tear in excess of the amount allowed to it by the Commissioner, the excess amount is, in practice, treated as a reserve for purposes of section 51 (*f*).

Criticisms of section 51 (*f*)

The exemption contained in section 51 (*f*) has virtually rendered the undistributed profits tax provisions ineffective. It defeats the purpose of undistributed profits tax because by reason thereof the tax may be avoided without the necessity to declare dividends by forming a sufficient number of companies. Each department or section of a company can be formed into a new company with the resultant effect that no undistributed profits tax is payable until each company has accumulated reserves and undistributed profits totalling £50,000. For example, a company dealing in hats, socks and shoes and whose reserves have exceeded £50,000 can sell out to three new companies, one to trade in hats, one in socks and the other in shoes. Under the law as it stands at present, each of the three new companies will be exempt from the undistributed profits tax as long as its reserves and balance of profits unappropriated have not exceeded £50,000. If at any stage in the future the accumulated reserves in respect of any of the companies exceed £50,000, the business can be transferred to a new company which has the opportunity of building up another £50,000 accumulated reserves before being liable for the undistributed profits tax. On this basis, he can carry on the process of forming one company after another indefinitely. Experience has shown that a tax concession ought never to be granted to a company in the form of a fixed abatement since by the simple process of forming a number of companies, the concession can be exploited for the benefit of the shareholders.

Another criticism of section 51 (*f*) is the reference it makes to 40 per cent of the company's paid-up capital. Although there are safeguards to prevent the inflation of paid-up capital, there is nothing to prevent a taxpayer from purchasing a company with a paid-up share capital of, say, £500,000 and thereafter transferring his lucrative business to the company and claiming exemption from the undistributed profits tax on the grounds that the balance of unappropriated profits has not exceeded £200,000 (40 per cent of £500,000).

Section 51 (*f*), therefore, encourages the widespread avoidance of super tax on dividend income and the Treasury would be well advised to abandon it altogether. After all, a company is free of the undistributed profits tax each year in respect of 40 per cent of its taxable income by way of a ' plough-back ' allowance as well as in respect of the cost of new productive machinery acquired, and it would appear to the writer that there is no convincing reason why, in addition to these big concessions, a company should be permitted to accumulate £50,000 before being liable for undistributed profits tax. The individual who is carrying on business, whether on a sole-proprietorship basis or on a partnership basis, must pay super tax on his full earnings. He is not given the opportunity of accumulating any amount of reserves before he will be subject to super tax. In this respect, section 51 (*f*) amounts to a discrimination against the individual who is carrying on business not through a company. In addition, there is the important consideration that it has left the door to the avoidance of super tax by shareholders wide open. If the Treasury is not prepared to withdraw section 51 (*f*), it is imperative that there should be inserted into the Act suitable anti-avoidance provisions to prevent the multiplication of companies and the splitting up of existing businesses into a group of companies so that each company can claim the benefit of the section.

§ 31. Companies whose profits for year do not exceed 5 per cent of capital

Any company whose *total net profits* (as defined) for the year of assessment do not exceed 5 per cent of its paid-up capital as at the *specified date* (as defined) is exempt from undistributed profits tax — section 51 (*g*). Thus, if for the year of assessment ending 30th June, 1958, a company's total net profits are £10,000 and the issued share capital at 30th June, 1958, is £250,000, the company is exempt from the undistributed profits tax as its total net profits, viz. £10,000, do not exceed 5 per cent of the issued capital, i.e. £12,500. The exemption applies even though the total net profits are made up entirely of dividend income.

Paid-up capital includes both ordinary as well as preference share capital. It is defined in section 50 to exclude so much of the nominal value of any bonus shares awarded as did not rank as a 'dividend' in terms of the definition in section 1 (see § 44) but includes any such bonus shares awarded out of a share premium. The provisions of section 53 (2), which are designed to prevent the inflation of paid-up capital by the issue of shares as consideration for the purchase of assets where the fair value of the assets purchased is less than the nominal value of the shares issued, should not be overlooked.

Although there are safeguards to prevent the inflation of paid-up capital, there is nothing to prevent a taxpayer from purchasing a company with a substantial paid-up share capital and thereafter transferring a lucrative business to the company and claiming exemption from the undistributed profits tax on the ground that the total net profits do not exceed 5 per cent of the paid-up capital. For example, if the share capital is, say, £500,000, a business yielding not more than £25,000 profits per annum could be sold to the company. The company will be exempt from undistributed profits tax in terms of section 51 (*g*) which means that the profits can be accumulated each year free of the necessity to distribute the requisite dividend in order to avoid payment of the undistributed profits tax. Here again, the exemption encourages the avoidance of super tax on company dividends. This concession is not granted to the individual and there appears to be no good reason why a company should receive the benefit.

§ 32. Wholly-owned subsidiary companies

A company is exempt from undistributed profits tax in terms of section 51 (*i*) if all of its shares were throughout the *specified period* (as defined) held by one or more companies which are themselves exempt from the undistributed profits tax in terms of section 51, excluding para. (*f*) (see § 30) and para. (*g*) (see § 31). Thus, if a holding company is exempt from the tax in terms of any of the exemptions contained in section 51, other than paras. (*f*) and (*g*), any subsidiary company in which it held the entire capital throughout the specified period is also exempt from the tax.

By providing, with effect from the 1958 tax year, that the wholly owned subsidiary company can only claim exemption from undistributed profits tax if the holding company is specifically exempt from the tax in terms of section 51, other than the exemptions contained in paras. (*f*) and (*g*), the Legislature has closed a gaping loophole used for tax avoidance. Previously, by the simple process of creating a holding company which was made free from the undistributed profits tax by relying upon the exemptions contained in section 51 (*f*) or (*g*), the wholly owned subsidiary earning substantial income could also claim exemption in terms of section 51 (*i*). As a result, a cart and horse could be driven through the undistributed profits tax provisions. It may still be possible, however, to take advantage of the provisions of section 51 (*i*) by creating a holding company for an operating subsidiary company and by making this former company exempt from the undistributed profits tax in terms of section 51 (*d*). In § 33 *infra* it is shown how by the manipulation of the issued capital of a company with non-resident individuals exemption can be claimed in terms of section 51 (*d*). It could also be arranged that 50 per cent of the shares in the holding company be held by a second holding company registered in a foreign country, e.g. South West Africa or Rhodesia. It may be an easy matter to satisfy the income requirement for foreign company shareholders. For example, the holding company in South West Africa could earn, say, £100 income from sources in the Territory. As the holding company in the Union need not earn any income but merely hold all the shares in the operating subsidiary company, the notional dividend to be included in the foreign company's income in terms of the proviso to section 51 (*d*) (see § 33) is nil. Thus, the Union holding company is exempt in terms of section 51 (*d*) and the operating wholly owned subsidiary is exempt in terms of section 51 (*i*). It must be pointed out, however, that this procedure would involve the operating subsidiary company in non-resident shareholders' tax at 1*s*. 6*d*. per £ on such proportion of its income (50 per cent) as is apportionable to the foreign holding company (section 42 (*e*) read with section 37 *bis*).

§ 33. Companies with foreign shareholders

Statutory provisions

A company is exempt from the undistributed profits tax if it can satisfy the Commissioner that —

(i) 50 per cent or more of its issued capital was throughout the specified period held by one or more persons (other than companies) not ordinarily resident nor carrying on business in the Union; or

(ii) 50 per cent or more of its issued capital was throughout the specified period held by one or more companies registered outside the Union which derive the greater portion (more than 50 per cent) of their profits for the year of assessment in question from sources outside the Union; or

(iii) 50 per cent or more of its issued capital was throughout the specified period held by one or more persons referred to in (i) and one or more companies referred to in (ii) — section 51(*d*).

In the case of foreign company shareholders referred to in (ii), it is specially provided — no doubt to prevent abuse — that in the determination of the extent of their profits derived from Union sources for any year of assessment there must be included in the Union profits and also in the total profits derived from all sources the amount, if any, by which the dividends actually derived from companies registered in the Union during that year of assessment fall short of the dividends which would have been derived from such companies if these companies distributed by way of dividend during the year of assessment an amount equal to not less than 30 per cent of their total net profits (as defined) for that year of assessment.

Any decision by the Commissioner under this exemption is subject to objection and appeal in terms of section 54.

Issued capital includes both ordinary share capital (equity share capital) and preference share capital.

The income-requirement for foreign company shareholders does not apply to non-resident individual shareholders. Thus, if Mr. X, not ordinarily resident nor carrying on business in the Union, holds 50 per cent or more of the issued capital of a Union company, such company is exempt from the undistributed profits tax even though Mr. X may earn all his income from Union sources, e.g. dividends and interest income. If Mr. X and Mr. Y, or Mr. X, Mr. Y and Mr. Z, all being not ordinarily resident nor carrying on business in the Union, together hold 50 per cent or more of a company's issued share capital, such company is exempt from the tax.

If one or more individuals not ordinarily resident nor carrying on business in the Union together with one or more foreign companies which satisfy the 50 per cent income requirement, hold at least 50 per cent of a company's issued share capital, such company is also exempt.

The 50 per cent or more shareholding must be held *throughout the specified period* by the foreign shareholders. Thus, if a company makes up its accounts to 30th June, in order to be exempt from the tax for the 1958 tax year, the shares must be held by the foreign shareholders throughout the period 1st January, 1958, to 31st December, 1958. If the accounts are made up to 31st December, so that in respect of the 1958 tax year the specified date is 31st December, 1957, the shares must be held by the foreign shareholders throughout the period 1st July, 1957, to 30th June, 1958.

Criticism of section 51(*d*)

Because of the income-requirement for foreign company shareholders, it may not be an easy matter for a Union company to take advantage of the provisions of section 51(*d*) by arranging for a foreign company to hold not less than 50 per cent of its share capital. But the same cannot be said of non-resident individual shareholders not carrying on business in the Union. The Union company qualifies for exemption from undistributed profits tax if they hold at least 50 per cent of its issued share capital. It is a simple matter for a non-resident individual to co-operate with a Union company to secure for it exemption under section 51 (*d*), and he can do so without having any say in its affairs or without profit-sharing rights in the company. For example, a Union private company could be formed with three classes of shares — A shares of £1 each, B shares of 5*s*. each and C shares of 5*s*. each. The A and B shares can have equal voting rights, irrespective of their unequal paid-up value, with no right to participate in profits. The C shares have voting rights as well as the right to participate in profits. The promoter of the Union company can subscribe for two B shares and one C share. He will be holding 15*s*. worth of issued capital. A non-resident individual, not carrying on business in the Union, can subscribe for one A share and he will be holding £1 of the issued capital. At least 50 per cent of the issued capital is held by a non-resident in spite of the fact that he does not control the company and is not entitled to any profit-sharing rights. Section 51 (*d*) applies and the Union company is exempt from the undistributed profits tax. A method of issuing a nominal amount of preferent shares to a non-resident individual may also exempt a Union company under section 51 (*d*).

In principle, it does not seem correct that a Union resident can avoid the payment of super tax on dividends from a company simply because at least 50 per cent of the shares in that company is held by a foreigner. There are numbers of private companies in the Union where the shareholders consist of Union as well as non-Union residents but the mere association of a Union shareholder with a non-Union shareholder in the same company should not be the determining factor for exemption from undistributed profits tax. The Treasury is only asking for a dividend distribution of 27½ per cent of a company's taxable income and since a non-resident is liable for only the non-resident shareholder's tax of 1*s*. 6*d*. in the £ in respect of dividends, there is no good reason why the exemption should be granted. If, for any reason, dividends cannot be declared and the undistributed profits tax is payable, the inequity that would result by making a non-resident bear his share of a high undistributed profits tax rate as compared with the rate of non-resident shareholders' tax of 1*s*. 6*d*. per £ for which he is liable in respect of dividends, can be overcome by apportioning the undistributed profits as between Union and non-Union residents, so that such part as appertains to the interest of the non-residents will be taxed at 1*s*. 6*d*. in the £ whereas the part that appertains to the interest of Union residents will be subject to the higher rate. In this respect see the recommendations of the Committee of Enquiry (§ 35).

§ 34. LOANS IN LIEU OF DIVIDENDS

It must follow that if shareholders of companies avoid the payment of super tax by the non-declaration of dividends, unless the shareholders receive the profits in some other form they must accumulate in the hands of the companies without the shareholders personally deriving the benefit therefrom. Thus, it is not uncommon to find in the case of private companies that, instead of paying out dividends to their shareholders, they make loans, with or without interest, to their directors and shareholders. In this way shareholders can receive moneys from the company other than dividends in such a manner that they do not become liable to super tax. Moneys received by a shareholder from the company by way of loan is a receipt of a capital nature and not subject to any tax. Thus, the practice of taking loans instead of dividends is prejudicial to the *fiscus* since it permits a director during his lifetime to exist on money which has not borne super tax. Quite a common feature of present-day private company balance sheets is the reflection of large accumulated undistributed profits on the one side and a corresponding large debit owing by the directors or shareholders on the other side. Directors may lawfully borrow from a private company subject to the consent of the members holding at least 75 per cent of the issued share capital (see section 70 *oct*(1)(*a*) of the Companies Act (No. 46 of 1926)). A provision that loans by a company to its shareholders should when made be deemed to be a dividend distributed by the company may, therefore, be an effective counter to the avoidance of super tax by companies not declaring dividends. There are, however, difficulties attendant upon framing a suitable provision which will be both effective and equitable. For example, the effect of such a provision can be overcome by the company simply making the loan to a relation of a shareholder, e.g. a wife or a child, or to another company associated with the shareholder. Certain persons will, therefore, have to be deemed to be shareholders of the company making the loan. There are special provisions in the taxing laws of countries such as Canada, Australia and New Zealand in regard to loans by a company to its shareholders the effect of which are to deem such loans as having been received by the shareholders as dividends if they represent distributions of the company's income. In New Zealand, the effect of such provisions is not to deem all loans made by a company to its shareholders to be dividends but to penalize loans which are not genuine. In Australia and Canada, the provisions are more stringent. The introduction of provisions whereby loans are deemed to be dividends will not only complicate the law to a considerable extent but will also create much administrative difficulty in that virtually every loan to a director or shareholder will have to be examined by the taxing authorities in order to satisfy themselves whether it falls within the provisions or not.

The Committee of Enquiry into the Income Tax Act dealt with this aspect but only considered the case where private companies, instead of paying out dividends, make loans, with or without interest to their directors or shareholders and where such loans are later remitted or written off as irrecoverable by the companies. The Committee felt that the Act should be amended and that such loans should be deemed to constitute dividends to the recipients in the year of assessment in which the liability is waived or remitted or written off as irrecoverable by the company.[15] Although, in the writer's view, the definition of *dividend* in section 1 is wide enough to include the remission of a loan to a shareholder as a dividend as long as it is written off out of profits available for dividend, no harm will be done by the incorporation of such a special provision in the Act. It must be pointed out, however, that in view of the introduction of the donations tax it is doubtful whether private companies or their shareholders will resort to the device of the remission of loans since such a waiver of a right by the company constitutes a taxable donation and is liable to donations tax. It is interesting to record that the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland also considered the treatment of loans by companies to their shareholders and came to the conclusion that the difficulties attendant upon framing a provision which, while effective, is not inequitable are so great that the attempt was not worth while. It was of the view that the safeguard to the *fiscus* is to be found rather in a high rate of undistributed profits tax for controlled companies than in any special provisions relating to loans by companies to shareholders.[16] With this attitude the writer respectfully agrees. If the undistributed profits tax provisions in the Union can be made more effective, firstly, by radically modifying the exemption provisions, and, secondly, by imposing a high rate of undistributed profits tax, say 7*s*. 6*d*. or 8*s*. in the £, so as to stress the penal aspect of the tax, there would be no need for special provisions to deal with loans by companies to their shareholders.

§ 35. Recommendations of the Committee of Enquiry in regard to undistributed profits tax

Enough has been said to show that the exemptions contained in section 51 have rendered the undistributed profits tax provisions virtually ineffective.

The Committee of Enquiry into the Income Tax Act recommended a system for the taxation of incomes of companies which is essentially similar to the present system except that it did not contain the apportionment provisions relating to the imposition of non-resident shareholders' tax in terms of the present section 42(*e*) read with section 37 *bis*.[17]

[15] *Second and Final Report*, p. 30, para. 14. This recommendation was accepted by the Income Tax Commission (*First and Final Report*, p. 34, para. 63) who considered that the principle be applied to public as well as private companies.

[16] *Report of the Commission of Inquiry*, p. 73, para. 365.

[17] The Income Tax Commission rejected the system in part. It recommended that all dividends be exempt from super tax and non-resident shareholders' tax and that instead a distributed profits tax be imposed in respect of all dividends declared. An undistributed profits tax would not be imposed. (See *infra*, § 46, for a detailed reference to the Commission's recommendations).

The undistributed profits tax proposals of the Committee of Enquiry[18] differed from the present provisions in the following important respects:

(i) The Committee recommended that the undistributed profits tax be paid by every *private* company, the business of which is managed and controlled in the Union.

(ii) In the view of the Committee, the undistributed profits tax should be so designed as to exert especial pressure on private companies to distribute any income derived by them by way of dividends derived from other companies. The purpose of this is not only to prevent avoidance of tax by the device of forming investment holding companies to receive and retain dividend income which, if received by the original owner in his personal capacity, would be subject to super tax but also to prevent abuse by the creation of a chain of private investment companies each holding shares in the other and each claiming the benefit of the amount allowed to be retained by a company, i.e. the 'plough-back ', without incurring liability for the undistributed profits tax.

Accordingly, the Committee considered that the *distributable income* of a private company for any year of assessment should be defined as consisting of two parts, viz.:

(1) *Distributable taxable income*, which is defined as an amount equal to 70 per cent of the amount by which the taxable income of that company as determined for normal tax purposes for such year of assessment exceeds the *normal* tax chargeable thereon.

(2) *Distributable dividend income*, which is defined as the income derived from any other company by way of dividends from a source within the Union during such year of assessment *less* any expenditure incurred in connection with the earning of such dividend income (including any foreign taxation paid in respect of such dividends) which the Commissioner may allow.

(iii) In the view of the Committee, the rate of the undistributed profits tax should not be a rigid rate, but should be determined in each particular case with reference to the extent to which the collection of the super tax or non-resident shareholders' tax would suffer prejudice by the non-distribution of dividends by the private company concerned. Thus, where, and to the extent that, the shareholders of the company consist of individuals ordinarily resident or carrying on business in the Union, it is clear that the non-distribution of dividends will be to the prejudice of the super tax. On the other hand, where, and to the extent that, the shareholders consist of individuals not ordinarily resident nor carrying on business in the Union, the non-distribution

[18] See *First Report*, p. 57, para. 48 et seq.

of dividends will be to the prejudice of the non-resident shareholders' tax.

In the light of the above considerations, the Committee found it necessary to resort to the principle of apportionment and has recommended that the *undistributed profits* for each year of assessment be apportioned by the Commissioner among those persons who were shareholders of such company on the specified date, according to the rights of each such shareholder to participate in the profits or income of the company as determined in accordance with the provisions of the present section 36 of the Act.

The rate of the undistributed profits tax should, in the opinion of the Committee, be —

(*a*) in respect of so much of the undistributed profits of any company as is apportioned to shareholders who, being persons other than companies, were on the specified date not ordinarily resident nor carrying on business in the Union or being companies were not companies the business of which on the specified date was managed and controlled in the Union, for each pound of the amount so apportioned, 1*s.* 6*d.*, i.e. the present rate of the non-resident shareholders' tax. Under the present law, a private company registered or carrying on business in the Union has to pay the non-resident shareholders' tax on such portion of its income subject to super tax as is apportioned to shareholders which are companies not registered nor carrying on business in the Union — section 37 *bis* read with section 42(*e*). This provision, which was introduced after the Committee had drawn up its report, presumably renders unnecessary the recommendation that the undistributed profits tax should be paid on the amount apportioned to companies which are managed and controlled outside the Union otherwise there would be double taxation; and

(*b*) in respect of so much of the undistributed profits of any company as is apportioned to shareholders who, being persons other than companies, were on the specified date ordinarily resident or carrying on business in the Union, or, being companies, are companies the business of which on the specified date was managed and controlled in the Union, for each pound of the amount so apportioned a flat rate approximating to the maximum rate of super tax. The Committee did not specify an actual rate.

(iv) The Committee recommended that only two classes of private companies should be exempt from the undistributed profits tax, viz.:

(*a*) any company in respect of which the provisions of section 20 are applicable to the determination of the taxable income derived from its principal business, i.e. companies carrying on mining operations and which are subject to the provisions of section 20 of the Act; and

(*b*) any company whose distributable income for the year of assessment is not more than 1 per cent of its total paid-up capital as at the last day of the year of assessment.

(v) The Committee recommended a special set of rules for the calculation of the undistributed profits tax in the case of a company which derives its income from sources within and outside the Union. Such a company will be deemed to have distributed by way of dividends during any prescribed period an amount which bears the same ratio to the total amounts distributed by the company by way of dividends during that period as its *distributable income* bears to its *aggregate distributable income* for the year of assessment.

This procedure is in the main identical with the now repealed section 52 of the Income Tax Act which was in force up to the end of the year of assessment ended 30th June, 1950, and which formed part of the undistributed profits tax provisions relating to public companies. The Committee, no doubt, considered this necessary in view of its recommendation that only such part of a dividend distributed by a company as has been distributed out of profits derived by such company from a source within the Union should be included in the income subject to super tax of the shareholder.

Under the present law, all dividends distributed by a Union company are subject to super tax in the hands of Union shareholders irrespective of whether they are paid out of profits from Union sources or from non-Union sources. The Committee's recommendation, therefore, falls away.

§ 36. Conclusion

The present system in South Africa for the taxation of companies will certainly not stifle the formation of companies. On the contrary the registrar of companies must in recent years have worked at full pressure registering all the new companies that have come into being for the purpose of saving super tax for shareholders. The spate of companies formed in recent years is a natural result of the comparative ease with which tax can be avoided by shareholders operating through companies.

It is a consequence of the present system of company taxation in South Africa that it is a major factor whether or not a company should be formed for the purpose of carrying on a business. This is both unnatural and unhealthy. Taxation considerations should not become a dominant feature in the determination of the question of whether or not companies should be formed for the purpose of conducting business.

The present system of company taxation has the great merit of simplicity but in this case simplicity is purchased at too high a price.

Although there are striking differences between the various systems of taxing companies in the different countries, to the writer the South African system is the most vulnerable as regards loopholes for avoidance of super tax in respect of the undistributed profits. As has been shown the present system can readily be exploited for the benefit of the tax avoider. Whatever new system emerges, it is imperative that it be such that shareholders in companies cannot readily avoid super tax by the non-declaration of dividends.

The undistributed profits tax provisions require drastic revision. In the view of the writer the present rate of undistributed profits tax, viz. 5*s*. per £, is too low. The rate should correspond more closely with the maximum rate of super tax (including the provincial income tax superimposed thereon) payable by individuals, i.e. some 8*s*. 6*d*. in the £. There are shareholders who will rather let their companies pay the undistributed profits tax of 5*s*. per £ than let themselves pay super tax on the dividends at the rate of 8*s*. 6*d*. per £. The rate should be high so as to stress the penal aspect of the tax.

It is a matter for regret that some of the Committee of Enquiry's recommendations in regard to the imposition of the undistributed profits tax were not accepted by the Legislature particularly in regard to the limited exemptions which the Committee recommended (see § 35). Practically all the defects of the present system would have been avoided. In the interests of equity and fairness among the different classes of shareholders it would, of course, have been necessary to ensure that the undistributed profits for each year of assessment be apportioned among the shareholders in the manner indicated by the Committee. It is true that the system of apportionment of the undistributed profits would give rise to administrative difficulties. It is, however, equitable and ensures that justice is done among the different classes of taxpayers. In practice it will probably be found that the Commissioner will very seldom have to go as far as to make an apportionment since the company will probably declare a dividend in order to avoid payment of the undistributed profits tax.

Experience has shown that safeguards must be provided to ensure that tax is not avoided by the accumulation of income in companies by taxpayers whose individual rates of tax are greater than the rate paid by the company. Such safeguards are to be found in the tax laws of the United Kingdom, Australia and Canada. In the United Kingdom the object is achieved by giving Special Commissioners, who are full-time officials appointed by the Treasury, the power to direct that profits which are withheld be apportioned among members if the company does not distribute a reasonable proportion of its profits within a reasonable period after the end of the financial year. Such apportionment is made against the persons for whose benefit the distribution of income was withheld. The question of what constitutes an unreasonable withholding of profits is laid down in the Act. The legislation applies only to companies which are under the control of not more than five persons and which are not subsidiary companies or companies in which the public are substantially interested. A scheme along these lines was in force under the Income Tax Act, 1925, but was abandoned in 1941 in favour of the apportionment system as it was found to be unsatisfactory and ineffective. The writer is of the view that the Union should continue with the principle of an undistributed profits tax to compel companies to pay reasonable dividends to shareholders. Once the worst features of the present provisions are remedied, the tax should achieve its purpose of ensuring a steady flow of super tax to the Treasury.

There is no doubt that the problem of the taxation of a company and its shareholders is a difficult one as the tax laws in many countries reveal and there is no ideal solution. Although the present undistributed profits tax provisions have the merit of simplicity, they do not fundamentally achieve their object. In the writer's view, if information was available, it would be found that there is very little extra revenue to be collected by way of super tax in the hands of the shareholders as a result of the imposition of the undistributed profits tax. There has undoubtedly been a distribution of profits to avoid the undistributed profits tax but in the majority of cases the distributions have been made not to individuals but to holding companies.

Even if the worst features of the present undistributed profits tax provisions are remedied, e.g. the repeal of the exemption sections dealt with above, and the apportionment of the undistributed profits among Union and non-Union shareholders is resorted to, there will still be loopholes in the law. The time-lag between the end of the financial year and the end of the specified period, i.e. the period of six months granted to companies in which to make the necessary dividend declaration in favour of shareholders, will still enable shareholders to form companies to hold the shares and receive the dividends distributed and in this way avoid the impositon of the super tax or the undistributed profits tax. On this basis, a shareholder can carry on the process of pyramiding one company upon another. The period of grace within which to declare dividends, i.e. the period running from the end of the financial year until the end of the specified period, therefore, presents an almost insoluble problem but it is a necessary requirement. The writer feels, however, that devices such as pyramiding one company upon another in order to avoid the undistributed profits tax may prove to be too cumbersome and may not readily be resorted to by taxpayers. In any event, the Treasury can press for a special provision to be inserted into the law to counter this type of tax avoidance. There may be other devices to avoid the undistributed profits tax, e.g. a taxpayer by interlocking the shareholdings of a few companies can arrange for the dividends to be passed on in a circle from one company to another without such dividends ever being received by an individual. Such a device can also be countered by a special statutory provision. Experience has shown that loopholes cannot be eliminated entirely, but it has also shown that framers of Income Tax Acts are not so devoid of ingenuity as to be unable to cope with specific schemes, operations, practices or transactions designed to reduce liability to tax. In this respect, attention should be drawn to the anti-avoidance provisions in the United Kingdom Income Tax Act designed to prevent persons from avoiding liability to profits tax by arranging the affairs of their companies. Where the taxation authorities are of the view that the main purpose or one of the main purposes of a transaction was the avoidance or reduction of liability to profits tax, they may direct adjustments to be made in order to counteract the avoidance or reduction of liability. A further example was the introduction in 1941 of the principle of apportionment of the income of private companies to remove serious anomalies and tax avoidance devices in regard to liability to super tax. Unfortunately, the difficulties of administering the apportionment system and other attendant problems led to its repeal with effect from the 1952 tax year. We are now back again to where we were prior to 1941, when widespread avoidance of super tax was rife owing to the system of company taxation in force.

CHAPTER FOUR

AVOIDANCE OF SUPER TAX ON COMPANY DIVIDENDS

§ 37. Introduction

In the previous chapter, it was shown that on account of the loopholes in the present undistributed profits tax exemptions, the Treasury was not getting its fair share of super tax. Companies, particularly family and 'one-man' companies, are able to withhold profits from distribution for the purpose of avoiding liability for super tax which their shareholders would otherwise incur if the profits were distributed by way of dividend. Although it may be undesirable for the State to dictate to companies what proportion of their profits must be declared by way of dividend, experience has shown that companies closely controlled by individuals avoid super tax by the non-declaration of dividends and that in the interest of the *fiscus* the State is compelled to interfere. In the case of public companies in which the general public is interested, there is usually no unreasonable withholding of profits from distribution for the purpose of enabling shareholders to avoid the payment of super tax. If profits are unreasonably withheld from distribution by a public company, the reasons are usually unconnected with avoidance of super tax by shareholders. It is not unreasonable to suggest, therefore, that at present by far the greater portion of dividends that find their way into the hands of individuals constitute those distributed by public companies. Unfortunately for the *fiscus*, by the device of forming holding companies both in the Union and outside the Union, Union residents are able to divert the taxation of these dividends and free themselves of liability to super tax. There is evidence that this has been done on a large scale. Thus, the position today is that as regards most private companies, the controlling shareholders can avoid the declaration of dividends by claiming exemption from the undistributed profits tax under the extremely wide provisions of section 51, as shown in the previous chapter, whereas in the case of public companies and those private companies which do make a distribution of their profits, the recipients of the dividends are effectively able to avoid super tax by the device of forming holding companies as will be explained in this chapter.

§ 38. Present system of taxation of company dividends

In terms of section 7(*g*) *bis*, a dividend, as defined in section 1, distributed by a company, and which is from a source within the Union, is included in the gross income of the shareholder. By the exempting provision of section 10(1)(*k*) such dividend is excluded in the calculation of the taxable income of the recipient and is thus exempt from normal tax, except in certain special cases which are not material for present purposes (see § 112). Finally, under the provisions of section 27(*b*), the dividend is included in the income subject to super tax of the shareholder. If the shareholder is a person other than a company, ordinarily resident or carrying on business in the Union, he is subject to super tax on the dividend. If he is an individual not ordinarily resident nor carrying on business in the Union, the dividend is exempt from super tax — section 30(1)(*a*). If the shareholder is a person, other than a company, not ordinarily resident nor carrying on business in the Union then, subject to the provisions of section 46, non-resident shareholders' tax is payable on the dividend in terms of section 42(*a*) and section 42(*a*) *bis*. If the shareholder is a company registered or carrying on business in the Union, there is no super tax liability in respect of any dividend received since companies are exempt from super tax in terms of section 30(2)(*a*), and if the company is not registered nor carrying on business in the Union it will, subject to the provisions of section 46, be liable to non-resident shareholders' tax on any dividend received from a public company but not from a private company, in terms of section 42(*a*) and section 42(*a*) *bis*. In the case of a public company, dividends distributed to the holders of bearer scrip are liable to non-resident shareholders' tax, in terms of section 42(*a*), irrespective of whether such holder is resident within or outside the Union.

As regards dividends from sources outside the Union, i.e. dividends distributed by companies incorporated in foreign countries, only persons (other than companies) ordinarily resident in the Union are subject to super tax in respect thereof — section 7(*g*) *bis*.

Section 7(*g*) *bis* read with the definition of 'dividend' in section 1 is exceedingly wide and brings into the scope of the shareholder's gross income the full amount of the dividend distributed, whether in cash or in kind or in the form of bonus shares issued by the company by way of capitalization of its profits (other than bonus shares specifically exempted from tax — see § 44) and expressly provides that the dividend must be included even though it has been distributed by a private company out of profits which had previously been apportioned among the shareholders and taxed in their hands. This specific provision was inserted in order to overcome the effect of the decision in *Isaacs* v. *C.I.R.*[1] where it was held that where a dividend was paid by a company out of profits which had previously been taxed for super tax on apportionment in terms of section 37, it did not attract any further super tax. The Legislature has made it quite clear by this all-embracing provision that any dividend distributed by a private company must be included in the gross income and therefore in the income subject to super tax of the shareholder.

Where the registered shareholder holds the shares merely as nominee for some other person who, by virtue of any agreement or

[1] 1949 (4) S.A. 561 (A.D.); 16 S.A.T.C. 258.

contract or otherwise, is entitled to all or part of the benefit of the rights of participation in the income attaching to the shares so registered, such other person is also deemed to be a shareholder in terms of the definition of *shareholder* in section 33 (4).[2] In such a case, since the registered shareholder does not receive the dividend on his own behalf for his own benefit, the dividend cannot form part of his gross income. Instead, the dividend must form part of the gross income of the beneficial owner of the shares although he is not the registered owner.

§ 39. FORMATION OF FOREIGN HOLDING COMPANIES TO RECEIVE DIVIDEND INCOME

In *Boyd* v. *C.I.R.*,[3] the Appellate Division affirmed that the source of dividends was the shareholding and not the source of the company's profits and that the situation of the source was the place of registration of the shares. The consequence of the case has been that Union taxpayers, by the simple expedient of creating companies outside the Union to hold their shares in Union companies, have been able to obtain their income through the foreign holding company without being liable to South African tax since such dividends were not derived from a Union source.

With effect from the 1955 tax year, the Treasury closed the gap by levying super tax on all dividends received from whatever sources by a Union resident with the proviso that any foreign tax paid by the taxpayer in the country of origin of the dividend will be taken into account in order to avoid double taxation. This is what the Minister of Finance stated in his Budget Speech on 24th March, 1955, in regard to this matter:

> '. . . It has become necessary to amend the Income Tax Act also in another respect, in order to prevent the deliberate evasion of super tax.
>
> 'Under existing legislation, income received from outside the Union is not taxable. With the object of evading payment of super tax, certain Union citizens, or persons resident in the Union, have transferred their shares in local companies to companies specially established for this purpose, outside the borders of the Union. The profit earned in the Union is then paid out to the foreign company, which in turn then distributes it as dividend to its " shareholders " in the Union. Because such dividends are regarded as income obtained from outside the Union, they are not taxable here. This is an ingenious plan, which is intended to rob — and I use the word advisedly — the State of its rightful tax revenue, and which cannot be permitted to continue.
>
> 'In order to prevent this abuse, I propose that Union tax should be levied on all dividends received by residents of the Union, irrespective of the origin of the dividends, with the proviso that taxes which the taxpayer has already paid personally outside the Union in respect of such dividends, will be taken into account in the calculation of his Union assessment.'

[2] *Bell's Trust* v. *C.I.R.*, 1948 (3) S.A. 480 (A.D.); 15 S.A.T.C. 255; see also I.T.C. No. 636, 15 S.A.T.C. 120.

[3] 1951 (3) S.A. 525 (A.D.); 17 S.A.T.C. 366.

The new amendment was not favourably received by the tax-paying public which was affected by the provision. What it really amounted to was that the innocent had to suffer for the sins of the guilty. The amendment was introduced to hit at what the Minister designated as ' bogus companies ', i.e. companies which were formed in foreign countries to receive the dividends from Union companies and thus causing their promoters who were Union residents to escape Union super tax in respect of such dividends. As things have turned out, this provision, which was introduced to protect the Revenue, has sadly misfired since there is no means of compelling the foreign companies to declare dividends. Thus, the shareholder for whom the provision was really designed still escapes super tax since if the bogus company does not declare a dividend there is nothing to tax in the hands of the Union resident. This would be the case even with the adoption of the recommendation of the Committee of Enquiry into the Income Tax Act[4] that the Union source content of the dividend distributed by any company, i.e. so much of any such dividend as is attributable to profits derived from Union sources, should be subject to super tax in the hands of Union residents. On the other hand, those shareholders who own shares in foreign companies which derive no income from Union sources and who acquired such shares for genuine investment reasons have now to pay super tax in the Union on those dividends unless they fall within the range of the exemptions set out in § 42, *infra*. The plug does not, therefore, fit the hole.

The majority of these foreign ' bogus ' companies have been formed in South West Africa and the Federation of Rhodesia and Nyasaland and for good reason too. South West Africa has, like the Union, adopted the principle of source for taxing income which means that when companies established in the Territory receive dividends from Union sources, such dividends fall outside the scope of the taxing net. The dividends can be accumulated tax free in the foreign holding company. As regards the taxes payable in the Union in respect of these dividends, this will depend upon whether the dividends accrue from shareholdings in public or private companies. If they are public company dividends, the non-resident shareholders' tax of 1*s.* 6*d.* per £ is payable by the foreign company in terms of section 42 (*a*). If the dividends are from a Union private company, then the non-resident shareholders' tax will be payable by the Union private company on such proportion of its income as appertains to the interest of the foreign company (section 42 (*e*) read with section 37 *bis*). The dividend itself is, however, free of all Union taxes. The following illustrations attempt to explain the position:

Public company dividends

X, a married Cape resident, receives annually £9,000 worth of dividends from a Union public company. He registers a company in

[4] *First Report*, p. 61, para. 12.

South West Africa in which he is the sole beneficial shareholder. He transfers his public company shares to the new holding company so that the dividends no longer accrue to him but to the new company. The only tax payable in both the Union and South West Africa is the $7\frac{1}{2}$ per cent non-resident shareholders' tax. The Union public company is required to deduct this tax from the dividend so that only a net amount is remitted to the foreign company. The dividend ultimately received by the foreign company is £8,325 (the dividend of £9,000 *less* the non-resident shareholders' tax of £675). However, no further taxes are payable. X has reduced his annual taxes from some £2,100 (which is the tax he would otherwise have to pay if he did not transfer his shares to the foreign holding company) to £675.

Private company dividends

Y, a married Cape resident, receives annually a dividend of £6,000 from a Union private company. He forms a company in the Territory of South West Africa in which he is the sole beneficial shareholder. He transfers his Union private company shares to the new holding company so that the dividend no longer accrues to him but to the new company in the Territory. The Union private company earns an annual profit of £10,000 out of which Y receives the dividend of £6,000. Y holds all the shares in the Union private company. Y's only other income from Union sources is a salary of £2,000 per annum.

No taxes will be payable either in the Union or in the Territory in respect of the dividend of £6,000, passing from the Union company in favour of the foreign holding company. Dividends distributed by a Union private company in favour of a foreign company are not liable for the non-resident shareholders' tax in terms of section 42 (*a*) *bis*. However, by virtue of the fact that the shares in the Union private company are held by a foreign company, the provisions of section 37 *bis* read with section 42 (*e*) come into play and non-resident shareholders' tax at the rate of 1*s*. 6*d*. in the £ is payable on the income of the Union company, viz. £750 (1*s*. 6*d*. per £ on £10,000) (see § 85). The net tax saving to Y is as follows:

Tax payable on a taxable income of £2,000 (salary) and an income subject to super tax of £8,000 (salary £2,000 *plus* the dividend of £6,000 from the Union private company)		£1,884
Less Non-resident shareholders' tax payable by Union private company	£750	
Tax payable by Y on his taxable income of £2,000	170	
		920
Saving in Tax		£964

Companies formed in the Federation of Rhodesia and Nyasaland

As regards foreign companies formed in the Federation of Rhodesia and Nyasaland, owing to an amendment in the law with effect from the year of assessment ending 31st March, 1958, liability for undistributed profits tax arises in respect of dividends derived from all sources. Although the dividends received from Union sources are not subject to income tax or supertax in the hands of the Federal company, they form part of the company's distributable income for undistributed profits tax purposes. In determining the undistributed profits of the private company, there may be deducted from the foreign dividends an amount of £2,000 or one-third of the dividends, whichever is the greater amount. In respect of the balance the tax is payable, viz. 1*s.* 6*d.* per £ on the first £2,000 and 3*s.* per £ on the balance of the undistributed profits. Of course, the undistributed profits tax can be avoided by declaring appropriate dividends in favour of the South African shareholder but such dividends will be subject to super tax in the Union. If the Federal company receives dividends totalling up to £2,000 per annum, undistributed profits tax is not payable since there is a minimum abatement of £2,000. If the dividends amount to £3,000 (assumed to be from Union public companies), the undistributed profits tax is calculated thus:

Foreign dividends (*less* non-resident shareholders' tax $7\frac{1}{2}\%$ of £3,000 = £225)	£2,775	0	0
Less abatement £2,000 or ($\frac{1}{3}$ of £2,775) whichever is the greater	2,000	0	0
UNDISTRIBUTED PROFITS	£775	0	0
∴ *Tax payable* (1*s.* 6*d.* per £ on £775) ..	£58	2	6

If the dividends total £9,000 (assumed to be from Union private companies), the tax is determined as follows:

Foreign dividends	£9,000	0	0
Less abatement £2,000 or ($\frac{1}{3}$ of £9,000) whichever is the greater	3,000	0	0
UNDISTRIBUTED PROFITS	£6,000	0	0
∴ Tax payable: 1*s.* 6*d.* per £ on £2,000 ..	£150	0	0
3*s.* 0*d.* per £ on £4,000 ..	600	0	0
	£750	0	0

NOTE: Non-resident shareholders' tax is not payable in respect of dividends distributed by Union private companies to foreign companies.

Shareholders of Federal companies, however, can by taking advantage of certain loopholes in the law avoid payment of the undistributed profits tax. Firstly, the minimum abatement of £2,000 permits shareholders to avoid the tax by forming a sufficient number of companies. Whereas one company earning £6,000 of dividends is liable to the tax, three separate companies formed to take transfer of the dividend-producing investments so that each earns £2,000 dividends will not involve any of the companies in liability for the tax. Alternatively, the Union resident could arrange for the shareholding in the dividend-earning Federal company to be held by a number of other Federal companies. The former company could then distribute dividends to the latter companies so that each receives £2,000 per annum. Secondly, a holding company in possession of at least 90 per cent of the issued shares of a Federal private company may elect that the profit of the subsidiary company shall be deemed to have accrued to the holding company and thereupon its undistributed profits must be determined accordingly. The subsidiary company itself is in that event exempt from undistributed profits tax. Since a foreign company is not subject to undistributed profits tax, it must follow that the tax can be avoided by letting a holding company incorporated in South Africa hold the shares in the Federal private company receiving the dividends from Union sources. The loophole is that a foreign company, although it is not subject to undistributed profits tax, may, if a holding company, elect that the profit of its subsidiary Federal company be deemed to be its profit and thus is able to secure the exemption from undistributed profits tax of the subsidiary company in the Federation.

§ 40. Formation of local holding companies to receive dividend income

As has been shown, Union super tax on dividends can be readily avoided by the formation of foreign holding companies at the expense of being liable for the non-resident shareholders' tax of 1*s.* 6*d.* in the £. As long as the marginal rate of super tax in respect of dividend income accruing to a Union resident exceeds 1*s.* 6*d.* in the £, he is tempted to form his holding company in order to save the difference between his marginal rate of tax and 1*s.* 6*d.* The saving in tax accruing from this device can be substantial.

In view of the loophole for avoidance created by the undistributed profits tax exemption contained in section 51 (*i*), a Union resident may be saved the trouble of incorporating his holding company in a foreign country and also the expense of paying the non-resident shareholders' tax of 1*s.* 6*d.* in the £. Section 51 (*i*) exempts a company from the undistributed profits tax if its shares are held throughout the specified period by a company which is itself exempt from the undistributed profits tax in terms of section 51 excluding paras. (*f*) and (*g*) (see § 32). Thus, if X owns shares which produce £10,000 dividends annually, he could sell his shareholdings to a new holding company which will in future receive these dividends. He could then arrange for a second holding company to be formed which will be the sole shareholder of the first holding company referred to. Since the object is to obtain exemption from the undistributed profits tax for the first holding company, i.e. the company that receives the £10,000 dividends, an essential requirement is for the second holding company to be exempt from the undistributed profits tax. This may be arranged by the manipulation of the issued capital of the second holding company with non-resident individuals so that exemption can be claimed in terms of section 51 (*d*) (see § 33). Once the second holding company is made exempt from the undistributed profits tax in the manner described, it must follow that its wholly owned subsidiary company is also exempt in terms of section 51 (*i*). In this way the first holding company can accumulate the £10,000 dividends free of all taxes. As X would be liable to pay some £2,500 worth of super tax on dividends totalling £10,000, it must follow that by carrying out the arrangement described above, he can avoid the full tax liability which he otherwise would have to pay.

§ 41. Other devices to avoid super tax on dividends

In terms of section 51 (*f*), a company is exempt from the undistributed profits tax if it can satisfy the Commissioner that the sum of its reserves and balance of profits unappropriated does not exceed £50,000 or 40 per cent of its paid-up capital, whichever is the greater. The exemption does not apply to private companies whose total net profits are derived solely or mainly from dividends (see § 30).

The section 51 (*f*) concession encourages a shareholder who is carrying on a lucrative business through a company to transfer his dividend-producing share investments to such company in order to take advantage of the concession. For example, if Mr. A carries on a business through a company earning profits of £10,000 per annum and also earns dividends amounting to £5,000 per annum on which he is subject to super tax in his personal capacity, all he need do is to sell his share investments to the company so that the dividends accrue to the company in the future. The company will in future have a taxable income of £10,000 and dividend income amounting to £5,000. As the companys' profits have not been derived solely or mainly from dividends, it is entitled to the exemption in section 51 (*f*) as long as its reserves and balance of profits unappropriated have not reached £50,000. No taxes will be payable by the company on the dividends of £5,000 which it is entitled to accumulate tax free. If after a few years the reserves have reached £50,000, A would be tempted to transfer his business as well as his share investments to a new company which is entitled to accumulate a further £50,000 reserves before being liable for the undistributed profits tax. As long as the dividends do not exceed the taxable income, the new company will be exempt from the undistributed profits tax in terms of section 51 (*f*).

In terms of section 51(*g*), a company whose total net profits (which include dividend income) for the year of assessment do not exceed 5 per cent of its paid-up capital as at the specified date is exempt from the undistributed profits tax (see § 31). There is nothing to prevent a taxpayer from purchasing a company with a substantial paid-up share capital and thereafter transferring dividend-producing investments to the company and claiming exemption from the undistributed profits tax on the grounds that the dividend income, i.e. the total net profits, does not exceed 5 per cent of the capital. For example, if the share capital is, say, £100,000, shares yielding not more than £5,000 dividends per annum could be sold to the company. The company will be exempt from the undistributed profits tax in terms of section 51(*g*) which means that the dividends can be accumulated free of all taxes through the company whereas previously they were subject to and attracted super tax in the hands of the transferring shareholder.

As the maximum rate of super tax (including the provincial income tax superimposed thereon) payable by individuals is some 8*s*. 6*d*. in the £, it must follow that it is more advantageous for a taxpayer to allow a company to hold his dividend-producing shares since a company is not liable to super tax and if dividends are not declared in his favour, the dividends receivable by the company will attract undistributed profits tax at the rate of 5*s*. per £ only. Where an individual receives substantial dividends from companies, it must follow that the tax saving will be substantial if he causes the company to receive these dividends so that only 5*s*. per £ of undistributed profits tax is payable instead of the maximum rate of super tax applicable to individuals, namely some 8*s*. 6*d*. per £. If £20,000 dividends are caused to accrue to a company, the saving may amount to some £3,500 per annum. It is clear, therefore, that the present rate of undistributed profits tax is too low. The rate should correspond more closely with the maximum rate of super tax. It should be high so as to stress the penal aspect of the tax.

§ 42. Dividends exempt from super tax

The following dividends are exempt from super tax and must, therefore, be excluded from the income subject to super tax:

(1) Dividends from Union sources received by or accrued to an individual not ordinarily resident nor carrying on business in the Union — section 30(1)(*a*). Both conditions must be complied with. Thus, if a person not ordinarily resident in the Union carries on business in the Union, he is subject to super tax on dividends derived from Union sources.

(2) A person not ordinarily resident in the Union is not subject to super tax on any dividends derived from sources outside the Union even though he carries on business in the Union (see section 7(*g*)*bis*).

(3) A person ordinarily resident in the Union is exempt from super tax on dividends derived from any company not registered in the Union as the Commissioner is satisfied have been distributed out of profits in respect of which any amount has been included in his taxable income or income subject to super tax as a result of the apportionment of the taxable income or income subject to super tax of the company among its shareholders in terms of the income tax laws of South West Africa—section 30(1) (*b*). Any decision of the Commissioner in the exercise of his discretionary power, if *bona fide* and properly made, is not subject to review by the courts.

(4) Dividends received by or accrued to any person (other than a company) ordinarily resident in the Union from any company not registered in the Union in respect of shares acquired by such person —

(*a*) before he became ordinarily resident in the Union for the first time; or

(*b*) by inheritance or by a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Union; or

(*c*) out of funds derived by him from any trade carried on by him outside the Union; or

(*d*) as bonus shares awarded to him as the holder of shares the dividends on which are exempt from super tax in his hands in terms of this paragraph, or would have been so exempt if such dividends had been received by or had accrued to him; or

(*e*) out of funds derived by him from the disposal of shares the dividends on which were exempt from super tax in his hands in terms of this paragraph, or would have been so exempt if such dividends had been received by or had accrued to him — section 30(1) (*c*).

(5) Dividends received by or accrued to any person (other than a company) ordinarily resident in the Union during any year of assessment from any company incorporated in South West Africa if the Commissioner is satisfied that —

(*a*) so much of the total net profits of such company for that year of assessment as does not consist of dividends was derived wholly or mainly from a source within South West Africa; and that

(*b*) any dividends included in the total net profits of such company for that year of assessment were derived from companies the total net profits of which for such year of assessment consisted solely or mainly of taxable income, determined under the income tax laws of and derived from sources within South West Africa — section 30(1) (*d*).

'Total net profits' is defined as the net profits of a company for the year of assessment calculated in the manner prescribed under the income tax laws of South West Africa for the determination of taxable income for normal tax purposes but irrespective of the source of the profits and subject to the inclusion in the profits of such company of dividends from all sources. Any decision of the Commissioner in the exercise of his discretionary power, if made properly and *bona fide*, is not subject to review by the courts.

(6) Dividends received by or accrued to Union residents in respect of shares held in companies incorporated in the United States of America are exempt from super tax in terms of Article IV(2) of the Convention between the Union and the United States of America[5] which specifically provides that income arising from sources in the United States is not subject to any tax in South Africa.

§ 43. CRITICISMS OF THE DIVIDEND EXEMPTIONS FROM SUPER TAX

Exemptions (1) and (2), *supra*, are considered in detail in Chapter Six which deals with non-residents.

Exemption (3), *supra*, was considered necessary in order to avoid double taxation since if a Union resident has paid normal and super tax to the South West African Treasury on the basis of apportionment on profits earned by a company incorporated there and is again called upon to pay Union super tax on any dividend distributed to him out of such profits, this would amount to double taxation. It should be pointed out that the apportionment system of taxing private companies was abandoned by the South West African Legislature with effect from the 1956 tax year.

Exemption (4), *supra*, was intended to apply to British and foreign nationals who came to settle in South Africa. Unfortunately, it is couched in such wide terms that it could further encourage the formation of 'bogus' companies in foreign countries to hold the dividend-producing investments owned by Union residents.

Paras. (a) and (d)

Para. (*a*) and para. (*d*) simply give effect to the Treasury's intention not to penalize those taxpayers who come to settle in the Union for the first time by exempting their dividends on shares held in foreign companies prior to taking up residence including any dividends received on bonus shares awarded to the taxpayer after taking up residence. It was necessary to limit this exemption to persons who became ordinarily resident in the Union *for the first time* otherwise Union residents may be encouraged to take up residence in another country, acquire foreign shareholdings, and thereafter return to settle in the Union and claim the benefit of the exemption on the grounds that the shares were acquired before they became ordinarily resident in the Union.

[5] Proclamation No. 5, 1947.

Para. (*b*)

Para. (*b*) could encourage the formation of 'bogus' companies. Two thoughts come to the mind of the writer. Firstly, a company can be formed with any amount of share capital. A person ordinarily resident in Rhodesia could be requested by a Union resident, who is a friend of his, to incorporate a company in Rhodesia with a share capital of, say, two shares of £1 each, or 5*s.* each or 1*s.* each. The shares would be subscribed for by the Rhodesian resident who at the outset would be the beneficial shareholder. In the writer's view there is nothing to prevent the Rhodesian resident who paid £2 or 10*s.* or 2*s.* for the shares to donate the shares to his friend resident in the Union and thereafter, the Union resident could transfer his shareholding in Union companies to the Rhodesian company which will in future earn the dividends from Union sources. The Rhodesian company in turn could declare dividends out of the income received from Union sources and the Union resident can claim that such dividends are exempt from super tax on the grounds that the dividends were received in respect of shares acquired by him by a donation and that at the date of the donation the donor was not ordinarily resident in the Union. It will be observed that the exemption is not extended to donations made by companies not ordinarily resident in the Union because of the relative ease with which Union residents could create companies resident in a foreign country and could permit such companies to make donations to Union residents. Unfortunately, the Legislature did not consider that there may be no serious difficulty for a non-Union resident to donate to a Union resident the entire issued share capital in a foreign company valued at 2*s.* or 10*s.* or £2.

A further encouragement to the formation of 'bogus' companies in foreign countries is the provision that dividends received by a Union resident are exempt if derived from foreign company shares which have been acquired by inheritance. A Union resident during his lifetime can accumulate substantial dividends from Union sources in his 'bogus' company situate in a foreign country. On his death, his heirs can draw out these profits by way of dividend from the foreign company. As the new shareholders have acquired the shares by inheritance, the dividends in respect thereof are exempt from super tax. It may be a pleasing thought to a Union resident that on his death all the profits accumulated in his foreign company can be distributed tax-free to members of his family should he bequeath the shares in such company to them.

Para. (*c*)

Para. (*c*) contains an exemption which Union residents may take advantage of to free from super tax dividends passing to them from 'bogus' companies in oversea countries. As long as the shares in the foreign company were acquired by the Union resident out of funds derived by him from a trade carried on outside the Union, the dividends are exempt. Now, the term *trade* is defined in section 7 as follows:

Para. (b)

Para. (*b*) could encourage the formation of 'bogus' companies. Two thoughts come to the mind of the writer. Firstly, a company can be formed with any amount of share capital. A person ordinarily resident in Rhodesia could be requested by a Union resident, who is a friend of his, to incorporate a company in Rhodesia with a share capital of, say, two shares of £1 each, or 5*s.* each or 1*s.* each. The shares would be subscribed for by the Rhodesian resident who at the outset would be the beneficial shareholder. In the writer's view there is nothing to prevent the Rhodesian resident who paid £2 or 10*s.* or 2*s.* for the shares to donate the shares to his friend resident in the Union and thereafter, the Union resident could transfer his shareholding in Union companies to the Rhodesian company which will in future earn the dividends from Union sources. The Rhodesian company in turn could declare dividends out of the income received from Union sources and the Union resident can claim that such dividends are exempt from super tax on the grounds that the dividends were received in respect of shares acquired by him by a donation and that at the date of the donation the donor was not ordinarily resident in the Union. It will be observed that the exemption is not extended to donations made by companies not ordinarily resident in the Union because of the relative ease with which Union residents could create companies resident in a foreign country and could permit such companies to make donations to Union residents. Unfortunately, the Legislature did not consider that there may be no serious difficulty for a non-Union resident to donate to a Union resident the entire issued share capital in a foreign company valued at 2*s.* or 10*s.* or £2.

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Para. (*c*) contains an exemption which Union residents may take advantage of to free from super tax dividends passing to them from 'bogus' companies in oversea countries. As long as the shares in the foreign company were acquired by the Union resident out of funds derived by him from a trade carried on outside the Union, the dividends are exempt. Now, the term *trade* is defined in section 7 as follows:

> 'Trade' includes every profession, trade, business, employment, calling, occupation or venture including the letting of any property, and the use of or the grant of permission to use any patent, design, trade mark or copyright as defined in the Patents, Designs, Trade Marks and Copyright Act, 1916 (Act No. 9 of 1916), or any other property which, in the opinion of the Commissioner, is of a similar nature.'

It will be observed that the definition is a very wide one indeed. It includes any employment, calling or occupation and also includes the letting of property. It is, therefore, not a difficult problem for a Union resident to carry on a *trade*, as defined, in neighbouring countries such as Rhodesia or South West Africa and thereafter use the income from this trade to subscribe for the shares in his 'bogus' company. He may, for example, buy a small income-producing property in the foreign country and use the first rentals to pay for his shares in the 'bogus' company. He may even rail movable property to South West Africa or Rhodesia for the purpose of letting it to a resident there. The rental could be used to pay for his shares in the 'bogus' company. If he is a director of a foreign company, he may use his director's fees to pay for his shares. Para. (*c*), therefore, leaves the door wide open for the formation of 'bogus' companies.

Para. (*e*)

Para. (*e*) may encourage settlers to the Union to avoid super tax by the formation of 'bogus' companies. Their remedy is simply to dispose of a small portion of their tax-free shareholdings and use the proceeds to subscribe for the shares in the 'bogus' company. The taxpayer is then able to show that the dividends from the 'bogus' company were received in respect of shares acquired by him out of funds derived from the disposal of shares which he possessed before he became ordinarily resident in the Union for the first time. It is not uncommon for settlers to invest in Union securities upon arrival in this country. Take the case of Mr. A, who after taking up residence, acquires shareholdings in Union companies amounting to £10,000 per annum. He establishes his 'bogus' company, say, in South West Africa by selling a few shares in foreign companies which he possessed before he settled in the Union and instructing his broker to remit the proceeds to his lawyer in Windhoek who will apply such proceeds to the subscription price of the shares in his 'bogus' company. Thereafter, Mr. A could sell his Union shareholdings to the foreign company so that the dividends of £10,000 per annum will accrue to this company which in turn will declare dividends which will accrue to Mr. A, who can claim that they are free of super tax on the ground that the shares in respect of which they were paid were acquired out of funds derived from the disposal of shares which he possessed before becoming ordinarily resident in the Union.

Exemption (5), *supra*, frees from super tax in the hands of a Union resident dividends received from South West African companies which derive their income solely or mainly from sources in South West Africa. Although the exemption encourages Union residents to purchase shareholdings in companies operating and earning income in the Territory, it confers no advantage to the shareholder of a 'bogus' company incorporated in South West Africa which derives its income solely or mainly from Union sources.

§ 44. Definition of 'dividend'

Before an amount can be included as a dividend in the income subject to super tax, it must fall within the definition of *dividend* as defined in section 1.

'Dividend' means all amounts distributed by a company (not being an association or institution referred to in section 10(1)(*c*), e.g. building societies) to its shareholders.

'Amounts distributed' include —

(*a*) in relation to a company that is being wound up or liquidated, any profits distributed, whether in cash or otherwise, other than those of a capital nature, earned before or during the winding-up or liquidation; and

(*b*) in relation to a company that is not being wound up or liquidated, any profits distributed, whether in cash or otherwise, and whether of a capital nature or not, including an amount equal to the nominal value of any bonus shares, debentures or securities awarded to the shareholders; and

(*c*) in the event of the partial reduction of the capital of a company, any cash or the value of any asset which is given to a shareholder in excess of the cash equivalent of the nominal value by which the shares of that shareholder are reduced; and

(*d*) in the event of the reconstruction of a company, any cash or the value of any asset which is given to a shareholder in excess of the nominal value of the shares held by him before the reconstruction.

Dividend, with effect from the 1958 tax year, does not, however, include —

(i) the nominal value of any bonus shares payable out of the company's share premium account; or

(ii) any cash or the value of any asset given to a shareholder to the extent to which it represents a reduction of the company's share premium account; or

(iii) the nominal value of any bonus shares awarded to shareholders as part of the company's equity share capital, by any company recognized as public in terms of section 33 or by companies registered in the Union as public companies under the Companies Act, 1926, and in which the general public was throughout the year of assessment substantially interested as shareholders in every class of the equity shares issued by them and which comply with the requirements of section 33(2)(*b*)(ii) (see the distinction between public and private companies in § 85).

Generally speaking, therefore, bonus shares distributed by companies which are public in character are not regarded as 'dividends' and are consequently not subject to super tax in the hands of shareholders.

Para. (a) of the definition of 'dividend'

In terms of para. (*a*), a liquidation dividend, other than such part thereof as represents a return of the nominal value of the shares, is subject to super tax to the extent to which it has been paid out of the revenue profits of the company.[6] Liquidation dividends, to the extent to which they have been distributed out of a capital profit, are not subject to super tax irrespective of whether the capital profit was made before or during the winding-up or liquidation. Thus, assume that X Ltd. is in liquidation, and that after paying all liabilities, there is cash available to pay to shareholders the following amounts:

Issued share capital (2,000 shares of £1 each fully paid up)	£2,000
Trading profits accumulated up to the date of liquidation ..	1,000
Capital profit made on the sale of assets during liquidation ..	500
Capital profit made on the sale of assets many years ago ..	1,500
	£5,000

If M is a shareholder in X Ltd. and holds 500 shares in the company, in respect of the liquidation dividend of £1,250 that he receives from the company, only £250 is subject to super tax, viz.:

Amount of liquidation dividend	£1,250
Less return of nominal value of shares	500
	£750
Less distribution out of capital profits $\frac{500}{2,000}$ (£500 + £1,500)	500
∴ *Distribution out of revenue profits*	£250

To be exempt from super tax, it must be clear that the distribution of a capital profit is made in the course of the winding-up or liquidation of the company. It is not sufficient that the distribution is made in anticipation of liquidation. Thus, if a company ceases trading, sells all its assets and liquidates its liabilities and thereafter distributes a dividend to shareholders out of a capital profit but takes no steps in connection with liquidation, the distribution is one of profit among shareholders and not a distribution in liquidation and is, therefore, subject to super tax.[7]

[6] But for this provision, liquidation dividends would not be taxable as is the case in the United Kingdom — see *New Mines, Ltd.* v. *C.I.R.*, 1938 A.D. 455; 10 S.A.T.C. 9; *I.R.C.* v. *Burrell*, [1924] 2 K.B. 52; 9 T.C. 27.

[7] I.T.C. No. 101, 3 S.A.T.C. 324.

The Special Court has held that a distribution of a capital profit by a company which takes no formal resolution to wind up but applies to the Registrar of Companies to have its name removed from the register on the grounds that it has no assets or liabilities and is no longer carrying on business, is made in the liquidation of a company.[8]

Whether a liquidation dividend has been distributed out of revenue or capital profits is a question of fact. It is submitted that a liquidation dividend must first be appropriated to the paid-up value of the shares held. The excess, if any, must be apportioned pro rata according to the revenue or capital profits of the company made up to the date of liquidation.

Para. (b) of the definition of 'dividend'

Para. (*b*), which refers to distributions by a company that is not being wound up or liquidated, expressly includes distributions out of the capital profits of a company. Thus, whereas capital profits distributed on a winding-up do not attract super tax, they do attract liability in all other cases.

It is not essential that a dividend must be paid in cash in order to attract liability. A dividend in *specie*, for example in the form of shares in another company, attracts liability in the same way as a cash dividend. The asset distributed other than cash must be valued and included in the income subject to super tax. Thus, if X Ltd. distributes a dividend to its shareholders not in the form of cash but by awarding to them its holding of shares in Y Ltd. and M, a shareholder in X Ltd., receives 1,000 shares of £1 each in Y Ltd. (market value 40*s.* each) an amount of £2,000 must be included in M's income subject to super tax. It is submitted that this is authorized by the use of the terms 'amounts distributed' and 'profits distributed' in the definition. The valuation of bonus shares or securities on the basis of nominal value (see *infra*), it is submitted, applies only to an award of shares in the issuing company and which does not involve a distribution of any of the company's assets, as distinct from a distribution of securities in other companies which involves a release of the company's assets, and which must be valued according to the real value of the securities and not their nominal value. (See *Dibowitz* v. *C.I.R.*[9])

As regards dividends distributed out of profits that are not realized, para. (*b*), it is submitted, is wide enough to include them within its ambit, whatever may be the correct legal position as regards the payment of dividends out of unrealized profits.[10]

The use of the words 'any profits distributed' in para. (*b*) clearly brings within the scope of the definition dividends declared

[8] I.T.C. No. 346, 9 S.A.T.C. 49; see also *C.O.T.* v. *'T' Company*, 1957 (4) S.A. 90 (S.R.); 21 S.A.T.C. 335.

[9] 1952 (1) S.A. 55 (A.D.); 18 S.A.T.C. 11.

[10] The authorities appear to be conflicting. *Ammonia Soda Co.* v. *Chamberlain*, [1918] 1 Ch. 266, and *Stapley* v. *Read Bros., Ltd.*, [1924] 2 Ch. 1, favour the case for distribution of unrealized profits.

out of income from a source outside the Union or out of exempt income.

In terms of para. (*b*), distributions of bonus shares (other than those excluded from the definition of dividend — see *supra*), debentures or securities awarded by a company to its shareholders are deemed to be dividends and must be included in their incomes subject to super tax on the basis of the *nominal* value of such bonus shares, debentures or securities irrespective of the true value of the security. Thus, if M owns 1,000 shares of 10*s.* each in X (Pty.) Ltd. and the company capitalizes its undistributed profits by the distribution of bonus shares to shareholders on the basis of one bonus share for every two shares held, M is subject to super tax on an amount of £250 (the *nominal* value of the 500 bonus shares issued). The effect of issuing bonus shares is to retain the distributable profits in a non-distributable form and this is usually done by declaring a dividend or bonus to the shareholders which is not paid out in cash but which is utilized to pay up unissued shares of the company which are issued or it could be used to issue debentures or redeemable preference shares in the company. This process of capitalization, as long as it is effected pro rata among the existing shareholders, is of no advantage or benefit to shareholders since when bonus shares are awarded no profits are distributed by the company. In *C.I.R.* v. *Collins*,[11] Innes, C.J., said in reference to the issue of bonus shares by a company:

> 'The company has parted with no assets — no money or moneysworth — and the shareholders have received none. The profits dealt with remain in the business as they were before. The only difference is that as they have become portion of the capital they are represented by shares; but these shares do not increase the holders' interest in the company; that also remains exactly what it was before. The distribution being pro rata, his interest in the old capital plus the undivided profits under the old holding was exactly the same as his interest in the increased capital under the new holding. The total assets of the company have not been changed, and his original share represented the same proportion of the then issue as his increased shares do of the increased issue.'

Bonus shares may be issued for a number of reasons. A detailed discussion on this aspect is beyond the purpose of this treatise. It may be done to improve labour relations by paying a small dividend on an increased capital rather than a large dividend on a small capital. It may also be desirable for the share capital of a company to be brought into line with the capital employed in the business, e.g. when price controls are enforced. It may also be done at the instance of an important creditor, e.g. a banker supplying extensive overdraft facilities, who insists that the whole or part of the undistributed profits and reserves be capitalized so that they cannot subsequently be paid over to the shareholders.

[11] 1923 A.D. 347.

In *Dibowitz* v. *C.I.R.*[12] it was held that the whole of the nominal value of bonus shares paid for partly out of a share premium account and partly out of an amount standing to the credit of the profit and loss account of a company forms part of a shareholder's income subject to super tax. It was held that the word 'including' in para. (*b*) of the definition of *dividend* was used by the Legislature in order to enlarge the meaning of 'profits distributed' and had to be construed as comprehending not only profits distributed in the ordinary meaning of those words, but also things which were not profits distributed *stricto sensu*, viz. an amount equal to the nominal value of any bonus shares awarded to the shareholders.[13]

Provision for the imposition of super tax on bonus shares has been contained in the Union Act since 1925. The Committee of Enquiry into the Income Tax Act, by a majority decision, recommended that the provision be retained and that super tax should continue to be imposed upon the issue of bonus shares.[14] However, with effect from the 1958 tax year, certain distributions of bonus shares (mainly by public companies) are exempt from super tax in the hands of shareholders, and bonus shares paid for out of a share premium, whether by a public or private company, are similarly exempt (see *supra*).

Para. (c) of the definition of 'dividend'

Para. (*c*) deals with the case of a company which is not being wound up or liquidated but whose issued share capital has been reduced. If, in such circumstances, a shareholder receives cash or any other asset, to the extent to which the value he receives as a result of the reduction of capital exceeds the nominal value by which the shares of such shareholder are reduced, he is deemed to have received a dividend. Thus, if company B Ltd. reduces its issued capital of 100,000 shares of £1 each fully paid up by an amount of £75,000 or 15*s.* per share and awards to shareholders in respect of each share held 10*s.* in cash and one 5*s.* ordinary share in Y Ltd., whose market value is 20*s.*, Mr. Z, who holds 10,000 shares in B Ltd., is deemed to have derived a dividend, in terms of para. (*c*) of the definition of *dividend*, made up as follows:

Cash received (10,000 × 10*s.*)	£5,000
Value of shares in Y Ltd. (10,000 × 20*s.*)	10,000
	£15,000
Less nominal value by which shares in B Ltd. is reduced (10,000 × 15*s.*)	7,500
Amount of dividend	£7,500

[12] 1952 (1) S.A. 55 (A.D.); 18 S.A.T.C. 11.

[13] But for this provision, bonus shares would not be taxable as is the case in the United Kingdom. (See *I.R.C.* v. *Blott*, [1921] 2 A.C. 171; 8 T.C. 101; *C.I.R.* v. *Collins*, 1923 A.D. 347.)

[14] See *First Report*, p. 61, para. 17 et seq. Accepted by the Income Tax Commission (*First and Final Report*, p. 17, para. 72).

With effect from the 1958 tax year, it is provided that any cash or the value of any asset given to a shareholder and payable out of a company's share premium account, is not to be regarded as a dividend.

Para. (d) of the definition of 'dividend'

Para. (*d*) envisages the case of a company which is being wound up or liquidated as part of a scheme of reconstruction and as a result of which a shareholder may receive cash or the value of any asset in excess of the nominal value of the shares held by him in the reconstructed company. Such excess is deemed to be a dividend. For example, A Ltd. may sell its entire undertaking to B Ltd. for a sum of £200,000 to be discharged by a cash payment of £100,000 and 100,000 shares of £1 each fully paid up in B Ltd. As part of the scheme of reconstruction, A Ltd. may then be wound up or liquidated and assuming its issued capital consists of 100,000 shares of £1 each fully paid up and that each shareholder will receive £1 cash and one share in B Ltd. (valued at £1) for each share held in A Ltd., Mr. Z, who holds 1,000 shares in A Ltd., is deemed to have received a dividend in terms of para. (*d*) made up as follows:

Cash received (1,000 × £1)	£1,000
Value of shares in B Ltd. (1,000 × £1)	1,000
	£2,000
Less nominal value of shares held in A Ltd. (1,000 × £1)	1,000
Amount of dividend	£1,000

The term 'reconstruction' has no precise legal meaning. When an undertaking is being carried on by a company, and is in substance transferred, not to an outsider, but to another company, consisting substantially of the same shareholders, with a view to its being continued by the transferee company, there is a reconstruction.[15]

§ 45. Criticisms of the definition of 'dividend'

From the above exposition it will be observed that the definition of *dividend* is exceedingly wide and embraces just about all distributions made by the company out of its profits, whether in the form of cash or otherwise, and whether made in a winding-up or not, or in the event of a reduction of capital or a reconstruction of the company. The inclusion of liquidation distributions (other than those made out of capital profits) within the ambit of *dividend* is necessary as a measure against tax avoidance for, if such distributions were not taxed, profits could be accumulated in the company and upon winding-up could be distributed among the shareholders free of super tax.

Bonus shares are also taxable in order to prevent avoidance of super tax. If bonus shares were not taxable one could drive a cart and horse through the Income Tax Act for all that a company need

[15] Halsbury, vol. 6 (1954), para. 1547.

do is to issue bonus shares instead of distributing its profits and by going into liquidation or by obtaining a reduction of capital the shareholder can receive the accumulated profits in a tax-free form. With effect from the 1958 tax year, however, bonus shares distributed out of accumulated profits by companies which are public in character are not taxable (see § 44), but during the debate on the Income Tax Bill, 1958, the Minister of Finance stated that during the next session of Parliament it was intended to impose a special tax in order to discourage the issue of bonus shares for the purpose of converting them into cash by a reduction of the company's share capital.[15a]

In the writer's view, it is not sufficient that bonus shares should be taxed with reference to the *nominal* value of the shares. A company may apply its undistributed profits to pay for the price of new shares issued at a premium to shareholders. For example, it may capitalize £100,000 worth of undistributed profits by the issue of 100 shares of the nominal value of £1 each at a premium of £999 per share. This may mean that as the *nominal* value of the bonus shares is only £100, the amount of the dividend to be taxed is only £100. A company may also issue shares at a substantial premium partly paid up and in a later year may capitalize undistributed profits by making these shares fully paid up, e.g. it may issue 100 shares at a premium of £999 each, only £1 being called up on each share. In a later year, after the company has accumulated profits it may capitalize these by making the shares fully paid up. Although £99,900 of the profits will be capitalized, shareholders may be taxable on only £100, which is the nominal value of the shares. In fact, it may be very effectively contended that in such a case not even the nominal value of £100 constitutes a dividend since no bonus shares, debentures or securities have been awarded to the shareholders. All that has happened is that the company has made shares already issued fully paid up in the hands of the shareholders by applying the undistributed profits. No bonus shares are awarded to a shareholder when all that a company does is to make partly paid shares fully paid or paid up to a greater extent than before. If this is not the correct law, then the reference to *nominal* value may work hardships on a taxpayer. For example, a company may capitalize undistributed profits by making £1 shares, partly paid up to the extent of 10*s*. per share, fully paid up. If such an act on the part of the company constitutes an award of bonus shares among the shareholders, it must follow that they are subject to super tax on £1 in respect of each share — this being the nominal value — although the company has applied its undistributed profits to the extent of only 10*s*. per share which is the amount on which shareholders should be taxed. Para. (*b*) of the definition of *dividend* in section 1 should be so amplified as to ensure that it also embraces an amount equal to the extent to which the profits of the company are utilized in paying up the whole or part of the issue price in respect of any shares issued to the shareholders.

[15a] See House of Assembly Debates (Hansard) No. 10, 15th September to 19th September, 1958, column 3725.

Dividends declared out of capital profits or out of income from a source outside the Union or out of exempt income fall within the definition. The tax system, like most others oversea, does not, therefore, identify the dividend receivable by the shareholder with the profits of the company and shareholders cannot claim that dividends should not be treated as income in their hands merely because the profits from which they are drawn are not taxable income of the company. This, in the writer's view, is fundamentally equitable since all dividends, whether payable out of the company's taxable profits or out of profits which are not taxable income, represent benefits flowing from the ownership of the shares. The source of a dividend is the shareholding and not the profit of the company.[16] If the shareholder does not like this system of taxation, he is not without a remedy. He could arrange for the company's non-taxable income to be received by him personally and not through the company. Such taxable income will be altogether free of tax in his hands. Although capital profits earned by the company are, when distributed as a dividend, subject to super tax in the hands of the shareholders if the company is not being wound up, they are not subject to super tax in the shareholders' hands if the company is being wound up. In the former case, they constitute a dividend; in the latter case not. The Committee of Enquiry into the Income Tax Act[17] was of the view that where the full amount of a dividend can be shown to represent a distribution out of capital profits earned by a company, and it is expressly declared as a dividend out of such profits and actually paid out in cash to shareholders within a stipulated reasonable period, say, twelve months, after the capital profit has been earned, the dividend should not be subject to super tax in the hands of the shareholders. As the purpose of subjecting liquidation distributions to super tax is in order to prevent the avoidance of super tax, the exclusion from the taxable portion of the liquidation dividend of capital profits is in conflict with this purpose since by simply retaining the capital profit in the company until it is wound up, it lies within the power of the shareholders to prevent these profits from ever being subject to super tax. In the view of the writer, therefore, liquidation dividends should be wholly taxed whether or not they are distributed out of revenue or capital profits. Just as much as it is undesirable that the taxation system should be so devised as to influence to any material extent the formation of a company, so it is also undesirable that provisions in the taxing law be such as to influence the winding-up or liquidation of companies. A shareholder, who would be subject to super tax on a dividend declared out of capital profits earned by his company, should not have it in his power to free himself from super tax by putting the company into liquidation and receiving the capital profit in a tax-free form.

As regards amounts received by shareholders upon a reduction of capital, in order to prevent tax avoidance, the present definition of

[16] *Boyd* v. *C.I.R.*, 1951 (3) S.A. 525 (A.D.); 17 S.A.T.C. 366.
[17] See *First Report*, p. 61, paras. 13-16.

dividend includes within its ambit any amount received upon a reduction of capital in so far as it exceeds the amount by which the nominal value of the shares is reduced. Where, however, upon a reduction of capital, a company (whether public or private) returns to shareholders any portion of the balance of its share premium account, such distribution falls outside the definition of *dividend* (see § 44).

In order to prevent tax avoidance, the Legislature has also found it necessary to provide that in the case of a reconstruction of a company the amount by which the value of any property received by a shareholder in respect of his shares exceeds the nominal value of the shares held by him before the reconstruction, is a taxable dividend. It will be observed that it is the difference between the property received and the nominal value that is deemed to be a dividend. When shares are issued partly paid the nominal value will be more than the amount paid to the company for the shares. This can lead to avoidance of super tax under para. (*d*) as the following illustration reveals:

Balance Sheet of X (Pty.), Ltd.

Issued Capital		*Net Assets*	£100,000
10,000 shares of £10 each,			
£1 paid up	£10,000		
Undistributed Profits ..	90,000		
	£100,000		£100,000

X (Pty.) Ltd. is reconstructed by a sale of its entire undertaking to B Ltd. for a sum of £100,000 to be discharged by 100,000 shares of £1 each in B Ltd. As part of the scheme of reconstruction X (Pty.) Ltd. is wound up and each shareholder of the company receives 10 shares in B Ltd. for every 1 share held in X (Pty.) Ltd. If a shareholder in X (Pty.) Ltd. held 2,000 shares he would receive 20,000 shares in B Ltd. The dividend, if any, to be taxed under para. (*d*) must be determined as follows:

Value of shares in B Ltd. (20,000 at a market value of £1 per share)	£20,000
Less nominal value of the shares held in X (Pty.) Ltd. (2,000 × £10)	20,000
Dividend to be taxed	NIL

The example clearly illustrates that what should be taxed under para. (*d*) is the difference between the value of the property received as a result of the reconstruction, i.e. £20,000, and the amount paid for the shares held in the reconstructed company, i.e. £2,000, viz. an amount of £18,000 should be taxed. Para. (*d*), in the writer's view, should be amended so as to ensure that it is the difference between the value of the property received and the amount paid for the shares in the reconstructed company that must be deemed to be a dividend.

It is seen, therefore, that subject to the remarks above the definition of *dividend* is on the whole an all-embracing one. The avoidance of super tax in respect of company dividends is certainly not the result of a faulty definition of the term *dividend* but is due to the factors already discussed above.

§ 46. RECOMMENDATIONS

The avoidance of super tax on company dividends through the formation of foreign holding companies appears to the writer to be a virtually insoluble problem unless very drastic provisions are inserted into the Income Tax Act to counter this type of avoidance device. Such drastic provisions are to be found in the Internal Revenue Code of the United States of America which deals with the taxation of foreign personal holding companies controlled by citizens or residents of the United States. Briefly, a foreign personal holding company is a foreign corporation fulfilling:

(1) An 'income-requirement' which is met if *inter alia* the holding company derives its income substantially from dividends;

(2) a 'capital-ownership' requirement which is met if more than 50 per cent in value of the holding company's issued capital at any time during the tax year was owned directly or indirectly by or for not more than five individuals, citizens or residents of the United States. An individual is considered as owning stock owned directly or indirectly by or for his family which includes his brothers and sisters, spouse, ancestors and lineal descendants.

If the holding company is such a corporation, it is provided that there must be included in the taxpayer's income the amount he would have received as a dividend if there had been distributed by the company its undistributed net profits. There are complex provisions for determining the undistributed net profits of the foreign corporation.

The provisions in the Internal Revenue Code could be adapted to suit conditions in South Africa. For example, if A ordinarily resident in South Africa transfers dividend-producing share investments to A (Pvt.) Ltd. incorporated in the Federation of Rhodesia and Nyasaland and he is the sole beneficial shareholder in A (Pvt.) Ltd., then there would be included in A's income subject to super tax the amount he would have received as a dividend if there had been distributed by the company the amount of its undistributed profit. Power would have to be conferred on the Commissioner to obtain full information from Union residents as regards their shareholdings in foreign personal holding companies including the right to call for the balance sheets and other financial accounts relating to the foreign companies. The administrative work involved in the carrying out of the provisions may be considerable, but, in the view of the writer, the special provisions would be a strong deterrent to taxpayers from forming foreign personal holding companies with the express object of avoiding super tax on dividends from Union sources.

A further deterrent to Union residents from forming foreign holding companies would be the insertion into the Income Tax Act of provisions modelled on the lines of section 412 of the United Kingdom Act designed to prevent the avoidance of tax by means of the transfer of assets by United Kingdom individuals so that the income becomes payable to non-residents. It is there provided that if a person who had income-producing assets, the income in respect of which would be subject to tax so long as the assets remain in his own hands, by means of a transfer, either alone or in conjunction with associated operations, is able to arrange that while he himself parts with the income, such income becomes payable to persons resident or domiciled out of the United Kingdom, then if certain conditions are fulfilled, the whole of the income of the person resident or domiciled out of the United Kingdom which is due to the transfer (with or without associated operations), is deemed to be the income of the transferor. These special provisions do not apply where the person effecting the transfer proves to the satisfaction of the Special Commissioners, either —

(*a*) that avoiding liability to tax was not the purpose or one of the purposes for which the transfer or associated operations were effected; or

(*b*) that the transfer and any associated operations were ***bona fide*** commercial transactions and were not designed for the purpose of avoiding liability to taxation.

It may also be mentioned that Canada has very stringent provisions in its Income Tax Act to counter tax avoidance through the operation of what is termed 'personal corporations'. Section 68 (1) states that —

> 'a "personal corporation" means a corporation that, during the whole of the taxation year in respect of which the expression is being applied,
>
> (*a*) was controlled, whether through holding a majority of the shares of the corporation or in any other manner whatsoever, by an individual resident in Canada, by such an individual and one or more members of his family who were resident in Canada or by any other person on his or their behalf,
>
> (*b*) derived at least one-quarter of its income from
>
> (i) ownership of or trading or dealing in bonds, shares, debentures, mortgages, hypothecs, bills, notes or other similar property or an interest therein,
>
> (ii) lending money with or without securities,
>
> (iii) rents, hire of chattels, charter-party fees or remuneration, annuities, royalties, interest or dividends, or
>
> (iv) estates or trusts, and
>
> (*c*) did not carry on an active financial, commercial or industrial business.'

Section 68 (2) provides that for the purpose of the above definition, the members of an individual's family are his spouse, sons and daughters whether or not they live together.

It is provided that the income of a personal corporation whether actually distributed or not is deemed to have been distributed to, and received by, the shareholders as a dividend on the last day of each taxation year of the corporation (section 67(1)).

There must be included in computing the income of a taxpayer for a taxation year amounts deemed to have been received in the year by the taxpayer under section 67 as a shareholder in a personal corporation (section 6(*i*)). The Act, in section 67, sets out the portion deemed to have been received by a shareholder.

The Canadian Act also contains stringent provisions in regard to the returns to be rendered by controlling shareholders and in regard to penalties. Section 67(12) provides —

> 'The shareholder by whom a personal corporation is controlled shall file with the return of his income for each taxation year a statement of the assets, liabilities and income of the personal corporation for the year and if he fails to file such a statement for a year there may be included in his income for that year double the amount of the part of the income of the corporation for the year that under this section is deemed to have been received by him.'

As regards the avoidance of super tax on dividends by the formation of local holding and subsidiary companies which can claim exemption from undistributed profits tax in terms of section 51(*i*), the problem has to a great extent been solved by the amendment to the section in terms of the Income Tax Act, 1958. The various avoidance devices created by section 51(*f*) and section 51(*g*) render the withdrawal of these exemption provisions a matter of urgency.

The various devices of avoidance described in this chapter leave the door open to widespread avoidance of super tax on company dividends. If every taxpayer took advantage of the loopholes, the Treasury would not receive any super tax in respect of company dividends. This is indeed a serious state of affairs and one which calls for immediate action. If the Treasury is not prepared to plug the holes it may as well forgo its right to levy super tax on dividends and thus save the Department of Inland Revenue the administrative work involved in the collection of super tax in respect of company dividends including the carrying out of the undistributed profits tax provisions. In the last resort, the answer may very well be to increase the rate of normal tax on companies and to abandon the levy of super tax on dividends. But, if this is to be done, there must be provisions which will take into account the fact that the tax payable by the company is indirectly borne by the shareholders which individually may pay different rates of tax. The rich and the poor shareholder must, therefore, not be put on the same basis and a system of adjusting the rate of tax payable by companies to the rate of tax payable by the shareholder as is in force in the United Kingdom and the Federation of Rhodesia and Nyasaland must be introduced.

The Income Tax Commission recommended[18] that dividends declared by all companies, both public and private, be exempted from

[18] *First and Final Report*, p. 15, para. 65.

super tax and non-resident shareholders' tax and that in lieu of those taxes the rate of normal tax on companies be increased and that a *distributed profits tax* be imposed on all companies in respect of all dividends declared in favour of persons who are not companies managed and controlled in the Union. It considered that the normal tax rate on companies need not be increased by more than 1*s.* per £ and that the distributed profits tax need not exceed 2*s.* per £. It recommended that the distributed profits tax should be payable by the company declaring the dividend and should not be recoverable from the shareholder. In order to avoid double taxation, dividends declared by a company managed and controlled in the Union in favour of another company managed and controlled in the Union must, according to the Commission, be exempt from the distributed profits tax. The Commission's recommendations involve the rejection of an undistributed profits tax. They also do not provide for a system of adjusting the rate of tax payable by the company to the rate of tax payable by the shareholders as is in force in the United Kingdom.

There is no doubt that the Commission's recommendations have the great merit of simplicity and will greatly reduce the administrative machinery. But in this instance, simplicity will be purchased at too high a price. The recommendations involve increasing the taxation burden on the lower-income groups since the distributed profits tax will be payable by all those shareholders receiving dividends whose total income falls short of the present super tax level of £2,300, e.g. widows, pensioners and retired people who have invested their savings in shares. The proposal to impose a flat rate of tax departs from the principle of ability to pay since it involves the levy of a tax at the same rate upon taxpayers whether their income from dividends is a small amount, e.g. fifty pounds or a substantial sum, e.g. ten thousand pounds. The same hardship is involved in the Commission's proposal that the rate of company tax should be increased up to a maximum of an additional 1*s.* in the £ for the ultimate effect must again be to hit at the shareholder with a small income. For example, assume that we have a private company with an annual profit of £10,000. There are two shareholders, A, holding 80 per cent of the shares and B, holding 20 per cent of the shares. If the rate of company tax is increased to 7*s.* 6*d.* in the £ and a distributed profits tax of 2*s.* per pound is imposed in respect of dividends distributed, A and B will each receive the following income from the company assuming that the profits are distributed to the hilt.

Taxable income of company	£10,000
Less normal tax (7*s.* 6*d.* per £)	3,750
	£6,250
Less distributed profits tax (2*s.* per £ of dividend)	625
	£5,625

A will receive a net dividend of £4,500 and B will receive an amount of £1,125. In other words, both A and B would directly and indirectly have been subjected to tax at a rate approaching nearly 10s. in the £. Both taxpayers would have been put on exactly the same basis notwithstanding the fact that A's income is four times as much as B's. This is a flagrant violation of the principle of capacity to pay and for this reason alone the Commission's recommendations should be very cautiously approached.

Apart from the very important consideration of ability to pay, the imposition of a distributed profits tax in the manner recommended by the Commission is not likely to bring in much revenue from controlled and family companies. The proposal excludes from the tax, in order to avoid double taxation, dividends declared to companies. This will probably give rise to the formation of many new holding companies to receive the dividends and thus avoid the tax. Moreover, those taxpayers who do not form such companies cannot be compelled to pay the tax if they allow the profits in their companies to accumulate without a distribution. The result may well be that hardly any tax will be collected from the rich shareholder. All in all, the Commission's recommendations, apart from having the merit of simplicity, cannot be commended. In this instance, it is wrong that the principle of ability to pay be sacrificed for administrative expediency.

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§ 47. Advantages of income-splitting

The effect of a system of progressive rates of tax is that every additional pound of income accruing to the taxpayer increases the rate of tax on all the previous pounds of income. In this way taxation is based on ability to pay. A married Cape resident with two children and with a taxable income of £1,000 per annum, pays away in tax about 2 per cent of his income. If his income is £2,000, he pays about 6 per cent. On £3,000, the tax is 13½ per cent and on £4,000, about 20 per cent. On an income of £9,000, he pays away some 37 per cent in tax. It must follow, therefore, that if a taxpayer is able to split his income among a number of taxable entities, the tax saving may be considerable. A taxpayer earning £9,000 per annum, pays away 37 per cent or some £3,400 in tax. If the income is split up among three taxpayers each earning £3,000 per annum, each taxpayer will pay 13½ per cent or about £450 in tax making an aggregate liability of £1,350 and thus effecting a saving of some £2,000.

The following table indicates the saving under the present system of progressive rates of tax if a taxpayer (married Cape resident) were to split his income among a number of different taxpayers:

Taxable Income	Total Tax (1 Taxpayer)	Total Tax (2 Taxpayers earning income in equal shares)	Total Tax (3 Taxpayers earning income in equal shares)	Total Tax (4 Taxpayers earning income in equal shares)
£2,000 ..	£170 ..	£123 ..	£73 ..	£24
£4,000 ..	£833 ..	£341 ..	£291 ..	£247
£6,000 ..	£1,727 ..	£898 ..	£511 ..	£459
£8,000 ..	£2,790 ..	£1,665 ..	£995 ..	£682
£12,000 ..	£5,268 ..	£3,453 ..	£2,498 ..	£1,796

The above table shows that a taxpayer may be well rewarded if he enters into arrangements which have as their purpose the splitting of his income among a number of different parties so as to negative the effect of the system of progressive rates of tax. Common examples of income-splitting devices to avoid or reduce tax in this manner are partnership arrangements, transactions between parent and child and trust formations.

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§ 48. Disposal of income does not affect its nature as income

It must be emphasized that it is not every form of income-splitting that will secure for the taxpayer the advantages mentioned above. Income-splitting, to be effective from the tax point of view, must have been made by means of contractual arrangements entered into before the income legally vests or accrues to the taxpayer. Once income has accrued to a person in terms of section 7 of the Act, the ultimate disposal of such income by that person does not affect its nature as income in his hands. It remains taxable in his hands. No matter how much splitting takes place thereafter among different taxable *personae*, it is not effective from the income tax point of view. There is an important distinction between a disposal of income after it has accrued to a person and a disposal of a right under which income will accrue to the recipient of such right. In the former case, as the income has already accrued to the party who disposes of it, it remains taxable in his hands. In the latter case, under the right which has been disposed of, the income accrues to the recipient of the right and not to the person who disposed of the right.[1] Thus, if having received a dividend from X (Pty.) Ltd., Mr. Z passes it over to Mr. Y, Mr. Z is liable to tax thereon as the dividend has accrued to him. However, if prior to the declaration of the dividend, Mr. Z sold his shares to Mr. Y, it is Mr. Y who will be liable to tax on the dividend as it legally accrued to him. A taxpayer by retaining an income-producing asset and arranging for the income derived therefrom to be paid over to certain parties, is subject to tax in respect of such income. He is merely disposing of his income after it has accrued to him. The only way in which he can cause the income to accrue to the parties and be subject to tax in their hands is by transferring ownership of his asset to them. Only then will the income-splitting be effective for tax purposes.

An income-splitting device to be effective from the income tax point of view must, therefore, ensure that the income accrues to the recipients in terms of section 7 and that it is not merely a disposal of income by the taxpayer after it has accrued to him.

II. Partnership Arrangements

§ 49. Meaning of 'partnership'

Partnership has been defined in the authorities as a legal relationship between two or more persons, who carry on a lawful business or undertaking, to which each contributes either money or labour or anything else with the object of making a profit, and of sharing it between them. Such a partnership is not a separate legal *persona* as distinct from the individuals who constitute it.

[1] *Hiddingh* v. *C.I.R.*, 1941 A.D. 111; 11 S.A.T.C. 205; see also I.T.C. No. 350, 9 S.A.T.C. 69.

The essentials of a partnership are as follows:[2]

(i) Each of the partners brings something into the partnership, or binds himself to bring something into it, whether it be money, or his labour or skill;

(ii) the business must be carried on for the joint benefit of the partners;

(iii) the object of the partnership must be to make profits;

(iv) the contract between the parties must be a legitimate contract.

To establish the existence of a partnership the facts must clearly show that the relationship between the parties is that of partners.

> 'Partnership does not consist merely of a contract; it is a relationship between parties which arises from a contract, and if the contract is not carried out, then the relationship of partnership does not come into existence.'[3]

The mere fact that a person is entitled to a share of the net profits of a business is not on its own sufficient to make him a partner. The essentials set out above must be complied with. A person who advances money to another in return for a share of the profits derived from the business in which the loan is employed is not a partner,[4] neither is a person who sells his business to another and is entitled to receive, in lieu of goodwill, a share of the annual profits derived from the business.[5]

A partnership must be distinguished from a club or other body of persons associated together for some common object or purpose and which constitutes a separate legal *persona* as distinct from the members.[6]

In terms of section 4 of the Companies Act (Act 46 of 1926, as amended) no partnership consisting of more than twenty persons may be formed in the Union for the purpose of carrying on any business that has for its object the acquisition of gain unless it is registered as a company under the Companies Act or is formed in pursuance of some other law, or of Letters Patent or Royal Charter.

§ 50. Method of taxation of partnerships

The Income Tax Act does not recognize a partnership as a distinct taxable *persona*. The Act provides (see section 55 (15)) that persons carrying on any business in partnership must make a joint return as partners in respect of such business. Each partner is separately and individually liable for the rendering of the joint return. Although a joint return is required from the partners, they are liable to tax only in their separate individual capacities since section 67 (7) provides that separate assessments are to be made upon partners not-

[2] See *Joubert* v. *Tarry & Co.*, 1915 T.P.D. 277; see also *Rhodesia Railways, Ltd. & others* v. *C.O.T.*, 1925 A.D. 438; 1 S.A.T.C. 133.

[3] *Hoheisen* v. *C.I.R.* (not reported in S.A. Law Reports), 5 S.A.T.C. 207.

[4] *Kirsch* v. *C.I.R.*, 1946 W.L.D. 261; 14 S.A.T.C. 72.

[5] *Deary* v. *Deputy C.I.R.*, 1920 C.P.D. 541.

[6] I.T.C. No. 227, 6 S.A.T.C. 234.

withstanding the provisions of section 55 (15). In practice, the Department does not insist on a joint return by the partners but usually accepts from any one of the partners a copy of the financial accounts disclosing the total income of the partnership for the year of assessment under charge.[7] A partnership as such, is therefore, not liable to any tax. It has no existence as a taxable *persona* apart from the individual partners who comprise the partnership.

In practice, the Commissioner determines the taxable income and the income subject to super tax of a partnership as if it were a separate taxable *persona*. He then proceeds to apportion such income among the partners according to their rights to share in the profits of the partnership. The profits or losses of a partnership are divisible among the partners in the proportions agreed upon, or, failing such agreement, in proportion to the capital contributed. Where it is impossible to say whether one party has contributed more than the other, for example in a case where one partner contributes money and the other skill and labour, they share the profits equally. The partners are then individually assessed on their respective shares of the partnership income after taking into account any income derived from sources outside the partnership. Each partner pays tax according to his total income (including his share of the partnership income), his marital status and the rebates applicable to him. Where the determination of the taxable income of a partnership results in an assessed loss, such loss is apportioned among the partners according to their rights to participate in profits or losses. Each partner is entitled to set off such loss against any income received during the same year from sources outside the partnership.

In determining the taxable income or assessed loss of a partnership, the Commissioner must have regard to the terms of the partnership agreement. If, in terms of the partnership agreement, salaries are payable to the partners or interest is to be credited in respect of capital contibutions made by them, such salaries or interest are allowed as a deduction to the partnership. There must, however, be included in the taxable incomes of the partners the amount of the salary or interest allowed as a deduction to the partnership. In other words it is the practice of the Commissioner to tax a partner on his transactions with the partnership as if he were a third party. Partnerships and the partners are treated as distinct entities. As a partnership has no legal personality distinct from the personality of the partners, it must follow that in law a partner cannot be the debtor or creditor of the partnership which in effect means that transactions between partners and the partnership really amount to modifications of the partners' rights to their share of the profits and losses of the partnership. Whatever may be the correct legal position it does not matter whether partners are taxed on their transactions with the partnership

[7] The Committee of Enquiry into the Income Tax Act recommended that this practice be accorded statutory authority (*Second and Final Report*, p. 41, paras. 18 & 19). Accepted by the Income Tax Commission (*First and Final Report*, p. 38, para. 87).

or whether the transactions are regarded as modifications of the profit-sharing rights. From the tax point of view the result is the same in the end. Perhaps this is why the practice of treating partners and partnerships as distinct entities has never been tested by the courts.

It often happens in the case of a partnership that the firm takes out an insurance policy on the joint lives of the partners to provide liquid funds to the partnership on the happening of a certain event such as the death of one of the partners. The purpose of such an arrangement is usually to provide ready cash to pay out either the whole or portion of a deceased partner's share of goodwill as well as the amount standing to the credit of his capital account. The partnership is usually the owner of such a policy and is required to pay the annual premiums in respect thereof. The amount of such premiums is not deductible from the income of the partnership being in the nature of capital expenditure. Each partner is, however, entitled to claim the insurance rebate in respect of his share of the premium, in terms of the present practice of the Commissioner. When the policy eventually matures and the proceeds are received by the partnership, no tax is levied on such proceeds which constitute a capital accrual. The joint survivorship policy arrangement should be distinguished from the case where each partner individually and for his own benefit takes out a policy of insurance on his own life, the annual premiums being met by the partnership. In such a case, the Commissioner permits the annual premiums to rank as a deduction from the partnership income but includes the amounts thereof in the respective taxable incomes of the partners. The Commissioner apparently regards the premiums payable by the partnership as additional remuneration accruing to the partners. In practice, the partners are entitled to claim the insurance rebate in respect of the premiums paid on their behalf by the partnership. The position, it is submitted, would be different if the partners were to cede their policies to the partnership firm which continues to pay the premiums thereon. In such a case, the premiums paid by the partnership on the policies on the separate lives of the partners are not an allowable deduction in arriving at the taxable income of the partnership. Each partner is entitled to the insurance rebate in respect of that portion of the premium paid on the policy on his own life which is borne by him.

§ 51. Commencement of Partnership for Taxation Purposes

Where the owner of an existing business admits another person into partnership with him and it is agreed that the incoming partner is to share in the profits of the business from a date prior to the conclusion of the partnership agreement, the original owner remains liable to tax on the whole of the profits received by or accrued to him up to the date of the conclusion of the partnership agreement.[8] On the other hand, if it can be established that a partnership relationship had commenced at some earlier date prior to the execution of the

[8] I.T.C. No. 536, 13 S.A.T.C. 100. See, however, I.T.C. No. 362, 9 S.A.T.C. 191.

partnership deed which merely recorded the terms of the partnership which had already been formed, the profits or losses of the partnership business earned from the time that the relationship of partners had commenced must be apportioned to the partners irrespective of the date when the partnership deed is executed.[9]

§ 52. Partnership activities in different countries

Where there is a partnership the members of which carry on their business activities in two different countries, the income of the partnership is derived from two sources and when one of the partners carries on his business activities in the Union his income from the partnership is derived from a source within the Union while the income of the other partner is derived from a source in a foreign country. The income which the partner who carries on his business activities in the Union receives is the *quid pro quo* for the services he renders in the Union to the partnership.[10]

§ 53. Sale of right to share in partnership profits

A person who sells his right to share in the profits of a partnership of which he is a member, remains taxable on his share of the partnership income even though he is bound by agreement to pay over his share to another. The profits derived by him from the partnership business vest in him in his capacity as a partner, the payment over to the other party being merely a disposal of income after it has accrued to him.[11] This type of arrangement is fraught with difficulty as tax may be payable twice in respect of the same income. A partner who sells his right to a share in the partnership profits is taxable on such share whereas the person who acquires the right is also taxable on the profit being revenue derived from the productive employment of his capital. It may be suggested that this amounts to double taxation and that there is a presumption in the Act against double taxation. In *Isaacs* v. *C.I.R.*,[12] Watermeyer, C.J., was of the view that, bearing in mind that an income tax is fundamentally a tax upon a man's annual profits or gains, the Income Tax Act should not be read as imposing normal tax or super tax upon a taxpayer twice in respect of the same profits unless the language of the Statute makes it clear that such a result was intended. The learned Judge considered that this principle underlies the views expressed by the majority of the members of the Court who sat in the case of *C.I.R.* v. *Delfos*,[13] viz.

Per Wessels, C.J.:

> 'It may well be that if it was sought to tax the taxpayer twice over in a particular case it may be possible to invoke equitable principles in order to avoid the double taxation.'

[9] I.T.C. No. 551, 13 S.A.T.C. 204.
[10] *C.I.R.* v. *Epstein*, 1954 (3) S.A. 689 (A.D.); 19 S.A.T.C. 221.
[11] I.T.C. No. 350, 9 S.A.T.C. 69.
[12] 1949 (4) S.A. 561 (A.D.); 16 S.A.T.C. 258.
[13] 1933 A.D. 242; 6 S.A.T.C. 92.

Per Curlewis, J.A.:

'. . . a person's income for any year is liable to only one taxation and that therefore any item which forms part of his taxable income for one year cannot again be charged with tax in a subsequent year.'

Per de Villiers, J.A.:

'. . . There is, however, a "necessary implication" that the same amount shall not be taxed twice in the hands of the same taxpayer. . . .'

Different meanings may be attached to the expression 'double taxation'. As has been laid down in a number of cases, double taxation means the taxation of the same income over again or twice in the hands of the same person. It does not mean that the same amount is taxed twice in the hands of different people who received it on different grounds and in different capacities. Thus, a taxpayer cannot raise the contention that he is not subject to tax on a particular amount because someone else is paying tax on it, but he can raise the point that he is not subject to tax on income which has been taxed twice in his hands unless the language of the Statute makes it clear that such a result was intended.[14]

§ 54. Accrual of income from partnership

In *Sacks* v. *C.I.R.*,[15] Watermeyer, C.J., considered the legal position of a partner in relation to the partnership and to his co-partners and held as follows:

'It is clear that during the subsistence of a partnership agreement the partnership property is owned in common in undivided shares. Consequently, save in so far as the partnership agreement may modify the position, the receipts and accruals in the partnership business are acquired by the partners in common and no one partner acquires any several right of ownership in the receipts or accruals of the partnership. Furthermore, a partnership agreement almost invariably provides, either expressly or by implication, for the division of profits after the lapse of fixed periods of time. The effect of such a clause in a partnership agreement is to place an obligation upon the partners to continue to hold the receipts and accruals of the partnership business in common, subject to an obligation to bring them into account at the end of each fixed period for the purpose of ascertaining the profit or loss for the accounting period. When that time arrives, then, for the first time under the partnership agreement, a partner becomes entitled to claim a separate determinable share of the partnership profits and then, for the first time under the partnership agreement, that determinable share accrues to him as gross income. Besides a partner's right to claim such separate share of the partnership profits under the conditions of the partnership agreement, he also acquires such a right when the partnership agreement terminates, e.g. by dissolution, and in that case also an accrual of a right to a determinable amount takes place.'

[14] I.T.C. No. 554, 13 S.A.T.C. 211. See also I.T.C. No. 350, 9 S.A.T.C. 69, and *Orkin Bros. (Pretoria), Ltd.* v. *C.I.R.*, 1935 A.D. 9; 7 S.A.T.C. 179.
[15] 1946 A.D. 31; 13 S.A.T.C. 343.

In *Sacks's* case it was, therefore, held that profits from a partnership are only ascertainable and only accrue to the individual partners at the conclusion of the agreed period for the taking of account of the profits. Consequently, partners can vary their profit-sharing rights by agreement prior to the conclusion of the agreed period for determining the profits and this new basis will then apply to all the profits earned during the agreed period.

If a partner draws against his share of the profits of the partnership before it has accrued in terms of the principles set out above, such drawings are on capital account and are not taxable.

§ 55. DISSOLUTION OF PARTNERSHIP

In the case of a dissolution of a partnership during a tax year due to cessation of trading or due to the death or retiral of a partner, or admission of a new partner, accounts will usually be drawn up to the date of dissolution and each partner's share of the profits or losses for the period to the date of dissolution must be taken into account in the determination of his taxable income for the tax year in which the dissolution takes place. No subsequent dealing with a partner's accrued right to profits up to the date of dissolution can affect the obligation of the Commissioner to assess the outgoing partner in respect of such profits. Thus, where a partner paid an outgoing partner a lump sum for the share of the profits he was entitled to in respect of the profits earned up to the date of dissolution, the Court held that the outgoing partner was assessable on his share of the profits of the partnership earned up to the date of dissolution.[16] The consideration received by the outgoing partner for the disposal of his right to share in the profits of the partnership up to the date of dissolution is of a capital nature.[17]

Where, however, prior to dissolution it is agreed that the outgoing partner receives a lump sum in lieu of his share of the profits up to the date of dissolution, this will constitute a variation of the partnership agreement as to profits and the outgoing partner is subject to tax on the lump sum received and not on the share of the profits which he would have been entitled to had there been no variation of the partnership agreement. Thus, in *Sacks* v. *C.I.R.*,[15] the partners had, prior to dissolution, arranged that the retiring partner would receive a certain sum of money in lieu of his share of the profits earned up to the date of his retirement. This arrangement was made in order to avoid stocktaking and the preparation of a balance sheet. It was clear that if the accounts were drawn up at the date of retirement, the share of profits accruing to the retiring partner would have been much greater than the fixed sum he received in lieu of such share. The Appellate Division held that the retiring partner was taxable on the fixed sum he received. Per Watermeyer, C.J.:

[16] I.T.C. No. 104, 3 S.A.T.C. 331; see also I.T.C. No. 755, 18 S.A.T.C. 426.
[17] I.T.C. No 492, 12 SA.T.C. 80.

'But it was contended that Sacks became entitled to a share of the partnership profits immediately on dissolution. Undoubtedly that contention is correct, but the question is what share did he then become entitled to? If there had been no variation of the original partnership agreement, he would have become entitled by implication from the terms of the partnership agreement to 43⅓ per cent of the profits earned by the firm up to the date of dissolution; and, if he had chosen to cede that share of profits to anyone after he had become entitled to it, he could not, by so doing, have destroyed the accrual to him which had already taken place and consequently he could not have escaped the appropriate tax assessable on it. But in this case he did not cede a portion of his share of the profits to anyone after dissolution. Either before dissolution or *pari passu* with, and as a condition of dissolution he and his partners, by agreement among themselves, altered the previously existing agreement as to the division of profits and agreed that his share should not be 43⅓ per cent of the profits made during the half-year ending 31st December, 1940, but the fixed sum of £5,351. . . . The agreement between the partners was . . . a variation of the existing partnership agreement as to profits and there are no grounds for regarding it as a sale and transfer by Sacks to his partners of profits which had already accrued to him or of profits which might accrue to him on dissolution.'

It may happen that a retiring partner receives as consideration for his share in the goodwill of the partnership business annual payments representing a proportion of the future annual profits derived from the business. It is submitted that the annual amounts so received are of an income nature and taxable. Such periodical payments must be distinguished from lump-sum payments or fixed sums payable in instalments received as consideration for the sale of goodwill which are clearly of a capital nature. As regards the continuing partner who makes the payments out of the annual profits to the retiring partner in lieu of goodwill, he is not entitled to a deduction in respect thereof, such payments being of a capital nature[18] and being no different from the case where the purchase price of goodwill takes the form of a lump sum.[19]

Where a partner bequeathed his share in the partnership business to the surviving partner subject to a payment by such surviving partner to a third party out of the annual profits earned, the Special Cout held that the full amount of the profits of the business accrued to the surviving partner, the payments made to the third party in terms of the will of the deceased partner being an application of the profits after they had been earned, and thus not deductible.[20] In view of the case of *Holley* v. *C.I.R.*[21] this decision must be approached with caution. It is submitted that having regard to the decision in *Holley's* case, to the extent of the third party's participation in the profits of the business, the amount accrues to such third party and not to the surviving partner.

[18] I.T.C. No. 334, 8 S.A.T.C. 334.
[19] I.T.C. No. 140, 4 S.A.T.C. 215.
[20] I.T.C. No. 555, 13 S.A.T.C. 214; see also I.T.C. No. 285, 7 S.A.T.C. 318.
[21] 1947 (3) S.A. 119 (A.D.); 14 S.A.T.C. 407.

Care must, therefore, be exercised in the event of a partnership dissolution in order to avoid cases of partnership profits being taxed in the hands of the recipients and yet not being regarded as proper deductions to the parties responsible for payment. In such cases tax may be payable twice in respect of the same income. In the event of the retirement of a partner, the most favourable procedure as regards goodwill is usually the payment of a lump sum. This is not taxable in the hands of the recipient and it does not rank as a deduction to the payer. In this manner, double taxation can be avoided.

A partner may retire from active participation in the business of the partnership but this does not necessarily mean that the partnership is no longer in existence. In one reported case, a partner ceased to take an active part in the running of the partnership business, the remaining partner undertaking the sole management and control of the business. A share of the profits on a reduced scale was credited to the inactive partner. The Court held that in the absence of evidence that the partnership had been dissolved it continued in existence notwithstanding the cessation of any active participation in the affairs of the business by the one partner.[22]

§ 56. Consequences of 'Sacks's' case

The principle established in *Sacks's* case[15] creates loopholes for tax avoidance in that it lies within the power of the partners to determine the time when the profits from the partnership should accrue to the individual partners for tax purposes. For example, the partnership agreement may provide that the partners should be entitled to their shares in the partnership income every two years or every five years. In this way partners are able to postpone the accrual of their shares of the profits of the partnership business. A partnership may commence on 1st January, 1958, but it may not suit the individual partners to pay tax in the 1958 tax year on their shares of the partnership income earned to the 30th June, 1958. Apart from the partnership income, they may have substantial income from other sources in respect of the 1958 tax year which may not recur in the 1959 tax year. A simple solution would be to follow the principle established in *Sacks's* case and agree that the partnership accounts are to be made up to 31st December each year. Thus, the accrual of the shares of the partners in the partnership income in respect of the twelve months ending 31st December, 1958, takes place in the 1959 tax year.

A further consequence of *Sacks's* case is that from the tax point of view a distinction must be drawn between the joint accruals or receipts of the partnership firm and the accrual by the partner of his share in the partnership income. It would appear to the writer that on the principle established in *Sacks's* case, a partner is taxable on his share of the partnership income and not on the joint accruals or receipts of the partnership. This share does not accrue from day

[22] I.T.C. No. 634, 15 S.A.T.C. 114.

to day but only after the lapse of the agreed period for the taking into account of the profits. If one were to bring this to its logical conclusion, it would seem that if the income of the partnership consists of capital profits or profits from non-Union sources or items of exempt income, a partner should be taxed on such profits. Conversely, if the partnership has suffered a capital loss or has incurred expenditure not deductible for tax purposes, these amounts should not be added back in the individual assessments of the partners. This, certainly, could not have been the intention of the Legislature.

It is a matter for regret that the Committee of Enquiry into the Income Tax Act did not consider these problems connected with partnership taxation. The Australian Income Tax Act distinguishes between the assessable income of the partnership and the interest of the partners therein. Section 92 provides as follows:

> '(1) The assessable income of a partner shall include his individual interest in the net income of the partnership of the year of income, and his individual interest in a partnership loss incurred in the year of income shall be an allowable deduction.
>
> (2) The exempt income of a partner shall include his individual interest in the exempt income of the partnership of the year of income.'
>
> '"net income" is defined to mean —
> the assessable income of the partnership, calculated as if the partnership were a taxpayer, less all allowable deductions except the concessional deductions and losses of previous years;
>
> "partnership loss" means the excess, if any, of the allowable deductions, except the concessional deductions and losses of previous years, over the assessable income of a partnership, calculated as if the partnership were a taxpayer.'

The incorporation of provisions such as the above into our Act will do much to clarify the law in regard to partnership taxation. To avoid difficulties, the taxable income of a partnership should be calculated as if the partnership were a taxable *persona* and if the taxable income of a partner must include his individual interest in the net income of the partnership, this would provide an effective counter to the present loophole whereby partners can postpone the payment of tax by making up their accounts every two years, or five years and so on. With such special provisions it is also considered that the principle established in *Sacks's* case, namely that an outgoing partner who agrees to accept a fixed sum as his share of profits for the broken period up to the date of liquidation in lieu of taking out accounts is taxable on that sum and not on a sum calculated with reference to the actual profits of the period, will no longer apply. Statutory authority will also be given to the present practice of the Commissioner which is to tax a partner on his transactions with the partnership as if he were a third party, i.e. treating the partner and the partnership as distinct entities. It should also then be clear that the profits derived by the partnership retain their character in the hands of the individual partners, i.e. a partner is not taxable on capital profits or exempt income or profits from a foreign source accruing to the partnership, and capital losses and expenses not deductible will be added back in the assessments of the individual partners.

As regards the further principle established in *Sacks's* case that partners can vary their profit-sharing rights by agreement prior to the conclusion of the agreed period for determining the profits and that this new basis will then apply to all the profits earned during the agreed period, this could lead to avoidance since at any time prior to the end of the financial year the parties can agree to change their profit-sharing ratios so that more income accrues to one partner and less to another. This may encourage partners to 'juggle' with the annual profits and thus to regulate their incomes to the best advantage for tax purposes. As far as the writer is aware, neither the United Kingdom, Australia nor Canada has specifically dealt with this problem in their taxing laws. It appears to be an insoluble problem. However, to prevent partners from 'juggling' with their profit-sharing rights once the financial year has ended, which obviously cannot be effective from the tax point of view, it is suggested that a special provision could be inserted into the Act in terms of which partners are obliged to advise the Revenue prior to the end of the financial year of any change in their profit-sharing ratios as compared with the previous financial year. Unless such advice is given prior to the end of the financial year, the Revenue shall assess the partners in accordance with the profit-sharing ratios applicable to the preceding financial year.

The only recommendation made by the Committee of Enquiry into the Income Tax Act in regard to partnership taxation is that provision be made to counter the splitting of income, frequently between a parent and his children, on the basis of alleged verbal partnership arrangements. It held as follows:[23]

> 'Types of contractual arrangements for which we consider specific statutory provision should be made include those which are based on alleged verbal partnership agreements and which have the effect of varying the manner in which the profits or income of a business are shared, thereby enabling a taxpayer to avoid or reduce his liability for the payment of tax. To counter such devices for the avoidance of tax, *we recommend* that provisions be introduced into the Act requiring the Commissioner, if any arrangement is entered into purporting to confer upon any person who previously enjoyed no right to participate in the income of any trade, a right so to participate and the effect of such arrangement is that liability for the payment of tax on income derived from such trade is avoided or the total amount of such tax payable by all persons in respect of the income of that trade is reduced below what it would have been had the arrangement not been entered into, unless such arrangement is reduced to writing on or before the date on which it purports to be effective, to disregard such arrangement and to deter-

[23] See *Second and Final Report*, p. 31, para. 16. Although the Income Tax Commission rejected this recommendation (*First and Final Report*, p. 34, para. 64), it suggested that the underlying principle might serve a useful purpose if the provision could be framed in a manner which will diminish considerably the tax advantage conferred by the mere reduction to writing of the arrangement.

mine the tax payable in respect of the income of such trade as though the arrangement had not been entered into and there had been no variation of the pre-existing rights of participation in the income: Provided that if any such arrangement is reduced to writing on a date subsequent to the date on which it purports to be effective, it shall be recognized as effective between the parties, for taxation purposes, subject to the provisions of section 90 of the Act, only with effect from the date on which it is signed by the parties.'

The Committee was of the view that a provision along these lines would provide an effective counter to the splitting of income. With respect, however, it is doubtful whether the writing formality on its own will put an effective stop to tax avoidance. If it means saving tax, a simple requirement such as an agreeement in writing will create no problem for the taxpayer.

§ 57. Family partnerships

A common method of easing the burden of income tax is the formation of a partnership between a taxpayer and members of his family. Instead of the income being taxed in the hands of one person, it is split among two or more members of a family so that each recipient is entitled to the advantage of the tax free margins for both normal tax and super tax purposes. Family partnerships are not necessarily suspect as far as the Revenue is concerned but bearing in mind that the onus of proof of the existence of a partnership is on the taxpayer (see section 78) it is always advisable for the agreement to be put in writing and that the following steps should be taken:

(*a*) A partnership bank account should be opened and operated upon by the partners.

(*b*) The partnership assets should be transferred into the names of the partners.

(*c*) Customers, creditors, and other business connections should be notified of the existence of the partnership.

(*d*) Each partner must bring something into the partnership, whether it be capital or services.

(*e*) Proper books of accounts should be kept giving effect to the terms of the partnership. The business books should show the capital accounts of the respective partners.

The above is suggested particularly for the case where a taxpayer with an existing business takes in as a partner a member of his family formerly employed by him. The conduct of the partners in making no notification of the change in their relationship to their bankers or to the outside world may very well indicate that they themselves had not entered into any formal alteration of their relationship. The production of a partnership written agreement cannot of itself establish a partnership if the agreement is not acted on. The problem was very succinctly stated by Rowlatt, J.:[24]

[24] *Dickenson* v. *Gross* (1927), 11 T.C. 614; 137 L.T. 351.

> 'Many people . . . think that by putting a bit of paper in a drawer they can make an income tax partnership, and they go on treating the undertaking as though it were still the sole uncontrolled property of the one person . . . instead of a partnership.'

Partnerships between relatives are not ineffective from the income tax point of view simply because one of the partners has the real and effective control and disposal of the shares of the net income of one or more of the other partners. A family partnership can be so constituted or controlled that any partner has not the control and disposal of his share of the net profits. The vesting of the control of the partnership business in the hands of one dominant partner, e.g. a father, who may determine when any of the other partners are entitled to draw out of the business the whole or part of their shares of the partnership income, is not of itself sufficient to upset the relationship for tax purposes as long as it is clear that such share vests in the partners concerned and that it legally belongs to them. Thus, if after a lapse of a few years the partnership is dissolved and the profits originally credited to some of the partners are paid to the dominant partner, this may be indicative of an intention of not to share profits with a consequential effect that the partnership would be ineffective for income tax purposes. The *bona fides* of a partnership can, therefore, not be challenged on the ground of non-payment to a partner of his share of the partnership income, whether because the effective control of his share is in the hands of a dominant partner or because of business reasons, e.g. a desire to extend the scope of a business, he refrains from drawing out his share of the profit.

It is interesting to refer to section 94 of the Australian Act which is designed to protect the *fiscus* in cases of family partnerships where one or more of the partners has not the real and effective control and disposal of his share of the partnership income. The section reads as follows:

> '(1) Where a partnership is so constituted or controlled, or its operations are so conducted, that any partner has not the real and effective control and disposal of his share of the net income of the partnership, the Commissioner may assess the additional amount of tax that would be payable if the share of that partner, or of all such partners if more than one —
>
> (*a*) had been received by the partner who has the real and effective control of that share; or
>
> (*b*) had been divided between such other partners as have the real and effective control of that share in proportion to the extent to which, in the opinion of the Commissioner, they respectively have the real and effective control of that share
>
> (as the case may be), and had been added to and included in his or their assessable income, and the partnership shall be liable to pay the tax so assessed.
>
> (2) Where the provisions of this section are applied to a share of the net income of a partnership, that share shall not be included in the assessable income of any partner.

(3) For the purpose of this section, but without limiting its application, a partner shall be deemed not to have the real or effective control and disposal of any money received by him which is applied to meet the private or domestic obligations of any other partner.'

No similar provision is to be found in the United Kingdom and Canadian Taxing Acts although New Zealand has a special provision to prevent avoidance through family partnerships (section 106).

It is doubtful whether a provision such as section 94 of the Australian Act will carry the matter much further in South Africa. Decisions of the Australian courts indicate that the section has failed in its design.[25] Family arrangements will simply be modified to bring the partnership outside the ambit of the special provision.

There are other ways whereby a dominant partner can prevent one or more partners from drawing out his share of the income. For example, where a father admits a child into partnership in an existing business he could exact a heavy goodwill from the incoming partner, payment to be made out of the share of the profits accruing each year to such partner. In this manner, a partner can be prevented from taking out his share of the income for many years. Another method of retaining the profits in the partnership business or of preventing one or more of the other partners from receiving their shares of the profit is for the father to insist that the purchase price due to him for the sale of the business assets to the partnership shall be met first out of the profits before any partner is entitled to draw against his share of the profits.

III. Parent and Child Relationship

§ 58. Minor children — method of taxation under the present law

Where a minor child receives income in his own right and not by reason of any donation, settlement or other disposition made by his parents, such income is subject to tax in his own hands and *not* in the hands of the parent. Thus, if a child of 17 earns £500 salary during a tax year, this is assessable in his hands and is not included in the father's income. If an uncle donates money to his infant nephew, aged six months, the interest on such money is taxable in the hands of the infant. On the other hand, if, by reason of any donation, settlement or other disposition made by a parent, income has been received by or has accrued to a minor child or has been expended for the maintenance, education or benefit of such child or income has been accumulated for the benefit of a minor child, such income is deemed to have been received by or accrued to the parent of such minor child — section 9(3). Thus, if a father donates shares to his minor child, any dividends received by reason of these shares are deemed to be the income of the father in terms of section 9(3). The position would be different if the minor purchased the

[25] See Gunn's *Commonwealth Income Tax Law & Practice*, 5th ed., p. 2168 et seq.

shares with money that he acquired in his own right, for example from a salary that he might have earned, since in that case he is taxable on the income received.

Whether any income of a minor child is by reason of any donation, settlement or other disposition made by a parent deemed to be the income of such parent in terms of section 9(3), has in each particular case to be determined by the facts. If, in any particular case, it appears that, apart from proof of any specific intention on the part of the parent, the effective cause of income accruing to a minor child was the donation made by the parent, then such income is deemed under section 9(3) to have been received by the parent whether or not the income has been received from the original donation or from the reinvestment of such income.[26]

In *Kohler* v. *C.I.R.*,[27] the Court found as a matter of law that upon a proper construction of section 9(3) it was only income derived in the first instance by a minor from sums donated by his parent which could be included in a parent's income so that the section did not apply to income received by the minor from the utilization of the income so derived.

In *C.I.R.* v. *Widan*,[26] which involved a case of 'income upon income' to which the provisions of section 9(3) were applicable, although the Appellate Division did not expressly overrule the decision in *Kohler's* case it is clear from its judgment that whether a minor receives his income by reason of a donation made by the parent is a question of fact and not a question of law as was held in *Kohler's* case. It is implied in the judgment of the Appellate Division that the principle laid down in *Kohler's* case is not correct. Thus, in terms of *Widan's* case, it does not necessarily follow that the provisions of section 9(3) do not apply to 'income upon income'. Every case must be decided on its own facts in order to determine whether any income of a minor is 'by reason of' a donation made by his parent.

Per Centlivres, C.J.:

'. . . When income has been received by a minor child the inquiry is whether such income has been so received "by reason of any donation, settlement or other disposition" made by the parent of that child. There must be some causal relation between the donation and the income in question. Difficult cases may conceivably arise. Where, for instance, a father donates a sum of money to a minor child and the child buys a business to which he contributes his skill and labour and from which he earns an income that income may be regarded as being attributable to two causes, viz. the donation and the skill and labour of the child. In such a case it may be impossible to say which part of his income was the result of the donation and which part the result of his skill and labour and it may be that the Commissioner would not be able to apply section 9(3).'

It has been held that the words 'or other disposition' in section 9(3) are *ejusdem generis* with 'donation' or 'settlement' and that

[26] *C.I.R.* v. *Widan*, 1955 (1) S.A. 226 (A.D.); 19 S.A.T.C. 341.
[27] 1949 (4) S.A. 1022 (T); 16 S.A.T.C. 312.

they must be read as a gratuitous disposition.[28] Consequently, the provisions of section 9(3) do not apply to a *bona fide* partnership between a father and a minor son and to other non-gratuitous transactions between a parent and his minor child (see *infra*).

It will be seen that it is not an essential requirement of section 9(3) that the 'income' must be received by or accrue to the minor child. It is sufficient if it has been expended for his maintenance, education or benefit, or, if it is merely accumulated for his benefit. The words 'accumulated for the benefit of any minor child' may be paraphrased 'for the purpose and with the intention that his minor child may in the future benefit'. It is not necessary that the child should have a vested right in the income. The possibility that the child might not live long enough to benefit does not derogate from the fact that the parent's purpose was to benefit him. If the child dies before he can enjoy the income, although the parent's purpose is frustrated, it cannot be said that the parent did not have that purpose.[29]

It is not a requirement of the section that the donation, etc., must be made by the parent to the minor child. It may be made to some other person such as a trustee, but as long as the income from it accrues to the child or is accumulated for the benefit of the child, the provisions of section 9(3) operate.

Section 9(3) expressly provides that its provisions only extend to the income accruing or accumulating for the benefit of any *minor child* of the person who makes the donation, etc., by reason of which the income arises. *Child* does not include a grandchild, and it is submitted that it does not include a stepchild. If the Legislature intended to include a stepchild it would have said so.[30] Thus, if a grandparent were to make a donation to a minor grandchild, the income arising would not be taxed in the hands of the grandparent in terms of section 9(3) but in the hands of the child. Similarly, if a person were to donate assets to his stepchild the income derived from the donated assets is taxable in the hands of the child. As regards legally adopted children, it is submitted that they fall within the provisions of section 9(3) having regard to the provisions of section 71(2) of the Children's Act, 1937, which provide that for all purposes (save for certain exceptions not important for present purposes) a legally adopted child is to be regarded as a legitimate child. Thus, if a person were to donate assets to a legally adopted child, the income derived from the donated assets is taxable in the hands of the donor.

The word *minor* is not defined. It must be given its meaning in common law. It is submitted that a child under 21 who is married

[28] I.T.C. No. 551, 13 S.A.T.C. 204; see also I.T.C. No. 642, 15 S.A.T.C. 238.

[29] *Platt* v. *C.I.R.*, 1934 A.D. 552; 7 S.A.T.C. 75.

[30] As it does in sec. 13(2)(*a*), which confers the child rebate 'in respect of each unmarried child or stepchild of the taxpayer . . .', and in sec. 13(2)(*b*)(i) which grants the insurance rebate in respect of premiums paid by the taxpayer 'upon policies under which he, his wife, children or stepchildren . . . is or are insured . . .'.

is not a minor child for the purposes of section 9(3). Thus, income derived by a married child under 21 from a donation made by the parent is taxable in the hands of the child since the provisions of section 9(3) are not of application. It is doubtful whether a child under 21, who has been totally emancipated by his parents, is a minor child for the purposes of section 9(3). It should be pointed out that section 102 of the Australian Income Tax Act which deals with revocable trusts refers to persons under twenty-one years of age and unmarried. Sections 9(3) and 9(4) of the Income Tax Act of the Federation of Rhodesia and Nyasaland are in all respects identical with sections 9(3) and 9(4) of the Union Act except that the Federal Act does not refer to *minor child* but simply to *child*. 'Child' means any person who is under the age of twenty-one years and is unmarried and includes any such person who is lawfully adopted, is illegitimate, or is a stepchild. Section 397(1) of the United Kingdom Income Tax Act when dealing with certain settlements by parents in favour of children uses the phrase 'if the child was an infant and unmarried'. To obtain clarity the legislator would be well advised to delete the word *minor* from section 9(3) and (4) because of the uncertainty of the meaning of the term. It should take heed from the provisions in force in the taxing laws of other countries, particularly in the Federation Act where the term *child* is defined for purposes of section 9(3) and (4). In fact, in order to nip possible controversies in the bud, the legislator could also be recommended to define *child*, not only for the purposes of section 9(3) and (4) but also for the purposes of section 13(2)(*a*) which confers a rebate in respect of children, and section 54 *quat*(2)(*b*) which exempts from donations tax gifts to the children of the donor. For example, under the present law it is not clear at all whether an illegitimate child falls within the scope of the various sections referred to. The position may very well be that *child* for the purposes of these sections means a child of the taxpayer which the law recognizes as such. Thus, illegitimate children whom the law does not recognize as children of the father do not fall within the provisions whereas they do fall within the provisions in regard to the mother since the law recognizes the children as hers (the maxim is *eene moeder maakt geen bastard*). On the other hand, it could also be effectively contended that where the word *child* or *children* appears in the Income Tax Act there is no presumption that it means a legitimate child and that it may include an illegitimate child. On this latter interpretation, illegitimate children fall within the scope of the special provisions referred to which means that both parents can claim the rebate in respect of the same child in terms of section 13(2)(*a*) and both can also claim the benefit of the exemption in section 54 *quat*(2)(*b*) in regard to gifts to the same child. The legislator in the Federation has avoided these difficulties by including an illegitimate child in the definiton of *child* for the purposes of section 9(3) and (4) and by granting the child rebate only in respect of 'each unmarried lawful child' of a married person.[30a]

In certain special circumstances (see section 9(4)) the parent and not his minor child is taxed on any income received by or accrued to such minor child by reason of any donation, settlement or other disposition made by a person other than the parent of such child. In such cases it is provided that the income must be deemed to be the income of the parent if such parent or his spouse has made a donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the person who made the donation, etc., for the benefit of the minor child. The purpose of section 9(4) is clear, namely to ensure that parents do not avoid the provisions of section 9(3) by each making a donation to the minor child of the other. Thus if A donates £10,000 to the minor child of B, and B reciprocates by donating £10,000 to the minor child of A, were it not for section 9(4), any income received by the minor children would be taxed in their own hands and not in the hands of their parents.

In terms of section 58(4) every parent is required to include in his return —

(*a*) any income received by or accrued to any of his minor children, either directly or indirectly, from himself or his wife together with such particulars thereof as the Commissioner may require;[31] and

(*b*) any income deemed to be his in terms of section 9(3) and (4).

In terms of section 69(*c*), the guardian of a minor child, who is usually the father, is the *representative taxpayer* in respect of the income of such child. He is required to complete the return of income, pay any tax due on behalf of the child and generally represent the minor child in all matters relating to taxation.

§ 59. Recovery of tax from minor children

Where the minor's income is deemed, in terms of section 9(3) or (4), to be that of the parent, the latter may recover from the funds of the minor an amount equal to the tax falling on the parent because of the inclusion of the minors' income — section 84(*c*).

The Commissioner can recover from the assets of a minor child such an amount as represents so much of the tax payable by the parent as is due to the inclusion of the minor's income derived from those assets in terms of section 9(3) or (4) — section 85(4).

The method of recovery employed by the Commissioner when he recovers from the assets of a minor child in terms of section 85(4) is, to the writer's knowledge, as follows:

[30a] See the Taxes Charging Act, 1958.
[31] See Schedule 8 of the 1958 Income Tax Return (I.T. 12).

child rebate only in respect of 'each unmarried lawful child' of a married person.[30a]

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[30a] See the Taxes Charging Act, 1958.
[31] See Schedule 8 of the 1958 Income Tax Return (I.T. 12).

$$\frac{\text{Deemed income in terms of section 9(3) and (4) included in the taxable income of the parent}}{\text{Taxable income of parent (including deemed income in terms of section 9(3) and (4))}} \times \begin{array}{l}\text{Total normal tax}\\ \text{payable by parent.}\end{array}$$

Super tax is recovered on a similar basis. It is submitted that the above formula is also a fair basis to apply in the case of a parent who seeks to recover tax in terms of section 84(*c*). It could be strongly argued, however, that as the inclusion of any sum in the income of a taxpayer exercises an inflatory effect upon the taxation payable on the income as a whole, the basis of recovery by the parent should be the difference between the actual tax assessed on his income including the deemed income in terms of section 9(3) and (4), and the tax which would have been assessed had the deemed income not been included in his income.[32] The basis of recovery should be clearly laid down.

The provisions of section 84(*c*) and section 85(4) extend only to normal and super tax and not to the provincial taxes. This omission should be rectified in the interests of both the *fiscus* and the taxpayer.

§ 60. RECOMMENDATIONS IN REGARD TO THE TAXATION OF MINOR CHILDREN

The Committee of Enquiry into the Income Tax Act[33] was of the view that in the case of income accruing in favour of a minor child by virtue of a donation made by the parent, such parent continues to derive the benefit of such income in that it will serve to provide for the maintenance and education of the child, the cost of which he would otherwise have to meet. In the view of the Committee, it was wrong that a parent should not only be granted a tax rebate in consideration of his obligations to maintain and educate his child but also go free of tax in respect of any portion of his own income which he has diverted for the purpose of providing that maintenance and education. The provisions of section 9(3) were, therefore, justified.

Unfortunately, the Committee of Enquiry only confined itself to income which a parent may divert by means of donations to minor children and did not deal with the transactions between parent and child which do not involve a donation and which are, therefore, not hit by section 9(3). The Special Court has held that the words 'or other disposition' are *ejusdem generis* with 'donation' or 'settlement' and that they must be read as a gratuitous disposition.[34] In fact many other transactions of a non-gratuitous character often take place between parent and child, the result of which is that the income so diverted by the parent to his child does not fall under the provisions of section 9(3) and is, therefore, taxable in the hands of the child. Although certain non-gratuitous transactions between a

[32] See *Maskalik* v. *Levitt*, 1947 (4) S.A. 321 (W); 14 S.A.T.C. 437; *Mans* v. *le Riche* (not reported in Law Reports or S.A.T.C. but see 5 (1956) *The Taxpayer* 127).
[33] *First Report*, p. 18, para. 63.
[34] I.T.C. No. 551, 13 S.A.T.C. 204; see also I.T.C. No. 642, 15 S.A.T.C. 238.

parent and his minor child may be part and parcel of a tax-avoiding scheme, there may be others which need not necessarily have tax avoidance as their motive. Whatever the true motive may be, non-gratuitous transactions between parent and child are not hit by section 9(3) which applies only to gratuitous transactions. Thus, parents are effectively able to split their income by entering into non-gratuitous transactions with their minor children, the income in respect of which is taxable in the hands of the children. These transactions may take a variety of forms:

Sale

Agreements by parents to sell income-producing assets to their minor children are not open to objection, provided they are *bona fide*. It is not essential that the minor should have the cash resources to pay for the asset. The purchase price may be paid out of the annual income derived. The income is taxable in the hands of the minor. Section 90, it is submitted, is not applicable as the transaction involves the disposal or alienation of an income-producing asset (see § 7).

Lease

There is nothing in law to prevent a minor child from being his parent's tenant or landlord as long as the transaction is a genuine one. If the child is the landlord, the rental he receives from his parent is taxable in his own hands. The parent, if he expends the rental for the purpose of his business, is entitled to deduct same from his income. If the rental is excessive, the Commissioner is entitled to disallow portion thereof as not having been incurred in the production of income (see § 145).

Employment

A contract of employment may exist between a parent and his minor child. If a minor child works in his father's business and earns a salary, such salary, as long as it is a reasonable amount, is assessed in the hands of the minor and will be an allowable deduction to the father. If the salary is excessive, the Commissioner is entitled to disallow portion thereof as not having been incurred in the production of income (see § 145). In deciding whether remuneration payable by a father to a minor child is excessive or not, a test which may be applied is what the child's services are worth in the open market.[35]

Partnership

There appears to be no rule of law to prevent a minor from being a partner and where a father admits his minor child into a *bona fide* partnership with him the income derived by the minor from the conduct of the partnership is taxable in his own hands and not in the hands of his father. As long as the essentials of a partnership are present, the Commissioner must accept the relationship for tax purposes (see § 49).

[35] *Tobacco Father* v. *C.O.T.*, 1951 (1) S.A. 150 (S.R.); 17 S.A.T.C. 395.

Loan Agreements

The rule of the Roman law that minor children are prohibited from obtaining loans is considered obsolete in South African law.[36] If this is correct, there is nothing to prevent a parent from making a loan to his minor child. The minor can then utilize the loan to purchase an income-producing asset, the income in respect of which is taxable in his own hands since the provisions of section 9(3) do not apply.

It will be seen from the above, therefore, that it is not only gratuitous transactions that can take place between parent and child. Many other transactions of a non-gratuitous character are permissible thereby permitting income to be diverted from a parent to his child and rendering the provisions of section 9(3) completely ineffective. It is not even essential for the transaction to take place between the father and his minor child. For example, if a father wishes to purchase an income-producing asset, he could arrange for his minor child to acquire the asset in his own name. The father could finance the purchase price by way of a loan. There is, therefore, ample scope for a parent to avoid the provisions of section 9(3).

In the writer's view, the provisions of section 9(3) do not go far enough and need tightening up. The section should not only confine itself to transactions of a gratuitous character but should also deal with any transaction between parent and child, the effect of which is that income accrues to the child. It should also cover any case where income is received by or accrues to a minor child either directly or indirectly from his parents. Other countries have found it necessary to deal with the problem in this manner. For example, section 22(1) of the Canadian Income Tax Act provides as follows:

> 'Where a taxpayer has, since 1930, transferred property to a person who was under 19 years of age, either directly or indirectly, by means of a trust or by any other means whatsoever, the income for a taxation year from the property or from property substituted therefor shall, during the lifetime of the taxpayer while he is resident in Canada, be deemed to be income of the taxpayer and not of the transferee unless the transferee has before the end of the year attained the age of 19 years.'

The original section 9(3) of Act 40 of 1925 read as follows:

> 'Any income (other than *bona fide* remuneration for services rendered) received by or accrued to or in favour of a minor child of any person, which is derived either directly or indirectly from such person, shall for the purposes of this Act be deemed to be the income of that person, notwithstanding that it or the capital from which it is derived is held in trust for the sole benefit of such child.'

This is indeed a wider provision than the present section 9(3) since it is not confined to gratuitous transactions only. Under the present law, whereas section 9(3) covers only gratuitous transactions between parent and child, section 58(4)(*a*) provides that the parent must include in his return any income accruing to a minor either

[36] See Spiro, *Law of Parent and Child*, 1950, p. 125.

directly or indirectly from himself or his wife. This latter section was taken over from Act 40 of 1925 and was complementary to the original section 9(3) of that Act. However, when section 9(3) was changed to its present form, section 58(4) was left unamended.

§ 61. Major children

An income-splitting device that is commonly resorted to in practice is the transfer by a father, who falls in a high income bracket, of income-producing assets to a major child falling in a low income bracket. Such an action is normally justified by the parent on the grounds that he would rather have his son as a partner than the Receiver of Revenue. Whatever asset is transferred to the children, whether it be shares in a company, immovable property, interest-bearing debts or cash, the income accruing from the asset is taxable in the hands of the child and there is no provision in the Income Tax Act whereby such income can be taxed in the hands of the father. Since the transaction involves the alienation of an income-bearing asset, section 90 cannot be invoked to upset it (see § 7). Where it is a business that is being carried on by the father, he can either admit the child as a partner or employ him for a reasonable salary or he can transfer the entire business to one or more of his children.

The transfer of the income-producing asset to a child may take place either by way of a sale or by way of a donation. In the case of a donation, the provisions of section 9(3) are not applicable as they apply only to donations to minor children. There may be other transactions between a parent and child, the effect of which is to split the parent's income, e.g. a lease or a loan agreement.

§ 62. Impact of the donations tax

The introduction of a donations tax into the Income Tax Act has virtually put a stop to the transfer of substantial income-producing assets by way of donation from father to son. The reasons for the introduction of a donations tax were stated by the Minister of Finance in his Budget Speech on 24th March, 1955, as follows:

> '. . . a method also employed for avoiding taxation is by distribution of gifts — a practice which has, during recent years, been employed on a large and increasing scale. It serves a double purpose. In the first place, the "donor" reduces the assets on which estate duty would be payable at his death. But also, while he is still in the land of the living, he thereby reduces his income tax, because by means of these donations the assets, and hence also the income derived therefrom, are spread over a great number of taxpayers.
>
> 'In order to prevent these evasions, I propose to levy a tax on certain gifts.'

Rate of donations tax

The rate of the donations tax is set out in section 54 *undec.* and is as follows:

Cumulative taxable value of property disposed of under donations

On so much of the cumulative taxable value of property disposed of by the donor under donations —				Rate of tax per centum
as does not exceed £4,000				3
as exceeds	£4,000	but does not exceed	£5,000	4
„ „	£5,000	„ „ „ „	£6,000	5
„ „	£6,000	„ „ „ „	£7,000	6
„ „	£7,000	„ „ „ „	£8,000	7
„ „	£8,000	„ „ „ „	£9,000	8
„ „	£9,000	„ „ „ „	£10,000	9
„ „	£10,000	„ „ „ „	£11,000	10
„ „	£11,000	„ „ „ „	£12,000	11
„ „	£12,000	„ „ „ „	£13,000	12
„ „	£13,000	„ „ „ „	£14,000	13
„ „	£14,000	„ „ „ „	£16,000	14
„ „	£16,000	„ „ „ „	£18,000	15
„ „	£18,000	„ „ „ „	£20,000	16
„ „	£20,000	„ „ „ „	£22,000	17
„ „	£22,000	„ „ „ „	£24,000	18
„ „	£24,000	„ „ „ „	£26,000	19
„ „	£26,000	„ „ „ „	£28,000	20
„ „	£28,000	„ „ „ „	£30,000	21
„ „	£30,000	„ „ „ „	£35,000	22
„ „	£35,000	„ „ „ „	£40,000	23
„ „	£40,000	„ „ „ „	£45,000	24
„ „	£45,000	.. .. ..	..	25

Table of donations tax payable

The following table sets out the actual tax payable at selected levels of cumulative taxable values of donations:

Cumulative Taxable Value of Donations	*Tax Payable*
£1,000	£30
2,000	60
3,000	90
4,000	120
5,000	160
6,000	210
7,000	270
8,000	340
9,000	420
10,000	510
11,000	610
12,000	720
13,000	840
14,000	970
15,000	1,110
16,000	1,250
17,000	1,400
18,000	1,550
19,000	1,710
20,000	1,870
21,000	2,040
22,000	2,210

Cumulative Taxable Value of Donations	*Tax Payable*
£23,000	£2,390
24,000	2,570
25,000	2,760
26,000	2,950
27,000	3,150
28,000	3,350
29,000	3,560
30,000	3,770
31,000	3,990
32,000	4,210
33,000	4,430
34,000	4,650
35,000	4,870
36,000	5,100
37,000	5,330
38,000	5,560
39,000	5,790
40,000	6,020
41,000	6,260
42,000	6,500
43,000	6,740
44,000	6,980
45,000	7,220
in excess of 45,000	7,220 *plus* 25 per cent on the amount in excess of £45,000.

Calculation of tax liability

Since the donations tax is payable on the cumulative taxable value of gifts, every time the donor makes a donation all his donations on or after 24th March, 1955, including the current donation, must be aggregated and the tax must be determined on the cumulative value. From the tax so calculated there must be deducted the tax already paid on the cumulative taxable value determined when the last donation was made.

If, for example, a donor had made a taxable donation of £5,000 on 1st September, 1957, the donations tax payable would be 3 per cent on £4,000 *plus* 4 per cent on £1,000, making a total of £160. If, in 1960, he makes another taxable donation of £10,000, the cumulative taxable value of his donations will be £15,000 and the tax payable on the cumulative value will amount to a sum of £1,110 from which the £160 already paid by him in 1957 has to be deducted making an amount of £950 (£1,110 *less* £160) which he has to pay on the £10,000 donated in 1960. If in 1968, the same donor makes a further taxable donation of £35,000, the cumulative taxable value of his donations will be £50,000 and the tax will then be £7,220 on the first £45,000 *plus* 25 per cent on £5,000 making a total of £8,470 from which must be deducted the £1,110 previously paid by him in 1957 and 1960. The third donation of £35,000 will, therefore, be subject to a donations tax of £7,360.

§ 63. Gifts to children exempt from donations tax

The exemption from donations tax in respect of gifts by parents to their children is set out in section 54 *quat* (2) (*b*).

The exemption permits gifts to a donor's children up to an aggregate value of £5,000 per child. A parent cannot claim this concession annually. Once the value of the donations to his children exceeds an aggregate value of £5,000 per child, the parent is taxable on the excessive portion. If a donor has a family of three children, irrespective of their ages, he can donate £15,000 to them free of the donations tax. If he donates £6,000 to each child, donations tax will be payable on £3,000 (£18,000 *less* £15,000). If he donates £4,000 to each child in one year and £2,000 to each in the next year, in the first year the £12,000 will be exempt but in the second year £3,000 will be taxable (£12,000 *plus* £6,000 *less* £15,000).

In terms of section 9 (2) of the Income Tax Act, 1957, the exemption limit of £5,000 in respect of each child applies in respect of donations which take effect on or after 20th March, 1957. Prior to this date, the exemption was £2,000 in respect of each child. If, on the old exemption limit, a father was obliged to pay donations tax on gifts made to his children he is not entitled to a refund. In respect of any donations made to his children after 20th March, 1957, the father is entitled to an exemption based on £5,000 per child *less* any amount previously exempted on the old limit.

The terms of the exemption are couched in such a way that a parent may donate to any one of his children an amount equivalent to the total tax-free amount attributable to his family. Thus, if a donor has three children he may either donate free of donations tax £5,000 to each child, or £7,500 to each of any two of his children, or if he has two daughters and one son and he does not want to donate anything to his daughters he may give £15,000 to the son free of donations tax.

If a child dies, the parent does not lose the £5,000 exemption relating to such child as long as the deceased child has issue surviving him. It is provided that in such a case the children of the deceased child must be regarded as a single child of the donor in respect of which he will be entitled to an exemption of £5,000. Thus, if a father's original donation to his three children was £13,000 and one of the children dies, if the deceased child has issue surviving him, the father is entitled to make a further tax-free donation of £2,000 either to his other two children or to the children of the deceased child.

Children is not defined for the purposes of section 54 *quat* (2) (*b*). There is, however, no age requirement for a child to qualify for the exemption. It is submitted that the term *children* does not include stepchildren of the donor. If the Legislature intended including stepchildren it would have said so as it does in section 13 (2) (*a*) which confers the child rebate 'in respect of each unmarried child or stepchild of the taxpayer . . .' and in section 13 (2) (*b*) (i) which grants the insurance rebate in respect of premiums paid by the taxpayer 'upon policies under which he, his wife, children or stepchildren . . . is or are insured . . .'. However, the writer understands that in practice the Department takes the view that during the subsistence of a marriage the children of either spouse must be regarded as the children of the donor.

As regards legally adopted children it is submitted that they fall within the exemption contained in section 54 *quat* (2) (*b*) having regard to the provisions of section 71 (2) of the Children's Act, 1937, which provide that for all purposes (save for certain exceptions not important for present purposes) a legally adopted child shall be regarded as a legitimate child.

It is not an essential requirement that the donation made by the parent must be received by the child. It is sufficient if the donation is made 'for the benefit of his children' such as a donation to trustees for the benefit of the children. It is not necessary, it is submitted, that the child should have a vested right in the property donated to trustees for his benefit. As long as the parent's purpose in making the donation is to benefit the child, for example it may be provided that the annual income from the donation must be used for the maintenance and education of the child, it is submitted that the donation falls within the exemption. In this respect reference should be made to section 9 (3) (*b*) which provides that if by reason of any donation made by a parent, income has been accumulated *for the benefit* of his minor child, the parent is taxable on such income. In *Platt* v. *C.I.R.*,[37] the Appellate Division construed an essentially similar provision in Act No. 40 of 1925. The Court held that it is not necessary that the child should have a vested right in the income. The possibility that the child might not live long enough to benefit does not derogate from the fact that the parent's purpose was to benefit him. If the child dies before he can enjoy the income, although the parent's purpose is frustrated, it cannot be said that the parent did not have that purpose. It is submitted that these principles also apply to section 54 *quat* (2) (*b*) in respect of donations made by a parent for the benefit of his children.

The determination of the total tax-free amount attributable to a donor's family, must take place every time he makes a donation to any of his children. If one of his children has died, past calculations are not reopened. For example, if in June, 1957, a father with two children donated £9,000 to one child, so that donations tax was then not payable, upon the death today of any one of his children, the earlier calculation stands. Should the father make any further donation to the surviving child, tax is payable since at the date of this donation, the aggregate tax-free amount applicable to his family is £5,000 but £9,000 has already been exempted from tax in an earlier year. On the other hand, if the deceased child left children, the aggregate tax-free amount is then £10,000 and as £9,000 has already been exempt from tax the parent is entitled to make a tax-

[37] 1934 A.D. 552; 7 S.A.T.C. 75.

free donation up to £1,000 to his surviving child or to any of the children of his deceased child.

§ 64. Gratuitous *v.* non-gratuitous transactions

The exemption from donations tax in respect of gifts to children, i.e. £5,000 per child, is too limited to permit parents to avoid income tax by the distribution of large gifts to their children. Some of the children may, in any event, be paying a high marginal rate of tax. It is true that if a parent has four children he can make a donation of £20,000 free of the donations tax to one child who has no present income subject to tax. This procedure is not likely to be followed often in practice as this would involve favouring one child at the expense of another. Moreover, since the income-producing assets can be effectively transferred by way of a contract of sale, there is really no need to resort to a donation. The sale basis has certain distinct advantages over the donation method. A father can sell the assets at a current market value to his child with a condition that payment of the purchase price, although free of interest, must be made out of the income derived from the asset. In this manner the child is not entitled to the enjoyment of the income until the full purchase price has been paid. He is, however, subject to income tax on the annual income derived from the assets. In the case of a donation, the father is not entitled to anything once the donated asset has been transferred. The child is entitled to the enjoyment of both the income and the capital.

Whatever has been said above in relation to parent and child applies equally to transfers by other members of a family, e.g. uncle and nephew or a grandfather and grandson. As regards these relationships, the exemption from donations tax in respect of gifts made by parent to child does not apply. Thus, in these cases, the best method, from the tax point of view, is the transfer of the income-producing assets by way of an ordinary purchase and sale. The donations tax table shows that a transfer by way of a donation involves a heavy tax, which in certain instances may even exceed the tax saving. For example, a grandfather may wish to transfer an income-producing asset valued at £40,000 on which the income accruing to him is £4,000. Even if the £4,000 income is subject to maximum rates of tax, i.e. 12*s.* 6*d.* in the £, in the hands of the grandfather, he may not wish to transfer the asset by way of a donation since the donations tax payable on a donation valued at £40,000 is £6,020, which is a substantial liability. In addition, it should not be overlooked that the grandson will now be subject to tax on the £4,000 income.

In spite of the avowed purpose of the donations tax to prevent the avoidance of income tax by taxpayers who donate assets so that the income derived therefrom is spread over a number of taxpayers, it is doubtful whether this will be achieved in practice since income can also be spread by non-gratuitous transactions, e.g. purchase and sale, lease, loan, partnership, which are not hit by the donations tax provisions.

IV. Trusts

§ 65. Nature of a trust

In *Estate Kemp & others* v. *McDonald's Trustee*,[38] Solomon, J.A., held as follows in regard to the creation of trusts in South Africa:

> '. . . The constitution of trusts and the appointment of trustees are matters of common occurrence in South Africa at the present day. Thus it is a recognized practice to convey property to trustees under antenuptial contracts; trustees are appointed by deed of gift or by will to hold and administer property for charitable or ecclesiastical or other purposes; the property of limited companies and other corporate bodies is vested in trustees and the term is used in a variety of other cases, as e.g. in connection with assigned or insolvent estates. The underlying conception in these and other cases is that while the legal *dominium* of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose. The idea is now so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception.'[39]

A trust is a contract whereby a donor or settlor agrees to transfer property to the trustees for the benefit of third parties.

Where a trust is created by will, the testator stipulates in his will the particular assets or portion of his estate which are to form the subject of the trust, names the beneficiaries for whose benefit the trust is created, appoints the trustees, or administrators as they are usually called, to administer the assets and to define their powers, specifies the division of the income and the capital among the beneficiaries, and provides for other matters such as the termination of the trust, etc.

Where a trust is created during the lifetime of the settlor, a donation is usually involved in the formation of a trust. The contract is usually one whereby the donor agrees to transfer property to trustees for the benefit of third parties. The difference between such a donation and an outright or simple donation is that in the case of a trust the legal ownership of the assets transferred vests in the trustees and not in the beneficiaries. The trustees are appointed by the donor and it is their function to administer and distribute the income and capital of the trust in accordance with the provisions of the trust deed. Since the legal ownership of the property transferred vests in the trustees and no longer in the donor, it follows that the income derived from such property is now received by or accrues to the

[38] 1915 A.D. 491.
[39] See also *C.I.R.* v. *Estate C. P. Crewe & another*, 1943 A.D. 656; 12 S.A.T.C. 344.

trustees, and from the income tax point of view the important question that arises is: In whose hands is such income taxable?

In terms of section 69(*c*), the *trustee* (as defined in section 1) entitled to the receipt, management, disposal or control of any income, which is the subject of the trust administered by him, is made the *representative taxpayer* in respect of that income. But this does not mean that he is the person to be assessed in respect of the trust income.

§ 66. In whose hands trust income assessable

If the terms of the will or deed under which the trust is created are such that the administrator or trustee is required to pay the income to a particular beneficiary, that income accrues to the beneficiary. He is the person to be assessed to tax in respect of such income and not the trustee as representative taxpayer. The trustee in such circumstances is a mere conduit pipe by means of which the income is conveyed to the beneficiary who is legally entitled to it. This general rule applies even if the income is not actually paid direct to the beneficiary but is required to be expended by the trustees for the benefit of the beneficiary[40] or is accumulated or capitalized or otherwise dealt with in the beneficiary's name (in this respect see section 8 of the Act).[41] The general principle that the beneficiary and not the trustee will be taxable only applies where it is clear that the beneficiaries have a vested right in the income, i.e. they have an enforceable right to claim the income whether immediately or at some time in the future.[42] If they have no vested right to the income but merely a contingent right, it cannot be said that such income has accrued to them.[43] As regards the distinction between a vested right and a contingent right, the Special Court has held:

> 'Vesting implied the transfer of *dominium*, and the children had clearly not in the year under review acquired *dominium* of the trust income or any portion thereof. A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. A contingent interest was merely a *spes* — an expectation which might never be realized. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right.'[44]

In the case of discretionary trusts, i.e. where a trustee is required to distribute the income or portion thereof among the beneficiaries in such proportions as he thinks fit, it follows that there can be no accrual of any ascertainable amount of income to the beneficiaries until the trustee exercises his discretion and makes a distribution among the beneficiaries. As soon as the trustee exercises his dis-

[40] *Estate Munro* v. *C.I.R.*, 1925 T.P.D. 693; 1 S.A.T.C. 163.
[41] *C.I.R.* v. *Polonsky*, 1942 T.P.D. 249; 12 S.A.T.C. 11.
[42] I.T.C. No. 22, 1 S.A.T.C. 208; see also I.T.C. No. 799, 20 S.A.T.C. 222, and I.T.C. No. 269, 7 S.A.T.C. 164.
[43] *Lategan* v. *C.I.R.*, 1926 C.P.D. 203; 2 S.A.T.C. 16; see also I.T.C. No. 239, 6 S.A.T.C. 358; I.T.C. No. 242, 6 S.A.T.C. 366.
[44] I.T.C. No. 76, 3 S.A.T.C. 68; see also *Trustees of the Hull Trust Fund* v. *C.I.R.*, 1931 W.L.D. 193; 5 S.A.T.C. 201; I.T.C. No. 37, 2 S.A.T.C. 65; I.T.C. No. 206, 6 S.A.T.C. 46.

cretion, the contingent right of a beneficiary becomes a vested one and he is taxable on the income so distributed to him.[45] The Department applies this principle whether there is a duty on the trustees to exercise their discretion within the limits imposed in the trust deed or whether the trustees have an unfettered discretionary power whether or not to distribute the income among the beneficiaries. Where trustees have an absolute discretion whether or not to pay the income to the beneficiaries, that is where it is clear from the trust deed that at the time of its receipt or accrual the trustees are not legally obliged to pay over such income or portion thereof to the beneficiaries, it could be effectively argued that the income accrues for tax purposes in the hands of the trustees notwithstanding that it may at some later date during the same tax year be distributed among the beneficiaries in the exercise of the discretionary powers conferred on the trustees. What the beneficiaries receive in such circumstances, it may be argued, is income which has already vested for tax purposes in the hands of the trustees so that it partakes of the nature of capital in their hands.

The terms of a will or a trust deed may be such that the income must be distributed to a parent to be used by him towards the support, maintenance and education of his children. If, in such a case, any surplus over what is necessary for the support, maintenance and education may be retained by the parent as his own absolute property, the income distributed to the parent vests in him and is subject to tax in his hands.[46] This case must be distinguished from the case where the income is not in terms of the will or trust deed required to be distributed to the parent but the administrators or trustees are empowered to disburse as much of the income as in their discretion is necessary for the maintenance and education of the children. Even if such amounts are paid over to the parent for these purposes, they are taxable in the hands of the children and not the parent. As each child has an individual right which is enforceable against the trustees, the amount of the income actually received or enjoyed by each child is income in his hands. In effect there is one corpus, the trust fund, but so many different children may derive benefits therefrom upon the trustees exercising their discretion. As soon, however, as such discretion has been exercised, the contingent right of each child becomes a vested one and each child is taxable on the amount of the income received or enjoyed.[47] Any part of the income of the trust fund which is not distributed remains the income of the trust and is taxable in the hands of the trustees as representative taxpayers. From the tax point of view, therefore, a donor or testator must bear in mind that if it is desired that his surviving spouse should not be subject to any tax on income to be used for the benefit of his minor children, he should arrange that the income is donated or bequeathed not to his spouse but directly to his children or direct trustees to

[45] *Estate Munro* v. *C.I.R., supra.*
[46] I.T.C. No. 417, 10 S.A.T.C. 264.
[47] *Estate Munro* v. *C.I.R., supra.*

the whole annuity is subject to both normal tax and super tax in the hands of the beneficiaries. On the other hand, if what he donates or bequeaths is not an annuity but a distribution of the income, e.g. one-quarter or one-half or 40 per cent of the income, the dividends so distributed are subject to super tax only in the hands of the beneficiaries.

§ 68. Annuities payable in terms of a will or trust

It is common for testators to make provision for dependants by bequeathing annuities to them either for life or for a fixed term of years. In terms of section 7(*a*) any amount received or accrued by way of annuity must be included in the gross income. It is immaterial whether the annuity is payable out of the income or the capital assets of the estate.[53] Caution should, therefore, be exercised in advising a testator who desires to leave annuities where the income from the estate is not likely to be sufficient and where it is directed to make up an annuity out of capital. This involves the payment of income tax on moneys which partake of the nature of capital.

Where, in terms of a will, an annuity is payable by a legatee or heir by way of a bequest price for an inheritance and it is not provided in the will that such annuity is payable out of the income of the inheritance, such annuity, although taxable in the hands of the recipient in terms of section 7(*a*), cannot be deducted from any income derived from that inheritance, since from the point of view of the payer it is capital expenditure.[54] On the other hand, where assets are bequeathed by a testator on condition that the heir or legatee pays out of the income of such assets an annuity to some other person, the annuity is taxable in the hands of such other person in terms of section 7(*a*), but to that extent it will reduce the income that is subject to tax in the hands of the heir or legatee.[55] This difference between the two cases is due to the fact that in the latter case the will imposes a fideicommissum in favour of the recipient of the annuity, and the heir or legatee, who as the fiduciary is required to pay the annuity, is in the position of a representative taxpayer only and is not liable to assessment personally on the amount so paid over by way of annuity. The draftsman must, therefore, exercise great care if it is desired to avoid tax being paid twice in respect of the same income for, as the cases show, upon the terms of the will will depend whether an heir or legatee can deduct from his income any annuity which he is required to pay over to some other person.

The above principles apply *mutatis mutandis* to annuities payable out of an *inter vivos* trust.

It is clear from section 7(*a*) of the Act, read with proviso (iii) to section 10(1), that the Legislature is not concerned with the

[53] I.T.C. No. 70, 3 S.A.T.C. 58; I.T.C. No. 339, 8 S.A.T.C. 360.
[54] *Lambson* v. *C.I.R.*, 1946 C.P.D. 69; 14 S.A.T.C. 57.
[55] *Holley* v. *C.I.R.*, 1947 (3) S.A. 119 (A.D.); 14 S.A.T.C. 407; see also *M* v. *C.O.T.*, 1956 (4) S.A. 197 (S.R.); 21 S.A.T.C. 16.

source of the income or the nature of the assets out of which an annuity is payable. As long as the annuity is from a source within the Union (see § 20), it is immaterial how or from what source the funds are derived out of which the annuity is payable. The Committee of Enquiry into the Income Tax Act considered this question and held as follows:[56]

> 'We are of opinion that where a taxpayer is entitled to regular annual payments from a Union source by way of an annuity from an estate or trust, such payments represent income in his hands on which it is reasonable and proper that he should bear tax, irrespective of the source of the income of the estate or trust, or of whether or not payment is made out of the capital of the estate or trust. To grant to the recipient of such an annuity reliefs and exemptions resulting in his burden of taxation becoming less than that of a taxpayer in receipt of a like amount of income earned by his own efforts would, in our opinion, violate the principle of equality of taxation. It is our view, therefore, that no change should be made in the law in this respect.'

The soundness of this principle may be conceded in the case of an annuity granted by way of donation. For example, if X agrees to pay Y an annuity, the fund out of which X pays the annuity is of no concern whatsoever to Y. There is, however, a good case for putting an annuity received from a trust or an estate on a different footing, particularly when a comparison is made between the beneficiary of a trust or an estate who receives an annuity and the beneficiary who receives a proportionate share of the income. In the latter case, the beneficiary pays tax on his income according to the source of the income accruing to the trust or the estate so that if all the income consisted of dividends, he would not be subject to any normal tax on his income. In the example given, the annuitant would be subject to normal tax on his annuity. It is difficult to justify this distinction which the Income Tax Act draws between the two classes of beneficiaries bearing in mind that there is no difference between them other than the fact that in the one case the donor or testator has provided for the payment of a fixed amount whereas in the other case provision has been made for the payment of annual amounts depending upon the income of the trust or estate. Trust deeds and wills are often drawn up in such a way that it is difficult to determine whether a beneficiary is entitled to an annuity or a share of the income. A donor may direct that a beneficiary receive one-half of the income of a trust or £1,000 per annum, whichever is the greater. A testator may bequeath one-quarter of the income to a beneficiary, subject to a maximum annual payment of £500. What the beneficiary receives is not an annuity since the annual payment is uncertain. Thus, the beneficiary is taxable according to the nature of the trust income. If the beneficiary was entitled to receive a fixed annual amount of £1,000 or £500, he would be taxable on this sum irrespective of the nature of the trust income. It is wrong that cases of such a nature should lead to such a difference in taxation.

[56] *First Report*, p. 14, para. 19.

§ 69. Method of assessment of trusts

Where the assessment is made upon the trustee in his representative capacity, normal tax is assessed at the rates and according to the primary rebate applicable to an *unmarried* individual taxpayer. As long as the taxable income does not exceed £250 for the year of assessment or a proportionate amount thereof if the period of assessment is less than twelve months, liability to normal tax does not arise. Super tax is assessed at the ordinary rates applicable to individuals subject to the primary rebate of £285. If the income subject to super tax does not exceed £2,300 for the year of assessment or a proportionate amount thereof if the period of assessment is less than twelve months, liability to super tax does not arise. Since, in the year in which the trust comes into existence as a taxable *persona*, the period of assessment is less than twelve months, the rebates are proportionately reduced. In the determination of the income subject to tax in the hands of the trustee, deductions are allowed in respect of expenditure incurred in the production of the income, including administration charges, e.g. trustee's remuneration premium on fidelity bond.[57] Although the estate of a deceased person is not liable for the savings levy in respect of any income accruing to it, this exemption is not extended to any trust created under the will of a deceased person. If the trust is resident in any one of the provinces for at least ninety days during the tax year and is liable to normal or super tax, it is also liable to provincial income tax but not to personal tax which is confined only to individuals.

Where a beneficiary has a vested right to both the capital and income of a trust, he is subject to tax not only on the actual income received by him from the trust but also in respect of inadmissible expenditure laid out by the trust, e.g. donations.[58] It is submitted, however, that in a case where only the net income of a trust passes to the beneficiary and it is clear from the terms of the deed that the beneficiary has no vested right to the capital but is only entitled to receive a share of the income, he is not assessable to tax in respect of any inadmissible expenditure incurred by the trustees. The trust, it is submitted, is assessable to tax in respect of such inadmissible expenditure.

§ 70. Contingent trusts (section 9(5))

If the donor or creator of a trust has made a stipulation in any deed of donation, settlement or other disposition to the effect that the beneficiaries are not to receive the income until the happening of some event, whether the event is fixed or contingent, so much of the income as would, but for such stipulation, be received by or accrue to the beneficiaries, is, until the happening of the event or the death of the creator of the trust, whichever first takes place, deemed to be

[57] I.T.C. No. 262, 7 S.A.T.C. 141.
[58] I.T.C. No. 636, 15 S.A.T.C. 120.

the income of the donor or creator of the trust and is taxable in his hands — section 9(5).

The 'event' referred to may be the attainment of a certain age, or death[59] or marriage or it may include the exercise by the trustees of a discretionary power whether or not to pay income to the beneficiaries.[60]

The words 'or other disposition' in section 9(5) are *ejusdem generis* with 'deed of donation' and 'settlement' and they must be read as a gratuitous disposition. Consequently, a deed of partnership does not fall within the terms of section 9(5).[61]

It has been held by the Special Court[62] that section 9(5) firstly contemplates a hypothesis, viz. the existence of a stipulation that the beneficiary shall not receive the income under the deed until the happening of an event. Secondly, the subsection provides what is deemed to be the devolution until the event takes place. That devolution is back to the donor if *apart from the stipulation* it would be received by or accrue to the beneficiary concerned.

An example of where the Commissioner is entitled to invoke the provisions of section 9(5) is the case of a donor, A, who donates assets to a trustee with a direction that even though the income derived from those assets legally accrues to and vests in the beneficiary, B, he is not entitled to receive it until he reaches the age of 21. Under such circumstances, until B turns 21 or the death of A, whichever takes place first, each year's income, although accumulated by the trustee and legally accruing to B, is deemed to be the income of A, the donor, who will be chargeable to tax in respect thereof. If the stipulation that B is not to receive the income until he turns 21 were not there, it follows that B would be entitled to receive the income immediately. The Commissioner is, therefore, entitled to invoke section 9(5).

It will be observed that section 9(5) deals only with the income provisions of a deed of donation, settlement or other disposition and is not concerned with any stipulation in respect of the trust capital.

A trust deed may provide that the income has to be accumulated for beneficiaries who have no vested right in such income but who will only become entitled thereto, if and when certain events take place. Accordingly, if the stipulation is removed, it may be found that no income would be received by or accrue to the beneficiaries. It has been held by the Special Court that in such cases the provisions of section 9(5) are not applicable and that the income is assessable to tax in the hands of the trustees as representative taxpayers.[63] In terms of this decision, it would appear that section 9(5) only applies if the beneficiary has a vested right to the income (from the 'donation, settlement or other disposition') but, because of a stipulation in the

59 *Buchanan* v. *C.I.R.*, 1945 C.P.D. 173; 13 S.A.T.C. 219.
60 *Hulett* v. *C.I.R.*, 1944 N.P.D. 263; 13 S.A.T.C. 58.
61 I.T.C. No. 642, 15 S.A.T.C. 238; I.T.C. No. 551, 13 S.A.T.C. 204.
62 I.T.C. No. 673, 16 S.A.T.C. 230.
63 I.T.C. No. 775, 19 S.A.T.C. 314.

trust deed, cannot claim payment of the income until the happening of a future event. According to the facts of the case referred to, it was uncertain whether the beneficiaries would receive the income under the trust deed. The Court held that as there was no vesting of the income in any beneficiary, section 9(5) could not apply and the donor could not be taxed in respect thereof. The income was taxable in the hands of the trust. Thus, in terms of the decision, if a donor creates a trust in favour of beneficiaries and stipulates that the trustees are to accumulate the income until the beneficiaries reach majority, and there is a provision that if the beneficiaries die before reaching the age of 21, the accumulated income is to revert to other beneficiaries named in the deed, it follows that because the beneficiaries have no vested right in the income, the provisions of section 9(5) do not apply. In such circumstances, the income is not taxable in the hands of the donor but is taxable in the hands of the trust.

With the above case must be compared a later case of the Special Court (decided by the same Judge)[64] where the facts were apparently identical but where the Court was satisfied that, apart from the stipulation, the income would accrue to or be received by the respective beneficiaries and invoked the provisions of section 9(5). The Judge said that the earlier case went off on the finding that the Court was satisfied that apart from the stipulation the income did not accrue to nor was received by the beneficiary and that the position under every trust deed must be considered on its own facts. With the greatest respect, it is difficult to see how the earlier case was distinguishable from the later one since in both cases the beneficiary did not have a vested right to the income.

The writer understands that in practice the Commissioner has decided to follow the judgment in the later case and applies section 9(5) to all cases where there is a withholding of income in terms of the trust deed irrespective of whether the beneficiaries have a vested right to the income or merely a contingent right. This approach by the Commissioner is understandable. If the application of section 9(5) were to depend upon whether the beneficiaries have a vested right to the income or merely a contingent right, the door would be open to large-scale avoidance of tax since by the simple process of creating as many trusts as possible and by the provision for the accumulation of income so as to confer a contingent right on beneficiaries, a taxpayer's income may be split among a number of separate trusts, thus securing for him the benefits of a series of tax-free margins and a reduction in the progressive rate of tax. On the other hand, the present position created by the two apparently conflicting decisions of the Special Court referred to above is most unsatisfactory and, in the view of the writer, it is desirable for the Treasury to amend section 9(5) so as to create some certainty as far as the taxpayer is concerned. At the moment, the taxpayer is completely in the dark as to the correct interpretation to be placed on section 9(5),

[64] I.T.C. No. 823, 21 S.A.T.C. 77.

which is obscure in the extreme. The legislator may well consider re-enacting section 9(5) as it originally appeared in the Income Tax Act, viz.:

> 'If any person has stipulated in any deed of donation, settlement or other disposition that no beneficiary thereof shall receive the income thereunder or some portion of that income until the happening of some event, whether fixed or contingent, that income, to the extent that the right to receive all or part thereof is so withheld, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person.'

It would seem from the terms of this section that it applies whether the beneficiaries have a vested right to the income or merely a contingent right. The meaning of the original section was, therefore, clear. Any income accruing to a trust was taxable in the hands of the donor to the extent to which it was withheld from the beneficiary. If the beneficiary under the trust actually or in effect receives the income of the trust or portion of it during any tax year the donor shall not pay tax on such income or portion of it but where the trust income for the year or portion of it has not been utilized for the benefit of the beneficiary under the trust (except to accumulate it) then the income of the trust or the portion of it not utilized is deemed to be the income of the donor.

However, both the Committee of Enquiry into the Union Act and the Commission of Inquiry into the Federation Act considered that section 9(5) goes too far and that it should be restricted to the prevention of tax avoidance.

The Committee of Enquiry into the Income Tax Act[65] considered that the provisions of section 9(5) were very far-reaching and in some cases unfair in their effects. It considered that it is unreasonable to tax the donor in all cases in which there is a suspension of the enjoyment by beneficiaries of income the subject of a trust. In its opinion the reasonable course would be to provide for such income to be taxed in the hands of the donor, and not in the hands of the trustee, when there is a suspension of the enjoyment by beneficiaries of such income, only if —

> '(1) by virtue of powers conferred upon the donor or his spouse under the Trust deed, he or she is in a position in the capacity of Trustee of the property of the Trust, or otherwise, to control the ultimate devolution of funds derived from the accumulation of the income; or
>
> (2) such funds or any portion of such funds, or any property of the Trust could by any means or under any circumstances devolve upon the donor, his estate or his spouse, or become available by way of a loan or otherwise, for the use of, the donor, or his spouse.'

In regard to section 9(5) of the Income Tax Act of the Federation of Rhodesia and Nyasaland, the Commission of Inquiry held as follows:[66]

[65] *Second and Final Report*, p. 37, para. 14. Accepted by the Income Tax Commission (*First and Final Report*, p. 36, para. 70).
[66] *Report of the Commission of Inquiry*, p. 71, para. 353.

'Under section 9(5) income under a settlement which is withheld from the beneficiary is, if the other conditions mentioned in the section exist, deemed to be the income of the settlor while it is so withheld. It seems to us that it is unfair to tax the settlor merely because the beneficiaries are not entitled to immediate enjoyment of the income and that section 9(5) therefore goes too far. We consider that the settlor should be taxed only if he or his spouse may control the ultimate devolution of the accumulated income or if he, his estate or his spouse, may become entitled to the income or the accumulated income or to any part of the capital or may become entitled to borrow it. To give effect to our view and to overcome the decision in *Case No. 775*; (1953), 19 S.A.T.C. 314, we recommend that section 9(5) be redrafted as follows:

"If in any deed of gift, donation, settlement or other disposition any person has stipulated that the beneficiaries or some of them shall not receive the income or some portion of the income until the happening of some event, whether fixed or contingent, and

(*a*) if, by virtue of the powers conferred under such deed upon that person or his spouse, he or she has power to control the ultimate devolution of the income or of any funds derived from the accumulation of such income, or

(*b*) if the income or the said funds or any portion thereof or any property under the deed may devolve upon that person, his estate or his spouse or may be lent to that person or his spouse,

then the income, to the extent to which it is to be withheld from the beneficiaries, shall until the happening of that event be deemed to be the income of that person."'

There is much to be said for both recommendations set out above. Section 9(5) should be properly restricted to the prevention of tax avoidance. It cannot reasonably be said that the mere withholding of income from the beneficiaries constitutes an avoidance of tax. Where, however, a donor stipulates in a trust deed for the withholding of income and where he has the power to control the ultimate devolution of the accumulated income or to control the use of such income as effectually as if the income were his own, this would appear to be a proper case for the application of section 9(5).

In the writer's view, the recommendation of the Federation Commission is a more effective one since it attempts to overcome the conflict existing between the Special Court cases as regards the interpretation to be placed on section 9(5). The Union Committee uses words essentially similar to the present section. The Federation Commission refers to income 'to the extent to which it is to be withheld from the beneficiaries'. Both recommendations may, however, have to be tightened up so that the section can also be applied to cases where the trust income or capital may be lent to members of the donor's family or to companies controlled by him, his spouse or members of his family.

§ 71. Revocable trusts (section 9(6))

If any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income conferred by the trust deed may be revoked or conferred upon another under powers retained by the donor or creator of the trust, so much of the income as is received by or accrues to the beneficiaries is deemed to be the income of the donor or creator of the trust as long as he retains these powers — section 9(6).

It has been held that section 9(6) contemplates an express provision or clause in the deed of donation which reserves the right of the donor to revoke the right given or to confer it upon another, i.e. what is envisaged is an act of revocation depriving the donee of the subject-matter, or a transfer thereof from him to someone else.[67]

It is submitted that if no income is received by or accrues to a beneficiary, section 9(6) cannot be invoked even though a power of revocation is reserved to the donor. It would seem that section 9(6) contemplates the case of a beneficiary who has a vested right to receive income subject to a power of revocation being reserved to the donor. Thus, where a deed of donation provides for the accumulation of the trust income for the benefit of undetermined heirs or confers a discretion on trustees whether or not to distribute the income to certain beneficiaries, it is submitted that section 9(6) cannot be invoked in any year in which no income is distributed or awarded to a beneficiary.

It is also submitted that if the donor has reserved to himself in the deed of donation the right to cancel or terminate the trust this does not fall within section 9(6) as long as the donor has not reserved to himself in the deed the right to substitute another donee or to vary any of the donee's rights of participation in the income. Section 9(6) is also not applicable to a case where a donor creates a trust for a fixed period, say five years, after which period the trust terminates and the capital and income revert to the donor. Provided that the donor's right of revocation is not exercisable during the continuance of the deed of donation, section 9(6) does not apply.

Where the power to revoke is reserved to trustees of which the donor is one and it is clear that the donor cannot revoke without the authority of the remaining trustees, section 9(6) cannot be invoked.

It is not a requirement of section 9(6) that the donor must actually exercise the power of revocation reserved to him in the deed of donation. As long as the power is exercisable by him and when so exercised will result in the income being diverted to other beneficiaries or accumulated by the trustees pending the appointment of a new beneficiary, section 9(6) applies.

An example that would fall within the terms of section 9(6) is the case of a donor who donates assets in trust to trustees on condition that, although the specified beneficiary is to receive the income, the donor is entitled at any time to revoke the beneficiary's right to receive such income and is free to confer the right to receive the income on any other person. Under these circumstances, as long as the donor retains these powers, the income received by or accrued to the speci-

[67] I.T.C. No. 673, 16 S.A.T.C. 230.

fied beneficiary is deemed to be the income of the donor and the beneficiary is, therefore, relieved from tax.[68]

Like section 9(5), section 9(6) deals only with the income provisions of a deed of donation, etc., and is not concerned with any stipulations in respect of the trust capital.

The justification of a provision such as section 9(6) is usually on the lines that while a donor has the right to revoke or to confer the trust income upon another, he has not completely divested himself of all interest in the income and that the income should thus be deemed to be his for tax purposes. It is, therefore, a provision for the prevention of tax avoidance. It is interesting to compare section 9(6) with section 102 of the Australian Income Tax Act dealing with revocable trusts. In terms of the Australian provision, a donor can reserve the right to say to whom and in what proportion the income is to be distributed among the beneficiaries and as long as he does not exercise that right in his own favour, the section would not apply.

§ 72. Recovery of tax in section 9(5) and 9(6) cases

By virtue of the provisions of section 9(5) and section 9(6), a donor can, in the circumstances mentioned, be mulcted in taxation in respect of income which is neither received by him nor which accrues to him. However, section 84(*c*) provides that any person may recover so much of the tax paid by him as is due to the inclusion in his income of any income deemed to be his income in terms of section 9(5) and section 9(6) from the person entitled, whether on his own behalf or in a representative capacity, to the receipt of the income so included.

If the donor is unable to pay any tax which is due to the inclusion in his income of any income deemed to be his income in terms of section 9(5) and section 9(6), the Commissioner may recover such tax from the assets which produced the income — section 85(4).

The above provisions apply to normal and super tax but not to the provincial income tax. This omission should be rectified in the interests of both the *fiscus* and the taxpayer.

The method of recovery which the Commissioner is likely to use in practice when he recovers normal tax in terms of section 85(4) is as follows:

$$\frac{\text{Deemed income in terms of section 9(5) and (6) included in the income of the donor}}{\text{Taxable income of donor (including deemed income in terms of section 9(5) and (6))}} \times \text{Normal tax payable by donor in respect of his total taxable income (including deemed income in terms of section 9(5) and (6)).}$$

Super tax is recovered on a similar basis.

It is submitted that the above formula is also a fair basis to apply in the case of a donor who seeks to recover tax in terms of section 84(*c*). It could be strongly argued, however, particularly in

[68] See I.T.C. No. 543, 13 S.A.T.C. 118, in which the Court invoked the provisions of sec. 9(6).

a case where the inclusion of any sum in the income of a taxpayer exercises an inflatory effect upon the taxation payable on the income as a whole, that the basis of recovery by the donor should be the difference between the actual tax assessed on his income including the deemed income in terms of section 9(5) and (6), and the tax which would have been assessed had the deemed income not been included in his taxable income.[69] The basis of recovery should be clearly laid down.

§ 73. Charitable trusts created inter vivos

Opportunity is afforded to a taxpayer under the present law to create charitable trusts in such a manner that the payments to charity are payable out of the trust income and the donor is not taxable in respect thereof. The procedure is for the taxpayer to donate income-producing assets to trustees. Donations tax is not payable since section 54 *quat*(1)(*j*) provides that the tax is not payable 'in respect of the value of any property which is disposed of under a donation if such property or the income therefrom is required to be devoted wholly to purposes which the Minister of Finance is satisfied are in the interest of the public and which are of a charitable, educational or ecclesiastical nature'. It is not essential that the institutions must have a vested right to a fixed share of the income. It is sufficient if the trustee is legally obliged to pay over the income to the institutions named in the trust deed in the exercise of a discretionary power conferred upon him by the deed. As soon, however, as such discretion has been exercised, the contingent right of each institution becomes a vested one but they are not taxable on the amount of the income received since section 10(1)(*f*) provides that there shall be exempt from tax 'the receipts and accruals of all ecclesiastical, charitable and educational institutions of a public character, whether or not supported wholly or partly by grants from the public revenue'. Although the institutions have not got a vested right to the income until the exercise by the trustee of his discretion, it is submitted that section 9(6) is not applicable since it contemplates the case of a beneficiary who has a vested right to income subject to a power of revocation being reserved to the donor. From the income tax point of view, it is not essential that the institutions be named in the deed of donation. It is sufficient if the trustee is directed to make a distribution of the annual income to such institutions and in such proportions as he in his sole and absolute discretion may think fit. From the donations tax point of view, however, exemption can only be claimed if the property donated or the income therefrom is required to be devoted wholly to charitable purposes approved of by the Minister of Finance. Before the exemption can operate, the Minister's permission is essential which means that the institutions to benefit must be clearly defined so that the Minister's permission can be obtained.

[69] See *Maskalik* v. *Levitt*, 1947 (4) S.A. 321 (W); 14 S.A.T.C. 437; *Mans* v. *le Riche* (not reported in Law Reports or S.A.T.C., but see 5 (1956) *The Taxpayer* 127).

Where a donor does not wish to donate income-producing assets to a trust but desires that during his lifetime only the income from the assets should be distributed among charitable institutions in such a way that the income is not taxable in his own hands, a suitable procedure would be for him to create a trust by making a small donation of, say, £100 to the trustees. After the trust has been formed he should sell his income-producing assets to the trust at the current market price. The purchase price should be left free of interest. In the trust deed it could be provided that the annual income must be paid out to the various institutions nominated in the deed in such proportion as the trustees may think fit. Since donations tax is not material in this type of trust (the original donation being a small amount, viz. £100), it is not essential that the institutions be named in the deed. All that is required is for the trustees to be legally obliged to pay over the income to the institutions nominated by them in the exercise of a discretionary power conferred upon them by the deed. The deed should provide that on the death of the donor, the trust shall terminate and it will set out the beneficiaries entitled to the capital of the trust at the date of termination. In his will the donor could bequeath to his heirs or legatees the indebtedness due to him by virtue of the original sale of his income-producing assets to the trustees.

It must be emphasized that in the case of charitable trusts it is imperative that the annual income be distributed among the various institutions for if it is not then the Commissioner will seek to invoke the provisions of section 9(5) and to tax the donor to the extent to which the income has not been distributed. As stated earlier on, whatever amounts are distributed to the charitable institutions are exempt from income tax in terms of section 10(1)(*f*). They are also exempt from donations tax since it is provided in section 54 *quat*(1)(*l*) that donations tax is not payable 'in respect of the value of any property which is disposed of under a donation if such property is disposed of under and in pursuance of any trust'. (See also section 54 *quat*(1)(*i*) which exempts from donations tax donations in favour of charitable, educational or ecclesiastical institutions.)

It is not possible in this treatise to deal with the various methods which may be adopted for the creation of charitable trusts. Whatever procedure is followed, the essential point to remember is that the income be distributed to the charitable institutions so that it is exempt from tax in terms of section 10(1)(*f*). To the extent to which the income is withheld from distribution, it is taxable in the hands of the donor in terms of section 9(5). If the institutions have a right to receive the income but the donor has reserved to himself a power to revoke the right of any institution to receive such income or to confer it upon another institution, then the income is taxable in the hands of the donor in terms of section 9(6). If it is desired that the trust should be a revocable one, the power of revocation should not be in the hands of the donor alone. It should be in the hands of the trustees, of whom the donor may, of course, be one. Finally, the provisions of section 54 *quat*(1), which confer exemption from donations tax, must be borne in mind.

§ 74. Avoidance through a series of trusts

The introduction of a donations tax and the very far-reaching provisions of section 9(5) and (6) have gone a long way to counter widespread abuse resulting from the creation of trusts with the object of splitting the donor's income and securing the benefits of a series of tax-free margins and a reduction of the progressive rate of tax.

The donations tax provisions discourage the making of large donations to trusts. It must, however, be borne in mind that a trust may be created with a very small donation and yet earn a substantial income. For example, a taxpayer earning £10,000 per annum in dividends from public companies and paying some £2,500 in super tax can create four trusts by making a cash donation of, say, £100 to each trust. £12 donations tax is payable. After the trusts have been formed he could sell his public company shares to the four trusts so that each receives £2,000 dividends annually. He will receive the remaining £2,000 dividends. The dividends of £8,000 will accrue to the trusts and if the beneficiaries in respect of each trust are major children and have a vested and irrevocable right to the income, so that the provisions of section 9(5) and (6) are not applicable, the dividends are taxable in the hands of the children. As super tax is only payable once an income subject to super tax of £2,300 has been reached, it must follow that no taxes are payable in the future. Thus, by spending £12 on donations tax, the taxpayer is able to reduce his liability from £2,500 to nil. The illustration shows that the donations tax has not plugged all the holes. Another example where the trust device may substantially reduce the taxes payable and yet permit the taxpayer to retain control is for a grandfather to create, say, five trusts in favour of his five grandchildren, making a cash donation of, say, £100 to each. £15 donations tax is payable. The five trusts could enter into partnership to acquire a lucrative business owned by the father of the children. It is assumed that the business yields an annual net profit of £12,000 per annum. The father should sell the business to the partnership (the trusts) at a current market price. The father could manage the business on behalf of the trusts and earn, say, £2,000 by way of salary. As long as the five children have a vested and irrevocable right to the income so that the provisions of section 9(5) and (6) are not applicable, they are taxable in their own right on the net profit of £10,000. Thus, each is taxable on £2,000. The tax saving is substantial. Previously, the taxes payable by the father on an income of £12,000 were some £5,000. As a result of the trust device the income will be split among six different taxable *personae*, i.e. £2,000 is taxable in the hands of each. The aggregate tax payable by the six persons will be some £1,000 resulting in a saving of £4,000 per annum. There may be other variations of this procedure but the basic principle is to create as many trusts as will ensure that the income accruing to each is under the super tax exemption limit, i.e. £2,300. It may also not be a difficult matter for a parent to split his income among his minor children by allowing some relation, e.g. a grandfather, to create a number of trusts and thereafter selling his income-producing assets to the trusts. In this manner he may avoid the application of section 9(3), and as long as the children have a vested right to the income and the provisions of section 9(5) and 9(6) are not applicable, they are taxable thereon.

If a testator desires to create a trust for the benefit of his children, he may be saving much tax for his family on his death by the creation of a number of distinct and separate trusts in his will. For example, he may bequeath a sum in trust for his four children, the income to be accumulated after his death and to be paid out together with the capital to his children on the happening of specified events. If the beneficiaries have a community of interest in the trust estate and it is clear that a separate and distinct trust has not been created for each child, the trustee is assessable on the whole of the income. On the other hand, where it is clear from the terms of the will that the testator has created a distinct and separate trust in respect of each child, it is not competent for the Commissioner to make an assessment upon the trustee as a single taxpayer since the incomes of distinct and separate trusts cannot be amalgamated even where the same person is trustee of the different trusts. Testators would, therefore, be well advised to draw up their wills in such a way that a distinct and separate trust is created in respect of each beneficiary. This may be achieved by dividing the amount to be settled on the trustee into specific portions, each portion appertaining to a particular beneficiary. In this way it will be made clear that the will created distinct trusts in favour of the testator's children.

The above arrangements make it possible for income to be split by the creation of a number of trusts for the purpose of gaining the advantage of a series of tax-free margins. To counter the abuse resulting from the creation of a number of trusts by one person, the Committee of Enquiry into the Income Tax Act[70] recommended that where more than one trust is created, substantially all the assets of which are received from one person, class or group of persons, the income falling to be taxed in the hands of the trustee should be taxed as one trust in the hands of such one of the trustees as the Commissioner may determine. A provision along these lines should effectively counter any abuse resulting from the creation of a number of trusts.

It may also be suggested that to prevent the avoidance of tax through the creation of a series of trusts, no rebates or abatements for both normal tax or super tax purposes should be granted to a trust. This would render less attractive the creation of a series of trusts with the object of gaining the advantage of a number of tax-

[70] *Second and Final Report*, p. 38, para. 18. This recommendation was rejected by the Income Tax Commission for reasons not clear to the writer. (See *First and Final Report*, p. 37, para. 74.)

free margins. Both the Committee of Enquiry into the Union Act[71] and the Commission of Inquiry into the Federation Act[72] considered that since the normal tax rebate was granted on the grounds that it should not be paid on that portion of the income which must be spent on the bare maintenance of the taxpayer, it should not be granted to trusts who do not incur expenditure of this nature. They recommended, however, that trusts should be granted the super tax rebate, since such a rebate is not given for the reasons for which the normal tax rebate is given but to ensure that only the higher incomes are subject to the additional super tax.[73]

[71] *Second and Final Report*, p. 37, para. 16.
[72] *Report of the Commission of Inquiry*, p. 69, paras. 342 et seq.
[73] This principle was accepted by the Income Tax Commission (see *First and Final Report*, p. 37, para. 71).

CHAPTER SIX

NON-RESIDENTS AND TAX AVOIDANCE

§ 75. INTRODUCTION

The South African taxation laws generally draw no distinction as regards the method of taxation of persons resident in the Union and those persons resident overseas. There are, however, some instances where the place of residence is made the test for liability to tax. Apart from these exceptions, which are set out and considered in the ensuing paragraphs, the fact of residence in or without the Union does not determine a person's liability to South African income tax. Whether he resides in Cape Town or Timbuktu, as soon as a person receives income from a source in the Union or from a source deemed to be within the Union, such income is taxable no matter where the recipient resides. This general rule applies equally to individuals and companies.

As regards companies, the fact that they are registered or resident in some country outside the Union does not exempt them from liability to Union taxation as long as they derive income from Union sources and fall within the scope of the definition of *company* in section 1. As regards the scope of the definition and whether it is wide enough to include every company, see § 24. It is true that, in terms of section 76(1), only companies carrying on business or having an office in the Union are required to be represented by a public officer therein, but the fact that a foreign company, which does not carry on business in the Union or does not have an office in the Union, is not required to appoint a public officer, does not exonerate it from the necessity of complying with the provisions of the Act.

§ 76. INTEREST ON UNION GOVERNMENT AND LOCAL AUTHORITY STOCKS

If a person not ordinarily resident nor carrying on business in the Union receives interest on Union Government, local authority or Electricity Supply Commission stocks or securities, he is exempt from tax on such interest — section 10(1)(*h*). Both conditions have to be complied with, except that under the following circumstances a non-resident person is exempt from tax even if he carries on business in the Union, viz.:

(i) the stock or securities were issued in respect of a loan raised in a country outside the Union; and

(ii) the Treasury has, with the approval of the Minister of Finance, given an undertaking that the interest accruing to non-residents shall be exempt from Union tax; and

(iii) the stock or securities were acquired outside the Union and paid for in the currency of any country other than the Union.

There appears to be no good reason why carrying on business should be a necessary requisite before the exemption can operate. The term 'carrying on business' is considered in § 91 and it includes the letting of property. Thus, if a non-resident invests in rental-producing property in the Union he is deprived of the benefit of the exemption. In the view of the writer, this is an unreasonable restriction and if it is desired to attract and encourage non-residents to invest in this country, this restriction should be removed. It is true that non-residents can secure the benefit of the exemption by simply arranging for the rental-producing property to be transferred to a Union company in which they are the shareholders. The holding of shares in a company does not normally constitute the carrying on of a business (see § 91). It is wrong, however, that non-residents should be compelled to form companies to secure the advantage of an exemption. In any event, because of the rate of company tax in force, viz. 6*s*. per £, a non-resident may find it disadvantageous to earn income through a company. Many oversea countries grant similar exemptions to non-residents who hold their stock or securities. (See, for example, section 195 (1) of the United Kingdom Income Tax Act and section 12 (1) (*x*) of the Income Tax Act of the Federation of Rhodesia and Nyasaland.) Carrying on business is not made a necessary requisite before the exemption can operate.

A further point concerning the present section 10 (1) (*h*) is that a Union resident is able to obtain the benefit of the exemption by simply incorporating a company in South West Africa to hold his local authority and Escom stocks or securities. By making such a company not ordinarily resident nor carrying on business in the Union, the benefits of the exemption can be obtained in respect of interest on local authority and Escom stocks. Although the benefits of the exemption can also be obtained in respect of interest on Union Government stocks, it must be pointed out that the South West African company will be subject to tax in the Territory in respect of such interest having regard to the provisions of section 9 (7) of the Ordinance which provides that interest received by a person ordinarily resident or carrying on business in the Territory on stocks or securities issued by a foreign government, shall, if it is not chargeable with income tax in the country of origin by reason of the recipient not being domiciled or resident therein, be deemed to be income derived from a source within the Territory.

Union residents are not likely to take advantage of the exemption conferred by section 10 (1) (*h*) by transferring their stocks to companies incorporated and resident in the Federation of Rhodesia and Nyasaland. Section 10 (2)[1] provides *inter alia* that interest

[1] Of the Federation Income Tax Act.

received by any person ordinarily resident in the Federation by way of interest on stocks or securities, including Treasury bills, issued by the Government of any State, other than the Government of the Federation, or by any local authority or public utility body outside the Federation, shall be deemed to be income derived from a source within the Federation.

There may be other foreign countries whose taxing systems are such that Union residents, by the simple procedure of forming holding companies in such countries to hold their Government stocks, etc., can obtain exemption from tax in South Africa and also be free of tax in the foreign country in which the holding company is situated.

Where the securities are held by a married woman who is ordinarily resident or carries on business in the Union but whose husband is not ordinarily resident nor carrying on business in the Union, it is the practice not to exempt the husband under section 10(1)(*b*). The requisites of the exemption are determined with reference to the party to whom the interest accrues and not to the husband who is deemed to have received such interest under the provisions of section 9(2). Thus, if the wife who receives the interest is not ordinarily resident nor carrying on business in the Union, the exemption will be granted to the husband even though he may be ordinarily resident or carrying on business in the Union. There is no clear authority for this procedure in the Act. Having regard to the provisions of section 9(2) whereby the wife's interest is deemed to accrue to the husband, the position may well be that exemption in terms of section 10(1)(*b*) must be determined in relation to whether the husband and not the wife is not ordinarily resident nor carrying on business in the Union.

§ 77. Special classes of taxpayers

Shipping and aircraft business

Where a person, who is ordinarily resident in the Union, or where a company, which is registered, managed or controlled in the Union, carries on any business as owner or charterer of any ship or aircraft, i.e. the business of transporting by sea or by air, persons, livestock, goods or mail, or disposes of any commodity acquired in connection with the operation of such ship or aircraft, for example, whale oil, no matter where such ship or aircraft may be operated, or such disposal of the commodity may be effected, any income derived from such operations is deemed to have been derived from a source within the Union — section 9(1)(*a*)*ter*.

As regards persons not ordinarily resident in the Union or companies not registered, managed or controlled in the Union carrying on business as owners or charterers of any ship or aircraft, if they embark passengers, load livestock, mail or goods in the Union, they are deemed to have derived therefrom a taxable income equal to ten pounds for every £100 of freight received in respect of goods shipped in the Union, unless the countries in which they are resident have negotiated double taxation agreements with the Union (see § 82). This arbitrary basis for determining the taxable income does not apply if such person can render accounts which satisfactorily disclose the taxable income derived from Union sources — section 15.

Foreign film companies

Persons, other than companies, not ordinarily resident in the Union and companies which are not registered, managed nor controlled in the Union who derive income by virtue of any agreement with any person in relation to the carrying on in the Union by such person of any business of distributing, exhibiting or exploiting motion picture films, or of leasing such films to other persons, or of licensing other persons to exhibit or display such films or who derive income in relation to the acquisition of any advertising matter for use in connection with such films, are deemed to have derived by virtue of such agreement a taxable income equal to 10 per cent of the income so derived *less* any expenditure or losses (other than of a capital nature) actually incurred in the Union during the year of assessment by virtue of such agreement — section 16 *bis*.

Non-resident Banks

There shall be exempt from tax in terms of section 10(1)(v) the receipts and accruals of any bank if the Commissioner is satisfied that —

(i) it is not resident in the Union; and

(ii) it is entrusted by the Government of a Territory outside the Union with the custody of the principal foreign exchange reserves of that Territory,

and if the Minister of Finance decides to grant this exemption to the bank.

Certain companies dealing in gold bullion or shares

Section 10(1)(*u*) provides that the receipts and accruals derived by a company from the realization of assets consisting of gold bullion or shares in companies shall be exempt from tax if —

(i) such assets were acquired by the company with funds which were transferred to the Union from any foreign country by arrangement with the Treasury or with funds derived from the realization of similar assets acquired with the profits derived from any such assets or from dividends received in respect of such shares; and

(ii) the Treasury has with the approval of the Minister of Finance given an undertaking that any such receipts and accruals shall be exempt from tax.

Details of any arrangements with and any undertakings given by the Treasury must be published in the *Gazette*.

§ 78. Undistributed profits tax

In terms of section 51 (*d*), a company is exempt from the undistributed profits tax if not less than 50 per cent of its issued capital was throughout the specified period held by one or more persons not ordinarily resident nor carrying on business in the Union, or, in the case of companies, registered outside the Union and deriving the greater portion of their profits from non-Union sources. By virtue of this exemption, a non-resident who operates through a Union company maximizes his rate of tax at 6*s*. in the £. The extent to which this exemption can assist a Union company to avoid the declaration of dividends and thus save the payment of super tax by its shareholders, has been dealt with in § 33.

Attention must also be drawn to Article VII of the double taxation agreement with the United Kingdom in terms of which a company which is a resident of the United Kingdom is exempt from the undistributed profits tax if at the last day of the year of assessment residents of the United Kingdom control, directly or indirectly, more than 50 per cent of the entire voting power of the company.

§ 79. Services rendered

Services rendered in Union ships or aircraft

If an individual ordinarily resident in the Union renders services as officer or member of the crew of any ship or aircraft owned or chartered by a person resident in the Union and referred to in section 9(1) (*a*) *ter*, the remuneration received is deemed to be from a Union source notwithstanding that such services are rendered outside the Union — section 9(1) (*c*) *bis*. Individuals not ordinarily resident in the Union do not pay Union taxes on any remuneration received in similar circumstances.

Services rendered abroad for Union Government, etc.

An individual who is not ordinarily resident in the Union, and who renders services outside the Union for the Union Government, any provincial administration or local authority in the Union or the South African Tourist Corporation and whose remuneration is subject to tax in terms of section 9(1) (*c*), is exempt from Union income tax on the emoluments received provided such amount is chargeable with income tax in the country in which he is ordinarily resident, and the income tax so chargeable is borne by himself and is not paid on his behalf by the Union Government or other authority (section 10(1) (*p*)). This exemption does not extend to individuals ordinarily resident in the Union and who render the services referred to in section 9(1) (*c*) on behalf of the Union Government, etc.

Services rendered in the Union for foreign governments

An individual who is not ordinarily resident in the Union but who is stationed in the Union for the purpose of holding office here as an official of any foreign government (other than the administration of the territory of South West Africa), e.g. consuls, is exempt from tax in terms of section 10(1) (*j*) (ii) on the salary and emoluments payable to him. The exemption does not extend to individuals who are ordinarily resident in the Union and who are appointed to such posts by a foreign government.

§ 80. Donations tax

Donations tax is payable by persons, other than companies, who are ordinarily resident in the Union, and by companies which are registered, managed or controlled in the Union — section 54 *ter*. Thus, a company which is registered in the Union but resident outside the Union or a company which is resident in the Union but incorporated in a foreign country is subject to donations tax. Non-resident individuals are not liable to donations tax even though the subject-matter of the donation is property situated within the Union. On the other hand, residents are subject to the tax even if the subject-matter of the donation is property situate outside the Union.

§ 81. Savings levy

Persons (other than companies) not ordinarily resident nor carrying on business in the Union and companies not registered nor carrying on business in the Union are not liable for the savings levy portion of the normal tax and super tax — section 3 (2) (*d*) of the Income Tax Act, 1958.

Unfortunately, the law does not make it clear whether the non-resident claiming exemption from the payment of the loan levy must be not ordinarily resident nor carrying on business in the Union for the whole of the tax year, or, in the case of a company, must be not registered nor carrying on business in the Union, for the whole of the year. It may be suggested that as long as the taxpayer is not ordinarily resident nor carrying on business in the Union on the last day of the tax year, he is entitled to the exemption but it is doubtful whether this is the correct interpretation. A further possible interpretation may be that as long as the taxpayer can show that at the date when the assessment is made he is not ordinarily resident nor carrying on business in the Union, he is entitled to the exemption notwithstanding the fact that he may have been ordinarily resident or carrying on business in the Union for the whole or for the greater portion of the relevant tax year. In this respect, it may be suggested that if the Legislature intended that the taxpayer must be not ordinarily resident nor carrying on business in the Union for the whole of the tax year in order to qualify for exemption, it would have clearly said so (cf. section 51 (*d*) and (*i*)).

The Departmental attitude appears to be that as long as the taxpayer was ordinarily resident or carrying on business in the Union during any portion of the tax year he is not entitled to the exemption from the payment of the loan levy. For example, the Department has ruled that oversea actors, artists and other persons who visit the Union temporarily to exercise their calling or profession on their own account and not on behalf of an employer, must be regarded as carrying on business in the Union in respect of the period during which the income was earned. They are, therefore, liable for the savings levy in respect of the income derived from Union sources and which is subject to normal or super tax.

There is no doubt that the scope of the exemption in section 3(2)(*d*) is obscure and should be clarified.

§ 82. Double taxation agreements

The double taxation agreements which the Union Government has entered into with other Governments in order to prevent the levying of income tax twice in respect of the same income by the two Governments provide further examples of differences in the method of taxation of Union and overseas residents. A good example is contained in Article V of the agreement with the United States of America (Proclamation No. 5 of 1947) which provides that the industrial and commercial profits of an enterprise in the United States is not subject to tax in South Africa unless the enterprise is engaged in trade or business in South Africa through a permanent establishment.

If this provision did not exist, a resident in the United States might in the circumstances be subject to tax twice in respect of the same income, once in the Union and again in the United States. As consideration for this benefit, the United States Government extends a similar concession to persons resident in the Union.

The various 'shipping' agreements entered into with overseas countries, e.g. with Denmark (Proclamation No. 31 of 1951), Sweden (Proclamation No. 172 of 1951), Norway (Proclamation No. 241 of 1951), etc., provide that the Union Government will exempt all income derived from Union sources and arising from the business of sea or air transport carried on by persons resident in those foreign countries. In turn these countries will exempt Union residents engaged in the business of sea or air transport from income derived from sources in these countries.

The agreement with the United Kingdom (Proclamation No. 229 of 1946) provides further examples of how Union residents can be taxed differently from residents overseas. Article X(1) provides:

> 'An individual who is a resident of the United Kingdom shall be exempt from Union tax on profits or remuneration in respect of personal (including professional) services performed within the Union in any year of assessment if —
>
> (*a*) he is present within the Union for a period or periods not exceeding in the aggregate 183 days during that year; and
>
> (*b*) the services are performed for or on behalf of a person resident in the United Kingdom; and
>
> (*c*) the profits or remuneration are subject to United Kingdom tax.'

Article XI(1) provides:

> 'Any pension (other than a pension paid by the Government of the Union for services rendered to it in the discharge of governmental functions), and any life annuity, derived from sources within the Union by an individual who is a resident of the United Kingdom and

subject to United Kingdom tax in respect thereof, shall be exempt from Union tax.'

Articles III(1), V(2), VIII, IX and XII also exempt residents of the United Kingdom from the income specified therein which income would otherwise be taxable as being income derived from a source within the Union.

Article VII exempts companies which are residents of the United Kingdom from the undistributed profits tax subject to the compliance with certain conditions.

§ 83. Provincial taxes

An individual who is not resident in a province for at least ninety consecutive days in a tax year, is exempt from the payment of all provincial taxes, i.e. personal tax and provincial income tax. Oversea residents are, therefore, not subject to the provincial taxes if they are not resident in a province for at least ninety days. When they are so resident, for example in the case of temporary visits by overseas radio artists, they become subject to the provincial taxes irrespective of the fact that they are ordinarily resident oversea. On the other hand, individuals resident in the Union are subject to the provincial taxes unless they can show that during a particular tax year they have not been resident in any of the four provinces for at least ninety consecutive days.

Non-residents who happen to be on holiday in the Union and who overstay the period of ninety consecutive days in any of the four provinces can involve themselves in a heavy liability for provincial tax. The following table indicates the extent of the provincial tax liability in the Cape Province in the case of a married person.

Taxable Income	*Provincial Taxes Payable*
£2,000	£43
£4,000	£180
£6,000	£365
£8,000	£585

The effect of the law is such that non-residents, if they wish to avoid the tax, must see to it that their period of stay in any one province during the particular year of assessment does not exceed ninety days. If their stay is approaching the ninety-day period, from the tax point of view it would certainly pay them to enjoy the balance of their vacation in another province where they are entitled to live for another period of ninety days before attracting liability for the provincial taxes.

Union residents are effectively able to avoid payment of the provincial taxes by simply moving from province to province during a tax year and by ensuring that their stay in any one province during the year is less than ninety days. For example, it could be arranged that eighty-nine days be spent in each of the four provinces and the remaining nine days in, say, South West Africa or Rhodesia or the Native Territories. If a Cape resident proceeds towards the end of September, 1958, on an overseas trip for, say, six months and returns early in April, 1959, by spending the last period of the tax year in another province he can avoid payment of the provincial tax since he would not have been resident for ninety consecutive days in any one of the provinces during the year of assessment.

The absurdity of the present rule can also be illustrated in the case of a resident who, having spent eighty-nine days' residence in one province, leaves on nine months' holiday overseas hoping to return to the Union on 1st July of the next tax year. It was hoped that this arrangement would free the taxpayer from provincial tax for that particular tax year. Supposing that the ship on which the taxpayer was due to arrive on 1st July, by making a faster voyage than expected, arrived in South Africa on 30th June, the taxpayer would lose the exemption that he would otherwise have enjoyed through no intentional act of his own but possibly due to a favourable wind.

In this respect, the rules set out in the Territorial Surcharges Act (section 4) of the Federation of Rhodesia and Nyasaland for the determination of any question as to the Territory in which a taxpayer is to be regarded as resident for the purpose of the Territorial Surcharge, may usefully be adopted in the Union for the purpose of provincial tax. These rules may be summarized as follows:

(1) A person who has resided during the whole or any portion of the year of assessment in one province and no other must be treated as resident in that province for that year of assessment;

(2) if, during the whole or any portion of the year of assessment, a person has been resident in two or more of the provinces, he must be treated as having been resident in the province in which he lived for the greater or greatest number of days in the aggregate as the case may be and in no other province;

(3) if this aggregate period of residence is the same for two or more of the provinces, the taxpayer must be treated as having been resident in that province in which he last lived during the year of assessment;

(4) if the Commissioner is satisfied that a person maintained his usual home in one province during the whole or any portion of the year of assessment, any period during which such person was temporarily resident in another province must be treated as a period of residence in the province in which he so maintained his usual home.

The adoption of the above rules will remove the present anomalies in regard to the provincial tax.

The test of ninety consecutive days' stay in a province is not a satisfactory one and should be replaced by the requisite that a taxpayer must be resident in a province before attracting liability to the provincial taxes. A person should not be regarded as resident in a province if when he visits such province, he does so for a temporary purpose only and with no intent of establishing a residence there.

§ 84. Non-resident shareholders' tax on company dividends

Individuals not ordinarily resident nor carrying on business in the Union are exempt from super tax on dividends received from Union souces — section 30(1)(*a*). Both conditions must be complied with. Thus, if a person not ordinarily resident in the Union carries on business in the Union, he is subject to super tax on dividends derived from Union sources.

A person not ordinarily resident in the Union is not subject to super tax on any dividends derived from sources outside the Union even though he carries on business in the Union — section 7(*g*)*bis*.

The non-resident shareholders' tax, which is charged in terms of section 41, has primarily been imposed to provide a mode of tax recovery from non-resident individuals whose dividend income is exempt from super tax in terms of section 30(1)(*a*).

The tax is charged at a flat rate, namely 7½ per cent on the income liable to the tax.

Income liable to non-resident shareholders' tax

The income liable to non-resident shareholders' tax is set out in section 42 and comprises in the main dividends distributed by companies to non-resident shareholders. In addition, the income of certain private companies is also liable to the tax.

'Dividend' must be given the meaning it bears in section 1. It includes a distribution of bonus shares unless such bonus shares are specifically excluded (see § 44).

The non-resident shareholders' tax is paid in respect of the following dividends:

(1) Dividends paid or payable by a public company to a person, other than a company, not ordinarily resident nor carrying on business in the Union — section 42(*a*)(1). If A Ltd., a Union public company, declares a dividend of £1,000 in favour of X who is not ordinarily resident nor carrying on business in the Union, he is liable to non-resident shareholders' tax of £75 (7½ per cent on £1,000). Both conditions must be complied with. Thus, if X carries on business in the Union, liability for non-resident shareholders' tax cannot arise but, as stated before, he is subject to super tax in respect of the dividend if it is from a Union source.

It is difficult to understand why carrying on business in the Union or not should determine whether a non-resident is liable to super tax or not on company dividends. In § 91 the meaning of 'carrying on business' is considered. It includes the letting of property. Thus, if a non-resident invests in rental-producing property in the Union, he is liable to super tax on dividends from Union sources. This is an unreasonable restriction which in the writer's view should be removed. To secure exemption from super tax on company dividends, non-residents are discouraged from carrying on any business in the Union. It is true that they can carry on business through a company in the Union and thus avoid being classed as carrying on business in the Union. But the formation of a company is not always of advantage to a non-Union resident. For example, the rate of company tax, being 6*s*. per £ of taxable income, may be greater than the personal rate of tax of the non-resident. Then again, residents of the United Kingdom may prefer to own immovable property situated in the Union in their own name since under the estate duty law in force in the United Kingdom landed property situated outside the United Kingdom does not form part of the dutiable estate of a resident of the United Kingdom. On the other hand, the value of shares in a Union company which owns the immovable property in the Union forms part of the dutiable estate. A non-Union resident with a large dividend income from Union sources will, because of the incidence of super tax, be very reluctant to invest in immovable property in the Union. If the estate duty advantage in the United Kingdom is very significant he may be tempted to invest in landed property in another country, e.g. Rhodesia or South West Africa.

It is to be observed that liability under section 42(*a*)(1) arises in the case of 'a person other than a company'. This includes artificial entities such as estates and trusts not ordinarily resident nor carrying on business in the Union. However, the exemption from super tax on dividends in terms of section 30(1)(*a*) applies only to 'an individual not ordinarily resident nor carrying on business in the Union'. It would seem, therefore, that an estate or trust not ordinarily resident nor carrying on business in the Union is subject to both super tax and non-resident shareholders' tax in respect of dividends accruing from Union sources. This anomaly should be rectified.

(2) Dividends paid or payable by a public company to any other company not registered nor carrying on business in the Union — section 42(*a*)(2). Thus, if X Ltd., a Union public company, declares a dividend in favour of Y (Pty.) Ltd., a private company, and W Ltd., a public company, both companies not being registered nor carrying on business in the Union, Y (Pty.) Ltd. and W Ltd. would be liable to 7½ per cent non-resident shareholders' tax on the dividends accruing to them. The recipient company must comply with both requirements, i.e. it must not be registered in the Union and it must not carry on business in the Union. It is submitted that a foreign company which in terms of section 201 of the Companies Act (Act 46 of 1926) is required to lodge certain documents with the Registrar of Companies cannot be regarded as registered in the Union for the purposes of section 42(*a*)(2), and provided that it does not carry on business in the Union, it is liable for the tax.

If the company carries on business in the Union, for example if it purchases a rental-producing property, it can avoid the payment of non-resident shareholders' tax and since the dividends will not be subject to any other Union taxes, no taxes are payable in respect of such dividends. Here again it is difficult to understand why carrying on business in the Union or not should determine freedom from or liability to tax. Tax can be so easily avoided by simply arranging for the foreign company to carry on some business in the Union. Thus, a foreign company earning annually, say, £100,000 dividends from public companies in the Union in respect of which the non-resident shareholders' tax would ordinarily amount to £7,500 each year, can avoid this liability by carrying on some business in the Union no matter how small the business. In the view of the writer, there appears to be no good reason why the tax should not be levied on dividends paid or payable by a public company to any other company not registered nor managed nor controlled in the Union. It may be easy for a foreign company to arrange the carrying on of a business in the Union to avoid tax but it is not so easy for it to transfer its central management and control to the Union.

(3) Dividends paid or payable by a public company to the holder of bearer scrip, irrespective of whether he is resident in or outside the Union — section 42(*a*)(3). The effect of this provision is that a Union resident who owns bearer shares in a Union public company is liable to non-resident shareholders' tax as well as super tax on any dividends received on such shares. This anomaly should be rectified.

(4) Dividends paid or payable by a private company to a person, other than a company, not ordinarily resident nor carrying on business in the Union — section 42(*a*)*bis*.

It is clear from the provisions of section 42(*a*)*bis* that the tax is not paid in respect of dividends distributed by private companies to any other company not registered nor carrying on business in the Union. A private company with foreign companies as its shareholders is liable to the non-resident shareholders' tax on the amount of its income subject to super tax which is apportioned to its foreign company shareholders. Thus, if any dividends distributed by the private company to its foreign company shareholders were to be liable for non-resident shareholders' tax, double taxation would arise — hence the exclusion of companies in section 42(*a*)*bis*.

The non-resident shareholders' tax is paid on the amount of the dividend declared. Thus, expenditure incurred in the production of dividends, e.g. interest on money borrowed to acquire the shares, commission, etc., is not an admissible deduction from dividends subject to non-resident shareholders' tax.

It is specifically provided in section 42 that the non-resident shareholders' tax is payable on the 'amount of any dividend which has been declared by any private company on or after the first day of July, 1951', and in terms of an express provision (proviso (ii) to section 42) the liability embraces any dividend 'distributed by a company out of, or by way of the capitalization of, the profits of that company which had previously been apportioned among its shareholders in terms of section 37 as the taxable income or income subject to super tax of that company'. In the result, therefore, it will not avail a non-resident shareholder whose dividend is subject to the non-resident shareholders' tax to claim that the profits out of which the dividend has been distributed had previously been apportioned to him in terms of section 37. In terms of the clear wording of the Act, he will be unable to dispute liability on the grounds that normal tax or super tax or non-resident shareholders' tax has already been paid by him on the income out of which the dividend, which now bears non-resident shareholders' tax, has been distributed.[1a]

Dividends distributed out of profits derived from non-Union sources

Section 42 does not lay down that the tax is payable only in respect of dividends derived from Union sources and it would seem that dividends from whatever source may be liable to the tax. Section 46, however, provides that a dividend is liable to the tax only to the extent to which it has been distributed out of profits derived from a Union source. The test of liability to non-resident shareholders' tax is, therefore, not the source of the dividend but the source of the profits out of which the dividend has been paid. Thus, a dividend distributed by a company incorporated in Canada is liable to non-resident shareholders' tax if it has been paid out of profits derived from Union sources. Where such a company is outside the jurisdiction of the Union courts, the Commissioner may be faced with difficulties in the recovery of the tax due. Conversely, a dividend distributed by a company incorporated in South Africa is completely free of the tax if it has been paid out of profits derived wholly from sources outside the Union.

Where a company derives income from a source in and outside the Union, and declares dividends to non-resident shareholders, the non-resident shareholders' tax is payable on an amount determined in accordance with the provisions of section 46, viz.:

Taxable proportion of dividend =

$$\text{Total dividend received} \times \frac{\text{Union net profits of company}}{\text{Total net profits from all sources.}}$$

The net profits are those as last determined by the Commissioner, or, in cases in which there has been no previous determination, as estimated by him according to such information as is available to him.

If M Ltd., a Union company, carries on business in and outside the Union and X, an individual, not ordinarily resident nor carrying on business within the Union, receives a dividend of £500 from the company, X would pay non-resident shareholders' tax on an amount determined thus (assuming that the last determination by the Commissioner revealed that the company's Union net profits amounted to £5,000 and the total net profits from all sources were £10,000):

[1a] I.T.C. No. 778, 19 S.A.T.C. 323.

$$£500 \times \frac{£5{,}000}{£10{,}000} = £250$$

Therefore TAX PAYABLE (7½% of £250) £18 15 0

In terms of Article VI(1)(*b*) of the Double Tax Agreement with the United Kingdom, any dividend paid by a company which is a resident of the United Kingdom, is exempt from the non-resident shareholders' tax. Thus, if a company, which is a resident of the United Kingdom, derives income from Union sources, any dividend that it pays to non-resident shareholders falls outside the provisions of section 46 and is not subject to the non-resident shareholders' tax.

Shareholder liable to non-resident shareholders' tax

The shareholder liable to the tax is the person to whom the dividend accrues as at the date of declaration of the dividend. However, if some date other than the date of declaration of the dividend is specified as the date at which a shareholder is required to be registered to be entitled to the dividend, the shareholder liable to the tax is the person to whom the dividend accrues as at such other date — proviso (i) to section 42.

'Shareholder', it is submitted, must be given the meaning assigned to it in section 33(4), and includes not only the registered shareholder but also any other person who has the right to participate in the income attaching to the shares. A person who is not the legal owner of shares but is entitled to the dividends derived therefrom, e.g. a beneficiary under a trust, is a shareholder within the meaning of the definition,[2] and if such person is not ordinarily resident nor carrying on business in the Union, it is submitted that liability to non-resident shareholders' tax arises even though such person has no vested right in the shares but has merely a contingent right or has no right at all in the shares. In the writer's view this principle also applies to a non-resident deriving an annuity paid from company dividends accruing to a Union trust or estate notwithstanding that such annuity is not exempt from normal tax in terms of the proviso to section 10(1). Although the annuity is subject to normal tax, it is, in the writer's view, exempt from super tax in terms of section 30(1)(*a*), but it is submitted that liability for non-resident shareholders' tax arises in terms of section 42. The writer understands that it is the practice of the Department to subject the annuity to both normal tax and super tax in the hands of the non-resident and not to levy the non-resident shareholders' tax.

Exemptions from non-resident shareholders' tax

The following dividends are exempt from the payment of the non-resident shareholders' tax in terms of section 48:

[2] *Bell's Trust* v. *C.I.R.*, 1948 (3) S.A. 480 (A.D.); 15 S.A.T.C. 255.

(i) Dividends declared by companies registered under the Co-operative Societies Act, 1939.

(ii) Dividends declared by insurance companies subject to assessment in terms of the First Schedule to the Act.

(iii) Dividends declared by public utility companies established by Act of Parliament.

(iv) Dividends declared by companies operating ships or aircraft and which are assessed in terms of section 15.

Walvis Bay residents

Although Walvis Bay is legally part of the Union, for administrative purposes it falls within the Territory of South West Africa. It is submitted that by virtue of section 43 of the South West Africa Constitution Act of 1925, it is not part of the Union for the purposes of the Income Tax Act. However, in terms of the present practice, persons who are ordinarily resident in Walvis Bay and who are not carrying on business in the Union are not liable for non-resident shareholders' tax in respect of company dividends. The Department apparently regards such persons as being ordinarily resident in the Union for the purposes of non-resident shareholders' tax. Residents of Walvis Bay are, therefore, in a singularly fortunate position as compared with other non-residents who are liable to non-resident shareholders' tax on dividends from Union companies. South West African companies which are resident in Walvis Bay are also exempt from non-resident shareholders' tax in respect of dividends received from Union public companies. Companies operating in the Territory may, therefore, avoid Union non-resident shareholders' tax by taking up residence in Walvis Bay.

It is doubtful whether the Commissioner's practice is correct. Section 43 of the South West African Constitution Act (an Act of the Union Parliament — No. 42 of 1925) provides as follows:

> 'Notwithstanding anything to the contrary contained in any law, the port and settlement of Walvis Bay shall be deemed to form part of the territory for the purposes of this Act.'

The purposes of the Act are to provide for the constitution of a Legislative Assembly, Executive Committee and Advisory Council, to define the powers of the various bodies and to make other provisions in respect of the administration of and legislation for that territory. The result of the deeming provision of section 43 is, therefore, to make Walvis Bay an integral part of South West Africa for legislative, fiscal and administrative purposes, which means that a resident of Walvis Bay cannot be regarded as a resident of the Union for tax purposes.

If the Departmental practice is correct, it must logically follow that a resident of Walvis Bay is subject to super tax on dividends received from all sources. On the same reasoning, he is subject to donations tax. It is submitted that this is not the effect of the law.

Husband and wife

Where shares are held by a married woman, liability for non-resident shareholders' tax is, in practice, dependent upon whether or not she and *not* her husband is ordinarily resident or carrying on business in the Union. If she is not ordinarily resident nor carrying on business in the Union, the tax is payable even though her husband may be ordinarily resident or carrying on business in the Union. In such circumstances the husband is not subject to super tax in respect of the dividends having regard to the exemption contained in section 30(1)(*a*). If the wife is ordinarily resident or carrying on business in the Union, the non-resident shareholders' tax is not payable even though the husband is not ordinarily resident nor carrying on business in the Union. In this event, however, the dividends will be subject to super tax in the hands of the husband since the exemption in section 30(1)(*a*) does not apply — the recipient of the dividends being ordinarily resident or carrying on business in the Union. There is no clear authority for this procedure in the Act. Section 9(2) provides that the income of a wife 'shall be deemed for the purposes of this Act to be income accrued to her husband'. The position may, therefore, well be that as a wife's dividends are deemed to be the husband's, the exemption from super tax in section 30(1)(*a*) and the liability for non-resident shareholders' tax must be determined in relation to whether the husband and not the wife is ordinarily resident or carrying on business in the Union.

Payment of non-resident shareholders' tax

With regard to dividends liable to the tax, the company paying the dividend is responsible for the payment of the tax where the address of the shareholder concerned appears in the share register of the company as being outside the Union — section 44(*a*). Where such dividends are received by an agent in the Union on behalf of the non-resident shareholder, the agent is responsible for the tax. A person shall be deemed to be the agent of a shareholder and shall be deemed to have received a dividend on behalf of that shareholder if that person's address appears in the share register of the company as the registered address of the shareholder and the dividend warrant or cheque in payment of the dividend is delivered at that address — section 44(*b*). In terms of section 43 and the proviso to section 44, the company or the agent may recover the tax payable from the oversea shareholder concerned. In practice, the company or the agent deducts the amount of the tax from the dividend declared and remits the net amount to the shareholder. Thereafter they must account to the Commissioner, in terms of section 47, for the amount of the tax that is due. In terms of section 47(4), the Commissioner can recover direct from the shareholder any tax which has not been paid by the due date.

In the case of a dividend distributed by any company, payment must be made within thirty days, or such further period as may be allowed, of the date on which the dividend is payable. When making payment, the company is required to furnish a return showing the names and addresses of the shareholders to whom the dividend accrues, with the amount in each case — section 47(1). Where the dividend is received by an agent in the Union on behalf of the non-resident shareholder, the agent is required within thirty days of the date of receipt of the dividend, or such further period as may be approved by the Commissioner, to pay the tax, at the same time furnishing a return showing the amount of the dividend and the name and address of the person to whom it has accrued — section 47(2).

It may happen that a shareholder, who is ordinarily resident or carrying on business in the Union, is registered in the books of a company under a non-Union address in which event any dividend that is distributed to him is subject to a deduction in respect of non-resident shareholders' tax. In such circumstances, application for a refund of the tax deducted must be made to the Commissioner. It may also happen that a registered shareholder is not the beneficial shareholder so that if the registered shareholder is not ordinarily resident in the Union but the beneficial shareholder is resident in the Union, the tax would have been incorrectly deducted. In such cases, once the beneficial shareholder proves to the Commissioner that he is either ordinarily resident or carrying on business in the Union, a refund will be made of the non-resident shareholders' tax deducted. In all cases where there is no liability for the tax but the paying company or Union agent by mistake or in ignorance of the residence status of the shareholder deducts the tax from a dividend, the appropriate remedy is by way of application to the Commissioner for a refund.

§ 85. NON-RESIDENT SHAREHOLDERS' TAX PAYABLE BY PRIVATE COMPANIES

Levy of non-resident shareholders' tax on private companies

Section 42(*e*) read with section 37 *bis* provides for the imposition of a non-resident shareholders' tax of 7½ per cent on the income subject to super tax of a private company registered or carrying on business in the Union and whose income is apportioned to any company not registered nor carrying on business in the Union.

Foreign companies which receive dividends from Union public companies are liable for the non-resident shareholders' tax thereon. This is not so in the case of foreign companies which hold shares in Union private companies since it is the Union private company itself which is liable for the non-resident shareholders' tax on its income that is apportioned to the foreign company.

It is to be observed that the private company from which the apportionment is made must be registered *or* carrying on business in the Union whereas the foreign company to which the apportionment is made must be not registered *nor* carrying on business in the Union. Thus, the provisions do not apply to a foreign company registered outside the Union but which carries on business in the Union. It is submitted that a foreign company which in terms of section 201 of the Companies Act (Act 46 of 1926) is required to lodge certain documents with the Registrar of Companies cannot be regarded as registered in the Union for the purposes of section 42 (*e*) and section 37 *bis*.

The Union private company is liable for the non-resident shareholders' tax and cannot recover it from the foreign company concerned. This imposes a distinct hardship on co-shareholders who indirectly have to bear their proportionate shares of the non-resident shareholders' tax payable by the company, and, if they are individuals resident in the Union, have also to pay super tax on dividends received from the company, and, if non-resident individuals, have to pay non-resident shareholders' tax on dividends received from the Union private company. The Commissioner raises the assessment on the public officer of the company who is required to make payment within thirty days of the date of such assessment — section 47 (3).

Apportionable income

Section 37 *bis* provides that for each year of assessment, the Commissioner must determine the 'apportionable income' of every private company which is registered or carries on business in the Union and in which any company not registered nor carrying on business in the Union is interested directly as a shareholder in such first-named company, or indirectly as a shareholder in another private company which is registered or carries on business in the Union. It is, therefore, clear that it is only necessary to determine the 'apportionable income' of a private company which is registered or carries on business in the Union, any of the shares in which are held by any company not registered nor carrying on business in the Union, or any of the shares in which are held by any private company which is registered or carries on business in the Union, and in which last-mentioned private company any of the shares are held by any other company not registered nor carrying on business in the Union.

The 'apportionable income' of the private company is defined to be the sum of —

(*a*) the income subject to super tax of that company for the year of assessment but excluding any dividends received from any other private company registered or carrying on business in the Union; and

(*b*) any amount apportioned to the company out of the apportionable income of another private company.

The determination of a company's income subject to super tax is, therefore, important from the point of view of liability to non-resident shareholders' tax in terms of section 42 (*e*). It is determined in the same manner as an individual (see § 170) except that dividends from sources outside the Union are not included since the proviso to section 7 (*g*) *bis* includes within the gross income of a taxpayer 'all dividends from sources outside the Union received by or accrued to any person (other than a company) who is ordinarily resident in the Union'. If the company has an assessed loss, it is the practice of the Department to set off such loss to the extent that may be necessary to reduce the income subject to super tax to zero, in terms of section 28 (*b*). The amount so set off is included in the company's income subject to super tax in the next year, in terms of section 27 (*c*). It would appear that for this purpose the Department reads the proviso to section 28 (*b*) as if the words 'super tax' were non-resident shareholders' tax. The practice is clearly equitable but the law should embody it.

Method of apportionment

The apportionable income determined in the above manner is apportioned by the Commissioner among those persons who were shareholders of such company on the specified date according to the rights of each such shareholder to participate in the profits or income of the company as determined in terms of section 36. Such apportionment takes place only for the purposes of non-resident shareholders' tax and does not form part of the taxable income or income subject to super tax of any shareholder. The apportionable income so apportioned to any company not registered nor carrying on business in the Union is then subject to the non-resident shareholders' tax in the hands of the Union private company, in terms of section 42 (*e*), which reads:

> 'The non-resident shareholders' tax shall be paid in respect of so much of the income subject to super tax of any private company registered or carrying on business in the Union as is, in respect of any year of assessment, commencing with that ending on the thirtieth day of June, 1952, apportioned by virtue of the provisions of sub-section (1) of section *thirty-seven bis* (directly through the apportionment of the apportionable income of that company or indirectly through the apportionment of the apportionable income of another private company registered or carrying on business in the Union) to any company not registered nor carrying on business in the Union.'

If there is more than one private company involved, the apportionable income is subject to the tax in the hands of the Union companies according to the extent to which the income subject to super tax of each company is contained in the apportionable income apportioned to the foreign company. Thus, where there is a chain of Union private companies and a foreign company which is the ultimate beneficial shareholder of the group, it is necessary, in terms of section 37 *bis*, to ascertain the apportionable income of each Union private company in the group. Such apportionable income must then be apportioned from company to company until it is finally apportioned to the foreign company. Although the apportionable income is apportioned from the last Union private company in the chain to the foreign company, it does not follow that the former company is the one which bears the non-resident shareholders' tax liability. Section 42 (*e*) clearly provides that it is 'so much of the income subject to super tax of any private company registered or carrying on business in the Union . . .' and not the apportionable income of such private company that is liable for the tax. Consequently, in the case of a chain of Union private companies, the tax is not paid on the apportionable income of each company but on so much of the apportionable income as consists of the company's income subject to super tax that is apportioned to the foreign company, whether directly or indirectly.

Before an apportionment of the apportionable income of a Union private company can take place to a company not registered nor carrying on business in the Union, such latter company must be a shareholder on the specified date. *Specified date* is defined in section 33 (4). Where the company's accounts close on 30th June, this date is the specified date. If the company makes up its accounts to 31st December and the Commissioner agrees to this procedure in terms of the proviso to section 55 (13), 31st December is the specified date. In the case of any company which has been required to furnish interim accounts in terms of section 55 (4), the date up to which such returns have been rendered is the specified date.

Shareholder is defined in section 33 (4), and, in terms of the definition, the registered shareholder is always a shareholder within the meaning of that definition, and where some person other than the registered shareholder is entitled to all or part of the benefit of the rights of participation in the profits or income attaching to the shares, such other person is also deemed to be a shareholder. Thus, where A is the registered shareholder, but is a mere nominee for B, who is the real owner, both A and B are shareholders within the meaning of the definition. In terms of the definition, it would seem that there can be two or more shareholders in respect of the same share at a given time.

Determination of shareholders' rights to participate in profits

Once a foreign company is a shareholder on the specified date, the next step is to determine its rights to participate directly or indirectly, immediately or at a future date, in the profits or income of the Union private company, whether they have been distributed in whole or in part or have been wholly undistributed. In making such determination the Commissioner must have regard *inter alia* to —

(*a*) the provisions of the company's memorandum and articles of association and amendments thereto;

(*b*) the purposes of the company's incorporation;

(*c*) any special circumstances affecting its operations;

(*d*) the terms of any agreement or contract between a registered shareholder and the company or any other person; and

(*e*) any facts affecting such determination which he may have ascertained.

Thus, where A and B are shareholders by virtue of A being the registered shareholder and B the beneficial shareholder, the Commissioner must then determine the extent of the rights of each in terms of section 36. Applying the section he will find that A has no right whatsoever to participate in the profits or income of the company whereas the rights are vested in B.

The provisions of section 36(2) must also be borne in mind, viz.:

> 'If any shareholder in any company is vested with rights or powers exceeding those of other shareholders in that company, the Commissioner may determine that such shareholder was entitled to the profits or income of the company for the year of assessment in question, to the exclusion of such other shareholders, except to the extent to which such other shareholders have participated by way of dividend in the said profits or income, unless it is shown to the satisfaction of the Commissioner that the said rights or powers have not been exercised in that year of assessment.'

The decision of the Commissioner in making the determination under section 36 is subject to objection and appeal — section 40.

If the foreign company has sold its shares before the specified date, it is no longer a shareholder, and therefore no apportionment can be made to it even though it may have been a shareholder for the greater part of the tax year and notwithstanding that it may have received practically all of the company's profits by way of dividend during such year.[3] Thus, the apportionable income must be apportioned to the foreign companies which were shareholders on the specified date irrespective of the period of time that they may have been shareholders during the period of assessment in question. On this principle, if a foreign company became a shareholder on the last day of the year of assessment, its share of the apportionable income of the Union private company for that year must be apportioned to it and not merely a proportionate part depending upon the period of time that it was a shareholder during the tax year under consideration.[4]

Exemption — Convention with the United Kingdom

Article VI(1)(*a*) of the Double Taxation Agreement with the United Kingdom provides:

> 'There shall be exempt from the Union Non-resident Shareholders' Tax any amount in respect of which the person chargeable with such tax is a company, if the amount so chargeable represents the whole or a portion of the taxable income of a private company which, under the law of the Union relating to the taxation of the income of private companies, is apportionable (either directly or through another private company) to a public company which is a resident of the United Kingdom.'

It is submitted that Article VI(1)(*a*) applies to the provisions of section 37 *bis* read with section 42(*e*) so that if the apportionable income of a private company which is registered or carrying on business in the Union is apportioned to a public company which is a resident of the United Kingdom, the non-resident shareholders' tax

[3] *Bell's Trust* v. *C.I.R.*, 1948 (3) S.A. 480 (A.D.); 15 S.A.T.C. 255.
[4] See also I.T.C. No. 653, 15 S.A.T.C. 378; I.T.C. No. 540, 13 S.A.T.C. 110.

is only payable on such part of the apportioned income as represents public company dividends and is not payable on the taxable income of the company which is apportioned to the United Kingdom public company.

'Public company' for the purposes of Article VI(1)(*a*) bears the meaning assigned to this term in section 33(2).[6] Thus, if the company to whom the income is apportioned is a public company and is resident in the United Kingdom, Article VI(1)(*a*) provides exemption from non-resident shareholders' tax in respect of the income subject to super tax of the Union private company apportioned to it which consists of taxable income. On the other hand, if the company to whom the income is apportioned is a private company, resident in the United Kingdom, Article VI(1)(*a*) does not apply which means that the Union private company will be liable to non-resident shareholders' tax on the income subject to super tax apportioned to the United Kingdom private company. The distinction between private and public companies as set out in section 33 of the Act becomes, therefore, of importance in applying the exemption contained in Article VI(1)(*a*). (See *infra.*)

Distinction between public and private companies

Only *private companies* registered or carrying on business in the Union can be liable for the non-resident shareholders' tax in terms of section 42(*e*). The distinction between private and public companies is, in this respect, important. Other instances of where the distinction is of importance are in regard to the undistributed profits tax. Public companies are entitled to the 40 per cent 'plough-back' allowance in respect of dividend income if their total net profits have been derived solely or mainly from dividends (see § 25). They are also entitled to the benefit of the section 51(*f*) exemption (see § 30) even though their total net profits are derived solely or mainly from dividends. The distinction may also be of importance in regard to the taxability of bonus shares (see § 44).

There is no definition of *private company* in the Act but section 33(3) provides that a company which at the specified date is not recognized as a public company must be recognized as a private company.

In terms of section 33(2), the following companies are recognized as public companies:

(*a*) Any company all classes of whose shares are publicly quoted on the specified date by a stock exchange in the list issued under its authority. The Commissioner must be satisfied that —

  (i) the stock exchange is a recognized and *bona fide* stock exchange under adequate control; and

  (ii) the rules and regulations of the stock exchange for granting and continuing a quotation for the purchase and sale of

[6] I.T.C. No. 789, 19 S.A.T.C. 434.

shares provide for full protection of the interests of the public in regard to dealing in the shares of the company; and

(iii) the memorandum and articles of association of the company contain no such restriction on the right to acquire or transfer any of its shares as are likely to preclude members of the general public from becoming shareholders in any class of the company's shares; and

(iv) the general public is substantially interested as shareholders in every class of the shares issued by the company; or

(*b*) any other company, not being a private company as defined in section *one hundred and four* of the Companies Act, 1926, in respect of which the Commissioner is satisfied that —

(i) the general public is substantially interested as shareholders in every class of the shares issued by the company; and

(ii) the business of the company is conducted and its profits are distributed in such a manner that no person enjoys or receives or is entitled to enjoy or receive, by reason of shareholding, participation in the management or otherwise, any advantage which would not be enjoyed or received by him if the company had been under the control of a board of directors acting in the best interests of all its shareholders and had been one which could have been recognized as a public company under paragraph (*a*); or

(*c*) any company which the Commissioner is satisfied was incorporated to serve a specified purpose, beneficial to the public or a section of the public, if under the constitution of the company no shareholder is entitled to participate in the profits or income of the company to an extent greater than seven per cent on the nominal value of his shareholding; or

(*d*) any society or company registered under the Co-operative Societies Act, 1939 (Act No. 29 of 1939); or

(*e*) any insurance society or company subject to assessment in terms of the First Schedule to the Act; or

(*f*) any public utility company established by or under a special Act of Parliament; or

(*g*) any company, the sole or principal business of which in the Union is mining for gold or diamonds; or

(*h*) any company to which the provisions of section 15 apply, i.e. companies which are owners or charterers of ships or aircraft and which are not registered, managed or controlled in the Union (see § 77).

The distinction between public and private companies, under section 33, is entirely different from that in the Companies Act, 1926. Generally speaking, in terms of the Income Tax Act, any company, all classes of whose shares are quoted on a stock exchange, such as the Johannesburg or London Stock Exchanges, or any company in all classes of whose shares the general public is substantially interested, is recognized as a public company for tax purposes.

For a consideration of the meaning to be attached to the words 'the general public is substantially interested', in paragraphs (*a*) and (*b*) of section 33 (2), the following cases may prove helpful: *National Trading Co., Ltd.* v. *C.I.R.*,[7] and *Searles, Ltd.* v. *C.I.R.*[8] In *Searles'* case Fisher, J.P., held: 'Now *substantially* may mean *predominant* but I am of the opinion that its more usual meaning with reference to an interest and the one here intended is *not illusory* or *not nominal*. In other words, it has reference to an interest that has some substance in it. One is strengthened in this view by the Appellate Division judgment (*National Trading Co., Ltd.* v. *C.I.R.*,[7] 1943 A.D. 496; 12 S.A.T.C. 171) where the interest was held to be substantial though admittedly devoid of the power of conferring control. Then, too, a reference to the Afrikaans text discloses the word *aansienlik* which could never bear the meaning of *predominant*.'

Where there have been changes in the constitution or shareholding of a public company recognized as such under paragraph (*a*), (*b*) or (*c*) of section 33 (2) so that the company ceases to comply with the requirements of those paragraphs, the Commissioner, in terms of section 34, may notify the company that it will be recognized as a private company at the next succeeding specified date. In certain circumstances such a notification may be necessary, but it does not relieve the Commissioner from making the annual determination of the company's status on the specified date in terms of section 33 (1) and section 33 (3).

Any decision of the Commissioner in the exercise of his discretion under paragraph (*a*), (*b*) or (*c*) of section 33 (2) is subject to objection and appeal — section 40.

Criticisms of the definition of public company

From the above definition of public company it is observed that companies are classified broadly on the basis that those in which the general public is substantially interested are recognized as public companies whereas all others are regarded as private companies. It is an essential requirement, however, that the general public must be substantially interested as *shareholders* in the company. Thus, where a public company in which the general public is substantially interested as shareholders, holds all the shares in a subsidiary company, this wholly owned subsidiary company is regarded as a private company for the reason that the general public is not directly interested as shareholders in such company. The general public is only indirectly interested through the shares held by it in the parent company. The Committee of Enquiry into the Income Tax Act[9] felt that the requirement that the interest of the general public should be by way of a direct interest as shareholders in the shares of

[7] 1943 A.D. 496; 12 S.A.T.C. 171.
[8] 1943 O.P.D. 157; 12 S.A.T.C. 312.
[9] *First Report*, p. 57, para. 43.

the company to make it a public company, should be excluded so that if a public company in which the general public is substantially interested as shareholders holds either all the shares or a substantial shareholding in another company this latter company should also be regarded as a public company.

A further requirement for classification as a public company under the present law is that the general public must be substantially interested as shareholders *in every class* of the shares issued by the company. Thus, where a company has issued more than one class of shares and the general public is substantially interested in one class of the company's shares but not in all classes, for example the general public may be interested in the ordinary shares but not in the preference shares, it will be regarded as a private company. For purposes of the scheme of taxation recommended by it, the Committee of Enquiry into the Income Tax Act[10] considered that a company should be recognized as a public company if the general public is substantially interested in all classes of its non-preference shares. In terms of this recommendation, a company in which the general public is not substantially interested in a preference issue of shares, provided the general public is substantially interested in all classes of its non-preference shares, will be regarded as a public company.

In the two respects discussed above, it does seem that the definition of a public company is narrowly drawn but the Committee of Enquiry made its recommendation for the purposes of the scheme it proposed in regard to the taxation of companies, namely that private companies and not public companies should be subject to the undistributed profits tax. It cannot be expected that the Treasury will widen the definition of public company the effect of which will not only be to give more exemption from non-resident shareholders' tax to Union private companies whose shares are held by public companies resident in the United Kingdom in terms of Article VI(1)(*a*) of the agreement with the United Kingdom, but will render the provisions of section 42(*e*) virtually ineffective since the dominant purpose of the introduction of these provisions was to ensure the collection of non-resident shareholders' tax from Union private companies whose shareholders were the large public companies resident outside the Union. If such wholly owned subsidiary companies in the Union were now to be regarded as public companies, then the provisions of section 42(*e*) will no longer apply to them, thus resulting in a substantial loss of non-resident shareholders' tax to the Treasury.

The Income Tax Commission did not find it necessary to consider the proposals of the Committee of Enquiry in regard to the widening of the definition of public company in view of its recommendations that dividends should be altogether exempt from super tax or non-resident shareholders' tax, thereby making the imposition of an undistributed profits tax unnecessary. There would, therefore, according to the Commission no longer be any need to classify companies for purposes of income tax.[11]

[10] *First Report*, p. 57, para. 46.
[11] *First and Final Report*, p. 16, paras. 67 and 68.

§ 86. Criticisms of the provisions of section 42 (*e*)

The effect of section 42 (*e*) is that foreign companies carrying on a trade in the Union through the operation of a private company are obliged to pay 7*s.* 6*d.* per £ of income derived from Union sources (the normal tax being 6*s.* and the non-resident shareholders' tax 1*s.* 6*d.* per £). As has been shown in Chapter Three, the effect of the present unsatisfactory undistributed profits tax exemption provisions is to render Union companies liable to tax at only 6*s.* per £. It may be said, therefore, that the present arrangement amounts to imposing higher taxation on profits earned through the medium of foreign companies than on profits earned through the medium of Union companies. This is a most unsatisfactory feature of the present system since it will act as a deterrent to foreigners to invest in this country. The tax laws should not be such that a higher rate of tax is imposed on the profits of non-residents than on the profits of residents. This is perhaps another reason why it is imperative that the present undistributed profits tax provisions call for examination and tightening up.

The provisions of section 42 (*e*) may also work hardship on Union companies with foreign shareholders which for some reason or other are not entitled to exemption from undistributed profits tax and are liable to pay the tax at 5*s.* per £ on portion of their income. In such cases, the Union companies, in addition to the payment of undistributed profits tax, are also required to pay the non-resident shareholders' tax in terms of section 42 (*e*). It seems unjust that a company should pay both the undistributed profits tax and the non-resident shareholders' tax in such circumstances.

Since the Union private company cannot recover the non-resident shareholders' tax from its foreign company shareholders, it must follow that the other shareholders are severely prejudiced in that they have to bear their proportionate share of the tax payable by the company. The non-resident shareholders' tax, in terms of section 42 (*e*), is payable only because of the interest of the foreign company shareholder and it is, therefore, only right that this shareholder should bear the tax. The Act should confer a power on the Union company to recover the tax from the foreign shareholder concerned otherwise serious hardships could fall on the other shareholders. For example, take the case of a Union company, all of whose ordinary shares are held by Union residents whereas non-resident companies own the preferent shares. In such a case, under the present law, the ordinary shareholders have to bear the non-resident shareholders' tax attributable to the income apportioned to the foreign company shareholders, i.e. the amount of the preferent dividends apportioned to them.

Another aspect which must be mentioned is that in terms of section 42 (*e*) the tax is payable on the income subject to super tax of the Union private company that is apportioned to the foreign company shareholder. This means that no allowance is made for the normal tax payable by the Union company. If the shares in a

Union company are held by an individual resident overseas, the Union company will pay tax at *6s.* in the £ and the non-resident individual will pay the non-resident shareholders' tax on the dividend received from the company after deducting the normal tax payable by the company. Thus, if a Union private company derived a taxable income of £10,000, the normal tax payable is £3,000 (*6s.* per £ on £10,000). If the shares were held by a foreign company, the Union company would also be liable for non-resident shareholders' tax in terms of section 42(*e*) amounting to £750 (1*s.* 6*d.* per £ on £10,000). If the net profit remaining of £6,250 (£10,000 *less* £3,750) is distributed by way of dividend to the foreign company shareholder, no further Union taxes are payable. On the other hand, if the shares were held by an individual resident overseas, the Union company would only pay the normal tax of *6s.* per £, i.e. £3,000. If the net profit of £7,000 remaining is distributed by way of a dividend to the shareholder, non-resident shareholders' tax is payable at 1*s.* 6*d.* per £ amounting to £525 which is £225 less than the case where the shares are held by a foreign company.

A further drawback of the section is that it discriminates between the individual holding shares in a Union company and a foreign company holding shares in a Union company. The former pays only *6s.* per £ through his company in the Union. There is no obligation to declare any dividends since section 51(*d*) makes his company exempt from the undistributed profits tax. In other words, he can postpone the payment of non-resident shareholders' tax indefinitely. On the other hand, where the shares in the Union company are held by a foreign company, the former pays non-resident shareholders' tax at 1*s.* 6*d.* in the £. Moreover, the non-resident individual, if he wishes to declare dividends out of the undistributed profits free of all tax, can sell his shares to a company in South West Africa in which he is the sole beneficial shareholder. He could thereafter arrange for a dividend to be declared by the Union private company in favour of his foreign company. No tax is payable on this dividend. It is true that the Union private company will thenceforth be liable for the 1*s.* 6*d.* non-resident shareholders' tax on its annual net profits since its shares will now be held by a foreign company, but the non-resident individual may arrange for a new Union company to take over the business thus avoiding the operation of section 42(*e*). The same device may be used by Union residents to get rid of their undistributed profits in their Union companies free of all taxes. Thus, if A is the shareholder in A (Pty.) Ltd. which has substantial undistributed profits, he may arrange to register a company in South West Africa in which he or his family holds all the shares and to which company he will sell his shares in A (Pty.) Ltd. at a price which includes the undistributed profits. Thereafter, A (Pty.) Ltd. could distribute a dividend in favour of the foreign company. This dividend will be free of all tax both in the Union and South West Africa. In this manner, Union residents are able to clear the 'kitties' of their companies without attracting any tax liability (see also § 28). It is true that a disadvantage of this procedure is that the Union company will now be liable for the non-resident shareholders' tax in terms of section 42 (*e*) by virtue of its shares being held by a foreign company. This liability may, however, be avoided since the Union resident could arrange for a new Union company to buy the existing business from the present company and thereafter to liquidate this latter company, or there may be other ways of avoiding the operation of section 42 (*e*).

The provisions of Article VI (1) (*a*) of the Double Taxation Agreement with the United Kingdom in terms of which exemption from the non-resident shareholders' tax is granted to a Union private company in respect of taxable income apportioned to a United Kingdom public company, is probably losing substantial revenue for the Union Treasury. This concession has not been extended to any other country and since it would appear that the Union Government has not received any reciprocal concession from the United Kingdom Government, it may not perhaps have been wise for the Union to forgo this amount of tax. The effect of the exemption is that a Union private company which is controlled by a United Kingdom public company pays only 6*s*. per £ on its taxable income since any dividends declared in favour of the foreign company is exempt from all tax. In other words, such a Union private company is able to distribute its entire undistributed profits either by way of a cash dividend or by the issue of bonus shares free of all taxes. A further anomaly is that the exemption only applies where the shares in the Union private company are held by a United Kingdom public company. It does not apply where the shares are held by a private company in the United Kingdom even though all the shares of such private company may be held by a public company in the United Kingdom. There has been strong criticism from sources in the United Kingdom that the exemption should also extend to United Kingdom private companies which may hold the shares in Union private companies. It is claimed that it is inequitable that there should be this difference in taxation between a United Kingdom private and public company. It is doubtful, however, whether the Union Treasury will widen the concession having regard to the fact that substantial revenue is being lost under the existing scope of the exemption. In cases where the shares in the Union private company are held by a public company in the United Kingdom, the benefit of Article VI (1) (*a*) can be obtained by the United Kingdom private company simply selling its shareholding in the Union private company to the United Kingdom public company. Since the shares in the Union private company will now be held by the public company in the United Kingdom, the exemption will apply.

Since, in terms of section 42 (*e*), the tax is only payable if the foreign company shareholder to whom the apportionment is made is not registered *nor* carrying on business in the Union, avoidance of the tax will result if the foreign company can arrange to carry on business in the Union. In practice it is not difficult for a company to arrange the carrying on of a business particularly if the extent of such business is not material. A property could be purchased to yield a rental income or some other form of business can be carried on. The writer can envisage a case where a foreign company purchases a general dealer's business to supply the employees of its wholly owned subsidiary company in the Union with provisions. It is carrying on a business even though the annual net profit earned may not be substantial and since section 42 (*e*) cannot be applied it may save non-resident shareholders' tax to the tune of many thousands of pounds. If these types of avoidance are practised more often, section 42 (*e*) is not likely to achieve its purpose.

In the writer's view the provisions of section 42 (*e*) should be repealed for the reasons set out above. Union companies, whether controlled by individuals resident oversea or by foreign companies should be taxed on the same basis. Dividends distributed should be liable for non-resident shareholders' tax in all cases and if the Union company refrains from distributing reasonable dividends an undistributed profits tax should be imposed at a rate not exceeding the rate of non-resident shareholders' tax. The repeal of the provisions of section 42 (*e*) will mean a loss of tax to the Treasury since at present it collects the tax on the income subject to super tax of the Union company, which is greater than the tax it will collect on dividends declared. This loss will be offset to some extent by the tax which it will collect on dividends passing from Union private companies whose shares are held by United Kingdom public companies and to which companies Article VI (1) (*a*) of the Double Taxation Agreement at present applies. It is felt, however, that the repeal of section 42 (*e*) will stimulate investment in that the non-resident shareholders' tax will only be paid on dividends declared and that if companies are required to distribute only about 30 per cent of their taxable income in order to avoid the undistributed profits tax, this will be an added incentive for non-residents to transfer capital to the Union. In the 1957/58 financial year, nearly £6,000,000 was collected by way of non-resident shareholders' tax but this included both the tax on dividends distributed to non-residents as well as the tax levied on private companies. It is not likely, therefore, that the Treasury will be making a big sacrifice by the repeal of section 42 (*e*) and it may very well be that if the undistributed profits tax provisions are rendered more effective, there will be no falling-off in the amount of the non-resident shareholders' tax collected.

§ 87. Tax consequences for non-residents

In respect of dividend income

Individuals not ordinarily resident in the Union and who derive company dividends from Union sources are not subject to super tax thereon unless they are carrying on business in the Union (section 30 (1) (*a*)). If they are carrying on business in the Union, they are able to free themselves from super tax by transferring their business to a company in the Union. They will then be holding shares in the company which does not constitute the carrying on of a business (see § 91). They are, however, liable for the $7\frac{1}{2}$ per cent non-resident shareholders' tax on the dividends received. Since super tax is only payable after an income subject to super tax of £2,300 has been reached, it must follow that until a non-resident has received this amount of income, it is more advantageous for him to fall outside the exemption of section 30(1)(*a*), i.e. it is better for him to be subject to super tax — which will involve him in no liability — rather than pay the 1*s.* 6*d.* per £ non-resident shareholders' tax. After an income of £2,300 has been reached, super tax is payable and since the rate of super tax is very much greater than the rate of non-resident shareholders' tax it is clear that the non-resident must seek the exemption contained in section 30(1)(*a*) by not carrying on any business in the Union.

Non-resident shareholders' tax on dividends can also be avoided by non-Union residents by the simple operation of forming a Union company to hold their share investments. The dividends can be accumulated free of all taxes in the company in which the non-resident is the sole beneficial shareholder. This type of company is exempt from the undistributed profits tax in terms of section 51(*d*) which confers exemption if not less than 50 per cent of a company's issued capital was throughout the specified period held by one or more persons not ordinarily resident nor carrying on business in the Union. In this manner non-residents are effectively able to avoid payment of the non-resident shareholders' tax.

As the law stands at present, non-resident shareholders' tax is payable in respect of any dividend distributed by a foreign company to foreign shareholders to the extent to which such dividend has been distributed out of profits derived from Union sources. In terms of section 46 of the Act, the company is required to pay the amount of the tax chargeable in respect of the dividend distributed to the foreign shareholders. In the case of a foreign company which is outside the jurisdiction of the Union courts, there are obvious difficulties facing the Commissioner in regard to the recovery of the tax. Not only has he no means of enforcement of the obligations which the Union Act imposes on such a foreign company but there is also the difficulty of obtaining the information from the company which will permit him to apportion the dividend in the manner indicated in secton 46. The writer is of the view that a substantial sum of non-resident shareholders' tax has been lost to the Union under the present arrangements. It is impossible for the Revenue to keep a check on the dividends declared by all those foreign companies earning income from Union sources and then to secure the necessary information which will permit the apportionment set out in section 46. The practical way out is for the non-resident shareholders' tax to be imposed only in respect of dividends distributed by companies registered or managed or controlled in the Union. The Committee of

Enquiry into the Income Tax Act also considered the present arrangement unsound and impracticable and considered that the scope of the non-resident shareholders' tax should be restricted to dividends distributed by companies the business of which is managed and controlled in the Union. In its view a more satisfactory arrangement would be for the non-resident shareholders' tax to be imposed upon foreign companies in respect of any income accruing to any such foreign companies from Union sources. It recommended the repeal of the present provisions which impose the charge to non-resident shareholders' tax in respect of dividends distributed by foreign companies out of profits derived from Union sources.[12] Under the present provisions of section 37 *bis* read with section 42 (*e*), where a foreign company holds shares in a Union private company, this latter company is liable for the non-resident shareholders' tax on so much of its profits attributable to the interest of the foreign company shareholder. There is every justification, therefore, for a foreign company to pay the tax should it not earn income from Union sources through a Union private company but instead earns the income directly in its own name. Foreign companies earning income directly from Union sources and those companies earning indirectly through a Union private company should be put on the same basis. The writer considers that this recommendation of the Committee if adopted by the Legislature will bring in more non-resident shareholders' tax for the Treasury than the amount collected under the present apportionment provisions of section 46. The Committee's recommendation is practicable of administration in that an assessment has in any event to be raised on the foreign company for normal tax which means that the non-resident shareholders' tax can be incorporated in the same assessment. However, unless the Treasury ensures that Union companies do not refrain from declaring reasonable dividends to shareholders, it may be said that the arrangement would amount to imposing higher taxation on income earned through the medium of foreign companies than on profits earned through the medium of Union companies.

In respect of income other than dividends

A non-resident desirous of carrying on a business in the Union or of earning investment income, other than dividends, from Union sources, has various alternatives open to him, for example —

(1) he may do so in his own name;

(2) he may form a South African company to undertake the business or investment. He may be the sole beneficial shareholder or he may form a company in his country of residence to be the shareholder;

(3) he may form a company in his country of residence to undertake the business or investment in the Union.

The alternatives will be here considered only from the South African tax point of view. It must be borne in mind that the choice

[12] *First Report*, p. 67, para. 8.

of the alternative may be very much influenced by the income tax law in force in the taxpayer's country of residence or it may be influenced by the estate duty laws. For example, should the non-resident operate as an individual taxpayer in the Union he may find that the rate of tax payable on such income in his country of residence is so high that it would pay him better to trade through a company in the Union and pay the company rate of 6*s.* since the income is then not taxable in his hands in his country of residence.

Since super tax is payable only once an income subject to super tax of £2,300 is reached, and bearing in mind that the marginal rate of normal tax payable by an individual in respect of the first £2,300 of his taxable income is considerably lower than the 6*s.* rate of normal tax for companies, it must follow that until the marginal rate of tax for an individual exceeds 6*s.* in the £ it will not pay the non-resident to earn his income through a company, whether incorporated in South Africa or in his country of residence. For example, a married non-resident first starts paying a marginal rate of 6*s.* in the £ at a taxable income of about £3,500. In making his calculation, a non-resident should take into consideration that he may be entitled to a director's remuneration which is taxable in his individual capacity but which is an allowable deduction from the company's income. Bearing in mind, however, the fact that he is non-resident, the Revenue may be reluctant to permit the deduction of too large an amount, and the writer's remarks on the disallowance of excessive remuneration in § 27 must therefore be borne in mind.

The following table shows the taxes payable by an individual resident oversea if he earns the income in his individual name or if he earns it through a private company operating in the Union. (Based on 1958 rates of tax.)

COMPARATIVE TABLE SHOWING TAXES PAYABLE BY MARRIED NON-RESIDENT INDIVIDUALS AND COMPANIES AT SELECTED LEVELS OF INCOME

Taxable income	Tax payable by non-resident (excluding the savings levy)	Marginal rate of tax (on each £ of increment)	Tax payable by company (6*s.* per £) (excluding the savings levy)
£1,000	£41		£300
£2,000	£127	1*s.* 9*d.*	£600
£2,300	£155	1*s.* 11*d.*	£690
£3,000	£348	5*s.* 6*d.*	£900
£4,000	£652	6*s.* 1*d.*	£1,200
£5,000	£990	6*s.* 9*d.*	£1,500
£6,000	£1,362	7*s.* 5*d.*	£1,800
£7,000	£1,766	8*s.* 1*d.*	£2,100
£8,000	£2,205	8*s.* 9*d.*	£2,400
£9,000	£2,677	9*s.* 5*d.*	£2,700
£9,300	£2,825	9*s.* 11*d.*	£2,790
For each £1 in excess of £9,300.	10*s.*	10*s.*	6*s.*

If it is more advantageous to form a company to earn the income, from the tax point of view it is better that the shares in this company be held by the non-resident rather than another company incorporated in his country of residence in which he may be the beneficial shareholder. If he adopts this latter course, his Union company is liable for non-resident shareholders' tax at 1*s*. 6*d*. per £ of income since its shares are held by a foreign company not registered nor carrying on business in the Union (section 42(*e*)). On the other hand, if he is the shareholder in his individual capacity, liability for non-resident shareholders' tax only arises as and when dividends are declared by the Union company.

§ 88. RECOMMENDATIONS

The system of taxation that should be carried out in the case of Union companies is that the income should be subjected to a flat rate normal tax in the hands of the company and that super tax or non-resident shareholders' tax should be payable by Union and non-Union residents respectively when the income is distributed in the form of dividends. As regards foreign companies, the system contemplated by the Committee of Enquiry[13] would not require the payment of non-resident shareholders' tax by the shareholders upon declaration of a dividend to foreign shareholders but involves the payment of non-resident shareholders' tax by the company itself on the amount of its taxable income derived from Union sources. The Committee recommended that the tax be paid on the taxable income after deduction of the amount of the normal tax paid thereon. The writer is of the view, however, that if the normal tax payable should rank as a deduction, this concession should also be granted to foreign companies which earn the income through the medium of a Union private company which under the present law has to pay the non-resident shareholders' tax on the gross income subject to super tax before deducting any normal tax in terms of section 37 *bis* read with section 42(*e*). The deduction of the normal tax from the amount subject to the non-resident shareholders' tax is only reasonable having regard to the fact that non-resident individuals pay the tax on dividends distributed by Union companies after payment of the normal tax in respect of the profits out of which the dividends are paid. It is also considered that as all Union companies are entitled to 'plough-back' 40 per cent of their profits free of the undistributed profits tax, this abatement should also be deducted from the amount subject to the non-resident shareholders' tax. In this way Union companies and foreign companies will be put on the same basis as regards income derived from Union sources and equality would have been achieved.

Non-residents holding minority shareholdings in Union companies may be severely prejudiced by the incidence of the undistributed profits tax. Section 51(*d*), which confers exemption from undistributed profits tax, only applies if not less than 50 per cent of the company's issued capital is held by non-residents and if the other provisions of the section are complied with. Thus, where a Union company, which is not exempt from the undistributed profits tax, fails to distribute the requisite dividend required to relieve it from the tax, the minority shareholders resident outside the Union have to bear their proportionate shares of the tax calculated at

[13] *First Report*, p. 67, para. 8.

the rate of 5*s.* per £ on that part of the distributable income which ought to have been distributed. This is manifestly unjust since as regards that portion of the undistributed profits attributable to the non-residents the non-distribution of dividends is to the prejudice of the non-resident shareholders' tax which is only 1*s.* 6*d.* per £. The system of apportionment of the undistributed profits as between Union and non-Union shareholders, as recommended by the Committee of Enquiry (see § 35), is fair and equitable and ensures that justice is done among the different classes of taxpayers.

Once the present undistributed profits tax provisions are made more effective so that Union residents are compelled to pay super tax on reasonable dividend distributions from their companies each year, there may be a temptation for them to form holding companies outside the Union to receive their trading or investment income from Union sources. In practice, unless drastic and complex provisions are inserted into the Act, an undistributed profits tax can only be effectively applied to companies registered or carrying on business in the Union. Thus, under the present law, Union residents are entitled to transfer their investments to a foreign personal holding company in, say, South West Africa or Southern Rhodesia which would fall outside the net of the undistributed profits tax. They need not, therefore, distribute dividends from their companies and in this way they can avoid the payment of super tax although, in terms of the Committee's recommendation, their companies would be liable for the non-resident shareholders' tax on the taxable income derived from Union sources. As this type of avoidance may be practised on a large scale, special provisions to prevent it will have to be inserted in the Act. In this respect, see the recommendations made in Chapter Four to prevent the avoidance of super tax on dividends by Union residents.

The Committee of Enquiry also recommended[13] that if any shareholder receives from a foreign company a dividend which is subject to Union super tax in his hands, he should be entitled to a credit in respect of an appropriate proportion of any non-resident shareholders' tax paid by the company, based on the amount of the profits derived from Union sources by the company and on which non-resident shareholders' tax has been paid, which is contained in the dividend received. In practice it may be difficult to effect such an adjustment since the required information necessary to make it must be obtained from a company not registered, managed nor controlled in the Union. Such a foreign company is outside the jurisdiction of the Union courts and it cannot, therefore, be compelled to furnish the information. In the majority of cases, the Union resident will probably be a minority shareholder in such a foreign company and he will, therefore, have no means at his disposal to force the company to supply the Commissioner with the necessary information. In the writer's view, therefore, where a Union resident receives a dividend from a foreign company it should be subject to super tax without the necessity of having to make an adjustment in respect of any non-resident shareholders' tax payable by the foreign company. This may possibly be a deterrent to Union residents from forming foreign holding companies to hold their income derived from Union sources. 'It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.'[14]

To sum up, therefore, the writer's recommendations as regards the taxation of foreign companies are as follows:

(1) If they earn taxable income in the Union through a private company which is registered, managed or controlled in the Union normal tax should be payable by the Union company at the ordinary company rate. Non-resident shareholders' tax should be payable on all dividends distributed by the Union company. In respect of the failure to make an adequate distribution of the profits, undistributed profits tax should be payable by the Union company at the rate of the non-resident shareholders' tax. The present provisions of section 37 *bis* and section 42 (*e*) should be repealed.

(2) If they earn income in the Union in their own names and not through a private company which is registered, managed or controlled in the Union, in addition to normal tax which must be payable at the ordinary company rate they should be liable to non-resident shareholders' tax on the taxable income derived after deducting from such taxable income the normal tax payable in respect thereof as well as a 'plough-back' allowance of 40 per cent equivalent to that granted to all companies for undistributed profits tax purposes. Such companies should be exempt from undistributed profits tax. No further non-resident shareholders' tax should be payable when they declare dividends.

(3) Stringent provisions should be inserted into the Act in order to prevent Union residents from forming foreign private companies to earn profits derived from Union sources, e.g. they could transfer their lucrative business to companies incorporated in South West Africa or Southern Rhodesia or the Native Territories (see § 46 for the recommendations made in regard to the formation of foreign companies by Union residents to avoid dividends from Union sources). Prejudice to the *fiscus* will arise through such foreign companies unreasonably withholding from distribution the profits derived from Union sources as a result of which super tax can be avoided by Union residents.

§ 89. Importance of 'Residence' and 'Carrying on Business'

It will be seen from the special provisions relating to non-residents that there are a number of instances in the Act where the place of residence or the place where business is carried on is made the test either for the taxation of a certain type of income or for the grant of an exemption. The place of residence also assumes importance

[14] Per Lord Greene, M.R., in *Lord Howard de Walden* v. *I.R.C.*, [1942] 1 K.B. 389; 25 T.C. 121.

in regard to the application of the provisions of the double taxation agreements which the Union Government has entered into with other countries.

It is considered that this treatise would not be complete without considering the meaning of 'residence', 'carrying on business' and the determination of the place where business is carried on.

§ 90. Meaning of 'residence'

The Income Tax Act does not define *resident* or *ordinarily resident.* In the United Kingdom, where the fundamental basis of the incidence of income tax is the *residence* of a taxpayer, some useful tests have been evolved from a long series of decided cases.

In the case of an individual taxpayer

'Resident' and 'ordinarily resident' bear no special or technical meaning.[15] The question whether a person is 'resident' or is 'ordinarily resident' is one of fact.[16]

A visitor who maintains no place of abode in the Union and whose visits are not habitual but occasional only, it is submitted, cannot be regarded as resident in the Union. If, however, he maintains a place of abode in the Union available for his use, he is likely to be regarded as resident for any year in which he pays a visit of whatever length to the Union.[17]

Where a person visits the Union year after year so that his visits become in effect part of his habit of life and the annual visits are for a substantial period of time, it would be difficult to resist a challenge that such person is ordinarily resident in the Union. Thus, where a British subject who lived abroad for health reasons paid short yearly visits to the United Kingdom where he lived in hotels because he had no place of abode there so that these visits in fact became the usual order of his life, he was held to be ordinarily resident.[18] An American who was ordinarily resident in New York hired a shooting-box in Scotland where he spent two months year after year. He was held to be ordinarily resident in the United Kingdom.[19]

It has long been established that a person may have more than one residence for the purpose of income tax. It has also been held that a person can be ordinarily resident in two places.[20]

A person can, as a matter of law, be ordinarily resident in a country from which he was absent throughout the tax year. The question whether an individual was in any one year of assessment ordinarily resident in the Union or elsewhere is not to be determined solely by his actions during that year of assessment; his condition of

15 *Levene* v. *I.R.C.*, [1928] A.C. 217; 13 T.C. 486; *I.R.C.* v. *Lysaght*, [1928] A.C. 234; 13 T.C. 511.
16 *Cohen* v. *C.I.R.*, 1946 A.D. 174; 13 S.A.T.C. 362.
17 *Robinson* v. *C.O.T.*, 1917 T.P.D. 542.
18 *Levene* v. *I.R.C.* (*supra*).
19 *I.R.C.* v. *Cadwalader*, 42 Sc.L.R. 117; 5 T.C. 101.
20 *Reid* v. *I.R.C.*, 1926 S.C. 589; 10 T.C. 673.

ordinary residence during that year can be determined by evidence as to his mode of life outside the year of assessment under consideration.[21]

Physical presence, it is submitted, is not a conclusive test for determining whether or not an individual is resident or ordinarily resdent in a country. 'It is the character in which a person is physically present in a country that is the determining factor. The physical presence . . . must be combined with a continuity which would exclude any element of chance or occasion.'[22]

It has been held that residence is not synonymous with domicile. The setting up or maintaining of some kind of establishment or home appears as the main criterion of residence.[23]

In the case of a company

The question as to whether a company can be regarded as resident is one of fact.

The place of registration or incorporation of a company is not the sole test of the place of residence. It has long been established that a company resides at the place where its central management and control actually abides. 'In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house or do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of a foreign nationality, and yet reside in the United Kingdom. So may a company. . . . The decision of Kelly, C.B., and Huddleston, B., in *Calcutta Jute Mills* v. *Nicholson*[24] and the *Cesena Sulphur Co.* v. *Nicholson*,[25] now thirty years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides.'[26]

The place of the central management and control of a company is not necessarily the place where the company carries on its trading or manufacturing operations. It is the place where the directors, who are the governing body, meet and exercise their control over the business of the company or perhaps better it is the place where the superior and directing authority of the company is to be found. 'The company may be properly found to reside in a country where it "really does business", that is to say, where the controlling power and authority which, according to the ordinary constitution of a limited liability company, is vested in its board of directors, and the

21 *Cohen* v. *C.I.R.*, 1946 A.D. 174; 13 S.A.T.C. 362.
22 Simons: *Income Tax*, 2nd ed., vol. 1, p. 363.
23 *Robinson* v. *C.O.T.*, 1917 T.P.D. 542.
24 35 L.T. 275; 1 T.C. 83.
25 35 L.T. 275; 1 T.C. 88.
26 *De Beers Consolidated Mines, Ltd.* v. *Howe*, [1906] A.C. 455; 5 T.C. 198 (per Lord Loreburn); see also *Estate Kootcher* v. *C.I.R.*, 1941 A.D. 256; 11 S.A.T.C. 298.

exercise of that power and authority, is to some substantial degree to be found.'[27]

A company can have a dual residence if its central management and control is divided between more than one country. It has been held that the central management and control of a company can be found in any country where there is present some part of the superior and directing authority of the company.[27]

Estates and Trusts

Fictitious or artificial persons such as deceased estates, trusts, clubs and associations are capable of having a residence and being resident.[28]

§ 91. Meaning of 'carrying on business'

The words 'carrying on business' are not defined in the Act although *trade* is defined in section 7 to include every profession, trade, business, employment, calling, occupation or venture, including the letting of any property. Carrying on a *trade* is clearly not the same thing as *carrying on business*. For example, an employee is carrying on a trade within the meaning of *trade* in section 7 although he will not be regarded as carrying on a business.

The question whether a person is or is not carrying on business is an inference from facts and this inference is a matter of law.[29]

In considering whether a taxpayer is carrying on business the following factors have to be borne in mind:

(*a*) The motives of the taxpayer and whether there is an intention to make profit; and

(*b*) the frequency of the action that gives rise to the income and whether the earning of the income involves the conduct of a series of actions.

In *Smith* v. *Anderson*,[30] Jessel, M.R., laid down a general definition of 'business', namely 'anything which occupies the time and attention and labours of a man for profit is business'. However, in *Modderfontein Deep Levels, Ltd.* v. *Feinstein*,[31] where the factor of profit was absent, the Court declined to adopt the view expressed in *Mullins & Meyer* v. *Pearlman*[32] that the making of profit was of the essence of trading. In the former case, a mining company which from time to time bought clothing for resale to its employees at cost, i.e. without making a profit, was held to be carrying on a trade or business. Juta, J.A., in *Platt* v. *C.I.R.*,[33] while accepting the objective of profit as a test, remarked that in certain cases there may be a carrying on of a business without the contemplation of procuring

[27] *Union Corporation, Ltd. & others* v. *I.R.C.*, [1953] A.C. 482; 34 T.C. 279.
[28] *Nathan's Estate* v. *C.I.R.*, 1948 (3) S.A. 866 (N); 15 S.A.T.C. 328; *C.I.R.* v. *Jagger & Co. (Pty.), Ltd.*, 1945 C.P.D. 331; 13 S.A.T.C. 430.
[29] *C.I.R.* v. *Stott*, 1928 A.D. 252; 3 S.A.T.C. 253.
[30] (1880), 15 Ch. D. 247.
[31] 1920 T.P.D. 288.
[32] 1917 T.P.D. 639.
[33] 1922 A.D. 42.

gain. Thus, the objective of making a profit is not an essential feature in every case. The Special Court has held that hiring a property and letting it at the same rental constituted the carrying on of a trade.[34]

'Carrying on business' normally involves a series of actions on the part of a person. Although generally speaking one or two isolated transactions could not be regarded as the carrying on of a business, a single transaction may be carried out in such a way that it might be regarded as the carrying on of a business. Different considerations might apply in the case of a company as was held by Wessels, J.A., in *C.I.R.* v. *Stott*.[35]

> 'As a general rule one or two isolated transactions could not be described as the carrying on of a business. There were no doubt exceptions. A single undertaking might be of such a nature that it could be correctly described as a business. Thus in *Stephan's* case,[36] the salvaging of a single ship's cargo was considered a business because "these salvage operations which were managed by the staff of the appellant's business, and which necessitated so many ordinary business acts such as the engaging of services of men, hiring apparatus, purchasing equipment, the transport of the cargo to Cape Town and the like stand on an entirely different footing", per Mason, J., at p. 7. In dealing with a company one of whose objects was to buy and sell land, then the company might well be considered to be doing the business of selling and buying land even though it carried out only a single transaction; but when an individual like a surveyor who was not professedly carrying on the occupation of a landjobber bought and sold one or more plots of land, he could not be said prima facie to be doing the business of a landjobber. Before it could be said that an individual was carrying on a business there must be some proof of continuity. Thus in *Smith* v. *Anderson*,[37] quoted with approval in *Platt's* case,[38] Jessel, M.R., pointed out that acts which were done by a company would be regarded as business, whilst these same acts if done by an individual would not be so regarded, and then he added: "The same observation may be made as regards a single individual buying or selling land, with this addition that he may make it a business and then it is a question of continuity. A man occasionally buys and sells land, as many landowners do, and nobody would say that he was a landjobber or dealer in land, but if a man made it his particular business to buy and sell land to obtain profit he would be designated as a landjobber or dealer in land."'

That the test to be applied in the case of an individual was not quite the same as the test in the case of a company was also laid down in *C.I.R.* v. *Lydenburg Platinum, Ltd.*,[39] in which Stratford, J.A., held that 'continuity was a necessary element in the carrying on of a business in the case of an individual but not of a company'. 'In

[34] I.T.C. No. 615, 14 S.A.T.C. 399.
[35] 1928 A.D. 252; 3 S.A.T.C. 253.
[36] 1919 W.L.D. 1; *Stephan* v. *C.I.R.*, 1919 W.L.D. 1.
[37] (1880), 15 Ch. D. 247.
[38] 1922 A.D. 42.
[39] 1929 A.D. 137; 4 S.A.T.C. 8; see also *Yates Investments (Pty.), Ltd.* v. *C.I.R.*, 1956 (1) S.A. 612 (A.D.); 20 S.A.T.C. 368; and *C.I.R.* v. *Strathmore Exploration & Management, Ltd.*, 1956 (1) S.A. 591 (A.D.); 20 S.A.T.C. 375.

the case of a company formed for a certain purpose, it would be said at once that it was carrying on business, because it was formed for that purpose and for nothing else, and from the very nature of the association the idea of continuity is inferred.'[40]

In *Platt* v. *C.I.R.*[41] the appellant guaranteed certain advances made by the bank to a company in the profits of which he was interested and was called on to make payment thereof and sought to deduct this from his income as a sugar manufacturer. His right to do so depended on whether in the making of such advances he was carrying on a trade. The Court held that he was not carrying on a trade or business.

The following are some common illustrations of whether a person is carrying on business or not.

1. The investment of money on mortgage bond or loan or fixed deposit, where such transactions are not part of a general financial or financier's business, does not amount to carrying on a business.

2. Letting property regularly or systematically amounts to the carrying on of a business.[42] There must, however, be evidence of an intention of holding the property in order to make an income by letting it.[43]

3. The temporary letting of a property in the Union by a non-resident while waiting for an opportunity to sell will probably not be regarded as the carrying on of a business provided that the intention to sell can be clearly established.[44]

4. Usufructuaries enjoying the income from a rent-producing property by reason of a provision in a will or deed of donation, it is submitted, cannot be regarded as carrying on business.[45]

5. The mere employment of an agent to buy goods in the Union for shipment and sale outside the Union does not of itself constitute the carrying on of a business in the Union.

6. The receipt of royalties may amount to the carrying on of a business, e.g. in the case of a novelist whose business is to write books or the case of a company formed to exploit copyrights or patent rights.

7. The investment of surplus funds in shares in companies, as long as it does not form part of a general scheme of profit-making, cannot be regarded as carrying on business.

[40] Per Juta, J.A., in *Platt* v. *C.I.R.*, 1922 A.D. 42.

[41] 1922 A.D. 42.

[42] I.T.C. No. 290, 7 S.A.T.C. 333; I.T.C. No. 425, 10 S.A.T.C. 340.

[43] I.T.C. No. 258, 7 S.A.T.C. 67.

[44] I.T.C. No. 136, 4 S.A.T.C. 203.

[45] See, however, I.T.C. No. 137, 4 S.A.T.C. 209, which the Commissioner does not follow in practice.

§ 92. Place where business is carried on

The place where a taxpayer carries on business may be an important consideration under the Income Tax Act. See for example section 10(1)(*b*), section 30(1)(*a*), section 37 *bis*, section 42(*a*), (*a*) *bis* and (*e*), section 49, and section 51(*d*).

In *Joel & Joel* v. *C.I.R.*[46] it was held that the question where a person carries on business is one of fact. In this case the question for decision was whether under section 31 of Act 41 of 1917[47] the taxpayers, who were members of a partnership firm, were exempt from super tax on dividends on the grounds that they were not ordinarily resident nor carrying on business in the Union. The taxpayers, who were resident outside the Union, had their head office in London, but had an office in Johannesburg under their business name. They had a salaried staff in the Union. Business propositions were laid before their representative, who submitted the proposal to the firm's technical adviser and advised the London office. If the latter were prepared to take up any such proposition they notified the Johannesburg office. In the course of their business as financiers, the taxpayers entered into contracts to float companies and described themselves as carrying on business in Johannesburg. Their local office occasionally bought and sold shares in their business of share-dealing. The Johannesburg office received all dividends and interest payable to the taxpayers within the Union. Three members of the salaried staff sat as directors on the boards of companies as representatives of the taxpayers and two of them paid over their directors' fees to the partnership. The Court held that the above facts supported the decision of the Special Court that the taxpayers were carrying on business in the Union.

In *Overseas Trust Corporation, Ltd.* v. *C.I.R.*[48] one of the contentions of the taxpayer was that its business extended to South West Africa and that it was therefore entitled to the benefit of the statutory adjustment in section 14 of Act 41 of 1917.[49] Innes, C.J., held:

> 'But there was no proof upon the record that the Overseas Trust carried on any business in the Protectorate or in any place outside the Union. It had a registered office somewhere in South West Africa, with a name plate, and there was an official there to accept service. It had shareholdings and interests in that territory, but it did not otherwise function there. But the mere possession of shares and investments did not amount to carrying on a business; and the appellant would appear to have conducted no operations of any description in the Protectorate. It was impossible, therefore, to hold that its business extended to that territory.[50]

A person can carry on business in more places than one and the place where a taxpayer resides is no criterion as to where he carries on

[46] 1922 W.L.D. 29.
[47] Similar to sec. 30(1)(*a*) of Act 31 of 1941.
[48] 1926 A.D. 444; 2 S.A.T.C. 71.
[49] Similar to sec. 17 of Act 31 of 1941.
[50] See also I.T.C. No. 244, 6 S.A.T.C. 372.

business. For example, a company which is resident in one country can carry on business in another country.[51] A person can employ an agent to carry on business on his behalf and such person must be regarded as carrying on business at the place where the agent carries on the business.[51]

[51] *Rhodesia Railways, Ltd. & others* v. *C.O.T.*, 1925 A.D. 438; 1 S.A.T.C. 133.

CHAPTER SEVEN

HUSBAND AND WIFE

§ 93. Aggregation of income of husband and wife

Whether married in or out of community of property, the income of a wife is deemed to be the husband's income — section 9(2). The wife pays no tax, but the husband is taxed on his income and that of his wife. This rule does not apply where the wife is separated from her husband under a judicial order or written agreement of separation. The wife's income must be included by the husband in his return — section 58(1). It is the husband and not the wife who is obliged to make a return of the wife's income.

'Married' is defined in section 1 and means married not only in the legal sense but also in accordance wtih any law or custom not recognized in the Union as valid, and 'husband', 'wife' or 'spouse' must be construed accordingly. The purpose of this definition is to regard as married men and women those who are married according to a law or custom not recognized in the Union, e.g. Mohammedans.

Where the spouses are married out of community and the husband cannot pay the tax due, the Commissioner can recover from the wife's assets such an amount as represents the tax payable by him due to the inclusion of the wife's income — section 85(3). This affords a safeguard to the *fiscus* where the wife's income forms a large proportion of the combined incomes of the spouses and the husband's resources are insufficient to meet the total tax liability. In *Israelson* v. *C.I.R.*,[1] the Appellate Division held that the provisions of section 85(3) do not entitle the Commissioner to claim a judgment against a wife for the recovery of her husband's taxes in respect of her income that is deemed to be his under the provisions of section 9(2). The Commissioner can, however, obtain an order of execution of the wife's assets. The Act does not stipulate the method of calculating the recovery of tax from the assets of the wife but the Commissioner adopts the same basis which he uses in the case of separate returns and assessments (see *infra*). The provisions of section 85(3) apply only to the recovery of normal and super taxes. They do not extend to the recovery of provincial taxes payable by the husband on the combined income. Thus, the Commissioner may not recover from the wife's assets any provincial tax payable in respect of her income. It is also not clear from the section whether the husband must be excussed before proceeding against the wife. Recently the Income Tax Act of the Federation of Rhodesia and Nyasaland (section

[1] 1952 (3) S.A. 529 (A.D.); 18 S.A.T.C. 247.

67(3)) was changed to ensure that the husband would first be excussed before proceeding against the wife.

Where a husband is liable for any penalties for delay in rendering the joint return or for omitting any income from the return, in circumstances where separate returns have not been rendered under the provisions of section 58(1), and if the husband is unable to pay such penalties, no portion of the penalties can be recovered by the Commissioner from the assets of the wife under the provisions of section 85(3).[2]

There appears to be no statutory authority whereby a husband can recover from his wife any tax payable by him which is due to the inclusion of his wife's income. Other persons who are subject to tax on income which is deemed to be theirs (see sections 9(3), (4), (5) and (6)) have a right of recourse against the person to whom the income legally belongs. If the husband desires to avoid the payment of tax in respect of his wife's income, it would seem that his only remedy is to apply for the issue of separate returns and assessments in terms of section 58(1) and section 67(6) (see *infra*).

The term 'income' in section 9(2) must be given its ordinary meaning, i.e. profits or gains, and not its meaning as defined in section 7.[3] Thus dividends received by a wife must be deemed to be the husband's. If the wife carries on a business, it is submitted that in terms of section 9(2) the husband must be deemed to be carrying on such business. Any income derived therefrom must be deemed to be his and any expenditure incurred must be deemed to have been incurred by him.

§ 94. Separate assessments of the spouses

If either husband or wife make written application or the Commissioner considers it desirable, returns of income may be required to be rendered separately by the parties — section 58(1). In terms of the section, separate returns of income may be rendered by the husband and wife at the instance of either spouse on making written application or at the instance of the Commissioner. Such returns are separately assessed and separate assessments sent to the spouses but the total tax payable on the two assessments shall not be less than the total amount which would have been paid by the husband alone, if the wife's income had been assessed as his income — section 67(6). Where separate assessments have been made upon the two spouses, the tax is payable by the spouse upon whom any separate assessment notice has been served — section 84(*b*). Under these circumstances, the husband cannot be held responsible for payment of the wife's assessment. To protect the *fiscus* against the loss of revenue in the event of the wife not paying her tax, it should be provided that the husband by whom such tax would have been payable if the separate assessment had not been made shall be chargeable with the tax after the wife's assets have been excussed. The Income Tax Act

[2] *Israelson* v. *C.I.R.*, 1952 (3) S.A. 529 (A.D.); 18 S.A.T.C. 247.
[3] See the remarks of Watermeyer, C.J., in *C.I.R.* v. *Simpson*, 1949 (4) S.A. 678 (A.D.); 16 S.A.T.C. 268.

of the Federation of Rhodesia and Nyasaland now contains such a provision (section 67(3A)).

It is seen, therefore, that the issue of separate returns to the spouses does not lessen their aggregate tax liability. It merely provides for an equitable apportionment of the tax liability so that one spouse is not called upon to pay tax on income received by the other.

Where a husband and wife are not living together and are not separated by written agreement or by a judicial order of separation, the husband is still regarded as a married person for income tax purposes and to his income there is added the income of his wife. The Act, however, provides no authority whereby a husband can recover from his wife any tax payable by him due to the inclusion of her income in his, and a husband who does not have his wife living with him can be called upon to pay taxes on income enjoyed by his wife. If he desires to avoid the payment of such tax, it would seem that his only remedy is to apply in writing to the Commissioner in terms of section 58(1) for the issue of separate returns and assessments to him and his wife in the manner described above.

To secure the advantage of separate returns, the husband should make application in good time before the Commissioner's annual public notice calling for returns. His application will not be prejudiced if he makes immediate application upon receipt of his return of income, but to postpone application until an assessment has been raised on the joint income as disclosed by a joint return submitted by him could rob him of the advantage of separate assessments.

If the Commissioner considers it desirable he can also call for separate returns from husband and wife. This power he is only likely to exercise in special circumstances such as where the husband is resident abroad and the wife is in receipt of income that is subject to tax. He will then call for a separate return from the wife for the purpose of issuing a separate assessment.

The decision of the Commissioner in the exercise of his discretionary power to call for the rendering of separate returns by the spouses, if made properly and *bona fide*, is not subject to review by the courts.

There is no time limit to the proviso to section 58(1). After spouses are divorced the Commissioner does not lose his right to require the husband or wife to render returns of income separately, such returns referring to a period when the husband and wife were married to each other.[4]

If, in a case where husband and wife have been allowed to render separate returns in terms of section 58(1), penalties are imposed for the late rendition of returns or for the omission of any income, the Commissioner's practice is that it is only the guilty spouse responsible for the late rendition or omission of income who is liable to the penalty. Where both husband and wife render late returns or omit income, each is liable to the penalty which is calculated according to the tax apportioned to each spouse.

[4] *C.I.R.* v. *Bulcraig*, 1954 (1) S.A. 542 (C); 19 S.A.T.C. 137.

The Act does not lay down the method of calculating the amount that each spouse has to contribute to the total tax calculated on a joint assessment basis. The Commissioner, however, adopts the following basis of apportionment as regards normal tax:

Stage (a)

Calculate what normal tax (prior to the deduction of the savings levy) each spouse will pay on his or her own taxable income as if each was taxed separately as a married person. The rebates are granted in full to each spouse so that the wife is entitled to the same rebates which the husband is entitled to on a joint assessment.

Let A be the amount of normal tax (prior to the deduction of savings levy) payable by the husband on his own separate income.

Let B be the amount of normal tax payable by the wife on her own separate income.

Stage (b)

Calculate in the usual way the total normal tax payable by the husband alone on a joint assessment basis (before deducting the savings levy).

Let E be the amount of normal tax payable by the husband on the joint income.

Stage (c)

Deduct (A + B) from E and let the amount remaining be G.

Apportion G between husband and wife in the ratio that the taxable income of each spouse bears to the combined taxable incomes of the spouses.

Let I be the apportioned share of the husband.

Let J be the apportioned share of the wife.

Stage (d)

Determine the normal tax payable by each spouse (including the savings levy).

The *husband* will pay A + I.

The *wife* will pay B + J.

Stage (e)

Determine the normal tax payable by each spouse (excluding the savings levy).

The savings levy to be contributed by each spouse is 2/25ths of each completed pound of the amounts determined in (*d*), the balance remaining representing the actual normal tax payable by the parties.

Super tax is payable if the combined income subject to super tax exceeds £2,300. The method of calculating the amount of super tax that each spouse has to pay follows the same pattern as the normal tax calculations. The total super tax payable on the combined income subject to super tax is apportioned between the two spouses in the manner indicated above.

Although it is the husband who is liable for the personal tax on the combined income, each spouse is responsible for provincial income tax in respect of the normal and super taxes apportioned to and payable by them. As provincial income tax is payable on the normal and super tax before the addition of the surcharge, the normal tax and super tax apportioned to each spouse have to be reduced to exclude the surcharge. The rate of provincial tax depends upon the province in which each spouse resides.

§ 95. Criticism of the system of separate assessments

The above method of dividing the tax liability between the spouses is fair and reasonable since the tax liability of the spouse with the lesser income is not unduly inflated. The method of apportionment clearly has regard to the progressive nature of the rates of tax. The Committee of Enquiry into the Income Tax Act recommended that the Act should confer on the Commissioner statutory authority for the application of the present system of apportionment.[5] The apportionment of taxes is not a matter which should be left to the practice of the Commissioner as the proprietary rights of the spouses are affected thereby. The Act should, therefore, clearly lay down the basis of apportionment.

The system of apportionment works well in practice where the parties have been married for the whole of the tax year and where both have earned a taxable income for the year. Difficulties will be experienced where one of the parties incurs an assessed loss and the other derives a taxable income. For example, take the case of husband and wife who both carry on business. In year I, assume that the wife (W) has incurred a loss from her business amounting to £2,000 and the husband (H) has derived a profit of £4,000. In year II, W has derived a taxable income of £2,000 and H has also earned an income of £2,000. Now section 67(6) provides as follows:

> 'Any separate returns which may be rendered by spouses in terms of the proviso to sub-section (1) of section *fifty-eight* shall be separately assessed and separate notices of assessment shall be sent to the respective spouses: Provided that the total tax payable in respect of the separate assessments so issued shall not be less than the total amount which would have been payable by the husband alone if the incomes of both husband and wife had been assessed as the income of the husband alone.'

It is the well-established practice of the Department to apportion the tax liability in every case where liability does arise notwithstanding that the total tax payable in respect of the two separate assessments is greater than the tax payable by the husband on a joint assessment basis. In other words, the Departmental practice involves reading the words 'shall not be less than' as meaning 'shall be equal to'. Thus, in the example given, the Commissioner will probably act as follows:

[5] *Second and Final Report*, p. 36, para. 7.

Year I: W's assessment will reflect an assessed loss of £2,000 with no tax payable.
H's assessment will reflect a taxable income of £4,000 but he will be liable to tax on £2,000 (£4,000 *less* £2,000).

Year II: W's assessment will reflect a taxable income of £2,000.
H's assessment will reflect a taxable income of £2,000.
The total tax payable on a taxable income of £4,000 will be apportioned in equal shares between the parties.
Hardship falls on W, who over the two years has earned no taxable income, but has to pay tax on the basis of a taxable income of £2,000. H, on the other hand, has earned a taxable income of £6,000 over the two years, but pays tax on the basis of a taxable income of £4,000.

Anomalies and inequities, therefore, arise where one party incurs an assessed loss and the other a taxable income. The present practice of the Department has, so far, not been tested in the courts.

Another problem which arises concerns the case of where the parties are not married during the whole of the tax year and have applied for separate returns. During the prenuptial or postnuptial periods falling into the tax year, either spouse may have earned an income. This could arise in the year the marriage takes place or in the year the marriage is dissolved by death of one of the spouses or in the year of separation or divorce. For example, take the case of parties who are separately assessed and who were divorced on 30th September, 1958, and who derived the following incomes in respect of the 1959 tax year:

Husband:	Income	1. 7.58 to 30.9.58	£900
		1.10.58 to 30.6.59	£3,000
Wife:	Income	1. 7.58 to 30.9.58	£100
		1.10.58 to 30.6.59	£400

It must be borne in mind that whereas the wife is a new taxable *persona* from the date of divorce, the husband's status is not affected at all by the divorce. He is assessable as a taxable *persona* for the whole of the 1959 tax year and in determining what taxes would have been paid by him on a joint assessment basis, the taxable income must be taken as £4,000 (his own £3,900 *plus* his wife's £100 up to the date of divorce). But in regard to this amount of £4,000, it includes £3,000 income earned outside the marriage period. No doubt, in practice, the Department adopts some reasonable formula which is fair to both parties. But is it right that an issue affecting the proprietary rights of the spouses should be left to the practice of the Commissioner? The rejection by the Income Tax Commission[6] of the Committee of Enquiry's recommendation (*supra*) that the Act should clearly lay down the basis of apportionment of tax liability between husband and wife on the grounds that the Commission is not in favour of the introduction into the Act of rigid rules for interpretation, is not understandable.

[6] *First and Final Report*, p. 36, para. 69.

§ 96. Marriage during a year of assessment

Where there is a marriage during the year of assessment, the husband is regarded as a married person for that year since, in terms of para. (*a*) of the definition of *married person* in section 1, he is a person who was married during a portion of the year of assessment. Married rates of tax are applicable and he is entitled to the primary rebate of £31. This benefit he enjoys for the whole of the tax year in which the marriage takes place. Thus, if A, the husband, marries B on 1st March, 1958, he is regarded as a married person for the whole of the tax year ended 30th June, 1958, even though he was single for eight months. The husband's income for the year is determined in the usual manner but to his income there is added the income of his wife from the date of marriage to the last day of the tax year, in terms of section 9(2). As he was a taxable *persona* for the whole year of assessment, the rebates applicable to him are not proportionately reduced.

The wife loses her status as a separate taxable *persona* from the date of marriage[7] unless application is made for separate returns in terms of section 58(1). In respect of income derived from the beginning of the year of assessment until the date of marriage, this is taxable in her own hands as an unmarried person. As her period of assessment is less than a full year, the rebates applicable to her are proportionately reduced.[7] She is not liable to personal tax but provincial income tax is payable if she is liable to normal or super tax. The assessment so raised on her is payable by her and no liability attaches to the husband in respect thereof save in the case of marriage in community of property when pre-marital debts are payable from the community estate. From the date of marriage, any income accruing to her is taxable in the hands of her husband in terms of section 9(2).

As long as the wife earns no income, the husband pays less tax than what he paid as a bachelor. Firstly, as a married person his normal tax rate is 3*d.* per £ of taxable income less than that payable by a single person. Secondly, he is entitled to a primary rebate of £31 as compared with £23 granted to an unmarried person. Thirdly, he is entitled to lower personal tax rates than a single person and in certain of the provinces he also pays a lower rate of provincial income tax. Thus, if he is resident in the Cape, on a taxable income of £1,000 he pays £62 tax as compared with £96 payable by a single person. On a taxable income of £1,600, he pays £126 against £171 payable by an unmarried person, whereas if the taxable income is £2,000, he pays £170 as compared with £223 payable by a single person. A would-be husband planning his marriage in July or August would, therefore, be well advised to arrange his wedding prior to 30th June so that he can get the advantage of the lower tax rates and higher reb^te for married persons in respect of that tax year. On a taxable income of £1,000, the saving is £34, on an income of £1,600, the saving is £45 and on £2,000 it is £53. From the monetary point of

[7] I.T.C. No. 196, 5 S.A.T.C. 379.

view, therefore, it would be well worth his while to hasten his marriage so that it falls into the previous tax year.

Where both the wife and the husband earn income, it may not necessarily pay the parties to hasten their marriage so that it falls into the earlier tax year. Each case must be decided on its own merits. The writer has experienced a case of a couple who had planned their marriage for 15th June of a tax year, i.e. about two weeks before the end of the tax year. The husband earned a salary of £3,000 per annum, whereas the wife's income consisted of preference dividends totalling some £2,000 per annum. These dividends accrued as to £500 on 31st December and £1,500 on 30th June of each tax year. If the marriage had gone through as arranged, i.e. on 15th June, the husband's income for that tax year would have increased by £1,500 (at 30th June he would have been married and in terms of section 9 (2) his wife's income is deemed to be his). The additional tax payable would have amounted to some £400. The parties were well advised to postpone their marriage to 1st July so that the wife's dividends accrued to her for that previous tax year. On the £2,000 dividends received she was not liable for any tax except for a mere £10 of personal tax. The husband paid tax on £3,000 only for that year. The parties, by postponing their marriage to 1st July, saved £400 in tax and received their biggest wedding gift!

If, up to the date of her marriage, the wife has incurred an assessed loss it would appear that as she ceases to be a taxable *persona* such loss falls away. The husband is not entitled to the benefit of this loss. This is a most unfortunate result which should be rectified. It means that if, prior to her marriage, a woman has incurred an assessed loss in a business carried on by her and she continues to carry on the business after marriage, she is not entitled to carry forward the prenuptial loss and to set it off against postnuptial profits. It may be suggested that by requesting separate returns of income, the wife can preserve her prenuptial loss since she continues to be a taxable *persona* from the date of her marriage. Apart from the difficulty of satisfying the Department that the provisions of section 58 (1) and section 67 (6) make her a separate taxable *persona* — the Departmental practice does not appear to regard her as such but looks upon the provisions merely as a means of apportioning the tax liability between the spouses — there are also the provisions dealing with the carrying forward of an assessed loss to consider. Thus, section 11 (3) (*a*) provides that there shall be set off against income 'any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment'. Will a court be prepared to hold that an assessed loss incurred by a single woman in respect of the period from the beginning of the tax year to the date of her marriage and now separately assessed as a married woman for the period from the date of marriage to the end of the tax year, is one that has been incurred 'in any previous year which has been carried forward from the preceding year of assessment' and can thus be carried forward from the prenuptial assessment to the postnuptial separate assessment made on the wife? The problem is indeed a difficult one and one that has not yet been tested in the courts.

§ 97. DEATH OF A SPOUSE DURING A YEAR OF ASSESSMENT

In respect of the income of a person who dies during a year of assessment, or who dies after the close of a year of assessment but before rendering a return of his income for such year of assessment, the executor or administrator is the representative taxpayer — section 69. The executor is responsible for making a return of income to the date of death, admitting the claim for tax against the assets of the estate and generally representing the deceased in all matters relating to taxation.

Where the husband dies during the year of assessment, his income and his wife's from the beginning of the year of assessment to the date of his death are added together and are subject to tax. Since the deceased husband's period of assessment is less than a full year, the rebates applicable to him are proportionately reduced. If, at the date of death, the taxpayer had not resided in any province for at lease ninety days during the year of assessment, the provincial income tax, it is submitted, is not payable in respect of that year of assessment. Personal tax is not payable in respect of any tax year where the taxpayer has died prior to the date prescribed for the payment of personal tax by persons who are not income taxpayers. Income taxpayers resident in Natal are not entitled to this concession.

The wife's income for the period between the date of death and the last day of the tax year must be returned as her separate income, since, as from the date of death, she becomes a taxable *persona* and is subject to tax on such income — section 58(2). Since her period of assessment is less than twelve months, the rebates applicable to her must be proportionately reduced. She is regarded as a married person for tax purposes in terms of para. (*a*) of the definition of *married person* in section 1.

Where the wife dies during a year of assessment, her income to the date of her death is included in the husband's income for that year of assessment in terms of section 9(2). It follows, therefore, that no taxes are payable by her estate and there is no need for her executor to make a return of income to the date of death. The position would, however, be different if she or her husband had applied for the issue of separate returns in terms of section 58(1). In such a case she would be a taxable *persona* and her executor would be required to complete a return of income to the date of her death. The amount payable in respect of her separate assessment would, in terms of section 84(*b*), be due by her estate and the executor would be required to admit the claim against the assets of the estate. As far as the husband is concerned, his assessment in respect of the year of assessment is undisturbed by the death of his wife during that year. Though a widower, he is regarded as a married person in terms of para. (*a*) of the definition of *married person.*

Serious inequities in regard to the question of an assessed loss can fall upon a wife, who is carrying on her own business, in the event of the death of her husband during the tax year. If, up to the date of death, the wife has incurred a loss from the business, this loss attaches to the husband so that on his death it falls away. After her husband's death, the wife is taxable as a separate taxable *persona* on profits derived from the business without the right to set off previous losses. An actual case which comes to the writer's mind concerned a married woman who was carrying on a seasonal residential hotel business in a coastal resort. Her husband having died sometime in November, the executors submitted a return of income to the date of death covering the period July to November. This being the winter season, a loss of some £5,000 was incurred. The widow submitted a return of income for the period from the date of death to 30th June next disclosing a profit of some £10,000 which in effect meant that for the financial year an overall profit of £5,000 resulted which was the normal annual profit for a business of this nature. The Commissioner assessed the loss of £5,000 incurred up to the date of death of the husband in the hands of the executor as representative taxpayer for the deceased. As regards the profit of £10,000 derived during the remainder of the tax year, he assessed this amount in the hands of the widow but refused to permit her to deduct the loss of £5,000 since he rightly contended that this loss could not be carried forward as it attached to her late husband. In the result the widow was taxed on a taxable income of £10,000 whereas in truth she only earned £5,000 for the year. The tax payable on the additional £5,000 was indeed crippling since at that time the maximum tax rate was not 12*s*. 6*d*. but some 18*s*. or 19*s*. in the £. The law in this respect is most iniquitous and requires rectification. The question whether this anomaly can be avoided by the widow requesting a separate assessment in respect of the period from the beginning of the tax year until the date of death is similar to the one considered in relation to the carrying forward of an assessed loss incurred by a wife in a prenuptial period to a postnuptial period where separate returns have been requested (see § 96).

§ 98. Separation and divorce

Where husband and wife are separated under a judicial order or written agreement of separation or divorced under an order of divorce, the provision contained in section 9(2) of the Income Tax Act that any income of the wife is deemed to be income accrued to her husband does not apply. In the case of separated spouses, section 9(2) expressly provides that its terms do not extend to husband and wife who are separated under a judicial order or written agreement of separation, whereas in the case of divorce, since the relationship of husband and wife no longer exists, it is clear that section 9(2) does not apply. From the date of separation or divorce, the wife or former wife reverts to the status of a taxable person as she was prior to marriage. The husband or former husband continues to be a taxable person. Each party is responsible for the return of his or her own income, separate assessments are raised on each party, and each is liable for his or her own tax.

Where two spouses are separated under a judicial order or written agreement of separation or divorced during a year of assessment, the husband or former husband pays tax on his income for the whole year of assessment, plus the income earned by his wife or former wife to the date of separation or divorce. He is regarded as a married person for the whole of that tax year since he was married during portion of that year and therefore complies with para. (*a*) of the definition of *married person* in section 1. The wife or former wife becomes a taxable *persona* from the date of separation or divorce[8] and pays tax on income received from the date of separation or divorce to the end of that tax year. She is regarded as an unmarried person for tax purposes, unless she is entitled to the child rebate in terms of the proviso to section 13 (2) (*a*) (see *infra*), in which case she will be regarded as a married person. (In terms of para. (*b*) of the definition of *married person* in section 1, a person who is divorced or separated under a judicial order or written agreement during the whole of a period of assessment and is entitled to a child rebate in terms of section 13 (2) (*a*), is regarded as a married person.) Since her assessment covers a period which is less than twelve months, her rebates are proportionately reduced.[9]

During the next succeeding years of assessment, as long as the parties are separated or divorced throughout those periods, both are regarded as unmarried persons for tax puposes, unless they are entitled to a child rebate in terms of section 13 (2) (*a*) and therefore comply with para. (*b*) of the definition of *married person*.

As in the case of marriage or death during a year of assessment most iniquitous results can arise in regard to the question of assessed losses incurred by the wife in the carrying on of a business. If at the date of separtaion or divorce, the wife has incurred an assessed loss in her business, it is the husband who is entitled to the benefit of this loss and not the wife. He is entitled to carry it forward and to set it off against any taxable income earned by him in future years. The wife pays tax on all future profits derived from the business without regard to the assessed loss which she incurred in previous years. The results can be startling indeed. If the parties are divorced on, say, 31st March of the tax year, the wife's income for the period 1st July to 31st March is taxable in the hands of her husband. If she is carrying on a business and has incurred an assessed loss of, say, £6,000, this loss is assessed in her husband's name. If the husband is working and earns, say, £2,000 per annum, he is entitled to set off the assessed loss against his salary. On this basis, not only is he free of tax for the year in which the divorce took place, but his salary for the next two years is also free of tax because of the wife's loss which he is entitled to carry forward. As regards the wife, she is taxable in

[8] See I.T.C. No. 578, 13 S.A.T.C. 490.
[9] See I.T.C. No. 802, 20 S.A.T.C. 241.

her own name for income earned from the date of divorce. Thus, if her business yielded a taxable income of £3,000 for the period 1st April to 30th June, she is taxable on this amount without reference to the assessed loss of £6,000 made in the first nine months. Although she incurred a net loss of £3,000 from her business for the year, she is taxable on £3,000! The husband can utilize her loss of £6,000 incurred during the first nine months to free himself from taxation for three tax years. An Act which can permit such inequities is indeed bad law and it is a matter for regret that the Committee of Enquiry into the Income Tax Act did not consider this problem at all.

The question whether a divorced or separated wife can avoid this anomalous position by requesting a separate assessment in respect of the period from the beginning of the tax year until the date of divorce or separation is similar to the one considered in relation to the carrying forward of an assessed loss incurred by a wife in a prenuptial period to a postnuptial period where separate returns have been requested (see § 96).

§ 99. Alimony and maintenance payments

Any amount paid to his spouse or former spouse under any judicial order or written agreement of separation or under any order of divorce, by way of alimony or maintenance for such spouse and any children, forms part of the taxable income of such spouse. The person by whom such amount is paid has his taxable income reduced thereby — section 58(3).

It is submitted that the recipient of the alimony or maintenance is taxable thereon only if it has been received or accrued from a source within the Union. It is true that section 58(3) does not refer to a source at all but it is submitted that section 58(3) must be read together with section 7(*h*) which provides that 'gross income' includes 'any amounts which in terms of other sections of this Act are specifically required to be included in the taxpayer's income'. It is considered that section 58(3) is one of these *other sections*, and if this view is correct it must follow that the alimony or maintenance must be regarded as constituting part of the recipient's gross income provided that it has its source or origin in the Union.

As regards the payor of the alimony or maintenance, he is entitled to have his taxable income reduced whether or not the written agreement of separation or order of separation or divorce was executed or granted in the Union. There is also nothing in section 58(3) to prevent the payor from claiming the deduction in a case where the alimony or maintenance is drawn from funds situated outside the Union. Furthermore, it is submitted that the reduction in the payor's taxable income is not dependent on whether the payee is subject to tax on the alimony or maintenance so that if the alimony is from a source outside the Union and the payee is not subject to tax thereon, this, it is submitted, does not debar the payor from having his taxable income reduced by the amount of the alimony.

Very recently the Commissioner has ruled that the payee of alimony or maintenance is subject to tax thereon whether or not the source is in the Union as long as the payor's taxable income is reduced by the amount of such alimony or maintenance. The writer understands that as long as any portion of the alimony or maintenance is deducted from the payor's taxable income, the payee will be subject to tax on the full amount of such alimony or maintenance irrespective of the source thereof. Presumably if the payor has no taxable income from which any portion of the alimony can be deducted, the payee will not be subject to tax on such alimony even though the source is in the Union. It is doubtful whether this is correct law.

Section 58(3) provides that the person by whom the alimony or maintenance is payable 'shall have his taxable income reduced thereby'. This, it is submitted, means that the alimony paid cannot be used to create an assessed loss or increase an assessed loss. Thus, if the payor's taxable income before taking into account the alimony or allowance results in an assessed loss, such an assessed loss cannot, it is submitted, be increased by the amount of such alimony. If the payor has a taxable income of £500 before taking into account the alimony of, say, £750 paid, the taxable income must be reduced to nil but the excess of the alimony over the taxable income, it is submitted, does not constitute an assessed loss. The Commissioner follows this procedure in practice, although, until very recently, he did permit the payor to create an assessed loss or increase an assessed loss with the amount of any alimony paid.

Section 58(3) clearly provides that it is the *taxable income* that must be reduced by the amount of the alimony paid. It must follow, therefore, that a payor whose income consists wholly of dividends is not entitled to deduct the alimony in the determination of his income subject to super tax since only the *taxable income* is subject to reduction. For the same reason, any excess of the alimony over the taxable income does not rank for deduction from any dividends in the super tax assessment.

In *Price* v. *C.I.R.*,[10] it was held that the provisions of section 58(3) apply only to amounts which are made payable by the order of court or agreement to the wife or former wife. Thus, if in terms of the order or agreement, the husband is obliged to pay for all boarding and school fees, travelling expenses, clothes, pocket money, medical and dental expenses while the children are at boarding school and he is not compelled, by that order or agreement, to make these payments to his wife, he cannot deduct these amounts from his taxable income in terms of section 58(3) and his wife is consequently not taxable on these amounts.[11]

To fall within section 58(3), the alimony or maintenance must be paid under any judicial order or written agreement of separation or under any order of divorce. Thus, payments made under a notarial agreement, executed before the date of the order of court granting

[10] 1946 A.D. 676; 14 S.A.T.C. 177.
[11] See also I.T.C. No. 216, 6 S.A.T.C. 136.

the divorce and not incorporated therein, were held to be not deductible.[12] Where a Court when granting a divorce made an order excluding therefrom the payment of certain allowances for the support of the taxpayer's wife and minor child, and the husband thereafter by notarial deed entered into subsequent to divorce undertook to make these allowances, it was held that the deduction of these amounts was not allowable since they were not payable under the order of divorce as required by section 58(3).[13] Payments made prior to the date of divorce under an agreement which is subsequently made part of the order of divorce do not rank for deduction as they were not paid under the order of divorce.[14]

If the husband pays to the wife alimony in excess of the amount stipulated in the judicial order or written agreement of separation or in the order of divorce, he is not permitted to reduce his taxable income by that additional amount and the wife's taxable income will therefore not be increased by that amount. It has been held that an amount paid under an order of court for the maintenance of a wife, *pendente lite,* was not deductible since section 58(3) does not admit of the allowance of a deduction in respect of maintenance payments made under *any* judicial order but only in respect of such payments as are made under a judicial order of separation or under an order of divorce.[15]

In another case, an order of divorce provided *inter alia* for the settlement upon the wife and the transfer to her of a property which was bonded, the husband undertaking to pay the interest on the bond and the rates and taxes on the property. The Special Court held that these amounts constituted an 'allowance' payable under the order of divorce and were deductible in terms of section 58(3).[16] In another case,[17] a taxpayer was required in terms of an order of court to provide his wife with an insurance policy taken out on his life, the premium to be paid by him. It was held that the amounts paid in respect of premium constituted amounts payable by way of maintenance of his former spouse within the meaning of section 58(3) and were deductible. The Court considered that maintenance included making arrangements for the future.

A fixed sum payable by one spouse to the other being in full satisfaction of any claim which the recipient might have under an antenuptial contract or in respect of maintenance or otherwise, even if payable under an order of court, is not deductible in terms of section 58(3).[18] It has been held that a payment under a divorce order in settlement of a claim to a division of the joint estate does not fall within the provisions of section 58(3).[19]

[12] I.T.C. No. 804, 20 S.A.T.C. 327.
[13] I.T.C. No. 759, 19 S.A.T.C. 99.
[14] I.T.C. No. 822, 21 S.A.T.C. 76.
[15] I.T.C. No. 756, 18 S.A.T.C. 430.
[16] I.T.C. No. 759, 19 S.A.T.C. 99.
[17] I.T.C. No. 776, 19 S.A.T.C. 318.
[18] I.T.C. No. 109, 4 S.A.T.C. 57.
[19] I.T.C. No. 820, 21 S.A.T.C. 72.

Where a woman receives from her former husband under an agreement a fixed monthly allowance, whether for her maintenance or for the maintenance of the children, and this arrangement is not made part of the order of divorce, it is submitted that the fixed monthly amount payable to the former wife constitutes an annuity subject to tax in her hands in terms of section 7 (*a*), notwithstanding that the former husband is not entitled to have his taxable income reduced in terms of section 58 (3).

§ 100. CONSEQUENCES OF DIVORCE OR SEPARATION IN REGARD TO THE CHILD REBATE

A separated or divorced parent is not allowed the child rebate in respect of any child born of the marriage in connection with which the divorce or separation has taken place, unless, in terms of the proviso to section 13 (2) (*a*) —

(i) he has maintained such child during the period of assessment, and

(ii) there has not been deducted the cost of such maintenance, in terms of section 58 (3), from his taxable income.

Generally speaking, it is the party who has the custody of a child and maintains it who complies with (i) and (ii) *supra* and who is entitled to the child rebate.

It is submitted, however, that if, in terms of an order of court, the wife is given the custody of the children and the husband is to make monthly payments to the wife for the maintenance of the children, the husband is entitled to the rebate in respect of the children in the year of separation or divorce, since he complies with (i) above in that he has maintained the children during the period for which his assessment is made, i.e. twelve months, and he also complies with (ii) above in that the whole cost of such maintenance has not been deducted from his taxable income in terms of section 58 (3); only the maintenance payments made after divorce or separation have been deducted in terms of that section. This, it is submitted, appears to be the effect of the decision in *Savage* v. *C.I.R.*,[20] the Court holding that the word *maintained* in (i) above includes maintenance by a spouse who has not got the custody of the children but who pays the other spouse for the maintenance of the children. In that case a husband, who was separated from his wife by a notarial deed, paid, in addition to a fixed annual sum for ordinary maintenance for his children, which sum was made payable to the wife in terms of the deed, further sums in accordance with the deed in respect of education, unusual medical and hospital expenses. He was allowed to deduct from his taxable income the fixed payments made payable to his wife, in terms of section 58 (3), but the educational and medical expenses were disallowed since they were not paid to his wife in terms of the deed (*Price* v. *C.I.R.*).[21] The Court held that as

[20] 1951 (4) S.A. 400 (A.D.); 18 S.A.T.C. 1.
[21] 1946 A.D. 676; 14 S.A.T.C. 177.

the whole cost of the children's maintenance had not been deducted from the husband's income in terms of section 58 (3), but only a portion thereof, the husband satisfied the requirements of the proviso to section 13 (2) (*a*) and was entitled to be taxed as a *married person* in terms of para. (*b*) of the definition in section 1. In such circumstances, the Commissioner, in practice, also regards the wife as complying with the proviso to section 13 (2) (*a*), which means that both parties are granted the rebate in respect of the same children. The wife or former wife, who in terms of the order of court receives the periodical payments for the maintenance of the children, stands on the same footing as if she had maintained the children out of her own funds. There is no express authority of this in the Act, but this is well-established practice and, it is submitted, is the legal position because section 58 (3) provides that the maintenance must be regarded as her own income. She, therefore, complies with section 13 (2) (*a*) and is entitled to a rebate for the children. Once she is entitled to the deduction in respect of a child, she is also taxed at the normal tax rate and is entitled to the primary rebate applicable to a married person since she is regarded as a married person in terms of paragraph (*b*) of the definition of *married person* in section 1.

Where a third party is appointed guardian of a child, it is the spouse who is responsible for the making of the allowances to such third party for the purpose of maintaining the child who is entitled to the child rebate and thus regarded as a married person. If both spouses contribute towards the maintenance of the child, each must be granted a rebate in respect of the child and accordingly be treated as a married person.

The Special Court has held[22] that the words ' during such period ' in the proviso to section 13 (2) (*a*) meant ' throughout any portion of the year of assessment ' and regarded a divorced woman, who wholly supported her children throughout the school holiday periods they spent with her, as falling within the literal language of section 13 (2) (*a*) and thus entitled to the rebate in respect of such children and to be classified as a married person for income tax purposes. The Court left open the question whether the words ' he has maintained ' in the proviso to section 13 (2) (*a*) must be read as ' wholly ' or ' exclusively ' maintained. It is submitted, however, that if the legislator had intended exclusive maintenance, he would have said so and that a parent falls within the proviso to section 13 (2) (*a*) if he has maintained a child, whether wholly or partially, during any part of the year of assessment and such cost of maintenance has not been deducted from his taxable income in terms of section 58 (3).[23]

§ 101. ANOMALY CREATED BY ' SAVAGE'S ' CASE

Having regard to the principle established in the case of *Savage* v. *C.I.R.*[24] (*supra*), it would seem that it becomes a relatively simple

[22] I.T.C. No. 801, 20 S.A.T.C. 235.
[23] See I.T.C. No. 90, 3 S.A.T.C. 233, and I.T.C. No. 465, 11 S.A.T.C. 202.
[24] 1951 (4) S.A. 400 (A.D.); 18 S.A.T.C. 1.

matter for a separated or divorced spouse who is paying a fixed allowance to the other spouse for the maintenance of any children of the marriage to become entitled to a child rebate and hence enjoy the benefit of the higher rebate and the lower progressive rate of tax applicable to a married person in addition to his right to claim as a deduction from income in terms of section 58 (3) the amount of such allowance. All he need do is to make some voluntary contribution — it does not matter how much — during the year of assessment towards the maintenance of his child. Since he is not entitled to deduct this amount from his income in terms of section 58 (3), it must follow from the principle established in *Savage's* case that he is entitled to the child rebate and hence must be regarded as married for tax purposes. As regards the divorced or separated person who receives the allowance, which is included in her income in terms of section 58 (3), she is regarded as having maintained the children and is entitled to a child rebate and thus regarded as married. Both spouses are, therefore, entitled to the child rebate in respect of the same children and both are regarded as married for tax purposes. To take another method, by the expedient of providing in the order of divorce or in the deed of separation for a spouse to make some contribution to the maintenance of a child which cannot be deducted from his income in terms of section 58 (3), e.g. the spouse can undertake to pay the medical expenses of the children (cf. *Savage's* case), he is entitled to the child rebate and must be taxed as a married person in the same way as the other spouse who in effect maintains the child.

This is an anomaly which has so far not been rectified. The Committee of Enquiry into the Income Tax Act[25] pointed out the difficulties arising in regard to the determination of who shall receive the child rebate and be entitled to taxation on the basis of a married person in regard to separated and divorced persons. It recommended as follows:

(1) that in the case of persons separated by judicial order or written agreement, or divorced persons, the provisions of the present Act, whereby payments made by way of alimony or allowance under a judicial order or by written agreement are taxable in the hands of the spouse of the marriage or former marriage receiving the payment and allowed as a deduction by the spouse making the payment, should not be disturbed;

(2) that where the Commissioner is satisfied that one of the spouses has maintained a child of the marriage or former marriage during the year of assessment and that the other spouse has not contributed towards such maintenance (other than by means of a contribution of an amount which has been included in the income of the spouse who maintained the child), the spouse so maintaining the child shall be permitted a concessional deduction in respect of the child;

(3) that where the Commissioner is not so satisfied but is satisfied that the cost of maintenance of such a child has been borne by both spouses, the amount of the concessional deduction in respect of

[25] *First Report*, p. 42, paras. 42 to 50.

the child shall be allowed partly to the one and partly to the other spouse, in such proportions as the Commissioner may determine;

(4) that the basis of taxation applied to the spouses be that applicable to *unmarried* persons, except in the case of such a spouse who has a child or children in respect of which he or she is entitled to the full amount of the appropriate concessional deduction, when the basis applied shall be that applicable to *married* persons.

These recommendations are worthy of consideration by the Legislature. They will certainly plug the hole which permits both spouses to receive the child rebate in respect of the same children.

The Income Tax Commission rejected the recommendations of the Committee since it was of the view that the payment of alimony or maintenance by the one spouse to the other or for the maintenance of any children born of the marriage should not be deducted from the income of the payor nor taxed in the hands of the recipient.[26] It further recommended that divorced persons, whether with or without children, should be treated as unmarried and that where there are children, both parents should be allowed the child's rebate. This recommendation, if adopted, would certainly solve many difficulties in practice including the involved legal interpretation of section 58(3) discussed above. One wonders why the Income Tax Act should treat alimony, which is a completely personal matter concerning the parties, as income of the recipient and as an allowable deduction to the payor. The Commission's recommendation has the great merit of simplicity and is worthy of consideration, although it is wrong that both parties be allowed the child rebate (in this respect see the recommendations of the Committee of Enquiry *supra* in regard to whom should be entitled to the child rebate). It will certainly close the present loophole of both spouses claiming the child rebate in respect of the same children and thereby both being regarded as married persons. The *fiscus* will benefit from the adoption of the new proposal, not only because the parties will be assessed as single persons but by virtue of the fact that the payors of the alimony are usually the husbands or former husbands who are in the majority of cases in higher income groups than their wives or former wives. Thus, the Treasury is likely to collect more tax from the payors of the alimony that it will have to forgo by not taxing the recipients. Countries such as the United Kingdom, Canada and the Federation of Rhodesia and Nyasaland treat alimony payments in a manner similar to the Union, i.e. the payor can claim it as a deduction from income, whereas the recipient is taxable thereon. The Australian Income Tax Act, on the other hand, does not allow alimony as a deduction to the husband or former husband, and as regards the wife or former wife she is exempt from tax on such alimony provided that for the purpose of making such payments the husband or former husband has not divested himself of any income-producing assets, or diverted from himself income upon which he would otherwise have been liable to tax (section 23(2)).

[26] *First and Final Report*, p. 14, para. 58.

There is no doubt that the proviso to section 13(2)(*a*) and para. (*b*) of the definition of 'married person' requires rectification. One wonders why a divorced or separated person should be regarded as a married person simply because he is entitled to a child rebate particularly when he is entitled to deduct from his income the amount of any alimony or maintenance payable to his former wife or wife. In this respect, it is interesting to note that South West Africa in its Income Tax Ordinance provides in para. (*b*) of its definition of 'married person' in section 1 that a divorced or separated person shall only be regarded as married if during the whole of the assessment period he actually maintained a child of the marriage and whose taxable income has not been reduced by the amount of any alimony or maintenance payable to the wife or former wife. The Territory has, therefore, avoided some of the anomalies appearing in the Union Act.

§ 102. Donations tax in relation to the spouses

Donations tax is not payable in respect of the value of any property which is disposed of under a donation to the donor's spouse provided the parties are not separated under a judicial order or notarial deed of separation (section 54*quat*(1)(*b*)). Donations made by a husband to his wife are, therefore, free of donations tax. The reason for the exemption is obvious. A wife's income is deemed to be the husband's in terms of section 9(2). Thus, a husband cannot avoid income tax by transferring income-producing investments to his wife.

Section 54*quin*(1) provides that a donation made by a wife, whether married in or out of community but not separated from her husband under a judicial order or notarial deed of separation, is deemed to be a donation made by her husband and must form part of the husband's cumulative taxable value of donations for the purpose of calculating the tax payable. This is a necessary safeguard for the *fiscus* in order to prevent a reduction of the progressive rate of tax by the splitting of donations between the spouses. Although the husband is liable for the tax on donations made by the wife, any tax payable by him may be recovered from the assets of the wife. If the husband is unable to pay the tax on a donation made by the wife, the Commissioner is also able to recover the tax payable from the assets of the wife. On written application by either husband or wife, or, if the Commissioner considers it desirable, separate payments may be made by or separate assessments may be issued to, the husband and the wife but in such an event the tax payable must not be less than the tax which would have been payable if the donation had been made by the husband alone.

It should also be pointed out that donations by the one spouse to the other under a duly registered antenuptial contract or postnuptial contract are exempt from donations tax in terms of section 54*quat*(1)(*a*). This exemption applies only to donations between the spouses. Donations by other parties to one of the spouses, for example by a parent of one of the spouses, do not fall within the exemption even though made under an antenuptial contract.

Since donations tax is only payable by persons ordinarily resident in the Union and as the property disposed of by a wife is deemed for the purposes of the tax to have been disposed of by the husband, the question arises as to whether a donation by a wife ordinarily resident outside the Union is liable to tax if the husband is ordinarily resident in the Union and vice versa whether liability arises where the husband is ordinarily resident outside the Union and the wife is ordinarily resident in the Union. Section 54 *quin* (1) provides that property disposed of under a donation by the wife is deemed to be disposed of under a donation by her husband. The husband must, therefore, be regarded as having made the donation, and, if he is ordinarily resident in the Union, it is submitted that liability arises even though the wife who made the donation be ordinarily resident outside the Union. Vice versa liability does not arise in respect of a donation made by a wife ordinarily resident in the Union if the husband is ordinarily resident outside the Union.

After the death of the husband or after the wife is judicially separated or divorced from her husband, she is assessable to donations tax in her own name in respect of any donations made. It is submitted that any donations made by her, and which were deemed to be made by her husband during the subsistence of the marriage, must be ignored.

§ 103. Consequences of aggregation of income of husband and wife

A number of taxing systems include provisions whereby the wife's income is added to that of her husband so that the joint income is taxable as the income of one person. Aggregation has appeared in the very first Income Tax Act of the Union and is the rule in the United Kingdom and in the Federation of Rhodesia and Nyasaland. Canada and Australia have not adopted the principle of aggregation.

The Committee of Enquiry into the Income Tax Act[27] did not favour a change from the present position. It held as follows:

> 'We consider that the benefits granted to married taxpayers under the present system in the form of higher basic allowances and a lower rate of tax go far towards offsetting the prejudice to such taxpayers arising from the massing of the incomes of the spouses. The combined income of husband and wife constitutes the resources available to the economic unit comprising the family and we regard it as just and reasonable that taxation should be based upon the combined income. The system is, moreover, simple and easier of administration than a system of separate returns and assessments, particularly in the matter of granting appropriate relief in respect of minor children of the marriage. It is also less open to abuse, for if, in a system of separate assessment, any advantage were capable of being derived by attributing more of the income of the spouses to one and less to the other spouse, it is obvious that it would not be difficult for matters to be so arranged

[27] *First Report*, p. 18, para. 61.

as to bring about that result. In these circumstances we are unable to support any change in the system in this respect.'

Comparisons of the taxes payable by two single persons on their respective incomes and the taxes payable on the joint income if they were combined and taxed as if it was the income of one person, do not bear out the answer given by the Committee that any prejudice occasioned by the massing of incomes for tax purposes is largely offset by higher basic allowances and a lower rate of tax for married persons. Whereas this is true where only the husband earns income, the present system produces different results where both husband and wife earn income. The following table for Cape residents sets out the comparison (1958 rates of tax have been applied and the savings levy has been excluded):

Respective Earnings of the Spouses	*Total Tax Payable (if income merged)*	*Total Tax Payable (if taxed as single persons)*
Husband £300, Wife £300	£17	£10
Husband £400, Wife £300	28	23
Husband £500, Wife £400	51	50
Husband £800, Wife £400	82	91
Husband £1,000, Wife £800	148	169
Husband £1,600, Wife £900	273	256
Husband £2,000, Wife £2,000	833	447
Husband £4,000, Wife £4,000	2,790	1,843

The table shows that where both husband and wife earn income they pay in the lower income groups up to £1,000 or so more than they would pay if they were taxed separately. After £1,000 and where the joint income does not exceed some £2,300, they pay less jointly than if they were separately taxed. On the other hand, where the joint income exceeds £2,300 they pay very much more jointly than they would pay if they were taxed separately. As regards the higher income groups, therefore, persons with large incomes who marry must face the bare fact that simply because they are married to each other they have to pay more tax which is in effect a penalty upon marriage. Thus, if a husband with an income of £2,000 marries a wife with an income of £2,000, they will now pay jointly £833 as compared with a total of £447 if they were taxed separately. If a couple does not wish to suffer this penalty upon marriage there is no way out except not to get married. If they are already married only a divorce or separation, whether under a judicial order or written ageement of separation, will permit them to be taxed as single persons. In effect, therefore, the Income Tax Act makes it cheaper to live together without a marriage licence.

§ 104. Recommendations

The Committee of Enquiry referred to the possibility of abuse by a splitting between husband and wife of income which should really have accrued to one or the other party. The possibility of abuse should not be the decisive factor in this instance since the combining of the incomes of husband and wife is inequitable. As has been pointed out, as regards those taxpayers falling into the group of under

£1,000, marriage increases the burden of tax whereas in the case of those falling between £1,000 and £2,300 marriage lightens the tax burden. In the super tax categories the spouses are put to a very heavy disadvantage when comparing their lot with single persons. If the possibility of abuse is always to be a decisive factor with the legislator then the present Act calls for a number of changes since as has been shown throughout this work the possibility of abuse is very great indeed in many sections of the Income Tax Act. In any event, if aggregation of the incomes of the spouses were abolished, specific provisions can always be made in the Act to guard against abuse by transfer of income-producing assets from one spouse to another or by husbands and wives entering into partnerships.

In the view of the writer, married taxpayers should be given an option as to whether they are to be taxed as one taxable *persona* or as two single persons. Thus, in a case where a wife has no income, the husband will elect to be assessed as a married person. In this way he will receive the benefit of the higher primary rebate and the lower rate of tax. If his wife earns income, he can decide for himself which election will involve him in the smallest tax liability. This method will remove the serious anomalies in regard to the carry forward of assessed losses incurred by the wife at the commencement of marriage, at the date of her husband's death and at the date of separation and divorce and thus nip possible controversies in the bud. The possibility of abuse by a splitting of income between husband and wife should be taken care of by special statutory provisions. For example, income accruing to one spouse, whether directly or indirectly, from gratuitous or non-gratuitous transactions between the spouses should be deemed to be the income of the other spouse and the present exemption from donations tax in respect of the value of donations made by one spouse to the other should be withdrawn. In this respect, the provisions to overcome abuse in the Canadian Income Tax Act, where aggregation does not apply, may be recommended to the South African Legislature. Section 21 reads:

'21. (1) Where a person has, on or after the first day of August, 1917, transferred property, either directly or indirectly, by means of a trust or by any other means whatsoever, to his spouse, or to a person who has since become his spouse, the income for a taxation year from the property or from property substituted therefor shall, during the lifetime of the transferor while he is resident in Canada and the transferee is his spouse, be deemed to be income of the transferor and not of the transferee.

(2) Where a person has received remuneration as an employee of his spouse, the amount thereof shall not be deducted in computing the spouse's income and shall not be included in computing the employee's income.

(3) Where, in a taxation year, a person has received remuneration as the employee of a partnership in which his spouse was a partner, the proportion of the remuneration that the spouse's interest in the partnership business was of the interest of all the partners shall be deemed to have been received by the

spouse as part of the income from the business for the year and not to have been received by the employee.

(4) Where a husband and wife were partners in a business, the income of one spouse from the business for a taxation year may, in the discretion of the Minister, be deemed to belong to the other spouse.'

In the United States of America married persons have the option of either submitting separate returns of income or they may report their income on a joint return. If they adopt the latter course, they are entitled to split their income for purposes of computing their income tax, i.e. the joint income is divided into two, and the tax is then determined on one of the halves and then multiplied by two. It must follow, therefore, that a husband with a taxable income of $10,000 and a wife who has no taxable income will be well advised to file a joint return so that the tax may be computed on the basis of $5,000 income for each spouse. The saving is obvious, since the splitting of the income will throw the taxpayers into lower income brackets with a consequential lowering of the rate of tax.

If the Treasury is not prepared to give married persons an option whether to file a joint return or separate returns, then it is suggested that where a wife received income from employment, the husband should be entitled to elect whether the wife's salary should be taxed in his hands or in the hands of his wife as a separate taxable *persona*. In Israel this procedure has been followed. This will certainly overcome the objection that the country may be losing the services of many married women because the tax incidence does not make it worth their while to be employed. A wife who could possibly earn £480 per annum should she work will not be justified in doing so where her husband is already in possession of an income of £6,000. The additional tax payable by the husband on the wife's income would be about £240 (some 10*s*. per £). Bearing in mind that where the wife is working there is additional expense in the home, e.g. the salary and food for the additional servant or housemaid, the net result may well be that the wife receives very little reward for her labour.

In conclusion, it may be stated that our present system of tax does very little to encourage marriage and families. This fact only becomes too evident when the tax liability of a married man with, say, two children is compared with that of a bachelor at selected levels of income. (It is assumed that the taxpayer is resident in the Cape, 1958 rates of tax have been applied and the savings levy has been excluded.)

Taxable Income	*Tax Payable by Married Person*	*Tax Payable by Bachelor*	*Extent to which Bachelor Pays More*
£1,200	£42	£121	£79
£1,600	85	171	86
£2,000	130	223	93
£2,500	232	335	103
£3,000	408	520	112
£5,000	1,218	1,366	148

The table clearly reveals that there is no equality of sacrifice between married and single persons. It is inequitable that in respect of an income of £1,200, a married man is left with £1,158 (after payment of tax) out of which he, his wife and two children must be maintained, whereas a single man is left with £1,079 — only £79 less — with only himself to maintain. At an income of £1,600, the married man is left with £1,515 out of which to maintain four persons whereas the bachelor is left with £1,429 — only £86 less — out of which to maintain one person only. The inquiry, therefore, reveals that there is a good case for making the bachelor bear a larger share of the tax burden than the married man with a family. In this respect, the present system flagrantly violates the fundamental principle of taxation that the tax should be spread among the tax-paying public according to ability to pay.

CHAPTER EIGHT

TAX EXEMPTIONS AND THE REBATE SYSTEM

I. Tax Exemptions

§ 105. Introduction

In order to arrive at the 'income' of a taxpayer, there must be excluded from his gross income all receipts and accruals which are exempt from tax in terms of section 10.

Exempt income is simply income that is free or immune from tax in the same way as receipts or accruals of a capital nature, but there is a fundamental distinction between the two. A capital receipt completely lacks the quality of income and does not form part of the gross income except in certain exceptional cases. Exempt income, on the other hand, by its very nature is included in the gross income but does not form part of the 'income' in terms of section 7.

Exemption from tax is granted for various reasons, for example because of the special character of the taxpayer, or because of the special nature of the income, or to encourage thrift or savings by investment in certain securities, or to encourage investment by non-residents in Government Stocks or to avoid income being taxed twice.

It is expressly provided in section 10(2) that the exemption from tax conferred on certain bodies, institutions and companies shall not extend to salaries, wages, allowances or pensions paid out of their revenues or profits to their employees.

§ 106. Public revenues

The revenues of the Union Government (including the Railway Administration), any provincial administration in the Union and local authorities and the revenues of any other State are exempt from tax (section 10(1)(*a*) and section 10(1)(*b*)).

The revenues derived by foreign governments, including revenues derived from the carrying on of any kind of trade in the Union, are exempt.

Local authority is defined in section 1 and includes *inter alia* any divisional council, municipal council, town council, village management board and school board. It is not restricted to local authorities in the Union. Foreign local authorities are, therefore, exempt from tax.

The Committee of Enquiry into the Income Tax Act was of the opinion that the revenues derived from the carrying on of any trade in the Union by a foreign state should not be exempted from taxation.

and that the present exemption enjoyed by foreign local authorities should be withdrawn.[1] These recommendations were accepted by the Income Tax Commission.[2]

§ 107. Special bodies and associations

Building societies

The receipts and accruals of any building society are exempt from tax (section 10(1)(*c*)).

Building society is not defined but, it is submitted, it must be an institution essentially similar in character to those which are registered under the Building Societies Act of the Union (No. 62 of 1934).[3]

The exemption is not confined to building societies in the Union. A foreign building society is entitled to the exemption.

Whereas the Committee of Enquiry into the Income Tax Act recommended that the full exemption from taxation of building societies should continue,[4] the Income Tax Commission was of the view that the income of building societies after deduction of expenditure and the interest or dividends paid to investors, depositors or shareholders and any statutory allocations to reserve accounts, should be subject to tax.[5]

Pension, provident and benefit funds

The receipts and accruals of any pension fund, provident fund or benefit fund are exempt from tax (section 10(1)(*c*)).

To be entitled to the exemption, the fund must comply with the definition of 'pension fund', 'provident fund' and 'benefit fund' in section 1 (see §§ 188, 189, 190).

The exemption is not confined to funds in the Union. Approved funds established outside the Union are entitled to the concession.

Mutual savings banks, trade unions, etc.

The receipts and accruals of any institution which is, in the opinion of the Commissioner, a mutual savings bank, a mutual loan association, a fidelity or indemnity fund, a trade union[6] and a non-proprietary stock exchange, are exempt from tax (section 10(1)(*c*)).

It is not a requirement that the institution must be in the Union.

The Committee of Enquiry into the Income Tax Act felt that trade unions should be subject to tax on their investment income.[7] The Income Tax Commission, on the other hand, felt that no distinction should be made between trade unions and mutual loan associations or mutual savings banks and that trade unions should continue to enjoy total exemption from tax.[8]

1 *First Report*, p. 22, para. 6.
2 *First and Final Report*, p. 6, para. 14.
3 See *Benoni Board of Executors* v. *C.I.R.*, 1921 T.P.D. 170.
4 *First Report*, p. 89, chap. 16.
5 *First and Final Report*, p. 23, para. 105.
6 For the meaning of *trade union*, see I.T.C. No. 80, 3 S.A.T.C. 81.
7 *First Report*, p. 23, para. 14.
8 *First and Final Report*, p. 7, para. 20.

Mutual life assurance companies

The receipts and accruals of mutual insurance companies as are derived from the business of life assurance and the granting of annuities, including such receipts and accruals from investments as arise from the business of life assurance and the granting of annuities, are exempt from tax (section 10(1)(*d*)). See § 217 for a discussion on this aspect.

'Not for profit' companies

The receipts and accruals of any company registered in pursuance of a licence granted under section 21 of the Companies Act, 1926, which has not been revoked, are exempt from tax (section 10(1)(*o*)).

Non-resident Banks

There shall be exempt from tax in terms of section 10(1)(*v*) the receipts and accruals of any bank if the Commissioner is satisfied that —

(i) it is not resident in the Union; and

(ii) it is entrusted by the Government of a Territory outside the Union with the custody of the principal foreign exchange reserves of that Territory,

and if the Minister of Finance decides to grant this exemption to the bank.

§ 108. Ecclesiastical, charitable and educational institutions

The receipts and accruals of all ecclesiastical, charitable and educational institutions of a public character, whether or not supported wholly or partly by grants from the public revenue, are exempt from tax (section 10(1)(*f*)).

The exemption is not confined to institutions in the Union. Profits derived from carrying on a business fall within the exemption. Institutions for the relief of poverty, for the advancement of education and religion and for the protection and care of the sick, all fall within the exemption.

The Institution must be *of a public character.* It has been held that the word *public* does not necessarily mean the general community. It includes sections of the public when the benefit to that section is universal and not individual to certain members of that section.[9] Thus, an educational institution for the benefit of the Mohammedan community in the Union was held to be large enough to be described by the term 'public character'.[10]

[9] I.T.C. No. 69, 2 S.A.T.C. 264.

[10] I.T.C. No. 59, 2 S.A.T.C. 186.

Before an institution (which may include a company, or trustees appointed under a will or deed of donation)[11] can be regarded as an ecclesiastical, charitable or educational institution of a public character, it must be clear that it is applying its income directly for the benefit of the public, or, as the courts have put it, it must be 'the object called into existence to translate the purposes as conceived in the mind of the founder into a living and active principle'.[12] The institution must actually perform or carry out functions of an ecclesiastical, charitable or educational nature before it can be regarded as an institution of a 'public character' within the meaning of section 10(1)(*f*). Thus, where an executor under a will in terms of which assets of the deceased were bequeathed to him, was required to pay over the income to the kerkraad of the local Dutch Reformed Church under the condition that the income so received was to be administered by the kerkraad as the 'J.C.K. Fund' to be devoted to the making of annual grants to deserving persons of the district for educational or other purposes, the Special Court held that the 'J.C.K. Fund' was not an ecclesiastical, charitable or educational institution.[13]

It is submitted that where a trust is created, whether under a deed of donation or under the terms of a will, for the purpose of distributing the income derived from the trust assets among charitable institutions, the trustees in such a case cannot be regarded as a charitable institution of a public character within the meaning of section 10(1)(*f*).[14] Similarly, a company formed to call for donations for the purpose of distributing the funds to charitable institutions cannot, it is submitted, be regarded as an institution of a public character within the meaning of section 10(1)(*f*). To qualify, such persons must apply their incomes directly and not merely indirectly for ecclesiastical, charitable or educational purposes. Thus, where a company had as one of its principal objects, the purpose of creating and maintaining schools with the necessary teaching staff for the education, both secular and religious, of the children and other descendants of the Mohammedan community resident in South Africa, the Court held that the company was an educational institution of a public character. Per G. J. Maritz (President): 'The legal ownership of all its assets, of all subscriptions and donations, vested in the company, not for its own benefit or that of its shareholders, but for the benefit of others, viz. for the purpose of being utilized exclusively for the education, secular and religious, of Mohammedan children in the Union. Secondly, it fulfilled the function of a board of control. It controlled the education of those children. It employed teachers and

[11] The Committee of Enquiry into the Income Tax Act was doubtful whether section 10(1)(*f*) applies to trusts formed for ecclesiastical, charitable or educational purposes (*Second and Final Report*, p. 39, para. 24). It recommended a direct reference to trusts in the section. The Income Tax Commission, however, considered that the term 'institution' includes a trust and that the section does not need to include a direct reference to trusts. (*First and Final Report*, p. 37, para. 77.)

[12] I.T.C. No. 69, 2 S.A.T.C. 264; I.T.C. No. 59, 2 S.A.T.C. 186.

[13] I.T.C. No. 26, 1 S.A.T.C. 216.

[14] See I.T.C. No. 239, 6 S.A.T.C. 358; I.T.C. No. 242, 6 S.A.T.C. 366; I.T.C. No. 288, 7 S.A.T.C. 330.

paid them. It might erect schools which it must maintain together with the necessary teaching staffs. In the company, therefore, were all the elements of an educational institution.'[15]

In another case, the trustees appointed to administer a trust fund in terms of a will, were required to devote so much of the income to the payment over to a board of management to be brought into existence in terms of the will, as might be required for the maintenance of a home for aged and indigent ladies and gentlemen of European descent. The will made further provisions in respect of the Home to be established. The Court held that the trustees constituted an institution of a public character within the meaning of section 10(1)(*f*). Per G. J. Maritz (President): 'The trustees were called into being to administer a fund, the proceeds of which were to be devoted to the relief of aged ladies and gentlemen in a manner indicated by the founder of the fund. They were, therefore, translating that purpose as conceived in the mind of the testator into a living and active principle. They had bought a site for the Home; plans for the building were being discussed; the cost of maintaining the inmates and the general costs of administration had been considered by them; and applications for relief under this fund had already been received by them.'[16]

§ 109. NON-PROPRIETARY CLUBS, SOCIETIES AND OTHER ASSOCIATIONS

The receipts and accruals of non-proprietary clubs, societies and associations are, provided they comply with certain conditions, exempt from tax, except as regards investment income (section 10(1)(*e*)).

Investment income is subject to tax in the hands of clubs, societies, and other associations unless they are 'not for profit companies' exempt from tax in respect of all their receipts and accruals in terms of section 10(1)(*o*).

As regards all other profits or gains, whether or not the association is exempt from tax in respect thereof depends upon whether it falls within the terms of section 10(1)(*e*) which confers exemption from tax in respect of all associations which are in the opinion of the Commissioner amateur sporting associations and also in respect of all companies, societies or other associations of persons (other than 'not for profit' companies referred to in section 10(1)(*o*) and societies and companies registered under the Co-operative Societies Act, 1939), which comply with the following requisites:

(i) Their profits or gains (other than investment income) must be derived solely from transactions with or on behalf of their individual members; and

(ii) their constitution must not admit of the distribution of their profits or gains to any persons other than the members with whom or on whose behalf the transactions took place; and

[15] I.T.C. No. 59, 2 S.A.T.C. 186.
[16] I.T.C. No. 69, 2 S.A.T.C. 264.

(iii) their constitution must not confer on any person any benefit other than benefits accruing to that person from transactions with or on behalf of that person.

As regards amateur sporting associations, therefore, they are exempt from tax on all profits or gains, whether derived from transactions with members or non-members. Investment income is, however, subject to tax.

With regard to other clubs and societies, they are exempt from tax only where their profits or gains (other than investment income) are derived solely from transactions with members and which, in terms of the constitution, can only be distributed to members with whom the transactions took place. Investment income is subject to tax. If a club or society derives income from non-members, no matter to what extent, it cannot qualify for exemption in terms of section 10(1)(*e*) and all its profits or gains are then subject to tax. There is no partial exemption in respect of profits derived from members since the profits or gains 'must be derived solely from transactions with or on behalf of its members'.[17] The transactions which ensure exemption from tax are therefore limited in their scope. They have to be with individual members or for the benefit of individual members.[18]

In all cases where clubs, societies and associations have a taxable income, they are taxable *persona* as distinct from their members. They do not constitute partnerships but, as associations of persons for a common object or purpose, they fall within the terms of the definition of 'person' contained in section 2 of the Interpretation Act (Act No. 33 of 1957) and constitute an entity for **taxation** purposes.[19]

In the case of associations, not falling within the terms of section 10(1)(*e*), which serve a purpose beneficial to the public, e.g. racing clubs and stock exchanges, they are treated as companies for tax purposes in terms of para. (*d*) of the definition of *company* in section 1 and pay tax according to the rate applicable to companies.

Societies and companies registered under the Co-operative Societies Act, 1939, are excluded from the provisions of section 10(1)(*e*) but some concerns of a co-operative nature commonly known as consumers' buying associations, which are not registered under the Co-operative Societies Act, may qualify for exemption under section 10(1)(*e*). Such concerns are in direct competition with other non-exempted organizations engaged in similar trading activities and the granting of tax exemption to them amounts to unfair discrimination against these other organizations. The Committee of Enquiry into the Income Tax Act recommended[20] that the income of such concerns should be subject to tax on the same basis as it recommended should be applied to registered co-operative

[17] I.T.C. No. 456, 11 S.A.T.C. 171.
[18] I.T.C. 763, 19 S.A.T.C. 110.
[19] I.T.C. No. 227, 6 S.A.T.C. 234.
[20] *First Report*, p. 23, para. 12.

societies (see § 229). The Income Tax Commission recommended[21] that these consumer buying associations should be taxable on their net profits without any deduction being allowed in respect of any bonus which they may distribute to their members. However, in the case of a consumer buying association all the members of which are traders and the goods are acquired by these members for resale, the Commission considered that any bonus which the association may distribute to its members should be deducted in the determination of its taxable income.

§ 110. Interest

Interest on Post Office Savings Bank investments and tax redemption certificates

Interest received from any deposit in the Post Office Savings Bank of the Union, including interest on Post Office Savings Bank Certificates, or on tax redemption certificates, is exempt from tax to the extent of £50 per annum (£25 in respect of tax redemption certificates) for each investment in respect of each person who holds such investments (section 10(1)(*i*)).

A taxpayer is entitled to claim the benefit of the exemption for his wife or minor children if they are the owners of such investments even though such income is deemed to be his in terms of section 9(2) (§ 93) and section 9(3) (§ 58).

Interest on Union Loan Certificates, contributory shares and savings levy

Annual interest accrued in respect of any Union Loan Certificates and any amount credited as interest in respect of any contributory (subscription) share in any building society is exempt from tax (section 10(1)(*i*)). Interest received in respect of such investments by a taxpayer's wife and minor children and which is deemed to be his in terms of section 9(2) (§ 93) and section 9(3) (§ 58) qualifies for exemption.

Section 10(1)(*i*) also exempts from tax interest received in respect of any loan portion of the normal and super tax (savings levy) imposed under the Income Tax Act, 1953, or any subsequent Income Tax Act.

Interest on 5 per cent Five Year Treasury Bonds

Annual interest accrued in respect of 5 per cent Five Year Treasury Bonds is exempt from tax (section 10(1)(*i*)). It is expressly provided, however, that the exemption shall be limited to the sum of £500 in the case of any taxpayer. This exemption was introduced in view of the present scarcity of capital and to attract more loan funds.

Only individual natural persons may invest in these Bonds. All corporate bodies, such as companies, corporations, etc. are debarred from investing in these Bonds. The Bonds, which are not negotiable

[21] *First and Final Report*, p. 7, para. 19.

and not transferable, are redeemable at par five years after the date of subscription. The Bonds may, however, be redeemed upon the death of or the insolvency or liquidation of the estate of the holder. The interest, which is at the rate of 5 per cent per annum, is payable half-yearly on 15th February and 15th August. The maximum amount of Bonds which may be held by a taxpayer is £10,000. There is, however, nothing to prevent a taxpayer from taking out a further £10,000 Bonds for his wife or for any of his minor children. The interest on these investments will, of course, be deemed to be his in terms of section 9(2) and 9(3), but the maximum amount which he can claim by way of exemption from tax is limited to £500.

Recommendations of the Committee of Enquiry

The above exemptions enable a wealthy taxpayer to invest his capital with the Union Government and receive substantial income which is free of tax. For example, a married man with a wife and two children, by taking advantage of the concession can receive tax-free income to the extent of £2,000[21a] per annum and bearing in mind that the maximum marginal rate of tax is some 12*s.* 6*d.* in the £, he may in effect receive the equivalent of a return of £5,333 income subject to tax at maximum rates.

The Committee of Enquiry into the Income Tax Act recommended[22] that interest in respect of Post Office Savings Bank deposits and certificates, tax redemption certificates, building society contributory and permanent shares and savings bank accounts with building societies, commercial banks and other approved institutions, should be aggregated and a partial exemption should be granted in respect thereof, subject to a prescribed maximum, for the purpose of encouraging thrift. The Income Tax Commission, however, rejected this recommendation as it saw no reason for the extension of the then present exemption which was adequate and administratively less cumbersome than the Committee's recommendation.[23] It must be pointed out that at the time that the Committee made its investigation, the exemption in respect of Post Office Savings Bank investments was limited to £25 and there were no 5 per cent Treasury Bonds in existence.

Interest on Government stocks, etc., accruing to non-residents

Interest received by or accruing to any person not ordinarily resident nor carrying on business in the Union from stock or securities

[21a]

Maximum amount which can be invested in Union Loan Certificates (4 × £5,000) = £20,000: interest at 5½%	£1,100
Maximum exemption in respect of Post Office Savings Bank deposits (4 × £50)	200
Maximum exemption in respect of Post Office Savings Bank Certificates (4 × £50)	200
Maximum exemption in respect of Treasury Bonds	500
	£2,000

[22] *First Report,* p. 24, para. 22.
[23] *First and Final Report,* p. 8, para. 26.

(including Treasury Bills) issued by the Government of the Union or any Colony included in the Union or any local authority (as defined in section 1) in the Union or the Electricity Supply Commission, is exempt from tax (section 10(1) (*h*)). The purpose of this exemption is to stimulate and encourage the investment of foreign funds in the stocks or securities specified in the section.

In the following circumstances, a non-resident can enjoy this exemption even if he carries on business in the Union:

(i) The stock or securities must have been issued in respect of a loan raised outside the Union; and

(ii) the Treasury has, with the approval of the Minister of Finance, given an undertaking that the interest would be exempt from tax in the hands of a non-resident; and

(iii) the stock or securities were acquired by the non-resident outside the Union and paid for by him in a foreign currency.

A non-resident is not entitled to the benefit of the exemption if he receives an annuity payable out of a fund composed of such interest. The annuity is wholly taxable without regard being had to section 10(1) (*h*) (proviso (iii) to section 10(1)).

Notwithstanding the exemption in section 10(1) (*h*), the taxpayer must set out in his return of income all such interest accruing (proviso (i) to section 10(1)).

For a further discussion on section 10(1) (*h*), see § 76.

§ 111. Employment benefits

Gratuities

Two types of gratuities are exempt from tax, viz.:

(i) Any gratuity received by or accrued to a person from his employer as the Commissioner deems to be a grant made because such person had obtained a university degree or diploma or had been successful in some examination and not remuneration, or any portion of remuneration, for services rendered or to be rendered (section 10(1) (*q*));

(ii) any gratuity (other than a leave gratuity) received by or accrued to a person from public funds upon his retirement from any office or employment under the Union Government (including the Railway Administration) or any provincial administration provided that the Treasury declares such gratuity to be free of tax (section 10(1) (*t*)).

Salaries and emoluments

Certain persons are exempt from tax on salaries and emoluments payable to them for services rendered, viz.:

(i) The Governor-General (section 10(1) (*j*) (i)).

(ii) Any person who holds office in the Union as an official of any foreign government (other than the Administration of the territory of South West Africa), provided such person is stationed in the Union for that purpose and is not ordinarily resident in the Union.[24] This would include diplomats, consuls and High Commissioners representing foreign countries (section 10(1)(*j*)(ii)).

(iii) Any person not ordinarily resident in the Union in respect of services rendered by him outside the Union for the Union Government (including the Railway Administration) or any provincial administration or local authority in the Union or the South African Tourist Corporation, if his remuneration is chargeable with income tax in the country in which he is ordinarily resident, and the tax is borne by himself and not paid by the Government, etc. (section 10(1)(*p*)). In terms of section 9(1)(*c*), such remuneration is deemed to be from a Union source (see § 183).

Members of the Union defence forces

Any amount received by or accrued to a member of the defence forces of the Union, in time of war or during a period of three months thereafter, whether in cash or otherwise, as an allowance for any uniform, ration or lodging, is exempt from tax (section 10(1)(*n*)).

§ 112. Dividends

Dividends received or accrued from any company are exempt from normal tax in terms of section 10(1)(*k*), except in the following cases:

(i) In respect of dividends (other than those distributed out of profits of a capital nature) distributed by a *fixed property company*[25] on shares held by a company which is registered as a management company in property shares. By virtue of a deed of trust, such dividends usually accrue to the holders of unit certificates through the management company. Since these dividends are subject to normal tax in the hands of unit holders, section 11(2)(*m*) permits of the deduction from the income of the fixed property company of any dividends distributed by it to unit holders through a management company.

(ii) In respect of any portion of an annuity. If a person receives an annuity out of a fund composed wholly or partly from dividends from companies, no portion of the annuity is exempt from tax (proviso (iii) to section 10(1)).

Notwithstanding the exemption in section 10(1)(*k*), the taxpayer must set out in his return of income all dividends accruing to him (proviso (i) to section 10(1)).

[24] See I.T.C. No. 327, 8 S.A.T.C. 254.
[25] As defined in sec. 1 of the Units Trust Control Act, 1947 (Act No. 18 of 1947).

§ 113. Miscellaneous exemptions

Certain mining profits

The profits of mining made under a lease granted under section 46 of the Precious and Base Metals Act, 1908 (Act No. 35 of 1908), of the Transvaal, are exempt from tax (section 10(1)(*l*)).

War pensions

Any amount received as a war pension is exempt from tax (section 10(1)(*g*)).

Miners' phthisis awards

Any amount received as an award or a benefit under any law relating to miners' phthisis is exempt from tax (section 10(1)(*g*)).

Authors

Any amount received by or accrued to an author of a work in respect of the assignment of or grant of an interest in a copyright in such work is exempt from tax in terms of section 10(1)(*r*) if the amount is chargeable with income tax in a foreign country. The exemption does not apply to any person who is not the first owner of a copyright in terms of Chapter IV of the Patents, Designs, Trade Marks and Copyright Act, 1916 (Act No. 9 of 1916), or to a company. Thus, only the original author of a work can benefit from this concession. The purpose of this exemption is to avoid double taxation of authors on income derived from abroad in respect of their works, actual production of which took place in the Union. The author must show that tax is chargeable abroad on his royalty income.

Certain companies dealing in gold bullion or shares

Section 10(1)(*u*) provides that the receipts and accruals derived by a company from the realization of assets consisting of gold bullion or shares in companies shall be exempt from tax if —

(i) such assets were acquired by the company with funds which were transferred to the Union from any foreign country by arrangement with the Treasury or with funds derived from the realization of similar assets acquired with the profits derived from any such assets or from dividends received in respect of such shares; and

(ii) the Treasury has with the approval of the Minister of Finance given an undertaking that any such receipts and accruals shall be exempt from tax.

Details of any arrangements with and any undertakings given by the Treasury must be published in the *Gazette*.

§ 114. General exemption

The following are exempt from tax:

(i) Married persons whose taxable income does not exceed £300 for the year of assessment, or, if the period of assessment is less than a full year, an amount which bears to £300 the same ratio as the period assessed bears to one year (section 10(3)(ii)).

(ii) All other persons (excepting a company but including trusts, estates, clubs and societies) whose taxable income does not exceed £250 for the year of assessment, or if the period of assessment is less than a full year, an amount which bears to £250 the same ratio as the period assessed bears to one year (section 10(3)(iii)).

It does not follow that because the taxable income of a married or unmarried person exceeds £300 and £250 respectively he is liable to pay normal tax. The normal tax rebates may relieve him from liability to normal tax on a taxable income in excess of the prescribed limits. Thus, a married person with two children qualifying for the child rebate only starts paying normal tax on a taxable income of £892, and an unmarried person with two dependents qualifying for the dependant rebate is only liable to normal tax when his taxable income exceeds £365.

§ 115. Conclusions

The present field of exemption is so restricted and narrow that very little opportunity is afforded to the ordinary taxpayer to take advantage thereof. The few exemptions as are available to the general taxpayer, e.g. interest on Post Office Savings deposits, Union Loan Certificates, etc., are of a very limited nature indeed. There can be no possibility of abuse as far as the *fiscus* is concerned.

The Committee of Enquiry into the Income Tax Act dealt with the question of the extension of the scope of tax exemptions and held as follows:[26]

> 'It was urged in evidence before us that care should be exercised in extending the scope of tax exemptions and that the present exemption field should be restricted and narrowed to as great an extent as is possible. It was claimed that the existence of exempted groups of profits indirectly constituted a threat to the private enterprise system and in support of this contention it was argued that —
>
> (1) the granting of tax exemptions to various organisations which are fundamentally profit-earning enterprises leads to unfair discrimination against other non-exempted organisations engaged in similar trading activities;
>
> (2) the narrowing of the field of profits available for taxation inevitably gives rise to the imposition of higher rates of tax on profits remaining within this field; and
>
> (3) the present practice of exempting certain profits from taxation brings into existence factors which encourage the irrational allocation of productive resources. Maximum productivity is thus not attained and the State and the community as a whole suffer accordingly.
>
> The views expressed above are, in our opinion, fundamentally sound and we enunciate as a general principle that the Legislature should strive

[26] *First Report*, p. 22, paras. 2 and 3.

to impose tax on all amounts which are in the nature of income, as opposed to capital, and that exemptions should be granted only after careful consideration has been given to the necessity for maintaining equity and for avoiding unfair discrimination.'

In pursuance of the above policy the Committee proposed very few additional exemptions. In the main these exemptions affect only certain special classes of taxpayers. For example, it recommended that scientific institutions of a public character should be exempt from tax.[27] The Income Tax Commission accepted this recommendation but considered that total exemption should also be extended to the income of recognized political organizations of a public character.[28] The Committee also recommended that associations and societies formed to foster development of commerce, industry or any branch of agriculture, should be totally exempt from tax, provided the Commissioner is satisfied that no distribution of the income thereof is made to any person.[29] The Income Tax Commission accepted this recommendation.[30] Both the Committee[31] and the Commission[32] recommended that old age pensions paid under any Union law should be exempt from tax but, as pointed out by the Commission, under the present extent of the tax free margin, this exemption may only be of academic interest. For the purpose of encouraging thrift, the Committee recommended further relief from tax in respect of certain types of interest but this was not accepted by the Commission (see **§ 110**).

II. The Rebate System

§ 116. Introduction

Most tax systems provide for the grant of a primary rebate or abatement so as to ensure that tax should not be paid on that portion of the income which must be spent on bare maintenance of the taxpayer. In addition, secondary rebates are usually granted in respect of children, insurance and dependants and, where super tax is payable, a further rebate is usually granted.

The relief that is offered either takes the form of a deduction of a specified amount from the tax payable — known as the 'rebate system' — or the deduction of a fixed amount from the taxable income when it is known as the 'abatement system' or a system of 'concessional deductions'.

In the United Kingdom, Canada, Australia and New Zealand, a system of abatements is in force. As regards South Africa, a system of abatements was in force prior to 1941 but it was subject to reduction as the taxable income increased. With the passing of the Income

[27] *First Report*, p. 23, para. 10.
[28] *First and Final Report*, p. 7, para. 18.
[29] *First Report*, p. 23, para. 16.
[30] *First and Final Report*, p. 7, para. 21.
[31] *First Report*, p. 25, para. 31.
[32] *First and Final Report*, p. 9, para. 29(2).

Tax Act in 1941, the Union changed over to the rebate system which is still in force.

§ 117. Present system of rebates in the Union

In terms of section 13, certain rebates are deductible from the normal tax payable. There is a primary rebate which is granted to all persons, and, in addition, there are rebates in respect of children, insurance premiums and dependants. Companies are not entitled to any rebates, no doubt because the grant of such a rebate encourages the splitting of a company into a number of associated or subsidiary companies in order to obtain the benefit of a rebate in respect of each company. Rebates are also deductible from the super tax payable (see § 123).

No doubt to encourage investment in the Union, the rebates are granted to non-residents. Thus, in so far as rebates are concerned, the Act does not distinguish between residents and non-residents.

The rebates, unlike the rates of tax, are not fixed annually but continue from year to year until they are changed by Parliament.

In respect of the year of assessment ending 30th June, 1958, the normal tax rebates are as set out in the following paragraphs.

§ 118. Primary rebate

For *married persons* the primary rebate is £31 — section 13(1)(*b*). Since the income of husband and wife is merged in terms of section 9(2), only one primary rebate of £31 is granted in the joint assessment.

For *unmarried persons* the primary rebate is £23.

The effect of these primary rebates is that a married person is not liable for normal tax as long as his taxable income does not exceed £480. In the case of a single person, liability for normal tax does not arise as long as the taxable income does not exceed £301.

The Committee of Enquiry into the Income Tax Act, which recommended a system of 'concessional deductions' or abatements in place of the present rebate system, proposed[33] that a primary concessional deduction should be granted to all persons, other than companies, and such primary concessional deduction should be a higher amount in the case of —

(i) married persons;

(ii) unmarried persons over the age of 55 in the case of women and over 60 in the case of men;

(iii) widowed, divorced or separated persons under the age referred to in (ii) above, provided they are entitled to the allowance for a child.

The Income Tax Commission, however, which recommended the retention of the present system of rebates, was of the view that the primary rebate in respect of normal tax, viz. £31 and £23, should remain as at present. It rejected the age test as recommended by the

[33] *First Report*, p. 39, para. 16.

Committee in (ii) above and considered that widows and widowers should be assessed as at present, i.e. as married persons.[34] The Commission also considered the position of divorced or separated persons but this is more appropriately dealt with in § 101.

Taxable entities such as estates, trusts, clubs, etc., which are subject to normal tax, are entitled to the rebate.

§ 119. CHILD REBATE

A taxpayer is entitled to a rebate of £14 in respect of each child or stepchild qualifying for such rebate — section 13 (2) (*a*). A married person with one child is not liable for normal tax as long as his taxable income does not exceed £688. For two children, the figure is £891, and for four children, £1,282.

As regards legally adopted children, it is submitted that they qualify for the rebate having regard to the provisions of section 71 (2) of the Children's Act, 1937, which provide that for all purposes (save for certain exceptions not important for present purposes) a legally adopted child is to be regarded as a legitimate child. It must be clear, however, that there is a legal adoption.[35]

The following conditions must be complied with before a child or stepchild can qualify for the rebate:

(i) The child or stepchild must be alive during any portion of the year of assessment for which the assessment is made and unmarried. The child must be unmarried on the last day of the year or period of assessment. If the child married during the year, the rebate is not granted.[36] Children who have died during the year qualify for the rebate as they were alive during portion of the year. Still-born children do not qualify, but children born alive and who die immediately after birth qualify as they were alive during portion of the year.

(ii) The child or stepchild must not be, or would not have been had he lived, over 18 years, or, if he was wholly dependent for his maintenance upon the taxpayer, over 21 years, or, if he was wholly dependent for his maintenance upon the taxpayer and the Commissioner is satisfied that he was a full-time student at an educational institution of a public character, over 24 years on 30th June of the tax year. Thus, as regards a child or stepchild not over the age of 18 on 30th June, the rebate is granted whether or not he is wholly dependent for his maintenance on his parent. In regard to a child over the age of 18 but not over 21 on 30th June, he qualifies for the rebate provided that he is wholly dependent for his maintenance on his parent. In the case of a child over the age of 21 but not over 24 on 30th June, he qualifies for the rebate provided that he is wholly dependent for his maintenance on his parent and is a full-time student at an educational institution.

[34] *First and Final Report,* p. 13, para. 52.
[35] See I.T.C. No. 528, 12 S.A.T.C. 436.
[36] I.T.C. No. 274, 7 S.A.T.C. 235.

(iii) A child or stepchild who is incapacitated by mental or physical infirmity from maintaining himself and is wholly dependent for his maintenance upon his parent qualifies for the rebate irrespective of his age. It is not a requirement that he must be unmarried.

It has been held that the words 'wholly dependent' mean that the taxpayer must be the sole contributor towards the child's maintenance and that if the child has some income of his own available for his maintenance — no matter how small — the rebate does not apply.[37] The Department, however, does not in all cases require that a child or stepchild must have received no income whatsoever during the tax year in order that he may qualify for the rebate. Thus, in the case of university students who work during the vacation and earn a small income, they usually qualify for the rebate. The writer understands that the Department regards a child who is supported by a parent as totally dependent for his maintenance upon the parent where the child's income for the year of assessment was not more than £120.

A child or stepchild who turns 18, 21 or 24 on 30th June, does not qualify for the rebate in terms of (ii) above since he was over the age of 18, 21 or 24 on the last day of the tax year.

The last day of the tax year, i.e. 30th June, is the determining date of the age of a child for the purposes of the child rebate. Thus, where a taxpayer has been given permission to render a return to a date other than 30th June (see § 262), children qualifying for the child rebate must be determined with reference to their age on 30th June. Where a taxpayer dies during a tax year and his estate is liable to tax in respect of income earned up to the date of death, it is 30th June of that tax year and not the date of death which is the determining date for the child rebate.

In the case of separated and divorced persons, the question as to which party is entitled to the rebate in respect of children born of the marriage is dealt with in § 100.

§ 120. Insurance rebate

A taxpayer is entitled to a rebate in respect of life, accident or sickness insurance premiums, fees, subscriptions and contributions to an approved provident fund or benefit fund and unemployment insurance contributions paid during the year of assessment — section 13(2)(*b*).

The premiums, etc., are added together and a rebate of 1*s.* 3*d.* *per pound or part of a pound* is granted on the total amount, subject to a maximum rebate of £7 10*s.* 0*d.*

The following points must be borne in mind:

(i) The premiums must be paid for a policy under which the taxpayer, his wife, children or stepchildren are insured against death, accident or sickness. Premiums payable under an

[37] I.T.C. No. 669, 16 S.A.T.C. 139.

endowment insurance policy qualify. Premiums under a motor insurance policy do not rank for the rebate.

(ii) If the policy is in respect of children (including a legally adopted child) or stepchildren of the taxpayer, the premiums qualify if the children qualify for the child rebate.

(iii) The premiums, fees, etc., must actually have been paid by the taxpayer during the year of assessment. It is not sufficient to incur a liability in respect thereof.

(iv) *Provident fund* and *benefit fund* are defined in section 1 and must comply with the requirements of those definitions before contributions to such funds can rank for the rebate (see § 189 and § 190).

(v) No rebate is granted in respect of premiums paid under any policy, if such premiums have been allowed as a deduction from the income of the taxpayer in terms of section 11.

(vi) Where the wife pays the premiums on a policy on her own life or on the life of a child qualifying for the rebate, or where the wife contributes to a recognized provident fund or benefit fund, it is the practice of the Commissioner to grant the rebate to the husband in respect of such premiums or contributions although the section provides that the premiums or contributions must be paid by the taxpayer.

(vii) If the husband is separated from his wife, whether judicially or under a written agreement, he is still entitled to the rebate in respect of premiums paid by him on policies under which the wife is insured against death, accident or sickness.

(viii) As regards premiums payable in respect of partnership survivorship policies, see § 50.

(ix) Premiums payable out of the surrender value of a policy under a non-forfeiture clause in a policy are, in practice, admitted for rebate.

§ 121. Dependant rebate

A taxpayer is entitled to a rebate of £2 10*s*. 0*d*. in respect of each dependant qualifying for such rebate — section 13 (2) (*c*).

'Dependant' is defined in section 1 and in relation to any taxpayer means —

(*a*) any person (other than a child or stepchild qualifying for the child rebate in terms of section 13 (2) (*a*)) incapacitated by old age, infirmity or any other reason satisfactory to the Commissioner from maintaining himself; and

(*b*) any child (other than the child or stepchild of such taxpayer) under the age of 18 years on the last day of the year of assessment,

towards whose maintenance the taxpayer has expended in cash or otherwise during the year of assessment not less than £30.

The following points must be borne in mind:

(i) At least £30, whether in cash or otherwise, must be contributed towards the maintenance of the dependant.

(ii) If the taxpayer maintains the dependant for only a part of the tax year, he can still claim the rebate as long as he has contributed during that period not less than £30.

(iii) *Dependant*, in terms of para. (*b*) of the definition, includes any child (other than the child or stepchild of the taxpayer) under 18 on the last day of the tax year, and includes any such child who turns 18 on the last day of the tax year.[38] A child (other than the taxpayer's child or stepchild) over 18 may qualify as a dependant in terms of para. (*a*) of the definition if the conditions set out therein are complied with. A dependant rebate may be claimed in respect of an adopted child not legally adopted.

(iv) Para. (*a*) of the definition contemplates persons who are unable to maintain themselves by reason of some personal defect, e.g. old age or infirmity. A person who is unable to maintain himself because of circumstances of his own making which do not create an infirmity, e.g. a university student, cannot be said to be incapacitated and therefore will not rank as a dependant.[39]

(v) The words 'any other reason satisfactory to the Commissioner' in para. (*a*), confer a discretionary power on the Commissioner which, once properly and *bona fide* exercised, is not subject to review by the courts.[40]

(vi) It is not a requirement that the taxpayer must be the sole support of the dependant. Thus, two or more taxpayers may claim the rebate in respect of one dependant as long as they have each contributed not less than £30 towards the maintenance of that dependant.

(vii) The words 'cash or otherwise' include the value of a free house[41] and free board and lodging.

(viii) Where a taxpayer contributes not less than £60 towards the support of a married couple, he is entitled to a rebate of £5 (2 × £2 10*s*. 0*d*.). Where, however, he contributes not less than £30 but less than £60, it is the practice to allow a rebate of £2 10*s*. 0*d*.

§ 122. Proportionate rebates

The principle that an assessment may be for a period and not for a whole twelve months is implicit in several sections of the Income

[38] See I.T.C. No. 125, 4 S.A.T.C. 121.
[39] I.T.C. No. 739, 18 S.A.T.C. 216; see also I.T.C. No. 58, 2 S.A.T.C. 184, and I.T.C. No. 84, 3 S.A.T.C. 145.
[40] I.T.C. No. 739, 18 S.A.T.C. 216.
[41] I.T.C. No. 154, 4 S.A.T.C. 305.

Tax Act (see, for example, section 7, section 13(3) and section 29(2)).[42]

The rebates mentioned above are deductible in full where the taxpayer's period of assessment covers twelve months. In any case in which the period assessed is less than one year, the primary, child and dependant rebates applicable to the taxpayer are reduced proportionately in the ratio that the period assessed bears to one year — section 13(3). The insurance rebate, however, is not subject to reduction in a case where the period assessed is less than one year and must be calculated with reference to the actual premiums, etc., paid during the period of assessment.

Where the period of assessment is less than twelve months, the rebates are as follows:

Primary rebate $= \dfrac{\text{Period assessed}}{\text{Period of 12 months}} \times$ £31 0*s.* 0*d.* (£23 in the case of an unmarried person).

Child rebate $= \dfrac{\text{Period assessed}}{\text{Period of 12 months}} \times$ £14 0*s.* 0*d.*

Insurance rebate = Actual premiums paid during period of assessment.

Dependant rebate $= \dfrac{\text{Period assessed}}{\text{Period of 12 months}} \times$ £2 10*s.* 0*d.*

In certain special cases, however (see section 13(3)), the rebates may be allowed in full even though the period of assessment is less than twelve months. This may occur in the case of a period of assessment ending at the date of death of a taxpayer or commencing at the death of the taxpayer's spouse where there is an accrual representing a full year's earnings within the limited period of assessment such as in the case of a farmer receiving the proceeds of an annual crop. In special circumstances of this nature, the Commissioner can direct that the full amount of the rebate be allowed. The taxpayer must make special application for this concession.

A taxpayer's period of assessment is to be determined by the length of time that he was a taxable *persona* during the year of assessment. If a person was a taxable *persona* for the whole year of assessment it follows that he must be assessed in respect of a period of twelve months. If he was a taxable *persona* for only six months of the year of assessment, then his assessment period covers merely six months, and so on. For example, if a taxpayer died on 31st March, 1958, he would have been, in respect of the year of assessment ending 30th June, 1958, a taxable *persona* for a period of nine months (1st July, 1957, to 31st March, 1958) and the period of assessment would be nine months or 274 days. The rebates applicable to him (other than the insurance rebate) would be proportionately reduced.

It must be borne in mind that the period of assessment does not commence at the date when a taxpayer receives income for the first time. In the case of a person who starts work for the first time during a year of assessment, his period of assessment is a full year

[42] See I.T.C. No. 802, 20 S.A.T.C. 241, and I.T.C. No. 196, 5 S.A.T.C. 379.

since he was a taxable *persona* for the whole year of assessment. The rebates applicable to him will, therefore, not be proportionately reduced. The fact that he earned no income for portion of such year is irrelevant. The important point to remember is that he was subject to tax during the whole year, i.e. he was a taxable *persona* for the whole year of assessment. An immigrant who arrived in the Union on 31st May, 1958, and earned merely one month's salary in respect of the 1958 tax year, has an assessment period of one year since he was a taxable *persona* for the whole year. His rebates will not be proportionately reduced.

Rebates must be proportionately reduced not only in cases where a taxpayer ceases to be a taxable entity (e.g. in the case of death or in the event of a single woman marrying during the year) but also in cases where a taxpayer comes into being as a taxable entity during the tax year, as for example —

(i) in the case of a child born during the tax year and who is subject to tax;

(ii) in the case of a widow whose husband has died during the tax year and who is taxable on income earned by her after the date of death;

(iii) in the case of taxable entities coming into existence during the tax year, e.g. clubs, societies, associations, trusts, estates, who are subject to tax at the rates applicable to individuals.

The system of proportioning rebates where the period of assessment is less than twelve months is fair and equitable.

§ 123. Super tax rebates

From the calculated super tax, there must be deducted certain rebates in terms of section 29.

There is a primary rebate applicable to all taxpayers and there is also a rebate in respect of taxes payable to a foreign government in respect of oversea dividends included in the income subject to super tax.

The present rebates allowed for normal tax purposes are not also allowed for super tax purposes in addition to the primary super tax rebate of £285. The Committee of Enquiry into the Income Tax Act recommended the adoption of this principle in relation to its proposals for a system of 'concessional deductions' or abatements instead of a system of rebates.[43] The Income Tax Commission accepted this recommendation in principle.[44] It may be mentioned that only recently the United Kingdom adopted this principle for surtax purposes; the income is reduced by the excess of the aggregate of certain specified personal allowances to which the taxpayer is entitled over the single person's allowance.[45]

[43] *First Report,* p. 41, para. 40.
[44] *First and Final Report,* p. 14, para. 57.
[45] In terms of the Finance Act, 1957.

§ 124. Primary super tax rebate

The primary rebate in respect of super tax is £285 — section 29(1)(*b*). This rebate is sufficient to relieve a taxpayer from liability to super tax in respect of an income subject to super tax of £2,300 and under.

Taxable entities such as estates, trusts, clubs, etc., which are subject to super tax, are entitled to this rebate.

If the period of assessment is less than twelve months, for example in the case of death (see § 122), the rebate must be reduced to an amount which bears to £285 the same ratio as the period assessed bears to twelve months — section 29(2). Thus, if X died on 11th September, 1957, the rebate allowed in respect of the 1958 tax year would be $\frac{73}{365} \times$ £285 = £57 0*s.* 0*d.*

In certain special cases, however (see section 29(2)), the rebate may be allowed in full even though the period of assessment is less than twelve months. This may occur in the case of a period of assessment ending at the date of death of a taxpayer or commencing at the death of the taxpayer's spouse where there is an accrual representing a full year's earnings within the limited period of assessment such as in the case of a farmer receiving the proceeds of an annual crop. In special circumstances of this nature, the Commissioner can direct that the full amount of the rebate be allowed. The taxpayer must make special application for this concession.

§ 125. Rebate of foreign tax paid on oversea dividends

A credit for any foreign tax paid or payable on dividends from sources outside the Union included in a taxpayer's income subject to super tax by virtue of the proviso to section 7(*g*)*bis*, is authorized by section 29(1)(*c*) and takes the form of a rebate deductible from the amount of super tax payable, additional to the primary rebate of £285. The rebate is, however, limited to the amount of the Union super tax attributable to the inclusion of the foreign dividends in the taxpayer's income subject to super tax. The amount of the super tax attributable to the inclusion of the foreign dividends must be determined on a proportionate basis before the deduction of the primary rebate of £285 and before the addition of the 25 per cent surcharge, viz.:

$$\frac{\text{Income subject to super tax attributable to inclusion of foreign dividends}}{\text{Total income subject to super tax}} \times \text{Income subject to super tax} \times \text{rate of super tax (i.e. the super tax payable before deduction of the £285 rebate and before the addition of the 25 per cent surcharge).}$$

In terms of section 29(1)(*c*), the rebate is to be a sum 'equal to the taxes on income, if any, paid or payable by the taxpayer to the Government of any other country or territory on any dividends. . . .' It is submitted that in the case of those foreign companies which deduct from dividends declared tax for their own account and not on behalf of the foreign government concerned, e.g. companies incorporated in the United Kingdom and the Federation of Rhodesia and Nyasaland, the Union shareholder is taxable on the *net* dividend, i.e. after the deduction of the foreign tax, and is not entitled to the credit envisaged by section 29(1)(*c*). Section 184(1) of the United Kingdom Income Tax Act, 1952, provides that: 'The profits or gains to be charged on any body of persons shall be computed in accordance with the provisions of this Act on the full amount of the same before any dividend thereof is made in respect of any share, right or title thereto, and the body of persons paying the dividend shall be entitled to deduct tax at the standard rate for the year in which the amount payable becomes due.' Thus, the company pays tax in the United Kingdom on its profits as being a taxpayer itself. It is not an agent for its shareholders and does not pay the tax on their behalf. When the company distributes a dividend it is entitled to deduct United Kingdom tax at the standard rate. It will be observed that the company is merely authorized but *not compelled* to deduct tax from a dividend before paying it. The United Kingdom Revenue is not concerned with the deduction of tax from a dividend since it has already received tax on the profits earned by the company. In truth the portion of the gross dividend retained by the company by way of a deduction for tax is merely to reimburse it for the tax it has paid on the distributed profits. Thus it is clear that when a United Kingdom company deducts tax from a dividend declared, such tax is not paid over to the Revenue but is retained by the company as a recoupment of the tax it pays to the Revenue on the profits out of which the dividend has been paid. It is submitted, therefore, that the shareholders of a United Kingdom company on the declaration of a dividend have not got an enforceable right to claim payment from it of the gross amount of the dividend, but can sue the company for merely the net amount, i.e. the actual amount that they are entitled to receive after deduction of tax. As the company has distributed its profits to the extent of the *net* amount of the dividend only, it must follow, having regard to para. (*b*) of the definition of *dividend* in section 1, that the oversea dividend to be included in income subject to super tax must be its *net* amount, i.e. after deduction of the amount retained by the company.

The position, it is submitted, would be different if the tax deducted by the company is withheld for transmission to the Revenue so that the paying company is acting as the collecting agent for the Revenue (for example, the position of the non-resident shareholder's income tax in South West Africa and the 15 per cent withholding tax in respect of dividends distributed by Canadian companies to non-residents — in these cases the company is not entitled to retain the tax it deducts from the dividend but must hand same over to the Government). Here, the shareholder has an enforceable right to claim the *gross* amount of the dividend from the company which is the actual amount distributed by the company to its shareholders in terms of para. (*b*) of the definition of *dividend*. Accordingly, it is submitted that in these instances the dividend must be included at its *gross* amount in the income subject to super tax of the shareholder and since the paying company is in effect the collecting agent for the Revenue as regards the tax deducted from the dividend, it is submitted that the tax deducted must be regarded as 'tax paid or payable by the taxpayer to the Government of any other country or territory' so that the taxpayer is entitled to the credit envisaged by section 29 (1) (*c*).

The Commissioner has, however, ruled that if the taxpayer obtains a refund from the foreign government of any portion of the tax originally deducted by the company from the dividend, he is entitled to have his assessment revised on the basis that the *gross* dividend, i.e. before the deduction of the foreign tax, must be included in income subject to super tax and a credit granted in terms of section 29 (1) (*c*) of the net foreign tax paid in respect of the dividend. A good example where a taxpayer can obtain a refund of tax overpaid is in terms of the Income Tax Act of the United Kingdom which allows a British subject (including a citizen of a Commonwealth country) resident outside the United Kingdom to obtain a repayment of tax deducted by companies in the United Kingdom from dividends distributed by them. The repayment in effect represents the difference between the tax deducted by the company and the tax actually payable on the dividend after giving the taxpayer the benefit of the personal reliefs and allowances applicable to a United Kingdom resident but on a very much limited basis. In terms of section 227 of the United Kingdom Act, a British subject resident outside the United Kingdom is entitled only to a proportion of the personal reliefs applicable to a United Kingdom resident, namely the ratio which his United Kingdom income bears to his total world income. South African citizens are, therefore, entitled to obtain repayment of portion of the United Kingdom tax deducted from a dividend which means that if they so desire they can request a revision of their super tax assessment and be taxed on the dividend on a *gross* basis instead of on a *net* basis. As regards surtax payable to the United Kingdom Government, since this tax is directly payable to the Government, it ranks as a credit in terms of section 29 (1) (*c*).

Where the foreign tax is not paid by deduction from the dividend by the company but the shareholder pays it direct to the foreign government concerned, the dividend must be included at its gross amount in the income subject to super tax and the credit envisaged by section 29 (1) (*c*) must be granted. This procedure will, however, not arise often in practice as in the majority of cases the foreign tax will be deducted by the company from the gross dividend declared.

As regards the Commissioner's ruling that a taxpayer is entitled to have his assessment revised on a *gross* basis if he obtains a repayment of any portion of the foreign tax deducted from the dividend, this procedure is indeed cumbersome and one that will involve the taxpayer in much additional expense since he will have to submit a detailed return of income from all sources to the United Kingdom Revenue before any claim for repayment can be authorized. Apart from these difficulties, the logic behind this procedure is not understandable to the writer who can find no statutory authority to justify it.

In determining the amount of the credit in respect of foreign tax payable, must the comparison of the Union super tax with the foreign tax payable be made on a total basis, i.e. by taking all the dividends together as one sum, working out the Union super tax attributable to the inclusion of all these dividends and then comparing this with the total foreign taxes payable in respect of all the foreign dividends, or must the comparison be made in respect of each dividend separately? If the latter method is to be applied, i.e. if in respect of *each* dividend a comparison must be made between the Union super tax attributable and the foreign tax payable and the credit limited to the lesser of the two amounts, it must follow that in respect of a dividend where the foreign tax payable exceeds the super tax attributable, such excess cannot be set off against the super tax attributable to another foreign dividend in respect of which no foreign tax is payable or in respect of which the super tax attributable may exceed the foreign tax payable on such other foreign dividend. If this method is the correct one, it must follow that the taxpayer may be the loser since, if the former method is employed, i.e. if the Union super tax on the total foreign dividends is compared with the total foreign tax payable on all such dividends, foreign taxes not wholly deductible in respect of one dividend must automatically rank as a deduction from the super tax payable on another dividend in respect of which no foreign tax is payable.

In the view of the writer there is nothing in section 29(1)(*c*) to indicate that each dividend must be dealt with separately. On the contrary, the writer considers that the wording of the section favours a construction that the Union super tax attributable to the aggregate foreign dividends must be compared with the total foreign tax payable on all such dividends.

§ 126. Conclusions

A comparison with other countries

An examination of the present system of rebates in the Union Income Tax Act reveals that very little incentive is offered to the taxpayer to secure the benefit of the secondary rebates, i.e. the rebates in respect of children, insurance and dependants. Thus, the benefits to be derived from increasing progeny or taking out insurance or providing for dependants offer very little consolation to the taxpayer. The present system of rebates in the Union clearly does not favour the taxpayer with the larger income; in favours the person with the smaller income. A change to a system of abatements or concessional deductions will favour the higher income groups since the taxpayer will receive relief at his maximum rate of tax. It must follow, therefore, that if the Union were to change to a system of abatements, unless the rates of tax were changed, less revenue would be collected by the State.

Increase your progeny and pay less tax, is a slogan which is poor consolation to the South African taxpayer. To a taxpayer, whose marginal rate is 1*s.* 6*d.* in the £, the child rebate of £14 means a tax-free income of some £187. On the other hand, to a taxpayer whose marginal rate is 7*s.* 6*d.* in the £, the rebate means a tax-free income of £37. Where the marginal rate is 10*s.* in the £, a tax-free income of £28 is granted in respect of a child. It is clear, therefore, that under the present system, taxpayers are not entitled to the same minimum amount of income free of tax in respect of children. The child rebate in South Africa, in so far as it affects taxpayers in the higher income groups, is very much lower than in most other countries. For example, in the United Kingdom a children's allowance is granted on a sliding scale based on the age of each child at the beginning of the year of assessment, viz. 6th April, as follows:

Up to 11 years of age	£100
Over 11 but under 16 years of age	£125
Over 16 years of age so long as in receipt of full-time education	£150

Where a child's income in its own right exceeds £100, however, the parent forfeits the whole of the relief applicable to that child. Bearing in mind that the standard rate of income tax in the United Kingdom is 8*s.* 6*d.* in the £, the child rebate to a United Kingdom resident in the higher income groups may result in a tax saving of £42 10*s.* 0*d.*, £53 2*s.* 6*d.* and £63 15*s.* 0*d.* as the case may be. Since the child allowance is available as a deduction in the surtax assessment and bearing in mind that the maximum rate of surtax is 10*s.*, the child rebate to a United Kingdom resident subject to maximum tax rates (18*s.* 6*d.* in the £) results in a tax saving of £92 10*s.* 0*d.*, £115 12*s.* 6*d.* and £138 15*s.* 0*d.*, as the case may be.

In Australia, a concessional deduction is granted to a taxpayer who is a resident in respect of each child who is a resident of Australia and is under 16 at the beginning of the year of income. The maximum deduction which is £78 in respect of one child and £52 in respect of each other child applies if the taxpayer contributed to the maintenance of the child during the whole year and no other person contributed to his maintenance and the separate net income of the child did not exceed £52 for the year.

In Canada, $150 is allowed for each child or grandchild under 21 if wholly dependent on the taxpayer and if it was a child qualified for family allowance. If the child is not qualified for family allowance a rebate of $400 is allowed.

The secondary rebate for insurance is presumably given to taxpayers in order to encourage thrift and provision for old age and dependants. Here again, the rebate in South Africa is considerably less than in other Commonwealth countries. In Australia, the maximum deduction in respect of life insurance premiums is £300 in respect of the year of income. In the United Kingdom relief is allowed in respect of life assurance premiums paid by the taxpayer or his wife in respect of a policy on his own life or on that of his wife. Relief is given by deducting tax at the standard rate on 2/5ths of the allowable premiums. If the premiums amount to £300, the tax reduction will be £120 ($\frac{2}{5} \times$ £300) $\times$ 8*s.* 6*d.* = £51. The allowance is further restricted in so far as the premium in respect of each policy must not exceed 7 per cent of the sum assured and the total premiums paid must not exceed one-sixth of total income.

In the Federation of Rhodesia and Nyasaland, the rebate is 3*s.* per £ of premiums subject to a maximum of £45 (equivalent to £300 premiums).

The dependant rebate of £2 10*s.* 0*d.* may properly be referred to as a 'miserable rebate' and is indeed poor consolation to the taxpayer who contributes to the maintenance of his parents or other relations in straitened circumstances. In Australia, a deduction of £130 is granted if the taxpayer contributes to the maintenance of his parents. In Canada, a taxpayer may deduct $400 for each dependant or $150 if the dependant was a child qualified for family allowance. In the United Kingdom, the full relief available where an incapacitated relative or widowed mother of the taxpayer or spouse is maintained by the taxpayer is £60.

In the Federation of Rhodesia and Nyasaland, a taxpayer may deduct from his tax £15 for each dependant where the maintenance is between £50 and £150 and £22 10*s.* 0*d.* where the maintenance is in excess of £150.

The above description of the rebates in force in the United Kingdom and other Commonwealth countries is not intended to be exhaustive but serves only as a broad outline to indicate how meagre the Union's rebates are in regard to children, insurance and dependants when compared with those of other countries.

The very limited relief granted by the present system of rebates in South Africa and the very narrow field in which they operate have resulted in little abuse by the tax-paying public. There is just not sufficient incentive for the taxpayer to take advantage of the rebates offered. Perhaps one day if the present system of rebates is changed to a system of abatements or concessional deductions the taxpayer may be encouraged to increase his progeny, insurances or contributions to dependants in order to pay less tax. In this respect, the Committee of Enquiry into the Income Tax Act recommended that a system of concessional deductions or abatements be adopted in place of the rebate system and that the concessional deductions decided upon be fixed amounts and not diminished as the taxable income increases.[46] However, the Income Tax Commission rejected in principle the whole system of 'concessional deductions' and advocated the retention of the present system of rebates.[47]

[46] *First Report*, p. 38, para. 9.
[47] *First and Final Report*, p. 13, para. 50.

the number of concessions has been gradually increased. In the United Kingdom, for instance, a married man had a greater concession than an unmarried man, but if his wife is working he is allowed a further concession on their joint assessment in the form of a percentage, subject to a prescribed maximum, of her earnings, while a widower, who is regarded as an unmarried person, can claim a deduction if he employs a housekeeper. Such concessions always necessitate loading the law with a number of complicated provisions. They also require a number of calculations in the assessment of tax, thus slowing down the administrative machinery. The corresponding provisions in the Union are much simpler. It is desirable to preserve this relative simplicity by avoiding as far as possible the granting of new concessions which would require a number of complicated provisions. We have given careful consideration to the representations which were made to us for the granting of certain further concessional deductions from income for tax purposes, but we are unable to recommend any extension of the field of concessional deductions beyond those already recommended.'

CHAPTER NINE

THE ALLOWABLE DEDUCTION PROVISIONS OF THE ACT

I. PRELIMINARY

§ 127. INTRODUCTION

The final step in the determination of the taxable income is to deduct from the taxpayer's income (as defined) all the amounts allowed to be so deducted in terms of the Act.

> 'The court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act. . . . Regard, therefore, must be had to the Act and the Act alone in order to ascertain whether the deductions sought to be made . . . are permissible.'[1]

The main sections of the Act dealing with deductions are section 11 and section 12. Section 11, which is the positive section relating to deductions, enumerates a list of items which may be deducted from income. Section 12, which is the negative section, sets out a list of items which may not be deducted from income.

Apart from the above deductions, section 22 authorizes a special allowance to hire-purchase traders (§ 230), the Third Schedule sets out certain items which only a farmer may deduct from his income (Chapter 11, Part I), and section 58(3) provides for the deduction of alimony and maintenance in the case of separated and divorced persons (§ 99). The allowable deductions applicable to insurance concerns are set out in the First Schedule (Chapter 11, Part II).

It is outside the scope of this work to consider in detail the range and the effect of the allowable deduction provisions of the Act as interpreted by the courts. A taxpayer incurs expenditure in his trade not because he can claim it as a deduction from income and thereby reduce his tax but because the expenditure is necessary for the purpose of his business. If the expenditure is incurred not essentially for the purpose of his trade but in order to rank as an allowable deduction from income, the taxpayer would be the loser. In the case of a company where the normal tax rate is fixed at *6s.* per £, although an expenditure incurred of £1,000, assuming it is allowable as a deduction, will save the taxpayer £300 in tax, he still has to bear £700. As regards an individual who is paying tax at maximum rates, i.e. 12*s.* *6d.* per £, an expenditure of £1,000 if allowable will save the taxpayer £625 in tax but the net effect is that he still has to bear £375.

[1] *Sub-Nigel, Ltd.* v. *C.I.R.*, 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381, per Centlivres, C.J.; see also *Pyott, Ltd.* v. *C.I.R.*, 1945 A.D. 128; 13 S.A.T.C. 121.

Generally speaking, therefore, it cannot be said that taxpayers incur expenditure in their trades for the purpose of reducing tax. If an expenditure is necessary so that a taxpayer can carry on and earn profits in his trade, he will spend the money without regard to the fact whether the expenditure is allowable as a deduction from income or not. The fact that the expenditure is not deductible from income will not deter him from incurring it, as it is necessary in the interests of the business.

The very restricted and narrow formula in the South African Income Tax Act for the deduction of business expenses makes it virtually impossible for the taxpayer to avoid or reduce tax on any large scale. On the contrary, the business man is prohibited from claiming as a deduction many legitimate business expenses. In the light of these remarks, it is proposed to examine the operation of the general deduction formula in the income tax law of the Union and also to consider the field in which the special statutory deductions operate.

§ 128. Expenditure deductible only if trade carried on

A taxpayer can claim the deductible items set out in section 11 only against *income* (as defined) derived from the carrying on of any *trade* in the Union. Section 11 (1) provides as follows:

> 'For the purpose of determining the taxable income derived by any person from carrying on any trade within the Union, there shall be deducted from or set-off against the income of such person so derived as defined by section *seven* the amounts set out in this section.'

It would seem from the terms of section 11 (1) that the Act contemplates the carrying on of more than one trade and that deductions should be made from each trade as a unit by itself. Should the allowable deductions in any particular trade exceed the income, then as regards that particular trade there is an assessed loss which, in terms of section 11 (3) (*b*), can be set off against the income from any other trade. Notwithstanding the fact that the Act contemplates the separate determination of taxable income or assessed loss in respect of each trade carried on, these must be aggregated for the purpose of determining the taxable income as a single amount in the end (see the definition of *taxable income* in section 7).[2] It may then be asked why it is necessary to determine the taxable income derived from each particular trade carried on when ultimately the results of the different trades must be aggregated in order to arrive at the taxable income on which the tax is payable. One possible reason is that in the case of gold- and diamond-mining companies, which also carry on non-mining activities, the taxable incomes derived from the different trades are subject to different rates of tax. For example, a diamond-mining company pays a higher rate of tax on taxable income from mining for diamonds than on taxable income derived from non-mining activities. Another possible reason concerns farmers who can claim,

[2] I.T.C. No. 729, 18 S.A.T.C. 96.

in terms of para. 17 of the Third Schedule, expenditure on specified development work and improvements up to an amount equivalent to 'the taxable income derived from farming operations during the year of assessment'. These reasons, on their own, clearly do not justify the inclusion of the words 'from carrying on any trade within the Union' in the deduction formula which, as will be shown, unfairly restrict the scope of the allowable deductions.

Trade is given a very wide meaning in section 7, viz.:

> 'every profession, trade, business, employment, calling, occupation or venture, including the letting of any property, and the use of or the grant of permission to use any patent, design, trade mark or copyright as defined in the Patents, Designs, Trade Marks and Copyright Act, 1916 (Act No. 9 of 1916), or any other property which, in the opinion of the Commissioner, is of a similar nature'.

In the case of a person who accumulates his savings and invests them in bonds and other interest-bearing securities the interest so received, it is submitted, is not derived from the carrying on of any trade. A business of investment in shares or loans would, however, amount to the carrying on of a 'trade'. 'A business of investment in shares in companies is a well-established occupation in the business world and in my opinion it falls under all or some of the words "trade", "business", "occupation", or "venture" used in the definition of "trade", which is obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation.'[3]

Where a holding company, which carried on a retail merchant's business, made advances to a subsidiary company, which was the owner of the premises in which the parent company was operating, the Court held that the interest received by the holding company was not derived from the carrying on of a trade.[4]

Rentals derived from the letting of any property and royalties or similar payments received from the use of copyrights or patent rights amount to the carrying on of a trade. It has been held that the hiring of a property and the subletting thereof at the same rental constitutes the carrying on of a trade.[5]

As regards the term *venture*, the Special Court has held that it refers to a transaction in which a person risks something with the object of making a profit, i.e. a financial or commercial speculation.[6] In *Kirsch* v. *C.I.R.*[7] certain advances were made by an employee to his employer in return for a proportion of the profits of the employer's business based on the ratio that the advances made by the employee bore to the capital of the firm. The employee was required to bear a proportion of the losses of the firm based on the same ratio. The Court held that the employee was not engaged in a 'venture' in terms of the definition of *trade*. Per Malan, J.:

[3] I.T.C. No. 770, 19 S.A.T.C. 216, per Dowling, J.
[4] I.T.C. No. 496, 12 S.A.T.C. 132.
[5] I.T.C. No. 615, 14 S.A.T.C. 399.
[6] I.T.C. No. 368, 9 S.A.T.C. 211.
[7] 1946 W.L.D. 261; 14 S.A.T.C. 72.

'In a sense very many investments by way of loan are attended with risk but it would be going much too far to suggest that whenever risk is run in a loan the lender has engaged in a venture.'

In spite of its wide meaning, 'trade' does not embrace all activities which might be productive of income, e.g. the receipt of interest, dividends, annuity, pension.

The requirement that a taxpayer must be carrying on a trade before he can deduct the permissible items in section 11 is, however, not always strictly adhered to in practice. For example, a taxpayer who receives interest on a mortgage bond is in practice entitled to deduct commission payable in respect of the collection thereof even though he is not carrying on a trade. A person whose income consists solely of alimony or maintenance taxable in terms of section 58(3), an annuity or pension or building society interest or income from a testamentary or *inter vivos* trust, and who is, therefore, not carrying on a trade, is entitled to deduct the allowance in respect of medical and dental expenses set out in section 11(2)(*r*) (see § 162).

There is clearly no good or sufficient reason why expenditure incurred in earning non-trade income should not be deductible or why certain expenditure deductible in terms of section 11, e.g. medical expenses, should not be deductible from non-trade income. It cannot be denied that the practice is desirable and sound. Consequently the law should be amended to embody the practice.

The Committee of Enquiry into the Income Tax Act[8] felt that in view of the fact that the definition of 'trade' in section 7 does not embrace all activities which might be productive of income, the scope of section 11(1) should be extended to cover also all such activities which are at present excluded. The Committee was of the view that this could be achieved by the deletion from section 11(1) of the words 'from carrying on any trade within the Union'. Although the Income Tax Commission considered that the present provisions of section 11(1) should not be tampered with, it recommended that a further subsection be added to section 11 to cover expenditure incurred in the production of non-trade income.[9]

II. The General Deduction Formula of the Act

§ 129. The deduction formula

One of the biggest criticisms that can be made of our income tax legislation is in respect of the allowable deduction provisions of the Act. It can safely be stated that South Africa is one of the few countries in the world which has such a narrow and restrictive formula for the deduction of business expenses. The law is, in many respects, inconsistent with sound accountancy and business principles.

Under the present income tax law, deductions from income are dealt with positively in section 11 which sets out what may be

[8] *First Report* p. 27, para. 11.
[9] *First and Final Report,* p. 12, para. (*e*).

deducted, and negatively in section 12 which defines what may not be deducted. Each section contains a general deduction formula. Thus, section 11 (2) (*a*) — the positive test — allows as deductions 'expenditure and losses actually incurred in the Union in the production of the income, provided such expenditure and losses are not of a capital nature', and section 11 (2) (*b*) allows at the Commissioner's discretion expenditure and losses incurred outside the Union. The negative test, as provided by section 12 (*g*), prohibits the deduction of 'any moneys, claimed as a deduction from income derived from trade, which are not wholly or exclusively laid out or expended for the purposes of trade'. The courts have laid down that section 11 (2) (*a*) and section 12 (*g*) must be read together in considering whether or not any amount is capable of deduction.[10]

Turning first to section 11 (2) (*a*), two tests have to be complied with:

Firstly: The expenditure must not be of a capital nature.

Secondly: The expenditure must be actually incurred in the production of the income.

§ 130. Capital expenditure

As regards the question of what constitutes capital expenditure, the case law bearing on this subject indicates that the court's views and the accountant's or business man's approach are essentially the same. There is a wealth of case law on the subject including such valuable expressions of opinion as that of Innes, C.J., in *C.I.R.* v. *George Forest Timber Co., Ltd.*[11] when he said:

> 'Money spent in creating or acquiring an income-producing concern must be capital expenditure. It was invested to yield future profit and while the outlay did not recur, the income did. There was a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one was capital expenditure, the other was not.'

There is also the important *dictum* of Watermeyer, C.J., in *New State Areas, Ltd.* v. *C.I.R.*[12] who, after having considered various cases on the subject, expressed himself as follows:

> 'The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure even if it is paid in a lump sum.'

[10] *Sub-Nigel, Ltd.* v. *C.I.R.*, 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381; *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*, 1936 C.P.D. 241; 8 S.A.T.C. 13.

[11] 1924 A.D. 516; 1 S.A.T.C. 20.

[12] 1946 A.D. 610; 14 S.A.T.C. 155.

Notwithstanding the general rule that expenditure of a capital nature is not deductible, the Act expressly authorizes the deduction of certain types of capital expenditure, e.g. a wear-and-tear allowance and scrapping allowance is made in respect of specified capital assets, an initial allowance in respect of new machinery used in production, improvements by a lessee in terms of a lease, scientific research expenditure, redemption allowances to miners in respect of capital expenditure, initial allowances in respect of the cost of ships to a shipowner, expenditure on specified development and improvements in the case of farmers, and allowances in respect of the erection of houses for employees.

Attention should, however, be drawn to the question of the deduction of an amount spent on the acquisition of a wasting asset such as land with a plantation growing on it acquired for use in a business.

There is no provision in the Act permitting the deduction of expenditure incurred in the acquisition of wasting capital assets such as mineral-bearing land, quarries, forests, etc., even though the assets may become worthless once the minerals, clay, plantations, etc., have been removed. The expenditure is of a capital nature and not deductible in terms of section 11 (2) (*a*).

In *C.I.R.* v. *George Forest Timber Co., Ltd.*,[13] a company which carried on business as timber merchants and sawyers acquired a natural forest for the purpose of its business. The nature of the trees in the forest was such that they did not renew themselves and for practical purposes the value of the land without the timber was negligible. In the course of its business the company felled a quantity of timber each year which was sawn up in the mill and sold as part of its stock-in-trade. The company claimed to deduct from its income a proportionate part of the cost of the forest relative to the timber felled in each year. The Court held that the purchase price paid for the forest-bearing land was expenditure of a capital nature and that it was not permissible to divide the single purchase of the property between the bare land and the forest. Of course, if what the company purchased was not the land but merely the right to the plantation standing on the land, it would not have acquired a capital asset. The cost of the plantation would have constituted non-capital expenditure properly deductible from income.

There is one exception to the general rule and this concerns farmers who grow timber, i.e. plantation farmers. If they acquire land together with a plantation standing thereon, they are entitled to deduct from income the cost of acquisition of the plantation. Conversely, if they sell their farm together with the plantation growing thereon, the value of the plantation must be included in gross income (§ 215). The principle established in the *George Forest Timber* case is, therefore, not applicable to plantation farmers.

[13] 1924 A.D. 516, 1 S.A.T.C. 20; see also *Baikie* v. *C.I.R.*, 1931 A.D. 496; 5 S.A.T.C. 193; I.T.C. No. 88, 3 S.A.T.C. 150; I.T.C. No. 126, 4 S.A.T.C. 123.

The principle established in the *George Forest Timber* case can work considerable hardship on a taxpayer. The Act should permit a taxpayer to deduct the value of the standing timber at the time of acquisition where part of the price paid for the land is attributable to that timber. Precedent for such a provision is to be found in section 124J of the Australian Act and section 13 (2) (*l*) of the Income Tax Act of the Federation of Rhodesia and Nyasaland. The Committee of Enquiry into the Income Tax Act did not consider this aspect during the course of its investigation although it did consider the deduction of expenditure incurred in the acquisition of mineral-bearing land. It held that the principle is firmly entrenched in our income tax law that no allowance is permitted for the amortization of the cost of mineral rights in determining the taxable profits of mining. Nevertheless, it held that an allowance representing a fixed amount per unit of raw material used in manufacture should be granted to manufacturing concerns engaged in mining where the mineral involved (other than gold) is not disposed of in an unprocessed form, but is consumed in a process of manufacture by the concern which has won it from the soil.[14] The Income Tax Commission rejected this recommendation on the grounds that it would lead to requests for similar relief from genuine miners who work a purely wasting asset. In the view of the Commission, the proposal cuts across long-established Government policy and would involve the Department in many administrative difficulties and would also be open to serious abuse.[15]

A further observation that may be made is that the words ' provided such expenditure and losses are not of a capital nature ' in section 11 (2) (*a*) may not permit an apportionment of expenditure which is partly of a capital nature and partly of a revenue nature. A taxpayer may buy a business as a going concern for a lump sum. In addition to the capital assets passing there may be stock-in-trade. In practice the Commissioner does allocate a proportionate part of the purchase price to the trading stock and allow the deduction thereof. It is doubtful, however, whether the present deduction formula permits the apportionment of expenditure as between capital and revenue expenditure. Section 51 (1) of the Australian Act uses the following words in the deduction formula: ' except to the extent to which they are losses or outgoings of capital or of a capital . . . nature '. These words clearly authorize the apportionment of expenditure which is partly capital and partly revenue.

§ 131. MEANING OF ' IN THE PRODUCTION OF INCOME '

As regards the test of section 11 (2) (*a*) that to rank as a deduction from income the expenditure must actually have been incurred in the production of the income, the various interpretations placed by our courts on the words ' in the production of income ' clearly

[14] *First Report*, p. 84, para. 14.
[15] *First and Final Report*, p. 22, para. 98.

show that this test for allowable deductions is far too narrow and restrictive and that many expenses although necessarily incurred in the conduct of business, do not qualify as allowable deductions.

In the case of the *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*,[16] Watermeyer, A.J.P. (as he then was), considered the effect of section 11 (2) (*a*) of the Act and held:

> '. . . The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.
>
> 'The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.'

This and many other authorities clearly establish that to rank as deductions, the expenditure must have been incurred for the purpose of earning *income*. The income referred to is that as defined in section 7 of the Act, namely the gross income *less* the exempt income, i.e. the gross amount received from sales or services. This is fortified by the provisions of section 12 (*f*) which prohibit a deduction of any expenses incurred in respect of any amounts received or accrued which are not included in the term 'income' as defined in section 7. It follows that if the expenditure is incurred to produce income from sources outside the Union or to produce income which is exempt from tax in terms of section 10, all such amounts not being included in 'income' as defined, then the expenditure is not deductible. Thus, expenditure incurred in the production of dividends is not deductible in the determination of taxable income, since dividends do not form part of 'income' in terms of section 10 (1) (*k*). Such expenditure is, however, deductible in the determination of income subject to super tax which includes any income from dividends (see § 172). Expenditure on vacant or unproductive property is not deductible as it is not incurred in the production of income. Thus, rates, interest, and other standing charges in respect of a vacant property, which is not productive of income, are not deductible.[17] Fees or commissions paid for the raising of loans with which to acquire trading stock constitute expenditure incurred in the production of income.[18]

The case of *Sub-Nigel Ltd.* v. *C.I.R.*[19] authoritatively establishes that 'incurred in the production of income' does not mean that before a particular item of expenditure can be deducted it must be

[16] 1936 C.P.D. 241; 8 S.A.T.C. 13.
[17] I.T.C. No. 561, 13 S.A.T.C. 313; I.T.C. No. 490, 12 S.A.T.C. 72; I.T.C. No. 665, 16 S.A.T.C. 127.
[18] *C.I.R.* v. *Genn & Co. (Pty.), Ltd.*, 1955 (3) S.A. 293 (A.D.); 20 S.A.T.C. 113. Raising fees on loans acquired to purchase fixed capital assets are also deductible in practice.
[19] 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381.

shown that it produced a part of the income for the particular year of assessment. The important question is: Was the expenditure incurred for the purpose of earning income as defined in section 7, whether in the current or in a future year of assessment? Thus, it was held in that case that amounts paid by way of premiums on insurance policies against loss of profits and loss of standing charges occasioned by fire are incurred in the production of income. Centlivres, C.J., held that on the authorities it was clear that the Court was not concerned with whether a particular item of expenditure produced any part of the income. What the Court was concerned with was whether that item of expenditure was incurred for the purpose of earning income. The whole *raison d'être* of the company was to earn profits and in taking out the policies it was endeavouring to maintain its profits by making provision against loss in the event of fire. The act entailing expenditure of the amounts paid by way of premium was performed for the purpose of earning income. The mere fact that no income had actually resulted was irrelevant; the purpose was to obtain income from the happening of a fire which would prevent the carrying on of income-producing operations.

The *Sub-Nigel* case is, therefore, authority for holding that for expenditure to rank as a deduction in respect of a particular tax year, it is not necessary to show that it has had an effect upon the production of the income for that year. The income may only be earned in a future year or it may have been earned in an earlier year, or no income at all may be earned, but as long as the expenditure has been laid out for the purpose of earning such income, it is deductible. Thus, where a property is available for letting but is vacant owing to the fact that no tenant can be obtained, the rates, interest and other standing charges are deductible as they have been incurred in the production of income.

The above authorities also clearly establish that to rank as deductions the expenditure must not only have been incurred for the purpose of earning 'income' as defined, but there must be a sufficiently distinct and direct relationship or link between the expenditure incurred and the actual earning of the income. As the ensuing paragraphs reveal, these restrictive tests result in the disallowance of a vast number of business expenses which are necessarily incurred in the carrying on of a business but which fail to satisfy the requirement that they must be laid out for the purpose of earning the 'income'.

§ 132. EXPENDITURE INCURRED OUTSIDE THE UNION

Section 11(2)(*a*) provides that the expenditure and losses must be actually incurred in the Union. In terms of section 11(2)(*b*), however, the Commissioner may allow so much of any expenditure and losses incurred outside the Union as he thinks fit. The Commissioner's discretionary power is not subject to objection and appeal, which means that his decision cannot be reviewed by the courts as long as he has applied his mind properly to the matter and has acted *bona fide*.[20]

Thus, whereas in the case of expenditure incurred in the Union, a taxpayer has a right of objection and appeal should the Commissioner disallow any portion thereof, this right is not available to him in the case of expenditure incurred outside the Union which is allowed at the Commissioner's discretion.

The Committee of Enquiry into the Income Tax Act held that section 11 (2) (*a*) operates in the same way as does section 11 (2) (*b*) since the former does not preclude the Commissioner from disallowing any claim for deduction which he may consider is not sanctioned by the Act. The taxpayer is then free to refer any case of dispute to the courts for decision. The Committee therefore recommended the removal of the words 'in the Union' in section 11 (2) (*a*) which would permit the total deletion of section 11 (2) (*b*).[21] The Income Tax Commission rejected this proposal.[22] It is wrong in principle that the Commissioner should have the final say in a matter which affects the amount of tax payable by the taxpayer or the amount of his assessed loss for the year of assessment (see § 300).

§ 133. Meaning of 'expenditure' and 'losses'

The word 'loss' in section 11 (2) (*a*) is somewhat obscure and it may be that it does not mean anything different from 'expenditure'.[23] Since all expenditure incurred in the production of income is deductible, any loss is automatically allowed. It may happen, however, that a loss is sustained which does not involve any expenditure, for example, a bad debt. Such a bad debt may not be deducted under section 11 (2) (*g*) if the amount thereof has not been included in income, e.g. a debt due to a money-lender (see § 152). Another example of a loss which does not involve an expenditure concerns traders who sell their book debts at a discount to a finance company in the ordinary course of trade for the purpose of obtaining liquid funds for the running of the business. In practice these losses are deductible as having been incurred in the production of income as required by section 11 (2) (*a*).[24] It may very well have been the intention of the legislator to provide for such cases by the insertion of the word 'losses' in section 11 (2) (*a*).

It is submitted that 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. Thus, if a merchant were required to pay for his goods by tendering land or shares in a company, the value of such land or shares would

[20] I.T.C. No. 696, 17 S.A.T.C. 86; I.T.C. No. 564, 13 S.A.T.C. 326; I.T.C. No. 666, 16 S.A.T.C. 130; I.T.C. No. 786, 19 S.A.T.C. 421; see also I.T.C. No. 103, 3 S.A.T.C. 328.

[21] *First Report*, p. 27, para. 12.

[22] *First and Final Report*, p. 9, para. 32.

[23] *Joffe & Co. (Pty.), Ltd.* v. *C.I.R.*, 1946 A.D. 157; 13 S.A.T.C. 354.

[24] This case must be distinguished from the case of the trader who sells his business and incurs a loss on the sale of his book debts. Such loss is not deductible since it has not been incurred in the production of income but after the income has been earned.

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[21] *First Report*, p. 27, para. 12.

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[24] This case must be distinguished from the case of the trader who sells his business and incurs a loss on the sale of his book debts. Such loss is not deductible since it has not been incurred in the production of income but after the income has been earned.

constitute expenditure in terms of section 11 (2) (*a*) and would be deductible. If a merchant were to buy his goods in the United States at a price fixed in dollars, the liability so contracted would be 'expenditure' and must be brought to account at its equivalent in South African currency.

An interesting point arises in the case of a company which discharges an obligation by the issue of its own shares. For example, a company may remunerate one of its employees for services rendered by the issue of shares fully paid up. As the company has not lost or parted with any asset, it is submitted that it has not expended anything so that it is not entitled to claim as a deduction from income the nominal value of the shares issued to the employee. The position, it is submitted, would be different if the employee agrees to work for a salary payable in cash, but subsequently decides to subscribe for shares and utilizes the remuneration owing to pay for the shares. In such a case, the company has incurred expenditure in respect of the salary due notwithstanding that the obligation is subsequently discharged by the issue of shares. Where a company pays for trading stock by the issue of fully paid-up shares, it may well be that the provisions of section 11 (5) (*d*) are not applicable in that the trading stock has been acquired for a consideration, viz. the issue of the shares. Thus, the company may not successfully contend that it must be deemed to have acquired the trading stock at a cost equal to the current market price at the date of acquisition (see § 249). In such a case, it would be wiser for the company to purchase the stock for a sum of money. At a later date the seller may agree to take up shares in discharge of the purchase price. On this form of the transaction, the purchase price of the stock is deductible in terms of section 11 (2) (*a*).

§ 134. Expenses incurred to reduce or avoid deductible expenditure

Numerous decisions of the Special Court lay down that expenses incurred for the express purpose of reducing or avoiding deductible expenditure, even though they result in an ultimate increase in net profit, are not allowable since they have not been incurred in the production of income as defined. Thus, it has been held[25] that legal expenditure incurred in an endeavour to escape payment of assessment rates is not expenditure incurred in the production of income. The President of the Special Court remarked:

> 'The legal charges in question were no doubt incurred in the hope that certain of the company's expenses would be eliminated, and in that way its profits increased. That, however, is not the same thing as saying that the legal charges were incurred in order to increase the company's income.'

In another case,[26] it was held that legal expenses incurred in successfully resisting an action for the alleged underpayment of employees'

[25] I.T.C. No. 160, 5 S.A.T.C. 73.
[26] I.T.C. No. 650, 15 S.A.T.C. 365.

wages by the Department of Labour were inadmissible as a deduction. In one other case,[27] the taxpayer incurred legal expenses in an action to declare *ultra vires* a Government regulation which imposed a liability for customs duty in respect of the importation of tobacco used in his business of manufacturing cigarettes. The appellant was successful in securing an order declaring *ultra vires* the regulation and he obtained a refund of the customs duty he had so far paid. The appellant was, however, not permitted to deduct the legal expenses. Ingram, President, stated:

> 'What the expenditure by way of legal costs has effected has been to defend the expenditure in earning the income from being increased by the customs duty. Accordingly the expenditure has not been incurred for the purpose of producing income, that is, meaning the gross amount received. It has prevented the taxable income from being diminished.'

On the same principle, lump-sum payments to free a trader of a recurring business expense, even if made with a view to increasing the future net profits of the business, are not deductible as they have not been incurred for the purpose of earning the 'income' as defined. Thus, a lump-sum payment to an agent for the cancellation of an agency agreement so as to avoid the payment of large commissions in the future, is not deductible. Similarly, a payment to a lessor for the cancellation of a lease agreement in order to free the lessee of the payment of large recurring rentals under the agreement, is also not deductible.

It is highly unrealistic that a manufacturer's costs of representation in arbitration court proceedings for the purpose of reducing labour costs and thereby increasing the profits, would not be deductible under our law or that a taxpayer's costs of employing an efficiency expert to cut down production costs are not allowable since they are not incurred in the production of income as required by section 11 (2) (*a*).

The acceptance of this principle leads to results quite opposed to commercial and accountancy practice and to common sense. The end result of expenditure laid out to produce gross income and that incurred to reduce or avoid expenditure is in both cases a larger profit to the taxpayer. A common-sense approach seems to have been applied in one of the judgments of the Special Court.[28] In the particular case a firm dealing in second-hand cars was faced with a claim for damages arising out of an alleged defect in a car sold by it, and went to law. It paid certain damages and claimed as a deduction from income both the amount of the damages paid and its legal costs. The Commissioner conceded that the damages were an allowable deduction but contested the claim in regard to the legal costs. The Court, in upholding the taxpayer's claim, pointed to numerous instances in the commercial and business world where expenditure is incurred for the purpose of reducing loss and is allowed, and came to the conclusion

[27] I.T.C. No. 662, 16 S.A.T.C. 118.
[28] I.T.C. No. 817, 20 S.A.T.C. 501.

that 'money expended in minimizing expenses was expended in producing income, for the lower the expense the higher the income'; it considered the differentiation between, for example, costs incurred in recovering a debt due to a trading concern and the costs incurred in resisting a claim against it which arises in the ordinary course of its business as 'artificial, unreal and liable to produce injustice'. The Court also expressed the view that in most cases where the capital sum, i.e. the damages, was deductible the costs incurred in litigation would also be allowable.

> 'This', the judge said, 'is a common-sense view, and the further one goes from common sense the further one goes from natural justice.'

These views are only fair and equitable, but with the greatest respect to the learned Judge who decided the case, his opinion runs counter to a number of decisions which emphasize the distinction between expenses and losses incurred in the earning of gross income and those incurred in order to reduce expenditure. In the writer's view, this distinction is justified in terms of the Income Tax Act. If what was being taxed was the taxpayer's net profit from trade then it would be of no consequence whether the amount sought to be deducted was expended in the earning of the gross income or in the reduction of expenses or prevention of a loss. But the Income Tax Act taxes not profit or gain but 'income' as defined, namely gross receipts and accruals and section 11 (2) (*a*) allows only the deduction of expenses or losses incurred in the production of income, i.e. amounts expended for the purpose of earning income (gross receipts or accruals), and not expenses the purpose of which is to avoid a reduction in the net profit by avoiding or reducing an expenditure or a loss.

It is interesting to note that the Commissioner has now adopted the common-sense view expressed in this recent Special Court case, and his present practice is to allow legal expenses as a deduction against income in cases where the damages or compensation paid would be allowable as a deduction. Previously, in not allowing legal expenses as a deduction from income where they were incurred in an effort to resist a claim for damages, the Department has seemingly religiously followed the decision in the case of the *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*[29]

That the Commissioner has adopted this common-sense view is to be welcomed and will go a long way towards solving the question in the *Port Elizabeth Tramway* case[29] that has always vexed the layman, i.e. if the damages could be regarded as being incurred in the production of income, why not the legal expenses which were laid out in an attempt to minimize the allowable damages?

The Department has also recently decided that where taxpayers are required to conform to industrial legislation, price control and import control regulations, etc., any legal expenses incurred in connection with actions instituted against taxpayers are allowable,

[29] 1936 C.P.D. 241; 8 S.A.T.C. 13.

whether the action is successful or not. Under this new ruling, legal expenses incurred in resisting an action instituted against the taxpayer by the Department of Labour for alleged underpayment of wages are deductible from income, notwithstanding a Special Court decision given against the taxpayer.[30]

If the Commissioner would accept this principle that expenditure incurred for the purpose of minimizing expenses is an allowable deduction, then it would seem that legal expenses incurred for the purpose of reducing expenses, e.g. applications to have rateable value of rent-producing property reduced, might in future be allowable. These are allowed as a deduction for undistributed profits tax purposes, but only because of the specific provision in section 50 of the Act in terms of which any expenditure is allowed as a deduction where it is actually and necessarily incurred in the course of and by reason of the ordinary business operations of the taxpayer.

In Australia and in the United Kingdom expenditure directed towards reducing current and future expenses is allowable as a deduction. Surely this is a common-sense approach!

§ 135. Payment of damages and compensation resulting from negligence

For expenditure or losses paid by way of damages or compensation resulting from negligence during the course of earning income to be deductible, there must be a very close connection between the trade or business carried on and the cause of the liability for damages, or as has been put by the courts, the negligence must have been an *inevitable concomitant* of the trade.

In *Joffe & Co. (Pty.), Ltd.* v. *C.I.R.*[31] the taxpayer carried on business as engineers in reinforced concrete. The death of a workman was caused by the company's negligence in carrying out one of its contracts, and it was required to pay damages and costs. The company claimed a deduction of the amount paid. It was held, disallowing the claim, that the expenditure had not been incurred for the purpose of earning profits, nor, as it had not been established that negligent construction was a necessary concomitant of the trading operations of a reinforced concrete engineer, had it been incurred for the purposes of the taxpayer's trade. It was said by Watermeyer, C.J.:

> 'There is nothing to show that the appellant's method of conducting his business necessarily leads to accidents, and it would be somewhat surprising if there were.'

In *Weinberg* v. *C.I.R.*[32] the taxpayer was a garage owner who undertook to garage a car for one of his clients for an agreed monthly payment. On one occasion, an employee took the car and drove it to his own home, but on his way back ran the vehicle into a building, causing extensive damage. The taxpayer was obliged to pay damages

[30] I.T.C. No. 650, 15 S.A.T.C. 365.
[31] 1946 A.D. 157; 13 S.A.T.C. 354.
[32] 1946 C.P.D. 429, 14 S.A.T.C. 210.

and legal costs. It was held that neither the damages nor the costs could be deducted from his taxable income. Newton Thompson, J., held:

'. . . It appears that in order to earn £1 10*s*. 0*d*. per month, the garage proprietor had to—

(1) garage Oliver's car;

(2) dust Oliver's car every night and polish it once a month.

(3) allow Oliver to pick up one of his employees at the garage so that such employee could drive and deliver the car from Oliver's house to the garage.

'. . . When Daniel drove the car into the building at the top of Adderley Street he was not engaged in rendering to Oliver, on behalf of appellant, any of the three services set out above. It is this act to which the expenditure of £184 9*s*. 0*d*. is attached. It follows that in my opinion the expenditure of £184 9*s*. 0*d*. was not incurred in the production of income.

'It seems to me that before appellant could succeed in this matter he would have to establish that Daniel's act in damaging the car, as set out above, was the inevitable or practically inevitable result of the contract which appellant had with Oliver or of the business appellant carried on. I cannot find on the facts in the stated case anything which would justify that conclusion. . . .'

In a Special Court case,[33] the Court was concerned with a firm of building contractors, who during 1941 undertook the erection of a block of flats for a company, in accordance with the company's specifications. The building was completed and handed over to the company in 1942 and the firm received the purchase price. Some considerable time later the external walls of the building revealed dampness and it was discovered that the walls had not been built according to specifications. The company accordingly instituted action against the taxpayer for damages. The Court refused to allow as a deduction the damages paid since there was nothing to suggest that negligence in observing the plans and specifications, and the liability consequent thereon, were the inevitable or necessary concomitants of the taxpayer's trading operations. In another case[34] the Special Court also refused to allow damages paid by a consulting engineer as a result of an error which occurred during the carrying out of a contract, but in a case where taxpayers carried on business as stevedores and while unloading cargo from a vessel an article fell out of the net and killed a passer-by as a result of which they had to pay damages, the Court held that the damages must be regarded as incidental to a business such as stevedoring and therefore deductible.[35]

Where a trader, who supplied to certain of his customers a brand of sheep-dip of which he was the agent, was mulcted in damages because sheep which had been dipped with the dip supplied had died, the Court held that the damages were not incurred in the production of income.[36] In another case, where a taxpayer, as his

[33] I.T.C. No. 658, 15 S.A.T.C. 498.
[34] I.T.C. No. 727, 18 S.A.T.C. 91.
[35] I.T.C. No. 233, 6 S.A.T.C. 259.
[36] I.T.C. No. 30, 2 S.A.T.C. 51.

principal business, sold petrol-lamps under a guarantee in respect of each lamp sold and one of the lamps so sold exploded and caused injuries to the purchaser, the Court held that the damages were to be regarded as having been incurred in the production of income.[37] The Court, however, refused as a deduction damages paid by a baker and confectioner arising from the nuisance created to a next-door boarding-house owing to excessive smoke from the bakery chimney.[38]

In the *Port Elizabeth Tramway* case[39] the Court referred to the unlawfulness or negligence of an act done for the purpose of carrying on the trade which earns the income. Watermeyer, A.J.A., held:

> 'If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible.'

In practice, however, although the Commissioner does not allow expenditure attached to unlawful acts on the part of the taxpayer, e.g. fines for speeding and parking offences, contraventions of the price control regulations and Sunday trading, he does allow a loss sustained owing to negligence on the part of the taxpayer or his employees if the operations carried on by the taxpayer are of such a nature that they necessarily lead to accidents. He would probably not allow damages paid and due to negligence such as might occur if a trader's bacon-slicer cuts off the hand of a customer since such negligence cannot be regarded as an *inevitable concomitant* of the trade. The Commissioner, however, allows as a deduction damages paid by hairdressing saloons to customers who suffer from burns and electric shock. He also allows as a deduction compensation paid by a laundry for damage to or loss of articles entrusted to its care. Compensation paid by accountants and auditors to their clients is deductible in practice whether the negligence was their own or due to their employees.

The above cases show that the dividing line in respect of the deduction of damages and compensation paid is a very fine one indeed. The result in *Joffe's* case,[40] for example, seems to be inequitable and it is considered that expenditure of this kind should be deductible. In Australia, compensation of this nature would be an allowable deduction. Compensation paid by professional men to clients and patients is also deductible in Australia. Thus, where a solicitor claimed a deduction of £100 paid by him to a client for negligence in connection with the purchase of certain lands, his claim was allowed.[41] The Judge held:

> 'A solicitor performing his professional duties for reward is, of course, engaged in the earning of assessable income. If, while so doing, he is responsible for some negligent act, error or omission, whereby one of his clients suffers pecuniary loss, any compensation payment by the solicitor

[37] I.T.C. No. 49, 2 S.A.T.C. 122.
[38] I.T.C. No. 83, 3 S.A.T.C. 142; see also I.T.C. No. 191, 5 S.A.T.C. 358.
[39] 1936 C.P.D. 241; 8 S.A.T.C. 13.
[40] 1946 A.D. 157; 13 S.A.T.C. 354.
[41] 8 C.T.B.R., Case 45, cited in Gunn's *Commonwealth Income Tax Law and Practice*, 5th ed., p. 467.

is obviously a loss actually incurred in the course of gaining or producing his income. Whether the negligence is his own or that of his employees, the principle is the same.'

§ 136. Expenses incurred in the protection of income

The Special Court has held that legal fees incurred in connection with the making of a rent board application for higher rentals are deductible by the landlord even if his application fails. On the other hand, this expenditure would not be allowed if it were incurred by a landlord in resisting an action brought by tenants to reduce their rentals, even in the event of his being successful. In the former case[42] the Court has argued that the purpose of the proceedings was to increase the taxpayer's *income* as defined in section 7 whereas in the latter case[43] the Court held that the legal expenses in no way added to or increased the appellant's income but merely had the effect of protecting it and preventing its diminution.

Similarly, legal and other expenses incurred to protect the taxpayer's business from competition, if they have been incurred merely for the purpose of protecting the income and preventing its diminution, are not regarded as incurred in the production of income. Thus, in a case[44] where a taxpayer incurred legal charges on certain litigation in which he had engaged in seeking to prevent the owner of the premises in which he carried on business from letting certain adjoining premises to another person to carry on a business in competition with the taxpayer, and in opposing the granting of a trading licence to such other person, the Special Court held that the expenditure was not incurred in the production of income and was consequently not an allowable deduction. Support for this decision is to be found in *African Greyhound Racing Association (Pty.), Ltd.* v. *C.I.R.*,[45] which came before a full bench of the Transvaal Provincial Division, and where the Court decided that money spent on legal representation of the association before a commission, which was to inquire into the whole question of whether or not dog-racing should be allowed or its extent curtailed, was incurred for the purpose of preventing the total or partial extinction of the business from which the association's income was derived and was therefore not deductible. This, with respect, is indeed a very narrow interpretation of the words 'in the production of income' and, if applied strictly, might mean that a large proportion of advertising expenses laid out by merchants and industrialists should be disallowed to the extent to which they are incurred to prevent income from being diminished. It could also then be argued that if expenditure designed to diminish loss of income is not deductible, the expenditure directed to maintaining a steady income is not deductible, and that the only expenditure properly deductible is expenditure designed to increase income.

[42] I.T.C. No. 583, 14 S.A.T.C. 111.
[43] I.T.C. No. 585, 14 S.A.T.C. 120, and I.T.C. No. 632, 15 S.A.T.C. 102.
[44] I.T.C. No. 725, 17 S.A.T.C. 500.
[45] 1945 T.P.D. 344; 13 S.A.T.C. 259.

In spite of the above cases, there are other decisions of the courts which seem to support the view that steps taken to prevent a diminution of income are on the same footing as steps taken to produce income. In *Weinberg* v. *C.I.R.*[46] Newton Thompson, J., referred to the principle stated in the case of *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*[47] that the expenditure must be so closely connected with the earning of the income as to be regarded as part of the cost of earning it. The learned Judge presumed that this would include costs which are incurred to prevent or protect income from being diminished. In *C.I.R.* v. *Stellenbosch Farmers Winery*[48] it was held that as certain legal costs were incurred in seeking to nullify competition and thus prevent a loss of income they were directly connected with the earning of the income.

It cannot be said, in the writer's opinion, that the result of the litigation has been to produce a satisfactory position. The Cape and the Transvaal Courts do not seem to be in agreement on this question. So far there has unfortunately been no pronouncement from the Appellate Division. Whatever the correct legal position may be, it goes without saying that the general deduction formula should be extended to include all expenses inherent to the carrying on of a business or profession including all expenditure necessarily incurred in the protection of current and future income as long as such expenses are not of a capital nature.

§ 137. Expenditure incurred to protect or maintain capital assets

Expenditure made for the acquisition of a fixed asset is a capital expense including expenditure in acquiring goodwill or in enlarging it. On the other hand, the courts in the United Kingdom and Australia have held that expenditure incurred for the purpose of protecting or maintaining an existing asset is not expenditure of a capital nature. The position was well stated by an English judge as follows:[49]

> 'The money that you spend in defending your title to a capital asset, which is assailed unjustly, is obviously a revenue expenditure. There again, there is all the difference in the world between defending your assets against the claim of somebody who has no claim against them, and acquiring a new asset or adding to an existing asset.'

Under the South African Income Tax Act, expenditure incurred to protect or maintain capital assets would not be allowable since it has not been incurred in the production of income as required by section 11 (2) (*a*). Thus, if circumstances should arise in which a company might be justified in dismissing one of the directors, but, to avoid publicity injurious to the company's reputation, it pays the

[46] 1946 C.P.D. 429; 14 S.A.T.C. 210.
[47] 1936 C.P.D. 241; 8 S.A.T.C. 13.
[48] 1945 C.P.D. 377; 13 S.A.T.C. 381.
[49] Per Lord Greene in *Associated Portland Cement Manufacturers, Ltd.* v. *Kerr* (1945), 27 T.C. 103.

director a lump sum to induce him to retire, such expenditure, it is submitted, is not deductible. Again, if an action is brought against a taxpayer to declare its title to a capital asset used in its business invalid, the legal costs incurred, although they do not create any new asset at all but are expenses which are incurred in the ordinary course of maintaining the assets of the company, would probably also be disallowed under section 11 (2) (*a*). Another good illustration of the point is contained in a Special Court case[50] where it was held that legal expenses incurred in an attempt to protect a design which finally was declared invalid by the court, could not be regarded as expenditure actually incurred in the production of income. According to the evidence, it was stated that it was a regular part of the appellant's business to produce designs for the articles which it manufactured. The appellant was constantly engaged in making designs. Every design had a limited life and as a rule its usefulness was limited to a period of not over six months owing to seasonal trade. The Special Court held that the design in question having been established to have been invalid by the order of the Supreme Court, the expenditure was in fact laid out in an attempt to protect an invalid design and could not therefore be regarded as expenditure incurred in the earning of the appellant's income. It was also held that the costs of the legal proceedings had too remote a connection with the earning of the appellant's income to be regarded as a part of the cost of earning it. In another case the Special Court has held that the cost of obtaining a valuation for the purpose of insuring an income-producing property is not deductible being expenditure undertaken for the preservation of a capital asset.[51]

It is inconceivable that in a modern taxing system expenditure, such as that described above, should be disallowed in the assessment. This is in conflict with the well-established principle that the taxable income of any business should be its profits computed in accordance with sound accountancy practice.

§ 138. Meaning of 'actually incurred'

A further important requirement of the positive test, as set out in section 11 (2) (*a*), is that in order to be deductible the expenditure must be *actually incurred.*

The words of the statute are not 'necessarily incurred' but merely 'actually incurred'. The use of the words 'actually incurred' as contrasted with the words 'necessarily incurred', it is submitted, widens the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, incurring expenses which another man does not incur; such expenses are therefore not 'necessary' but they are incurred and are, therefore, deductible.[52]

[50] I.T.C. No. 440, 10 S.A.T.C. 468.
[51] I.T.C. No. 264, 7 S.A.T.C. 145.
[52] *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*, 1936 C.P.D. 241; 8 S.A.T.C. 13.

The words 'actually incurred' rule out the deduction of provisions for expenditure and losses which are uncertain or which may arise in the future or which are no more than impending or expected. Moreover, section 12 (*e*) prohibits a deduction in respect of income carried to any reserve fund or capitalized in any way. If there is no definite and absolute liability at the end of the tax year to pay an amount, expenditure has not been 'actually incurred'.[53] Thus, estimates in respect of contingent liabilities are not expenditure 'actually incurred'.[54]

'Actually incurred' does not mean that the expenditure must be due and payable at the end of the tax year. As long as there is a clear legal liability to pay at the end of the tax year, the expenditure is deductible notwithstanding that actual payment only falls due in a later tax year. Where a taxpayer at the end of the tax year made provision in his accounts for holiday pay due to his employees but payable only in the month of December following the year of assessment, the Court found that in terms of the industrial agreement appertaining to the industry of the taxpayer, there was an absolute liability which was deductible notwithstanding the fact that the liability was not payable at the end of the tax year.[55]

Although section 11 (2) (*a*) does not specifically say so, the courts have held that deductible expenditure is restricted to that incurred in the year of assessment.[56] It cannot be carried forward to a subsequent tax year or carried back to a previous tax year even though such expenditure properly relates to the income of those particular tax years. There is an exception in that section 11 (5) ensures that the cost of goods or other assets purchased for resale is deductible in the tax year in which the goods or assets are eventually sold. Farmers are permitted to carry back expenditure in certain special cases (see § 213). The general rule is, however, that no expenditure incurred in a year previous to the particular tax year can be deducted.

Provisions made by prudent traders at the end of the financial year for anticipated losses or expenditure in respect of goods sold or work done for which the taxpayer has undertaken liability in the future, are not deductible as no loss or expenditure has been actually incurred during that year as required by section 11 (2) (*a*). Moreover, such a provision is expressly prohibited by the terms of section 12 (*e*). The allowance granted in respect of doubtful debts (see § 153), the special allowance made to hire-purchase traders (see § 230), the allowance to Union shipowners in respect of estimated future repairs (see § 160), and the mortality allowance to farmers (see § 199), are special exceptions provided for in the Act. Other

[53] I.T.C. No. 505, 12 S.A.T.C. 160; I.T.C. No. 169, 5 S.A.T.C. 162; I.T.C. No. 380, 9 S.A.T.C. 347; I.T.C. No. 542, 13 S.A.T.C. 116; I.T.C. No. 545, 13 S.A.T.C. 193.

[54] *Pyott, Ltd.* v. *C.I.R.*, 1945 A.D. 128; 13 S.A.T.C. 121.

[55] I.T.C. No. 674, 16 S.A.T.C. 235.

[56] *Sub-Nigel, Ltd.* v. *C.I.R.*, 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381. *Concentra (Pty.), Ltd.* v. *C.I.R.*, 1942 C.P.D. 509; 12 S.A.T.C. 95. *Baxter* v. *C.O.T.*, 1937 S.R. 48; 9 S.A.T.C. 1; I.T.C. No. 47, 2 S.A.T.C. 120.

exceptions are to be found in the provisions of section 11 (5) in terms of which traders are permitted to deduct from income unrealized losses in respect of stock-in-trade on hand at the end of the tax year where the market value of such stock has fallen below cost (see § 249), and in the case of township owners who in practice are entitled to an allowance in respect of contingent development expenditure (see § 232).

§ 139. Expenditure incurred prior to the earning of income

The restriction of the deduction of expenditure to that incurred in the year of assessment leads to results quite opposed to ordinary commercial and accountancy principles. The restriction to the year of assessment prevents a person from carrying forward expenditure incurred in one year to another year even though the income which results from the operations to which the expenditure is attached accrues only in the later year. A good example is the case of building contractors who undertake the construction of buildings on land belonging to their clients. In practice, in the case of a builder who commences building operations, say, on 1st April, 1958, and becomes entitled to payment only on 1st October, 1958, the Commissioner allows the expenditure incurred during the period 1st April, 1958, to 30th June, 1958, to be carried forward and to be deducted from the amount accrued in the following tax year in order to determine the taxable income for that year of assessment. Such practice is in conflict with the deduction formula but it is in accordance with sound accountancy and commercial principles and it should be authorized by the Act. A further example is the case of a taxpayer who, towards the end of the tax year, proceeds oversea for the purpose of selling the products in which he deals. Before the end of that tax year he may have spent considerable sums of money on travelling expenses, e.g. steamship or air fares, but the benefits of the trip may only be felt in the next tax year when the orders are obtained. Correct accountancy procedure dictates that this kind of prior expenditure should be carried forward to the next tax year since it properly relates to the income of that year. However, in terms of the Income Tax Act, the expenditure cannot be carried forward but is deductible in the year in which it has been incurred.

It will be generally accepted that in proper cases past expenditure should be allowed to be deducted. The present deduction formula is too rigid in so far as it restricts deductible expenditure to that incurred in the year of assessment. The deduction of prior expenditure should be permitted to the extent to which such expenditure properly relates to the income of the year of assessment.

§ 140. Prepaid expenses

Another big class of expenditure incurred in advance of the earning of income falls under the heading of *prepaid expenses.*

It is well-established accountancy practice to apportion expenditure between one tax year and the next where the benefits derived from such expenditure extend into the tax year following that in which the expenditure is incurred. Thus, common items appearing on the balance sheets of most traders and manufacturers are prepaid insurances, rates, rent, etc. On this basis the expenditure is written off in the accounting years to which the expenditure is properly attributable. Thus, if an insurance premium for £120 is paid on 1st September, 1957, in respect of the year ended 31st August, 1958, it is well-established accountancy practice that £100 ($\frac{10}{12} \times$ £120) of the premium should be shown as an expense in the financial year ended 30th June, 1958, and the balance of £20 in the year ended 30th June, 1959. The Commissioner, in practice, appears to raise no objection to this procedure, and in computing the assessment he merely follows the accepted accountancy practice. Thus, in the example given, he will allow £100 as a deduction in the 1958 tax year and £20 in the 1959 tax year.

The accountant's approach is understandable and is based on sound commercial and business practice. But what authority is there in the Income Tax Act for the Commissioner's practice of permitting the apportionment of expenditure between different tax years?

Section 11 (2) (*a*) of the Income Tax Act permits the deduction from income of all 'expenditure and losses actually incurred in the Union in the production of the income, provided such expenditure and losses are not of a capital nature'. Our courts have laid down on numerous occasions that it is not a requirement that the expenditure must have been productive of income in the tax year in which it has been incurred (see § 131). As long as the expenditure has been incurred for the purpose of earning income, is not of a capital nature, and satisfies the requirement of section 12 (*g*) that it has been wholly or exclusively laid out or expended for the purposes of trade, it is properly deductible, the fact that the benefits therefrom may only be derived in a future tax year notwithstanding. It must follow, therefore, that there is no authority in our Income Tax Act for apportioning expenditure as between different tax years. In the example given, on what legal grounds can a deduction of £20 in the 1959 tax year be justified? No expenditure was incurred in the 1959 tax year. The full premium of £120 was incurred in the 1958 tax year. It is true that it would be in accordance with sound business principles for the taxpayer to deduct £100 in 1958 and £20 in 1959 in order to arrive at its true net profits. This consideration is surely irrelevant when it comes to income tax: the only relevant considerations are the provisions of the Income Tax Act which deal with permissible and non-permissible deductions. As was pointed out by Centlivres, J.A. (as he then was), in *Sub-Nigel, Ltd.* v. *C.I.R.*:[57]

> '. . . the Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions

[57] 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381.

which are permissible according to the language of the Act. . . . Regard, therefore, must be had to the Act and the Act alone in order to ascertain whether the deductions sought to be made . . . are permissible.'

The writer recalls the case of a taxpayer who conducted a manufacturing business and who was in terms of a service agreement compelled to pay his factory manager's salary in advance for a period of three years. The salary was actually £2,000 per annum and the service contract which commenced on 31st March, 1953, was for a period of three years. It was specially provided that the total salary covering the three years, viz. £6,000, was payable on the signing of the contract. From the accounting point of view, the £6,000 was apportioned over the respective years to which the services related (£500 in 1953, £2,000 in 1954, £2,000 in 1955 and £1,500 in 1956), but when submitting the taxpayer's return of income in respect of the 1953 tax year the full £6,000 was claimed as an allowable deduction from income. The Receiver refused a deduction of £6,000 and allowed an amount of £500, no doubt following the accepted accountancy practice.

Objection was lodged to the assessment on the grounds that the £6,000 was —

(*a*) actually incurred in the 1953 tax year; and

(*b*) incurred for the purpose of earning income; and

(*c*) wholly and exclusively laid out or expended for the purposes of trade; and

(*d*) not expenditure of a capital nature.

In the face of such authorities as the *Sub-Nigel* case,[57] the Receiver felt that the objection was sound in law and allowed the objection.

§ 141. EXPENDITURE INCURRED SUBSEQUENT TO THE RECEIPT OF INCOME

It has already been indicated how in numerous ways income for tax purposes does not coincide with the commercial or accountancy concept of profit. This distinction between the two is very well brought out in the case of the trader or manufacturer who receives advance payments against goods still to be delivered or services still to be performed, where the advance payments are received in the one tax year and the *quid pro quo* is to be given or performed in the succeeding tax year, i.e. the income is received in one tax year and the expenditure to be incurred in connection with such income is only incurred in the succeeding tax year.

The accountant or business man will, no doubt, exclude the advance payments from the profit and show them as liabilities, or if he includes them as income he will make provision for the expenditure to be incurred in connection with the payments. In this way he avoids taking credit for a profit until it has been realized. This is not the case with the Income Tax Act which looks upon the advance payment as gross income being an amount 'received or accrued' during the year of assessment and therefore to be included in the computation of the taxable income (see § 292). Moreover, the taxpayer is not entitled to deduct from the advance payments the expenditure which still has to be incurred. Section 11 (2) (*a*) only permits the deduction of expenditure and losses actually incurred during the year of assessment and section 12 (*e*) prohibits the creation of reserves or provisions to meet contingent liabilities. Serious consequences may follow from the position thus created by the Income Tax Act.

To illustrate let the case be taken of a taxpayer who in Year 1 when he commences business receives £10,000 income in advance with no expenditure having yet been incurred. He is taxable on £10,000 in Year 1. If the expenditure attributable to this income, say, £6,000, is incurred in Year 2 when the taxpayer receives a further £10,000 income in advance, he is taxable in Year 2 on £4,000. The truth of the matter is, however, that over the two years tax will be paid on £14,000, whereas, in actual fact, only £8,000 profit will be earned in respect of the £20,000 income received. There is no provision in the Act in terms of which the taxpayer can claim an allowance in Year 1 for the expenditure incurred in Year 2. Section 11 (2) (*a*) restricts the deduction to expenditure incurred during the year of assessment. Moreover, the taxpayer is not entitled to claim, by way of a provision, a deduction in respect of the deferred expenditure as section 12 (*e*) expressly provides that no deduction can be made in respect of income carried to any reserve fund or capitalized in any way.

There are a number of businesses which operate to a large extent on advance payments or which incur their expenses after the receipt of income, for example, the publisher of a periodical who receives subscriptions in advance and is still to incur the expenditure involved in producing the periodical over a period extending into the following tax year. In certain businesses commissions are payable to salesmen only upon collection of the purchase price of the goods sold. Businesses which operate by arranging for instalment payments and selling the article only when the price has been paid and hoteliers who receive deposits on account of reservations for accommodation in one tax year whereas the accommodation is only supplied in the next tax year, also come into this category. It may, therefore, frequently occur that expenditure is incurred subsequent to the receipt of income.

Because of the disallowance of provisions for deferred expenditure under the present law, considerable hardships may fall on a taxpayer as the above example shows. One solution to the problem is that the Act should authorize the allowance of reasonable provisions for expenditure which will inevitably be incurred although not during the year of assessment, as long as the income has accrued in that year. The allowance must, of course, be included in the income of the taxpayer in the following year of assessment. This would allow the taxpayer relief from paying tax on income which in fact bears no relation to his true profit. Such a provision is not without precedent in the Income Tax Act, e.g.:

(1) Section 11(2)(*b*) authorizes an allowance for doubtful debts.

(2) Section 11(5)(*a*) provides for an allowance against the cost price of trading stock of an amount representing damage, deterioration or decrease in market value.

(3) Paragraph 9 of the Third Schedule permits farmers to deduct a mortality allowance in respect of livestock on hand.

(4) Section 11(2)(*n*) authorizes a deduction for estimated repairs in the case of shipowners operating in the Union.

(5) Hire-purchase traders are entitled to a special allowance, in terms of section 22, in respect of unearned profits.

These are provisions for anticipated losses which may or may not occur. There is, therefore, a stronger case for allowing provisions for expenditure which will inevitably be incurred although not during the year of assessment. It is also the practice of the Commissioner, for which he apparently finds support in section 22 of the Act, to allow as a deduction a provision for contingent development expenditure still to be incurred by a township-owner (see § 232). This allowance is no doubt justified on the grounds that the township-owner's responsibility for the making of roads, etc., is usually carried out subsequent to the date of sale and in many instances after all the plots in the township have been sold. But, as pointed out above, there are other types of business which earn income in advance of expenditure still to be incurred and which are denied the advantages received by township owners.

In the writer's view, the best solution to the whole problem of advance payments would be for a provision to be inserted into the Income Tax Act, the effect of which would be to exclude the advance payments from the profits so that they only become taxable in the tax year in which they can truly and properly be regarded as income. For a full discussion on the taxation of payments received in advance, see § 292.

The Committee of Enquiry into the Income Tax Act recommended that subject to certain conditions, any provision made by a taxpayer for anticipated expenditure in respect of goods sold or work done for which he has undertaken liability in the future should be deductible.[58] This recommendation was rejected by the Income Tax Commission on the grounds that it conflicts with section 12(*e*) of the Act which provides that no deduction can be made in respect of any income that has been credited to a reserve. The proposition that traders be permitted to set aside current profits to meet contingencies was not acceptable to the Commission. Moreover, in the

[58] *First Report*, p. 36, para. 82.

view of the Commission the loss of revenue in the first year of allowance would be substantial.[59] With respect, the reasons advanced by the Commission are entirely inadequate. The Committee's recommendation does not involve setting aside current profits to meet contingencies. Its purpose is to attempt to arrive at the true profit of the trader by deducting a provision for expenditure which will inevitably be incurred. The argument that in the first year the loss of revenue would be substantial is not convincing. Loss to the revenue is no excuse for the retention of an anomaly which works hardship on a taxpayer.

Unfortunately, the recommendation of the Committee of Enquiry is concerned only with cases where goods have been sold and delivered or services have been rendered during the tax year, and in respect of which the taxpayer has undertaken liability in the future, i.e. it was dealing with cases where the income has already been earned and not with advance payments, for example, a motor trader who sells cars under a guarantee of service for one year during which period he undertakes to replace defective parts, give free service, etc. It does not deal with cases where amounts have been received in one tax year in respect of goods to be delivered or services to be rendered in a subsequent tax year.

§ 142. Expenditure wholly or exclusively for purposes of trade

The negative test (*section* 12(g))

As regards the negative test of section 12(*g*), this forbids the deduction of any moneys not wholly or exclusively laid out or expended for the purposes of trade.

The words 'expended for the purposes of trade' in section 12(*g*) are also found in section 137(*a*) of the Income Tax Act in the United Kingdom and the courts there have interpreted them to mean 'for the purpose of enabling a person to carry on and earn profits in the trade' or, in other words, 'for the purpose of earning the profits'.[60] 'Profits', in this sense, is a very much wider term than 'income' as defined in section 7. Thus, expenses incurred for the express purpose of reducing or avoiding expenditure in the future which would result in an ultimate increase in net profit, would be expenditure incurred for the purpose of earning the profits although it would not qualify as expenditure incurred for the purpose of earning 'income' as defined in section 7. Many items of expenditure would, therefore, satisfy the negative test of section 12(*g*) but fail to comply with the positive test set out in section 11(2)(*a*).

Certain decisions of the Special Court reveal that the words 'wholly or exclusively' used in section 12(*g*) still further unfairly restrict the scope of the deduction formula. On a strict interpretation of these words, no portion of any lump-sum expenditure, partly

[59] *First and Final Report*, p. 11, para. 46.
[60] See *Strong & Co.* v. *Woodifield*, [1906] A.C. 448; 5 T.C. 215.

admissible and partly inadmissible, would be deductible if the whole amount were indivisible. Put another way, the words of section 12 (*g*) appear to preclude the allowance of any portion of lump-sum expenditure partly expended for the purpose of earning income and partly expended for other unproductive purposes, if such expenditure is divisible only on a basis of estimate. A reference to some decided cases will illustrate the point.

Case law

In one case,[61] the return of income submitted by the taxpayer for the year of assessment under review disclosed the receipt of income from, *inter alia*, commission on brokerage transactions in connection with the sale of diamonds, amounting to £158. He claimed as a deduction from his income the sum of £348 incurred in respect of travelling expenses in connection with a trip abroad which was undertaken primarily in connection with the diamond-brokerage business in which he was engaged but also with the intention of opening up an export trade in various types of merchandise on behalf of certain manufacturers and producers in South Africa.

The Commissioner refused to allow the deduction claimed in respect of travelling expenses and the taxpayer appealed to the Special Court. It was held by the Special Court, who dismissed the appeal, that although the travelling expenses, in so far as they were incurred in connection with appellant's diamond-brokerage business, would be a legitimate deduction from his income, to the extent that the expenses related to the preliminary or exploratory work undertaken by him in connection with the opening-up of an export trade, they would not be an allowable deduction. It was further held that where expenditure is incurred for a dual purpose, and one of those purposes would not qualify the expenditure for deduction from income for tax purposes, then no portion of the amount expended may be so deducted. Consequently, no portion of the travelling expenses of £348 was deductible from income.

In another case,[62] the appellant, a farmer, proceeded overseas accompanied by his wife, the main purpose of the trip being to purchase a bull for use in connection with the farming operations carried on by him in the Union. During the trip about twenty-two days were spent in negotiating for the purchase of a bull which he shipped to the Union, after which he and his wife proceeded on a short holiday. The expenses of the holiday amounted to between £1,500 and £2,000. The bare expenses which he would have incurred in proceeding overseas alone for purposes of the purchase of the bull amounted to £337, which sum he sought to deduct in the determination of his taxable income from farming operations. The Commissioner refused to allow the deduction claimed. Objection was lodged against the disallowance, but the Special Court held, dismissing the appeal, that the expenditure on the overseas trip having had a dual

[61] I.T.C. No. 698, 17 S.A.T.C. 97.
[62] I.T.C. No. 734, 18 S.A.T.C. 202.

purpose and one of those purposes not qualifying the expenditure for deduction for tax purposes, no portion of the amount expended could be deducted. In the course of giving judgment, Newton Thompson, J., said:

> 'The terms of section 12(*g*) which says that "no deduction shall in any case be made for moneys which are not *exclusively* laid out or expended for the purposes of trade" seem somewhat harsh. It seems harsh that, on the facts of this case, the taxpayer should not be able to deduct expenditure incurred in purchasing a bull because he also took a holiday. I have considered whether, on the evidence, I could find that this expenditure of £337 was exclusively laid out in connection with the purchase of the bull. In view of the taxpayer's own candid and honest evidence I feel that I cannot do that. The following passages occur in the evidence:
>
> '"*The Commissioner's representative*: So there was a dual motive? *The Taxpayer*: Yes, there was a dual motive. All I put in is this: my expenses *as if* I had gone direct there and back.
>
> '"*The Commissioner's representative*: And you were also going to make this a holiday and a search for a bull? *The Taxpayer*: Yes."'

The Judge then continued:

> 'Under section 78 the onus is on the taxpayer to prove the exemption which he claims. Very reluctantly, I confess, I find that the taxpayer has not discharged that onus in this case and his appeal fails.
>
> 'It seems to me that the law would be more equitable if it were amended to give the Commissioner power to allow the taxpayer a portion of his expenditure as a deduction in a case of this kind. If the taxpayer could have been allowed a deduction of one-half of his expenditure here, the result would have been a fair one.'[62a]

A further case[63] concerned a taxpayer who carried on a business of printers and publishers. During the year of assessment under review he incurred certain expenditure on a trip overseas which he made for the alleged purpose of purchasing photographs and articles for use in connection with a magazine, the publication of which was begun during the year of assessment, and also to establish contacts and to appoint an overseas agency and representatives for the magazine. The Commissioner having refused to allow the deduction of this expenditure, the taxpayer appealed to the Special Court.

The Special Court pointed out that there was evidence which clearly suggested that the primary object of the taxpayer's overseas trip was to establish contacts and to appoint overseas representatives for the magazine, and the expenditure incurred was, therefore, primarily one of a capital nature, the object being to establish an agency which would be a permanent adjunct to the taxpayer's business as publishers of a magazine. If some of the expenditure, e.g. that in respect of the purchasing of the photographs, had been incurred in income-production, the motives with which the total expenditure was laid out would, according to the learned Judge, have

[62a] See also I.T.C. No. 847, 22 S.A.T.C. 77.
[63] I.T.C. No. 750, 18 S.A.T.C. 415.

been mixed with the result that no allocation of it could be made. The appeal was, therefore, dismissed.

Effect of the court decisions

From a study of these cases, it is clear that the provisions of section 12(g) as interpreted by the Special Court are fundamentally inequitable and must inevitably lead to considerable hardship. It militates completely against the principle that the taxable income of any business should be its profits computed in accordance with sound accountancy practice. Many items of expenditure are laid out with mixed motives. For example, motor expenses incurred by professional and business men who use their cars for business and pleasure. Then again, there are taxpayers who carry on more than one trade and who incur lump-sum expenditure for the benefit of the different trades. Companies might pay remuneration to their directors only portion of which the Commissioner considers has been laid out for the purpose of earning income. One can multiply such examples. The correct accountancy and business approach would be to apportion such expenditure on a reasonable basis and to deduct from income that part as relates to the earning of the income. Yet the current taxation legislation as interpreted in certain Special Court cases lays down that because the whole expenditure was not wholly and exclusively laid out or expended for the purposes of trade, no portion of it is deductible.

There are, however, other cases on record in which the court has approved of the principle of apportionment of expenditure laid out for dual or 'mixed' purposes. In a Special Court case,[64] Price, J., President, after reviewing a number of other cases came to the following conclusion:

> 'It is perfectly clear, therefore, that the taxpayer is himself entitled to make an apportionment, if it is possible for him to do so. It is also competent for the Commissioner to make such an apportionment, either himself or in consultation with the taxpayer, if he has the necessary data to enable him to do so. If neither the taxpayer, nor the Commissioner has made any allocation, it is still open to the Court to do so if the necessary evidence is available to enable the Court to make such allocation. . . . The principle of law therefore should be stated as follows: where a lump-sum expenditure is sought to be deducted from one's taxable income, that sum must have been wholly or exclusively expended for the purposes of trade. If portion of such lump sum was so laid out and portion was not and if it is not possible to allocate each portion to its appropriate purpose, then no portion of such lump sum can be deducted. But if the lump sum can be dissected and that portion expended for purposes of trade can be identified, such portion may be deducted. This is plainly the effect of the decisions. There is nothing in the section prohibiting such allocation and, I may add, it is in accordance with common sense. The allocation can be made in various ways — on a time basis, or perhaps (in a proper case where the facts justify it) on a piece-work basis.'

[64] I.T.C. No. 800, 20 S.A.T.C. 226.

Whatever may be the correct legal position, which to the writer appears to be very obscure at the moment, the Commissioner does not apply section 12(*g*) too strictly in practice and in the majority of cases he permits a taxpayer to apportion expenditure incurred for a dual purpose. This fact, however, is no justification whatsoever for the retention of such a restrictive provision as the present section 12(*g*). Expenditure incurred for a dual purpose should be apportioned and the proper part should be deductible. The deduction formula should not contain the words 'wholly or exclusively'. Precedent for the apportionment of dual purpose expenditure and losses is to be found in section 51(1) of the Australian Act which allows the deduction of expenditure and losses '*to the extent to which* they are incurred in gaining or producing the assessable income'. This clearly permits the dissection and apportionment of losses and outgoings incurred for dual purposes.

Expenditure may be wholly or exclusively laid out or expended for the purposes of trade but it may have been incurred partly for the earning of income and partly for the earning of exempt income or for the purpose of earning income from sources within and outside the Union. In *Schonegevel* v. *C.I.R.*,[65] the Court dealt with a taxpayer who derived income from sources within and outside the Union and who incurred expenditure in earning both classes of income. The Court approved of the basis adopted by the Commissioner in allowing as a deduction from income a proportionate part of the expenditure appertaining to the income derived from Union sources. The Appellate Division has also authorized the apportionment of expenditure in a case where a taxpayer incurred expenditure in earning an amount comprised of both income and exempt income.[66] Thus, apportionment of expenditure has been authorized in cases where the expenditure has been wholly or exclusively laid out for the purposes of trade but has been incurred partly for the production of income and partly for the production of amounts not falling within 'income' as defined, e.g. exempt income or income from foreign sources. In such cases, section 12(*g*) does not operate to prohibit an apportionment.

A further unsatisfactory feature of section 12(*g*) is that it is in direct conflict with certain of the special deductions set out in section 11(2). For example, section 11(2)(*i*)*ter* permits the deduction of annuities payable to retired employees or to their dependants (see § 186). Such payments are clearly not expended for the purposes of trade and thus whereas they are authorized by section 11(2)(*i*)*ter*, their deduction is prohibited by the terms of section 12(*g*). A further example is to be found in section 11(2)(*m*) which permits a 'fixed property company' to deduct from its income any dividends distributed (see § 112). Dividends, clearly, are not expenditure wholly or exclusively laid out or expended for the purposes of trade and

[65] 1937 C.P.D. 258; 9 S.A.T.C. 99.

[66] *C.I.R.* v. *Rand Selections Corporation, Ltd.*, 1956 (3) S.A. 124 (A.D.); 20 S.A.T.C. 390; see also *Local Investment Co.* v. *C.O.T.*, 1958 (3) S.A. 34 (S.R.); 22 S.A.T.C. 4.

their deduction would appear to be in conflict with section 12(*g*). These special deductions should be amended to ensure that they operate notwithstanding the provisions of section 12(*g*) (see, for example, section 11(2)(*r*)).

§ 143. Private and domestic expenses

No deduction may be made in respect of the cost incurred in the maintenance of a taxpayer, his family or establishment (section 12(*a*)). A deduction is also prohibited in respect of domestic or private expenses including the rent of or cost of repairs to or expenses in connection with any premises not occupied for the purpose of trade, or on any dwelling-house or domestic premises except in respect of such part as may be occupied for the purposes of trade (section 12(*b*)). Thus, a doctor or other professional man who uses one or more rooms of his private residence for the purpose of carrying on his profession is entitled to a deduction of a proportionate part of the expenditure incurred in connection with the maintenance of his dwelling. Domestic expenses relate to the house, home or family of the person incurring them.[67]

A common type of private expenditure is interest on money borrowed for private purposes. Taxpayers often in ignorance increase their tax liability by borrowing money for private purposes when they could instead realize income-producing assets and use the proceeds for such private purposes. If a taxpayer borrows money in order to acquire private assets which are non-revenue producing, e.g. a private residence or private motor-car, then the interest paid would not be allowed as a deduction since the purpose of the loan would not be for the production of income. The same principles apply to a bank overdraft. If a business man increases his overdraft in order to finance private expenditure, e.g. a private residence, a proportion of the interest paid on the overdraft would be disallowed.

Even if the taxpayer is able to prove that it was necessary for him to borrow money to acquire the private assets so that he could keep his existing income-producing business or investments intact, the interest is still disallowable.[68] In one case[69] a taxpayer purchased a house for occupation of himself and his family. To pay for the property, he borrowed money in respect of which for the year of assessment he was required to pay interest. During the same year of assessment he sold another property, and in terms of the sale the purchaser undertook to pay him certain interest. The taxpayer claimed that the interest paid by him should be set off against the interest received by him on the grounds that the payment had been rendered necessary by the fact that he had given credit to his own debtor. It was held that the interest paid by the appellant in respect

[67] I.T.C. No. 833, 21 S.A.T.C. 324.
[68] I.T.C. No. 829, 21 S.A.T.C. 199.
[69] I.T.C. No. 92, 3 S.A.T.C. 238; see also I.T.C. No. 144, 4 S.A.T.C. 223; I.T.C. No. 241, 6 S.A.T.C. 365; I.T.C. 385, 9 S.A.T.C. 452; I.T.C. No. 546, 13 S.A.T.C. 196

of the house occupied by him constituted a domestic or private expense, the deduction of which was debarred by the terms of section 12(*b*) of the Act, while the interest received by him constituted income and was liable to tax.

The principle of borrowing money for private purposes in order to keep existing income-producing business or investments intact can be most disadvantageous from the income tax point of view as the following illustration shows. Mr. A, a married Cape resident, has an annual taxable income from interest amounting to £5,000. He borrows money for private purposes instead of realizing existing income-producing assets. The annual interest payable is £1,000 and since the money was borrowed for private purposes, the interest payable of £1,000 does not rank as a deduction from income. Mr. A's total tax liability on a taxable income of £5,000 is £1,257 which leaves him with a net income after payment of tax of £2,743 (£5,000 *less* £1,000 *less* £1,257). If instead Mr. A had realized income-producing assets, his income would have fallen to £4,000 (assuming that the rate of interest receivable on his investments is the same as that which would be payable on borrowed money) but he is not obliged to pay any interest. On this income, the total taxes payable are £832 which means that his net income after payment of tax is £3,168 (£4,000 *less* £832). By realizing income-producing assets instead of borrowing money for private purposes, Mr. A would increase his net income by £425 (£3,168 *less* £2,743).

§ 144. Application and appropriation of income

> 'There is certainly one type of expenditure which must be excluded, and that is expenditure payable out of income after it has been earned. An example is a tax upon profits. In a sense such expenditure might be said to be attendant upon business operations, but there is a real distinction between a " charge against profits and an appropriation of profits after they have been earned ".'[70]

How a taxpayer applies and appropriates his income once it has been earned is usually of no concern to the tax-gatherer. Thus, donations to charities, etc., made out of the income earned, are not deductible as they are not incurred in the production of income or wholly or exclusively laid out or expended for the purposes of trade. It is conceivable that a donation may be made in such circumstances that it falls within the specific terms of the general deduction formula, e.g. if a trader makes a donation for the express purpose of securing a trade contract. In such a case, the donation is allowable. In the majority of cases, however, donations are made wholly for purposes other than trade although there must be cases where the donation is made partly for trade purposes, e.g. to retain or secure business. In practice, the Commissioner is not likely to apportion donations and allow that part made for trade purposes. He will probably disallow

[70] Per Watermeyer, A.J.P., in *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*, 1936 C.P.D. 241; 8 S.A.T.C. 13; see also *Van Ryn Deep, Ltd.* v. *C.I.R.*, 1922 W.L.D. 22.

the whole amount on the grounds that the expenditure has not been wholly or exclusively laid out or expended for the purposes of trade in terms of section 12(*g*).

The Committee of Enquiry into the Income Tax Act was of the view that specific provision for the prohibition of the deduction of donations should be made in the Act subject to the acceptance of its recommended new deduction formula.[71] It recommended, however, that the proceeds of charity meetings should not be subject to tax in the hands of the racing clubs which sponsor such meetings including the proceeds of cinema or theatre performances or other entertainments which are similarly held for the benefit of charity.[72] It has been held that where a horse-racing association agreed to hand over the net proceeds of a race meeting to a charitable organization, the profits were taxable in the hands of the association.[73] The Income Tax Commission was unable to draw any distinction between these types of donations and the ordinary donations made by traders and industrialists to charities, the allowance of which the Committee of Enquiry has recommended be expressly prohibited for tax purposes. It accordingly rejected the proposal to exempt from tax the proceeds of charity meetings and theatre performances.[74] It may be pointed out, however, that a racing club or a theatre company can avoid the payment of tax on the proceeds of charity meetings or performances by simply ensuring that the proceeds do not form part of its gross income. For example, if the particular charity is given the right to use the course or theatre for the purpose of conducting the meeting or the performance and makes its own arrangements to advertise it and to sell the tickets therefor and generally conducts the meeting or the performance in its own name, the proceeds form part of the gross income of the charity and not the racing club or the theatre company. Since charitable institutions are exempt from tax in terms of section 10(1)(*f*), tax can be avoided in the manner described.

§ 145. Disallowance of excessive expenditure

The use of the words 'actually incurred' as contrasted with the words 'necessarily incurred' widens the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, incurring expenses which another man does not incur; such expenses are, therefore, not 'necessary' but they are incurred and are, therefore, deductible.[75] In a business, inefficiently or extravagantly run, expenditure may nevertheless be incurred in the production of income and thus qualifies for deduction from income in terms of section 11(2)(*a*). There are, however, numerous cases of the Special Court in which it was held that the Commissioner is entitled to disallow expenditure to the extent to which it is excessive

[71] *First Report*, p. 37, para. 88.
[72] *First Report*, p. 97, para. 28.
[73] I.T.C. No. 526, 12 S.A.T.C. 426.
[74] *First and Final Report*, p. 24, paras. 114 and 115.
[75] *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*, 1936 C.P.D. 241; 8 S.A.T.C. 13.

on the grounds that the expenditure is not actually incurred in the production of the income in terms of section 11 (2) (*a*), or is not wholly or exclusively laid out or expended for the purposes of trade as required by section 12 (*g*) but is inspired by some other motive, e.g. tax avoidance or family feeling.

In one case, a taxpayer claimed a deduction of £500 paid for the insertion of an advertisement in a brochure. The Commissioner allowed only £60 thereof. The Court held that the amount expended was of such an extravagant character that it necessarily raised an inquiry as to why such an extravagant amount was paid and that the company had failed to discharge the onus of showing that the whole of the amount of £500 was expended in the production of its income and that it was wholly or exclusively laid out for the purposes of its trade.[76]

By far the majority of cases dealing with disallowances of excessive expenditure concern remuneration payable by companies to their directors and shareholders (see § 27).

There are also cases on record where the court has disallowed portion of interest payable by a company to its shareholders as being excessive and not incurred in the production of income. In one case[77] the Court sanctioned a reduction in the rate from 10 per cent to 8 per cent per annum whereas in another case[78] a reduction from 8 per cent to 6 per cent per annum was sanctioned. It must be borne in mind, however, that interest rates have changed considerably since the time when these cases were decided.

On the above principles, the Commissioner is also entitled to disallow portion of a rental payable by a company to its shareholders as being excessive and not incurred in the production of income.

Where an employer has contracted to pay an allowance in respect of travelling or entertainment to an employee, the deduction of the amount for which the employer is liable to pay can be challenged by the Commissioner if it can be shown that the allowance is out of all proportion to the amount that the employee would be likely to expend, thus indicating that the employer in making the arrangement had been actuated by some ulterior motive such as a desire to evade tax. In such a case, the Commissioner is entitled to claim that the whole or portion of the allowance cannot be regarded as expenditure incurred in the production of income.[79]

In cases where the Commissioner disallows portion of a remuneration, interest or rental payable by one person to another as being excessive and not incurred in the production of income, he taxes the recipient on the full amount received being in respect of services rendered[80] or being in respect of the use of money or property. It does not follow that because any particular amount is not allowed as

[76] I.T.C. No. 621, 14 S.A.T.C. 498; see also I.T.C. No. 629, 15 S.A.T.C. 93; I.T.C. No. 575, 13 S.A.T.C. 476.
[77] I.T.C. No. 558, 13 S.A.T.C. 300.
[78] I.T.C. No. 567, 13 S.A.T.C. 337.
[79] I.T.C. No. 575, 13 S.A.T.C. 476.
[80] I.T.C. No. 792, 20 S.A.T.C. 98.

a deduction from the income of the payer, it is not taxable in the hands of the recipient.[81] This principle of the income tax law can work considerable hardship, particularly in a case where the payer and the recipient are in reality one person, e.g. a company and a beneficial shareholder (see § 27).

§ 146. A BETTER APPROACH

Many cases can be quoted of where the Income Tax law is opposed to the accountant's or business man's approach to deductible expenditure. The point that it is necessary to stress, however, is that our present deduction formula has been with us too long. Most, if not all, of the disallowable expenditure mentioned above would be deductible under the English law where the taxable profits are generally speaking determined on sound accountancy or commercial principles, and would also be deductible under the Australian law (section 51) where the general deduction formula is as follows:

> 'All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.'

The writer believes that the Australian approach is a much better one than ours and fits in very well with sound accountancy practice. Its adoption in this country will be a great advance.

With that formula, at any rate, there will be authority in our law for the present practice of the Commissioner in allowing as a deduction from income, for example —

(*a*) expenditure on audit and accountancy fees;

(*b*) expenditure on transfer secretarial fees or on the printing of the annual accounts incurred by companies;

(*c*) expenditure on premiums to insure fixed capital assets, e.g. plant, buildings, etc.

It is considered that section 11 (2) (*a*) of our Act prohibits the deduction of the types of expenditure just quoted. Can it be said that a fee paid to an auditor is incurred for the purpose of earning income? Fees paid to transfer secretaries who look after the share registers of the large public companies, cannot by any stretch of imagination be regarded as incurred in the production of income! Premiums paid to insure against loss of machinery or buildings due to fire surely are not incurred for the purpose of earning income! All these should strictly speaking be disallowed in the assessment. It is true that they are allowed in practice on the grounds of regular recurrency, but recurrency is not necessarily a test for determining

[81] *W. F. Johnstone & Co., Ltd.* v. *C.I.R.*, 1951 (2) S.A. 283 (A.D.); 17 S.A.T.C. 235.

whether expenditure is incurred in the production of income or not within the meaning of section 11 (2) (*a*).

Once a deduction formula such as ours prohibits the allowance of the common types of expenditure just quoted, it is clear that there can be no room for it in our present tax legislation. The legislator has so far failed to realize that expenditure is not only laid out for the purpose of earning the gross receipts. It has already been shown that there are many expenses which, although not incurred for the purpose of earning the gross receipts, are inherent to the carrying on of a business or profession including expenditure incurred in the protection of the current and future income of the business. As long as the taxpayer's business is being carried on for the purpose of earning income all expenditure necessarily incurred in the carrying on of such business should be deductible except, of course, capital, private or domestic expenditure. Only in this way can the discrepancy which at present exists between taxable profits and profits computed in accordance with sound accountancy practice be reduced.

§ 147. Recommendations of the Committee of Enquiry

The Committee of Enquiry into the Income Tax Act[82] recommended that section 12 (*g*) be withdrawn and that section 11 (2) (*a*) be modified as follows:

> 'The deductions allowed shall be —
>
> any expenditure and losses actually incurred by the taxpayer during the year of assessment in the course of and by reason of the ordinary operations undertaken by him during that or any previous year of assessment for the production of income, as defined in the Act, except to the extent that they are of a capital, private or domestic nature.'

The Committee considered that the new deduction formula would have the effect of widening the scope of allowable deductions so as to bring in many expenses which the Commissioner at present would apparently not be prepared to allow, and thus bring the Union practice more into line with the accountant's or business man's concept of allowable expenses. However, without trying to anticipate the effect of the new general deduction formula recommended by the Committee, it is interesting to record that Ingram, President of the Special Court, during the course of a judgment,[83] held that one of the general principles laid down by the Superior Court for guidance in deciding the question whether expenditure is deductible or not, was as follows:

> 'The words "in the production of income" are equivalent to "in the course of and by reason of ordinary operations undertaken for the purpose of conducting the business".'

In *Lockie Bros., Ltd.* v. *C.I.R.*,[84] Mason, J., held:

> 'The usual meaning which I think an ordinary person would attach to these words [in the production of income] in connection with a

[82] *First Report*, p. 27, para. 15.
[83] I.T.C. No. 587, 14 S.A.T.C. 126.
[84] 1922 T.P.D. 42.

> business is that deductions are to be allowed for any losses or outgoings actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business, not being losses or outgoings of a capital nature.'

These words were quoted with evident approval in *Sub-Nigel, Ltd.* v. *C.I.R.*[85]

Judging from these court decisions, it seems that, apart from the advantages to be gained from the withdrawal of section 12 (*g*), the Committee may not achieve its aim of widening the field of deductible expenditure with its recommended new deduction formula in view of the fact that the courts have already held that the words 'incurred in the production of income' in the present section 11 (2) (*a*) are equivalent to the meaning of the words contained in the Committee's recommended new formula. This, it is feared, will then merely bring us back to where we are.

The Income Tax Commission[86] considered that the present deduction formula should remain. It held as follows:

> 'It is considered that the present provisions of section 11 (1), 11 (2) (*a*) and 11 (2) (*b*) of the Act should not be tampered with. The Committee of Enquiry has indicated (First Report, page 26, para. 7) that it does not favour the "profits and gains" system, which is in force in the United Kingdom but its amendments of the present section 11 (1), 11 (2) (*a*) and the proposed deletion of section 12 (*g*) go a long way towards the introduction of a "profits or gains" system within the framework of the present system. The Committee's redrafted paragraph gives no advantage to the taxpayer as the "capital nature" test is still and must remain present. Section 12 (*g*) serves a useful purpose and its elimination is not supported.'

With the greatest respect to the Commission, it seems to the writer that the reasons given for the rejection of the Committee's new deduction formula are entirely inadequate. In fact, it seems as though the Commission missed the point entirely. Although, in the writer's view, the Committee's wording of the recommended new formula may not solve the problem, what it was endeavouring to do was to permit the deduction of expenditure which although not incurred in the production of income is necessarily incurred for the proper carrying-on of the business. The Committee never intended to propose the abolition of the 'capital nature' test which is an essential requirement for a general deduction formula. The true aim of any system of income tax should be to tax a trader on what is the net profit derived from his trade and the Committee's recommendation was designed to achieve this purpose. If the result of its proposal is to achieve a 'profits and gains' system within the framework of the present system in the Union as is in force in the United Kingdom, it must follow that its recommendation is even more commendable because, unlike our present deduction formula, the 'profits and gains' system attempts to tax a trader on what is truly the net income based upon ordinary commercial principles.

[85] 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381.
[86] *First and Final Report,* pp. 9 and 10, paras. 32 and 33.

The Income Tax Commission[87] did, however, make certain specific recommendations to widen the scope of section 11 (2) (*a*). In regard to the deduction of legal expenses, it considered that the present provisions for deduction of this type of expenditure were somewhat narrow and suggested that a new paragraph to section 11 (2) be inserted into the Act to permit of an extension of the scope of the allowance, viz. —

> 'expenditure actually incurred during the year of assessment in respect of an action at law in the course of and by reason of the ordinary operations undertaken by the taxpayer in the carrying on of his business and includes any such expenditure as is incurred in respect of an action the result of which is that the taxpayer is entitled to deduct under paragraph (*a*) the amount of any damages which is awarded against him.'

A very fine distinction has been drawn by the courts in determining whether or not legal expenses can be allowed as expenditure incurred in the production of income. This has no doubt been due to the tests laid down in *Port Elizabeth Electric Tramway Co., Ltd.* v. *C.I.R.*,[88] which have been repeatedly upheld by the courts. This fine distinction is well illustrated in the case where legal expenses are incurred by a landlord in an appeal to the rent board. If such expenses are incurred in an attempt to have the rentals increased, then the expenditure will be allowed irrespective of whether or not the application is successful.[89] If, however, the landlord incurs the expenditure in order to oppose a complaint by a rent board inspector or an application by a tenant for a reduction in rent, any such expenditure will not be allowed.[90] In the first instance the expenditure is incurred in an effort to produce income whereas in the second, the motive is to protect income and not to produce it, and it is here that the main distinction is drawn. The taxpayer must show that the legal expenditure is linked to an operation undertaken with the object of producing income, and not linked to operations which merely serve to protect an existing source of income or to prevent its diminution. There is no doubt that a provision such as that recommended by the Commission will widen the field of deductible legal costs.

Another recommendation made by the Commission concerned the deduction of certain travelling expenses. The Commission felt that some consideration should be given to the taxpayer who carries on a number of businesses in different areas or who is required for the purpose of earning his income from different activities to incur expenditure on travelling and subsistence which under the present provisions is not allowable. It has been held that the words 'actually incurred in the production of income' in section 11 (2) (*a*) of the Union Act were not wide enough to permit a deduction in the case where an appellant, who carried on farming operations, claimed the cost of travelling to another place in order to attend directors'

[87] *First and Final Report*, p. 12.
[88] 1936 C.P.D. 241; 8 S.A.T.C. 13.
[89] I.T.C. No. 583, 14 S.A.T.C. 111.
[90] I.T.C. No. 585, 14 S.A.T.C. 120; I.T.C. No. 632, 15 S.A.T.C. 102.

meetings.[91] Similarly, an attorney, who practised in one province, but who had an hotel in another province, was not allowed the cost of travelling between the two distinct businesses.[92] The principle laid down in all these cases is that travelling expenses incurred in proceeding from one place of business to another place, where a distinct and separate business is carried on, are not deductible. Thus, while travelling expenses are allowed to a taxpayer where he proceeds from one place to another in respect of the same business,[93] they would not be allowed where he is carrying on two distinct businesses, for example a stockbroking business in Johannesburg and a draper's business in Durban.[94] In terms of the Commission's recommendation, travelling expenses incurred in proceeding from one place of business to another distinct business would be deductible, but not the expenses incurred in travelling from the taxpayer's residence to his place of business. The mere circumstance that a man has to travel to the place at which he earns his income is not *per se* sufficient to render the cost of such travelling as 'expenditure incurred in the production of income'.

It is a matter for extreme regret that the Income Tax Commission was of the view that the deduction formula should remain. One of the terms of reference of the Committee of Enquiry was to investigate the working of the Income Tax law and to make any recommendations for amendment of the law which may appear to be desirable with a view to removing anomalies and hardships in the incidence of the taxes imposed. The recommendations of the Committee in regard to the general deduction formula would have this result, but the Commission's rejection of it is to perpetuate an anomaly and a hardship in the imposition of the tax.

The words 'in the production of income' have been in our Income Tax Acts since 1917 and the trend of the decisions of our courts as to their meaning not only clearly shows that they are out of place in a modern taxation system but also clearly reveals that a taxpayer's profit and loss account and his income tax assessment may show two entirely different pictures. The deduction formula so restricts the ambit of permissible deductions that the taxable income from business is in many cases greater than the profits as ascertained on ordinary commercial and accountancy principles. So far, there has been a vast amount of litigation on the question of permissible deductions in South Africa but it cannot be said that the result of such litigation has been to produce a satisfactory position.

If the general deduction formula is widened in a manner similar to the Australian formula, it will not only be affording the taxpaying public a fair deal, but will also eliminate a lot of the uncertainty and legal niceties that at present surround the subject of deductions.

[91] I.T.C. No. 415, 10 S.A.T.C. 258.

[92] I.T.C. No. 619, 14 S.A.T.C. 486.

[93] *Earl of Verulam* v. *C.O.T.*, 1937 S.R. 156; 9 S.A.T.C. 107.

[94] See also I.T.C. No. 591, 14 S.A.T.C. 138; I.T.C. No. 259, 7 S.A.T.C. 71.

III. Special Statutory Deductions

§ 148. Expenditure on repairs

Introduction

Section 11 (2) (*c*) provides that there shall be deducted

> 'expenditure actually incurred during the year of assessment on the repairs of property occupied for the purpose of trade or in respect of which income is receivable, including any expenditure so incurred on the treatment against attack by beetles of any timber forming part of such property, and sums expended for the repair of machinery, implements, utensils and other articles employed by the taxpayer for the purposes of his trade'.

Repairs must be distinguished from reconstructions, replacements and renewals which are of a capital nature and not deductible. There has been much litigation on the distinction but the court decisions do not always provide satisfactory tests. A deduction cannot be claimed in respect of the notional or estimated amount which it would have cost to repair the dilapidated asset instead of reconstructing or improving it.

Meaning of 'repairs'

The Income Tax Act does not contain any definition of the word *repairs.* It must be understood in the ordinary natural sense of the word, and according to its ordinary grammatical meaning.[95] The meaning given in the *Shorter Oxford English Dictionary* (s.v. repairs) is:

> 'Restoration of some material thing or structure by the renewal of decayed or worn-out parts, by refixing what has become loose or detached.'

Webster's Dictionary gives the following meaning:

> 'Restoration or state of being restored to a sound or good state after decay, waste, injury, etc.'

Dr. Manfred Nathan, in delivering a judgment of the Special Court,[96] held that in the ordinary sense of the term, *repairs* means replacement or renewal of something which has become defaced or worn out or worn down by using or possibly by wear and tear.

A useful contribution towards an authoritative meaning of the word 'repairs' has been made by the Special Court, which has repeatedly followed the following principles:[97]

> '(1) Repair is restoration by renewal or replacement of subsidiary parts of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety, not necessarily the whole but substantially the whole subject-matter under discussion.

[95] I.T.C. No. 122, 4 S.A.T.C. 115; I.T.C. No. 238, 6 S.A.T.C. 353.
[96] I.T.C. No. 491, 12 S.A.T.C. 77.
[97] See I.T.C. No. 617, 14 S.A.T.C. 474; I.T.C. No. 651, 15 S.A.T.C. 369; I.T.C. No. 709, 17 S.A.T.C. 227.

(2) In the case of repairs effected by renewal it is not necessary that the materials used should be identical with the materials replaced.

(3) Repairs are to be distinguished from improvements. The test for this purpose is — has a new asset been created resulting in an increase in the income-earning capacity or does the work undertaken merely represent the cost of restoring the asset to a state in which it will continue to earn income as before?'

Repair as distinguished from renewal or replacement

The question as to what constitutes a repair as distinct from a renewal which results in a reconstruction of the entirety has, in the past, given rise to much litigation.

> 'Every repair is a replacement. *Repair* and *renew* are not words expressive of a clear contrast. Repair always involves renewal — renewal of a part, of a subordinate part. Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion.'[98]

It is not always easy to determine whether a particular asset, which has been renewed or reconstructed, forms a subsidiary part of a larger structure, in which case the work done would constitute repairs, or whether the asset must be looked upon as a separate entity and as the 'entirety', thereby taking the work done out of the category of 'repairs'. When one has to deal with 'borderline' cases there may be difficulties and, as has been emphasized in many decisions, the question is one of degree.[99]

New work and additions

Repairs must be carefully distinguished from work which is new or which results in an addition to the original structure. In such circumstances it cannot be said that the purpose was to restore the asset to the condition in which it was originally. Thus, it has been held that expenditure on deviations and improvements in a permanent way of a railway is capital expenditure and not a repair.[1]

An original structure may have been constructed to serve a particular purpose or objective which it no longer fulfils. In order to retain the objective for which the structure was brought into existence, it might be necessary to add to the existing structure rather than to repair it. In such circumstances the fact that the new work was undertaken in order to retain the same objective of the old work cannot convert it into repairs.[2]

Repairs involving the use of new materials

In the case of repairs effected by replacement of damaged parts, one of the principles laid down by the Special Court is that it is not necessary that the materials used should be identical with the original

[98] *Lurcott* v. *Wakely & Wheeler*, [1911] 1 K.B. 905, per Lord Justice Buckley.
[99] I.T.C. No. 709, 17 S.A.T.C. 227; I.T.C. No. 617, 14 S.A.T.C. 474.
[1] *Rhodesia Railways, Ltd., & others* v. *C.O.T.*, 1925 A.D. 438; 1 S.A.T.C. 133.
[2] I.T.C. No. 626, 14 S.A.T.C. 530; I.T.C. No. 617, 14 S.A.T.C. 474.

materials that are now being replaced. As long as the purpose of the work is to restore the asset to its original condition as distinct from creating an improvement, the work constitutes repairs; the fact that new materials are substituted for the old at a cost greater than it would have been had the same materials been used is immaterial. Each case must be decided on its own merits in order to determine whether the use of new materials is for the purpose of improvement or reconstruction or merely for the purpose of restoring the asset to its original condition.[3]

Reconstruction or improvement in lieu of repairs

Can a deduction be made in respect of the notional or estimated amount which it would have cost to repair the dilapidated asset instead of reconstructing it or improving it? In one reported case[4] the appellants had for many years carried on business in premises owned by them. The premises had been neglected with the result that they had got into a very dilapidated condition. When the question of repairs was forced upon the appellants by the action of the local authorities, it was found that in view of the condition of the premises it was necessary to embark upon a large scheme of reconstruction, and at the same time it was decided to take the opportunity of modernizing and improving the premises. An inclusive contract for all the work was entered into, and the appellants sought to deduct from their income a proportionate amount of the expenditure incurred as representing the estimated cost of repairs which would have been necessary had the reconstruction of the building not been undertaken. The Court held that the work done was a reconstruction, and even if it covered such portions as needed repairing and which, accordingly, were placed in a better state than they were before, the appellants were not justified in law in saying that as they intended to repair the buildings, they should be allowed to deduct what it would have cost them to repair.[5] It is submitted that, if in lieu of repairs there is a reconstruction of the entire subject-matter, it cannot be said that any amount was actually incurred on repairs. Section 11 (2) (*c*) clearly provides that the deduction is in respect of 'expenditure actually incurred . . . on the repairs of property . . . and sums expended for the repair . . .'.

The position is not so clear when there is no reconstruction of the entirety, but where portion of a subject-matter has deteriorated and instead of restoring it to its original condition, the repair is brought about in the process of creating an improvement. A good example would be the case of a theatre proprietor who is faced with the repair of a dilapidated floor in his cinema. If he erects a new sloping floor resulting in a definite improvement, is section 11 (2) (*c*)

[3] *C.I.R.* v. *African Products Manufacturing Co., Ltd.*, 1944 T.P.D. 248; 13 S.A.T.C. 164; I.T.C. No. 520, 12 S.A.T.C. 404; I.T.C. No. 709, 17 S.A.T.C. 227; I.T.C. No. 617, 14 S.A.T.C. 474; I.T.C. No. 361, 9 S.A.T.C. 189.

[4] I.T.C. No. 238, 6 S.A.T.C. 353.

[5] See also I.T.C. No. 442, 11 S.A.T.C. 78; I.T.C. No. 651, 15 S.A.T.C. 369, and *B* v. *C.O.T.*, 1955 (1) S.A. 404 (S.R.); 19 S.A.T.C. 353.

of the Act sufficiently wide to allow him to deduct the amount that it would have cost to restore the broken floor to its original condition? It is submitted that in principle there should be no distinction between the case cited above involving a reconstruction of the entirety and the present question involving a reconstruction of a subsidiary part of the entirety. If the intention is to effect a repair in the process of reconstructing the asset so as to create an improvement, it is submitted that the expenditure is no longer by way of repairs in terms of section 11 (2) (*c*) of the Act.

Initial repairs

Prudent accountancy procedure dictates that in the case of a purchase of second-hand assets and the subsequent repair by the purchaser to put them into an efficient state, the expense of repair is in the nature of capital expenditure and should be transferred to the asset account.[6] Does section 11 (2) (*c*) of the Income Tax Act vary the accountancy practice, and if so, to what extent? Section 11 (2) (*c*) does not prohibit a deduction of expenditure on repairs which are of a capital nature, the only requirement being that in the case of repairs to property it must be property occupied for the purpose of trade or in respect of which income is receivable and in the case of other assets that they are employed by the taxpayer for the purposes of his trade. In a reported case,[7] a taxpayer who had personally occupied a dwelling-house let it for a period of years. It was a term of the lease, included at the stipulation of the lessee, that the taxpayer should effect repairs up to a cost amounting to a substantial sum, prior to the occupation of the house by the lessee. The Court held that the expenditure fell within section 11 (2) (*c*) as being a sum expended for the repairs of property 'in respect of which income is receivable'. As soon as the lease was signed income was receivable from the property from the date on which occupation was to be given to the lessee. In another case[8] where a landlord made the necessary initial repairs to a dilapidated house immediately after purchase and prior to obtaining a tenant, the Commissioner refused to allow a deduction for repairs on the grounds that the house had been untenanted since its acquisition by the appellant, and that the expenditure on repairs was therefore part of the cost of acquisition of the property and therefore of a capital nature. The Court held that as the word 'receivable' meant 'capable of being received', it was not necessary that before the expenditure could be deducted there should be in existence an agreement for the receipt of income. The Court, holding that the words 'in respect of which income is receivable' merely mean that the property must be in such a state or of such a kind that income is capable of being received, allowed the deduction of the repairs.

As regards repairs of machinery, implements, utensils and other articles, section 11 (2) (*c*) requires that these assets must be employed

[6] See *Law Shipping Co., Ltd.* v. *I.R.C.*, [1924] S.C. 74; 12 T.C. 621.
[7] I.T.C. No. 163, 5 S.A.T.C. 77.
[8] I.T.C. No. 243, 6 S.A.T.C. 370.

by the taxpayer for the purposes of his trade. It is submitted, therefore, that where initial repairs are effected to a second-hand machine immediately after purchase but prior to its use in the business, such repairs are not deductible in terms of section 11 (2) (*c*) since it cannot be said that at that initial stage the machine is 'employed by the taxpayer for the purposes of his trade'. On the other hand, once the machine has been employed in the business of the taxpayer, all repairs are deductible even though the Commissioner is able to show that the bad state of repair is due wholly to the condition of the machine at the time it was acquired.

Property occupied for the purpose of trade

It is a requisite of section 11 (2) (*c*) that for repairs to rank as a deduction they must have been incurred in respect of property occupied 'for the purpose of trade'. In section 12 (*b*) the Legislature reaffirms this by not permitting any deduction for the cost of repairs of any premises not occupied for the purposes of trade or of any dwelling-house or domestic premises, except in respect of such part as may be occupied for the purposes of trade. The courts have interpreted the phrase 'for the purpose of trade' to mean 'for the purpose of enabling a person to carry on and earn profits in the trade'.[9] Thus, repairs on vacant premises hired by a taxpayer in order to prevent occupation by a competitor would not be in respect of property *occupied* for the purposes of trade and would not be deductible under section 11 (2) (*c*). In one case,[10] the appellant, who was the owner of a dwelling-house which he had let for a period of some years during his absence on active service, resumed occupation and on resumption found that the premises were in need of considerable repairs, due mainly to the treatment to which the property had been subjected by the tenant during his absence. The necessary repairs were effected by him subsequent to his reoccupation of the premises, and he sought to deduct the expenditure on repairs from rentals derived up to the date of his occupation. The Special Court held that in view of the fact that on reoccupying the property the taxpayer ceased to carry on the trade of letting, it was impossible to hold that the repairs were effected for the purposes of trade. Moreover, the deduction claimed was inadmissible in terms of section 12 (*g*), which prohibited the deduction of any moneys not wholly or exclusively laid out or expended for purposes of trade. The fact that the expenditure on repairs was due to the use of premises during a period in respect of which income was received was irrelevant.[11]

Criticisms

The Committee of Enquiry into the Income Tax Act felt that the decisions of the courts relevant to the question of repairs provide adequate and satisfactory guidance in distinguishing between repairs

[9] *Strong & Co., Ltd.* v. *Woodifield*, [1906] A.C. 448; 5 T.C. 215.
[10] I.T.C. No. 643, 15 S.A.T.C. 243.
[11] See also I.T.C. No. 605, 14 S.A.T.C. 361.

and alterations of a capital nature and that the present provisions of section 11 (2) (*c*) should thus not be disturbed.[12]

With respect, however, an examination of the many reported decisions shows that they do not always provide 'adequate and satisfactory guidance' particularly in regard to the determination as to whether the renewal is of the 'entirety' in which case the cost is capital expenditure, or whether it is of a subsidiary part when the cost is regarded as a repair. As Herbstein, J., pointed out in a Special Court case:[13]

> 'The test enunciated in the decisions is a quantitative one and in some ways not very satisfactory and certainly not easy to apply, for the difficulty of deciding where to draw the line between what is substantially the whole of the subject-matter and what is not is always present.'

Although it would probably be impossible to obtain a suitable definition of the term *repairs* for the purpose of the Income Tax Act which would draw a clear line between what repairs are and what are not deductible, the present wording of the Act should be amended in one important respect and that is in regard to the question of where a reconstruction is undertaken in lieu of repairs. The courts have held that a proportionate part of the expenditure on a reconstruction or improvement representing what it would have cost to repair the asset rather than reconstructing it is not deductible. Thus, if an asset is in need of repair and instead of repairing it, the taxpayer takes the opportunity to improve or reconstruct the asset, he cannot deduct from his income an amount equal to what it would have cost to repair the asset instead of reconstructing it. The question may, therefore, well be asked: Why should a taxpayer be penalized simply because instead of repairing his asset he went beyond effecting a repair and reconstructed the asset? The result of the present law is that if a taxpayer has the alternative of either undertaking a repair of his asset which would cost, say, £1,000 or of effecting that repair by a reconstruction or improvement of the asset which would cost, say, £4,000, the additional cost to the taxpayer if the reconstruction is undertaken is not merely £3,000 but also the additional tax which he would have to pay on account of the cost of the repair of £1,000 not being deductible from his income. Equity and common sense demand that he should be allowed by way of a deduction the estimated amount of what the repairs would have cost him had he in fact effected the repairs and only the balance of the cost of reconstruction or improvement should be regarded as capital expenditure. If section 11 (2) (*c*) is amended to give this relief, it will not only result in a more realistic approach to the deduction for repairs but it will also be affording the taxpayer a fair deal.

Initial repairs to property, whether on the acquisition thereof or after having been used for private or domestic purposes by the taxpayer, should not be deductible being in the nature of capital expenditure. Section 11 (2) (*c*) would appear to sanction a deduction.

[12] *First Report*, p. 27, para. 17.
[13] I.T.C. No. 709, 17 S.A.T.C. 227.

Australia has solved the problem of initial repairs by denying a deduction for repairs where the expenditure is of a capital nature. Thus, section 53 of the Australian Act permits as a deduction 'expenditure incurred by the taxpayer in the year of income for repairs, not being expenditure of a capital nature . . .'. Section 53 is in conformity with the English law on the subject where in *Law Shipping Co., Ltd.* v. *I.R.C.*[14] it was held that in a case where a taxpayer bought a ship in a state of disrepair and effected repairs thereto, the expenditure was of a capital nature.

§ 149. Wear-and-tear allowance

Statutory provisions

A taxpayer is entitled to deduct from his income, in terms of section 11 (2) (*d*), such sum as the Commissioner may think just and reasonable as representing the amount by which the value of any machinery, implements, utensils and articles used by the taxpayer for the purposes of his trade has been diminished by reason of wear and tear during the year of assessment.

In making the allowance, the Commissioner is required to take into consideration the amount of the repairs that he has allowed in terms of section 11 (2) (*c*) in respect of the assets.

In the case of machinery and plant, the value on which wear and tear is calculated must be reduced by the new machinery allowance of 10 per cent, granted in terms of section 11 (2) (*d*) *bis*. (see § 150).

It is expressly provided that no wear-and-tear allowance must be made for the depreciation of buildings or other structures or works of a permanent nature. This prohibition has been in force since the commencement of income tax in 1914. The case for and against the allowance for tax purposes of depreciation in respect of buildings was fully considered by the Committee of Enquiry into the Income Tax Act, who by a majority decision (two members out of the five disagreeing) recommended that the provision in the present Act excluding buildings from the depreciation allowance should remain unchanged.[15] The Income Tax Commission accepted this recommendation but felt that some form of relief should be provided for employees' housing projects in undeveloped areas possibly along the lines of the concession to farmers for farm improvements.[16] It should be noted that an allowance in respect of the depreciation of buildings is made in such countries as the United Kingdom, Australia, New Zealand, and the Federation of Rhodesia and Nyasaland. These countries, with the exception of New Zealand, do not grant the allowance in respect of all types of buildings. For example, in the United Kingdom and the Federation, the allowance is granted in respect of industrial buildings only. In Australia, buildings used in primary producing qualify for the allowance. In the United States

[14] [1924] S.C. 74; 12 T.C. 621.
[15] *First Report*, pp. 30-5, paras. 37-69.
[16] *First and Final Report*, p. 11, para. 42.

of America a wear-and-tear allowance in respect of buildings is also granted.

There is no doubt that should the Union decide to grant allowances in respect of all buildings this would involve a substantial loss of tax revenue. On the other hand, the expansion of industry is so important to the Union, that an incentive in the form of depreciation allowances may be very desirable. The minority of the Committee of Enquiry regarded the matter of depreciation of buildings as of particular importance in so far as industrial buildings are concerned and urged that if the volume of work involved in inaugurating a scheme which would apply to both industrial and commercial buildings is likely to necessitate its deferment for a protracted period, a special effort should be made to extend the concession at an early date to industrial buildings.

It is interesting to note that the proviso to section 11 (2) (*d*), which excludes buildings from the depreciation allowance, is word for word identical with the original proviso of section 17 (1) of Act No. 41 of 1917 and which during the last forty years has not changed its form in any respect. It must be accepted that buildings do depreciate or become obsolete during the course of years in the same way, though not so quickly, as in the case of plant and machinery. Prudent accounting procedure dictates that allowance for the depreciation of industrial buildings should be made although it is a noteworthy feature of published accounts here in South Africa that it is indeed a rare occurrence to find in them a wear-and-tear allowance in respect of buildings. It is true that where the property is maintained in a good state of repair, the period of its life will be considerably extended but with the passage of time the inevitable wear and tear do take place and when it may become necessary at some future time to demolish and rebuild, considerable hardship may be placed upon the taxpayer since profits have not been retained in the business to provide for the cost of rebuilding. Moreover, the scrapping allowance, which in terms of section 11 (2) (*j*) is restricted to 'any machinery, implements, utensils and articles used by the taxpayer for the purposes of his trade', does not, it would appear, apply to the cost of a building which has been demolished and which results in a total book loss to the taxpayer who has not made annual deduction for wear and tear although it may have been used for the purpose of trade in the same way as machinery and plant.

'Diminishing balance' versus 'straight line' method

In practice, the Commissioner adopts the 'diminishing balance' method for allowing wear and tear, i.e. the allowance is limited to a percentage of the value of the asset at the beginning of the year of assessment as reduced by the allowances made in respect of preceding years. The Commissioner has, however, decided to grant applications for wear-and-tear allowances calculated on the 'straight line' basis instead of on the 'diminishing balance' method where the taxpayer makes application therefor and agreement can be reached with him in regard to the estimated period of the life of the asset. Unless the taxpayer applies for the grant of wear-and-tear allowances calculated on the 'straight line' basis, which involves the writing off of the asset by equal annual instalments over its estimated life, the allowances will be granted on the basis of the 'diminishing balance' method. If application is made for the 'straight line' basis in respect of any asset which has been subject to wear and tear on the 'diminishing balance' method, the new allowance will presumably be granted at a rate each year which will reduce the income tax value of the asset at the date of the change-over to 'nil' at the end of its agreed estimated period of life.

The advantages and disadvantages of the diminishing balance method and the straight line method are well known. The main advantage of the former over the latter method is that it is a more scientific one in that the depreciation charge is heavier in the earlier years when the cost of repairs is light and lighter in the later years when the cost of repairs is usually heavy. The straight line method, however, has the advantage of simplicity since it entirely eliminates the asset value by the end of its estimated period of life but it has this disadvantage, that the early years bear the same depreciation charge as the later years when the asset may be losing its efficiency. Under the diminishing balance method the asset value can practically never be entirely written off.

Bearing in mind that in practice the Department has agreed upon the ordinary rates of wear and tear to be applied in cases where the diminishing balance method is followed, e.g. 10 per cent in the case of machinery and plant and 20 per cent in the case of motor vehicles, it must follow that in the majority of cases it will pay the taxpayer from the tax point of view to adopt the straight line method since he will be allowed the cost of his asset as a deduction over a much shorter period than in the case of the diminishing balance method. The following table clearly illustrates the point made. It postulates the case of a taxpayer purchasing a machine for £2,000 with an estimated working life of ten years and a motor vehicle for £1,000 with a life of five years. On the diminishing balance method, the Commissioner in accordance with his practice will grant wear and tear at the rate of 10 per cent on the machine and 20 per cent on the vehicle.

Depreciation allowed *Year*	*Machine costing* £2,000		*Vehicle costing* £1,000	
	Straight line method	*Diminishing balance method* (10%)	*Straight line method*	*Diminishing balance method* (20%)
	£	£	£	£
1	200	200	200	200
2	200	180	200	160
3	200	162	200	124
4	200	146	200	99
5	200	131	200	79

Depreciation allowed *Year*	*Machine costing* £2,000 *Straight line method*	*Diminishing balance method* (10%)	*Vehicle costing* £1,000 *Straight line method*	*Diminishing balance method* (20%)
	£	£	£	£
6	200	118		
7	200	106		
8	200	96		
9	200	86		
10	200	77		

The above table shows that where the life of an asset is ten years, a rate of 10 per cent wear and tear calculated on the diminishing balance method does not reduce the value of the asset at a rate commensurate with the expected lifetime of such asset. Thus, under this method, the asset's remaining income tax value at a rate of 10 per cent wear and tear after ten years would still be £698. Under the straight line method the asset value would be written down to nil after ten years. The table also shows that where the life of an asset is five years, a rate of 20 per cent wear and tear calculated on the diminishing balance method still leaves a residual income tax value of £338 at the end of five years.

General principles regarding the wear-and-tear allowance

In terms of section 11 (2) (*d*), the wear-and-tear allowance is such sum 'as representing the amount by which the value of any machinery . . . has been diminished by reason of wear and tear . . .'. It is now well-established practice of the Commissioner to take as the *value* for the purposes of wear and tear the *cost* of the asset to the taxpayer at the time of acquisition (cf. section 11 (2) (*j*) where the term *cost* is used). If assets are acquired by a taxpayer for no consideration, e.g. machinery acquired by donation, it is the usual practice of the Commissioner to allow the taxpayer to place a reasonable value on such assets for the purpose of claiming the annual wear-and-tear allowance. In one case[17] a taxpayer carried on a manufacturing business for the purposes of which he had himself constructed certain plant and machinery. The materials used in the construction of the machinery cost £160 whereas the taxpayer estimated the value of his skill and labour used in the construction at £750. The court refused to authorize a wear-and-tear allowance based on the value of the taxpayer's skill and labour.

Where an asset has been originally used elsewhere, e.g. for private or domestic purposes, but is subsequently used for trade purposes, it is the practice to grant a wear-and-tear allowance based on the value of the asset at the date that it is introduced into the business. The original cost price of the asset is not taken into account although it would appear that when the asset is scrapped, its original cost must be taken into account for the purpose of determining the scrapping allowance in terms of section 11 (2) (*j*) (see § 151).

[17] I.T.C. No. 780, 19 S.A.T.C. 328.

In regard to fixed assets used partly for trade purposes and partly for private purposes, it is also the practice to grant wear-and-tear allowances based on the proportion of use for business purposes. Section 11 (2) (*d*) merely requires that the asset, to qualify for the wear-and-tear allowance, must be 'used by the taxpayer for the purpose of his trade'. The section does not require that the asset must be used wholly or exclusively for the purposes of trade.

Where a taxpayer uses his own plant and machinery in an existing business to build new machinery for permanent use in his business, although the correct accounting procedure would be to regard the wear and tear on the present plant as being part of the cost of producing the new machinery, it could be effectively argued that the plant is nevertheless used for the purpose of the trade notwithstanding that it has been used by the taxpayer for the purpose of producing capital assets rather than trading stock. On the other hand, it may also be contended — perhaps not so effectively — that the purpose of trade is to earn profits and since it is the use of plant and machinery which produces the trading stock that directly gives rise to the profits, it cannot, therefore, be said that the plant and machinery which is used to produce the new plant is being used for the purposes of trade. On this argument it must follow that unless the taxpayer uses his plant and machinery directly for the purposes of trade, he is not entitled to the wear-and-tear allowance. Section 11 (2) (*a*), which prohibits expenditure or losses of a capital nature, does not assist in this instance since section 11 (2) (*d*) is independent of the provisions of section 11 (2) (*a*) and was specially introduced to authorize the deduction of capital expenditure which would otherwise not be deductible in terms of section 11 (2) (*a*). There is a precedent in practice where the Department permits the wear-and-tear allowance in respect of assets used to produce new capital assets, for example a farmer who buys a boring machine to construct a borehole is entitled to the wear-and-tear allowance in respect of the machine.

An allowance under section 11 (2) (*d*) is at the discretion of the Commissioner so that it is only possible for that discretion to be interfered with if it can be shown that he has not applied his mind to the facts and that he has in effect acted *mala fide* in making his decision.[18] For example, in a case where the assessor who dealt with the question of wear and tear admitted that he had 'simply guessed', the Court held that this was no basis for an allowance and although the section permitted of the exercise of a certain discretion it had to be a just and reasonable discretion and not based purely on a guess.[19]

It has been held that the rate of wear and tear allowed by the Commissioner in previous years is irrelevant to the question of the reasonableness of the allowance made in a later year and that it is

[18] I.T.C. No. 641, 15 S.A.T.C. 233; see also I.T.C. No. 780, 19 S.A.T.C. 328; I.T.C. No. 623, 14 S.A.T.C. 510; I.T.C. No. 663, 16 S.A.T.C. 121.
[19] I.T.C. No. 568, 13 S.A.T.C. 443.

competent for the Commissioner on reconsideration of the facts and on new evidence to reduce the allowance from what it was in an earlier year.[20]

The allowance is for ordinary wear and tear on the article used, and where injury to that article is caused through accident or removal or through some external or violent means, that cannot be said to be ordinary wear and tear as envisaged by section 11(2)(*d*).[21] Depreciation arising from other causes such as a loss in value due to the asset going out of fashion and becoming obsolete, is not deductible.

The allowance can be granted only in respect of wear and tear during the year of assessment. Short provisions for depreciation in previous years cannot, therefore, be allowed in a subsequent year.[22]

Even if the market value of the asset is considerably in excess of the book value or the income tax value, the allowance is still granted.

The words 'machinery, implements, utensils and articles' clearly refer to physical assets and do not include intangible or incorporeal assets such as patent rights, trade marks, goodwill, etc. Consequently no wear and tear is allowed in respect of these latter assets.

The Court has held that the words 'machinery, implements, utensils and articles' refer to some inanimate object and not to live animals. It expressed doubt as to whether animals could qualify for the wear-and-tear allowance.[23] In terms of the present practice, however, a wear-and-tear allowance is granted in respect of animals not constituting stock-in-trade, e.g. livestock used by a cartage contractor, racehorses, circus animals, etc.

A taxpayer is entitled to a wear-and-tear allowance up to the date of sale of an asset[24] or up to the time the article is scrapped and no longer used for the purposes of trade. If the asset is sold at a price above the book value, the profit is taxable to the extent to which it represents a recoupment of any wear-and-tear allowances previously made (see § 166). On the other hand, if at the date of scrapping of an asset, the full cost has not yet been deducted by way of wear-and-tear allowances, a scrapping allowance is made in respect of the portion of the cost not yet deducted (see § 151).

Rates of wear and tear

There is no special provision in the Act setting out the rate of wear and tear to be applied to any particular type of asset. Each case must be dealt with on its own merits and the rate of wear and tear determined according to the particular facts of each case.

The following rates of wear and tear are usually regarded by the Commissioner as being reasonable in relation to the more common types of articles used by a taxpayer for the purposes of his trade:

[20] I.T.C. No. 295, 7 S.A.T.C. 350; see, however, I.T.C. No. 213, 6 S.A.T.C. 66, where the Court refused to sanction a reduction.
[21] I.T.C. No. 240, 6 S.A.T.C. 363; I.T.C. No. 50, 2 S.A.T.C. 123.
[22] I.T.C. No. 311, 8 S.A.T.C. 152.
[23] I.T.C. No. 641, 15 S.A.T.C. 233.
[24] I.T.C. No. 215, 6 S.A.T.C. 133.

	Per cent
Furniture and fittings	5 to 7½
Machinery and plant (including machines used in offices) ..	10
Motor-cars	20
Motor-vans and lorries	25
Machinery, plant and implements in the case of a farmer ..	20
Moving parts of a lift	5
Law books	10

On certain articles of the smaller type, the calculation of wear and tear is impracticable, e.g. crockery, cutlery, glassware and linen in the case of hotels and boarding-houses, small tools in the case of manufacturers and engineering firms and surgical instruments in the case of medical practitioners. In such cases, the Commissioner is usually prepared to grant an allowance based on the cost of replacements. Additional equipment purchased, i.e. new equipment acquired not for the purpose of replacing broken or damaged articles, is not allowed being expenditure of a capital nature. Alternatively, the taxpayer may value these items at the end of each year like ordinary trading stock, the excess of the opening stock plus the purchases for the year over the closing stock plus sales representing the cost of the replacements to be allowed as a deduction in lieu of wear and tear.

It must be remembered that the allowance is only granted if the assets were *actually* used for the purposes of trade during the tax year, so that if certain of the machinery of a factory was idle during the whole of the tax year, no allowance can be claimed. On this principle, if the asset was acquired during the tax year, the allowance is usually proportionately reduced according to the period of use during the tax year.

The rate of wear and tear granted depends to a large extent on the use to which plant and machinery is put and the nature of the trade carried on by a taxpayer. Wear and tear on the same type of asset may vary in different classes of trade. A motor-car used by a commercial traveller would be subjected to far greater wear and tear than one used by an accountant who may use his car in going from one audit to another and accordingly the commercial traveller would be entitled to a larger allowance for wear and tear than the accountant. Similarly, certain machinery in a factory may be in use two or three shifts per day and the writer understands that, if the normal rate for machinery which works one shift a day is 10 per cent, the Commissioner, on application being made, is usually prepared to make an allowance of up to 17½ per cent in respect of two shifts per day and of 25 per cent in respect of three shifts per day.

Inflation and replacement allowance

Depreciation allowances granted on the basis of the historical cost of an asset, fail to take into account the many problems arising out of the fall in the value of money which commenced with the beginning of World War II. As prices have more than doubled since 1939, it must follow that depreciation reserves set aside by merchants and industrialists on the basis of the historical cost of the fixed assets used in the business will be completely inadequate to provide the funds necessarily required to replace those assets with possibly disastrous consequences to the firm or business who cannot obtain the required funds. The Committee of Enquiry into the Income Tax Act paid serious consideration to this important problem,[25] and recommended that, subject to certain conditions, in any case in which it is established to the satisfaction of the Commissioner that the replacement cost of a fixed asset used by the taxpayer in his trade, and which is subject to the wear-and-tear allowances provided for in the Act, exceeds the cost of such asset, the taxpayer should be entitled at his option, to a replacement allowance in respect of such asset. The Committee's recommendations would not only enable a taxpayer to preserve his capital intact in the face of the fall in the purchasing power of money, but would also, according to a strong school of thought in the accountancy world, result in a much fairer and more proper determination of the profits of his trade. The Income Tax Commission, however, rejected the Committee's recommendation for replacement allowances,[26] holding them to be 'an unnecessarily complicated set of provisions designed to take care of what is at best a theoretical possibility'. It considered that the present system in terms of which the cost of machinery, etc., used for trade purposes is allowed over its life is adequate. Revalorization schemes[27] may be objected to on practical grounds particularly to the considerable amount of work in which such schemes would involve both the taxpayer and the Revenue authorities. On these grounds, particularly, the Tucker Committee appointed to consider the taxation of trading profits in the United Kingdom and the New Zealand Taxation Committee did not favour the system of revalorization although the Tucker Committee did advocate the granting of flexible initial allowances in respect of the cost of replacement of fixed assets[28] whereas the New Zealand Committee recommended that taxpayers should be entitled at their discretion to larger depreciation allowances for the purpose of accelerating the writing off of assets.[29] In the writer's view, the granting of liberal initial and wear-and-tear allowances is probably the most practical method of assisting traders and manufacturers in meeting the high cost of replacement of fixed assets used in their businesses. The present initial allowance of 10 per cent in respect of producing machinery (see § 150) is not adequate. Its application should be extended to all assets and not only to assets used in production.

[25] *Second and Final Report*, chap. 10, p. 23.
[26] *First and Final Report*, p. 33, para. 53.
[27] This is the term given to schemes whereby fixed assets acquired before the fall in value of money are revalued in accordance with annual replacement values for the purpose of determining the amount on which depreciation allowances are granted.
[28] Cmd. 8189 published by Her Majesty's Stationery Office, London. The United Kingdom has recently increased its initial allowance for capital expenditure on industrial buildings from 10% to 15% and on machinery and plant from 20% to 30%.
[29] See the *Report of the Taxation Committee*, published by the Government Printer, Wellington, New Zealand (B-8).

§ 150. New machinery allowance

Section 11(2)(*d*)*bis* permits a taxpayer to deduct from his income an allowance of 10 per cent in respect of —

(i) the cost of new or unused machinery or plant,

(ii) brought into use by him for the purposes of his trade,

(iii) during any year of assessment,

(iv) and used by him directly in a process of manufacture.

It will be observed that the allowance does not extend to all assets but is limited to machinery and plant 'used directly in a process of manufacture'.

The 10 per cent allowance is in the nature of an initial allowance which is granted once only in the year in which the new machinery is brought into use by the taxpayer for the purposes of his trade. Unlike the wear-and-tear allowance, the initial allowance of 10 per cent is not proportionately reduced according to the period of use during the tax year. Thus, new machinery brought into use on the last day of the tax year will entitle the taxpayer to the full allowance of 10 per cent on the cost of the asset.

It is not necessary to write off the 10 per cent allowance in the books of the taxpayer. The allowance should be claimed when submitting the return of income.

The wear-and-tear allowance on the new machinery is calculated on the net amount arrived at after deducting the 10 per cent initial allowance.

'New or unused machinery' clearly excludes second-hand machinery acquired.

A profit made on the sale of plant or machinery is, in terms of section 11(4)(*a*), taxable to the extent to which it represents a recoupment of any allowances made in terms of section 11(2)(*d*)*bis* (see § 166).

§ 151. Scrapping allowance

In terms of section 11(2)(*j*), an allowance is granted in respect of any machinery, implements, utensils and articles used by the taxpayer for the purposes of his trade which have been scrapped by him during the year of assessment.

The assets referred to are the same as those listed in section 11(2)(*d*) except that there is no express prohibition as regards 'buildings or other structures or works of a permanent nature' and the scrapping allowance, it is submitted, therefore applies to all assets which rank for the wear-and-tear allowance.

The court has held that by not excluding 'buildings or other structures of a permanent nature' from the operation of section 11(2)(*j*), the legislator has recognized that these items may fall within the description of the enumerated articles in section 11(2)(*j*).[30] In practice, however the Commissioner does not grant a scrapping allowance in the case of buildings which may be scrapped by a taxpayer.

[30] I.T.C. No. 769, 19 S.A.T.C. 214.

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(iv) and used by him directly in a process of manufacture.

It will be observed that the allowance does not extend to all assets but is limited to machinery and plant 'used directly in a process of manufacture'.

The 10 per cent allowance is in the nature of an initial allowance which is granted once only in the year in which the new machinery is brought into use by the taxpayer for the purposes of his trade. Unlike the wear-and-tear allowance, the initial allowance of 10 per cent is not proportionately reduced according to the period of use during the tax year. Thus, new machinery brought into use on the last day of the tax year will entitle the taxpayer to the full allowance of 10 per cent on the cost of the asset.

It is not necessary to write off the 10 per cent allowance in the books of the taxpayer. The allowance should be claimed when submitting the return of income.

The wear-and-tear allowance on the new machinery is calculated on the net amount arrived at after deducting the 10 per cent initial allowance.

'New or unused machinery' clearly excludes second-hand machinery acquired.

A profit made on the sale of plant or machinery is, in terms of section 11(4)(*a*), taxable to the extent to which it represents a recoupment of any allowances made in terms of section 11(2)(*d*)*bis* (see § 166).

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In terms of section 11(2)(*j*), an allowance is granted in respect of any machinery, implements, utensils and articles used by the taxpayer for the purposes of his trade which have been scrapped by him during the year of assessment.

The assets referred to are the same as those listed in section 11(2)(*d*) except that there is no express prohibition as regards 'buildings or other structures or works of a permanent nature' and the scrapping allowance, it is submitted, therefore applies to all assets which rank for the wear-and-tear allowance.

The court has held that by not excluding 'buildings or other structures of a permanent nature' from the operation of section 11(2)(*j*), the legislator has recognized that these items may fall within the description of the enumerated articles in section 11(2)(*j*).[80] In practice, however the Commissioner does not grant a scrapping allowance in the case of buildings which may be scrapped by a taxpayer.

[80] I.T.C. No. 769, 19 S.A.T.C. 214.

The scrapping allowance is determined as follows:

(*a*) Start with the original cost of the machinery, implements, utensils or articles, say		£10,000
Deduct:		
(*b*) The amount of any new machinery allowances previously made in terms of section 11 (2) (*d*) *bis* (see § 150), say	£1,000	
(*c*) The total amount of the wear-and-tear allowances previously made by the Commissioner in terms of section 11 (2) (*d*) (see § 149), say	4,000	
(*d*) The amount or the value of any advantage accruing in respect of the sale or other disposal of the asset, say	3,000	8,000
Scrapping allowance — section 11 (2) (*j*)		£2,000

As regards (*c*), it is important to remember that it is the wear-and-tear allowance made by the Commissioner that comes into the computation, irrespective of what the taxpayer has claimed or has written off in his books.

Where the aggregate of (*b*), (*c*) and (*d*) exceeds (*a*), it follows that a profit has been made in respect of the sale or other disposal of the asset. To the extent to which such profit represents a recoupment of any new machinery allowances and wear-and-tear allowances previously made, as reflected in (*b*) and (*c*) *supra*, it is included in the taxpayer's income as a taxable recoupment in terms of section 11 (4) (*a*) (see § 166).

There is no definition of *scrapping* in the Act. Ordinarily an article is scrapped when it is consigned to the scrap-heap or when it is withdrawn because it has served its purpose and is now useless or worthless or because there is a new and better article on the market which is capable of an increased output. To constitute a scrapping there must have been a definite cesser of use which was due to the asset in question having become useless and unsuitable for further use.[31] For example, in one case[32] an advocate claimed the allowance on certain law books which he had been compelled to replace by new editions. He still, however, retained the old editions in his library for reference purposes. It was held by the court that as the law books in question were still in the advocate's possession and housed in his library, he could not be regarded as having scrapped them until such time as he got rid of them. This, it is suggested, does not presuppose that one must actually divest oneself of the asset but that rather such asset should not be capable of being put to any further use by the taxpayer, i.e. the law books would have to be withdrawn from the library.

[31] I.T.C. No. 200, 5 S.A.T.C. 389; I.T.C. No. 631, 15 S.A.T.C. 100; I.T.C. No. 657, 15 S.A.T.C. 495.
[32] I.T.C. No. 460, 11 S.A.T.C. 186.

It follows, therefore, that it is not essential to the granting of an allowance in section 11 (2) (*j*) that the asset scrapped should be sold or disposed of, nor is it essential that the article scrapped be replaced or if it is replaced that it be of the same type; it is sufficient that the taxpayer no longer uses it in his business. All that the section requires is —

(i) that there must, in fact, be a 'scrapping' of an asset used by the taxpayer for the purposes of his trade. If the article has never been put to use, the allowance cannot apply; and

(ii) that such scrapping must take place during the year of assessment in which the allowance is claimed.[33]

If the taxpayer can satisfy these requirements, he is entitled to the allowance in terms of the section irrespective of whether the scrapped asset has been sold by him or retained in his possession.

A further requirement laid down by the court is that to constitute a scrapping, it must be an act performed in the ordinary course of buiness, i.e. the trade or business for which the article in question was used must be continued.[34] This view was, however, not supported in a later case in which the court held that there is nothing in section 11 (2) (*j*) which provides that the scrapping allowance cannot be made unless the business is still continued.[35]

If assets are disposed of upon the cessation of the trade in which they were used the disposal would not ordinarily be regarded as a 'scrapping' since the assets have ceased to serve their purpose due to cessation of trade and not by their becoming useless or worn out. Thus, any loss made would be of a capital nature and not deductible.[36] In exceptional cases, however, it may happen that the disposal of an asset upon cessation of trading amounts to a 'scrapping' entitling the taxpayer to the allowance provided in section 11 (2) (*j*).[37]

An anomalous situation in favour of the taxpayer arises on the scrapping of an asset used partly for trade purposes and partly for private purposes. It would appear from the terms of section 11 (2) (*j*) that the full allowance must be granted since there is no provision for the apportionment of a scrapping allowance in respect of an asset used partly for trade purposes and partly for private purposes. The section merely requires that the asset must be 'used by the taxpayer for the purposes of his trade'. It does not say that the asset must be used wholly or exclusively for the purpose of trade. Since the allowance is determined by the excess of the original cost of the asset over the aggregate of the wear-and-tear allowances previously made and the sale price of the asset, it must follow that the fact that the asset was used partly for private purposes is immaterial. Thus, if an

[33] I.T.C. No. 200, 5 S.A.T.C. 389; I.T.C. No. 631, 15 S.A.T.C. 100; I.T.C. No. 358, 9 S.A.T.C. 179.

[34] I.T.C. No. 657, 15 S.A.T.C. 495.

[35] I.T.C. No. 769, 19 S.A.T.C. 214; see also I.T.C. No. 795, 20 S.A.T.C. 107.

[36] I.T.C. No. 657, 15 S.A.T.C. 495; I.T.C. No. 754, 18 S.A.T.C. 424; I.T.C. No. 200, 5 S.A.T.C. 389; I.T.C. No. 311, 8 S.A.T.C. 152.

[37] I.T.C. No. 795, 20 S.A.T.C. 107; see also I.T.C. No. 769, 19 S.A.T.C. 214; I.T.C. No. 631, 15 S.A.T.C. 100.

asset costing £1,000 is used as to 50 per cent for trade purposes and 50 per cent for non-trade purposes, and the wear and tear determined at the end of year I is £200, year II £160, and year III £128, the Commissioner, in practice, will allow only £100 in year I, £80 in year II and £64 in year III. If the asset is thereafter sold at its depreciated value of £512, it is submitted that in terms of section 11 (2) (*j*) the taxpayer is entitled to a scrapping allowance of £244 (the difference between the original cost of £1,000 and the aggregate of the wear-and-tear allowances granted, viz. £244 and the sale price of £512). Logically, this allowance of £244 should not be deductible as it represents, in effect, the wear and tear due to the private use of the asset. If the asset had been sold for £300, the scrapping allowance would be £456 (£1,000 *less* (£244 + £300)). As the section stands at present, it would appear that no regard need be had to the fact that portion of the allowance is attributable to the private use of the asset. Yet of the amount of £456, £244 was due wholly to the use of the asset for private purposes and £212 to the combined use for both trade and non-trade purposes. It is only correct that provision should be made for the apportionment of a scrapping allowance where the asset has been used partly for trade purposes and partly for non-trade purposes. Only such part of the allowance as is attributable to use for trade purposes ought to be deductible.

On a strict reading of section 11 (2) (*j*) it would appear that in the case of the scrapping of an asset originally used elsewhere, e.g. for private or domestic purposes, but subsequently used for trade purposes, the allowance must be calculated with reference to the original cost and the wear-and-tear allowances granted while the asset was being used in trade. For example, if an asset costing £1,000 is brought into the business at a time when its value is £400 and the Commissioner has allowed £150 wear-and-tear allowances by the time the asset is scrapped, it is submitted that in terms of section 11 (2) (*j*) the scrapping allowance is the difference between £1,000 and £150 = £850. This is obviously not correct since the allowance should be determined with reference to the value of the asset at the time it is introduced into the business and not to its original cost. On this basis, the correct allowance is £250 (£400 *less* £150). This difficulty arises because of the use of the expression 'original cost' in section 11 (2) (*j*).

A further problem arises in the case of assets acquired for no consideration, e.g. by donation or inheritance. Whereas it is the practice to grant a wear-and-tear allowance in respect of such assets based on the value thereof at the date when they are introduced into the business, it would seem that on a subsequent scrapping thereof the allowance in terms of section 11 (2) (*j*) cannot be made since they did not cost their owner anything, having been acquired for no consideration. The original cost being nil, it must follow that a scrapping allowance cannot be made even though the value of the asset at the date of scrapping (after allowing for wear and tear written off) is less than its value at the time it was brought into the business.

The above difficulties can be resolved by excluding the reference to 'original cost' in section 11 (2) (*j*) and by replacing these words by the term 'value' which could be defined as the cost to the taxpayer at the time the asset was acquired provided that if any asset has been used elsewhere and transferred for use by him in his trade or if the ownership of any such asset has been acquired by the taxpayer without payment of any valuable consideration, the value thereof shall be deemed to the current market value. This same definition should be used for the purposes of the wear-and-tear allowance in section 11 (2) (*d*) so as to provide the Commissioner with statutory authority for allowing wear and tear in respect of assets acquired without payment of valuable consideration. Precedent for these recommendations is to be found in section 13 (2) (*c*) and (*d*) and section 15 of the Income Tax Act of the Federation of Rhodesia and Nyasaland.

§ 152. Bad debts

Bad debts rank as a deduction from income in terms of section 11 (2) (*g*) provided that —

(*a*) the debt is one that is due to the taxpayer; and

(*b*) the debt must be proved to the satisfaction of the Commissioner to be bad; and

(*c*) the amount of the debt must be included in the income of the taxpayer either in the current year or in any previous year of assessment.

As regards (*a*), it is submitted that the debt must belong to the taxpayer on the last day of the year of assessment so that where during the year of assessment he sells his business including all his debts, whether good, bad or doubtful, he cannot claim an allowance in respect of bad debts.[38] On this principle, it must also follow that where a taxpayer compromises with one of his debtors during the year and waives his right to claim portion of the debt, the irrecoverable portion cannot rank as a bad debt since it does not belong to the taxpayer at the end of the tax year. In practice, the Commissioner permits a taxpayer to write off as bad debts any loss sustained in the event of a compromise.

In regard to (*b*), the allowance of a bad debt is at the discretion of the Commissioner so that it is only possible for that discretion to be interfered with by the courts if it can be shown that the Commissioner has not applied his mind to the facts or that he has in effect acted *mala fide* in making his decision.[39]

[38] *Cooper* v. *C.O.T.*, 1952 (4) S.A. 277 (S.R.); 18 S.A.T.C. 259; I.T.C. No. 451, 11 S.A.T.C. 103.

[39] I.T.C. No. 93, 3 S.A.T.C. 239; I.T.C. No. 168, 5 S.A.T.C. 160; I.T.C. No. 183, 5 S.A.T.C. 262.

As regards (*c*) *supra*, it follows that the debt must be in the nature of income before it can be allowed as a bad debt. A bad debt in respect of goods sold is deductible since it has been included in income. On the other hand, a bad debt in respect of money lent, for example, to an employee, is not deductible in terms of section 11 (2) (*g*) since the amount thereof has never been included in the lender's income. Taxpayers who in the past were permitted to render their returns on the basis of income actually received, e.g. certain professional men (see § 235), are not entitled to claim an allowance in respect of any bad debts, since, in view of the method of accounting they have adopted, the amount of such debts has never been included in their income.

On the purchase and sale of a business, debts taken over and subsequently found to be bad are not allowable since the amounts thereof have never been included in the income of the purchaser of the business. The loss is clearly one of a capital nature.[40] The same principle applies to the case of an inherited business. The heir is not entitled to deduct any bad debts outstanding at the date of death of the deceased. In the case of a taxpayer carrying on business on his own account and who admits a partner, such a partner is not entitled to deduct his share of the bad debts written off which relate to debts incurred prior to the commencement of the partnership. The original owner is, however, entitled to such a deduction.

Section 11 (2) (*g*) does not operate to prevent a finance company or a money-lender from writing off any moneys loaned which prove to be bad. In such cases, the loss is deductible in terms of section 11 (2) (*a*) as being a loss incurred in the production of income and not being a loss of a capital nature. Similarly, where it is satisfactorily established that it is the custom of a business or profession to make advances to customers or clients as an integral part of the business carried on for the purpose of securing or retaining business, such advances if found to be irrecoverable are allowable deductions in terms of section 11 (2) (*a*).[41]

Section 11 (2) (*g*) does not require as a prerequisite to the deduction of bad debts the continued existence of the taxpayer's business out of which the debts arose, and it would therefore follow that in regard to bad debts incurred in respect of a previous business, the taxpayer is allowed to deduct from his income from trade in a later year such bad debts provided that all the other requirements of section 11 (2) (*g*) are complied with.[42] On this basis, it does not pay

[40] I.T.C. No. 95, 3 S.A.T.C. 242. If a greater amount is collected than what was paid for the debts, the profit is not taxable, being in the nature of a capital profit since the debts were bought as part and parcel of the business acquired as a going concern and not for the purpose of deriving a profit on the collection thereof.

[41] I.T.C. No. 95, 3 S.A.T.C. 242; I.T.C. No. 434, 10 S.A.T.C. 447; I.T.C. No. 281, 7 S.A.T.C. 253; I.T.C. No. 167, 5 S.A.T.C. 87.

[42] The Committee of Enquiry into the Income Tax Act apparently thought that this could not be done under the present law and recommended the grant of such an allowance (*First Report*, p. 28, para. 24). The Income Tax Commission considered such an allowance equitable (*First and Final Report*, p. 10, para. 34).

a trader, from the tax point of view, to sell his book debts on the cessation of trading since if he incurs a loss in respect thereof due to the inclusion of certain bad debts, such loss is not deductible. If he retains the debts and collects them himself, any bad debts sustained are deductible. A vendor of a business, who has included his book debts in the sale and has guaranteed payment of these debts to the purchaser, cannot deduct any amount subsequently payable under his guarantee.[43] If these debts are re-ceded to the vendor, they are deductible as bad debts provided that they comply with the requirements of section 11 (2) (*g*).

If amounts previously allowed as bad debts are subsequently recovered, they form part of the gross income in the year of receipt and previous assessments cannot be reopened.[44] Section 11 (4) (*a*) is also authority for including such amounts in the income of the taxpayer in the year in which they are recovered.

Whether a debt is bad or not must be decided at the time when the debt is returned as an accrual for the income tax year and according to the then existing circumstances of the debtor; subsequent events cannot influence the determination made in respect of that income tax year.[44] In practice the Department permits the taxpayer to take into account the knowledge existing as to the debts at the time when the financial accounts of the taxpayer are prepared.

Where a taxpayer claims the deduction of a bad debt in terms of section 11 (2) (*g*), the Commissioner is entitled to refuse the allowance where the amount of the debt is recoverable from some other person under a guarantee or suretyship agreement. Section 12 (*c*) prohibits as a deduction any loss which would otherwise be allowable to the extent to which it is recoverable under a contract of insurance, guarantee, security or indemnity.

§ 153. Doubtful debts allowance

In terms of section 11 (2) (*h*), the Commissioner may make an allowance each year in respect of such debts due to the taxpayer as he considers to be doubtful.

The amount of such allowance must be included in the income of the taxpayer in the following year of assessment.

It will be observed that unlike section 11 (2) (*g*) the allowance is not restricted to debts the amount whereof was included in the taxpayer's income. It would seem that a taxpayer can claim an allowance for doubtful debts even if such debts, if proved bad, would not be deductible as bad debts by virtue of the fact that they have not been included in income. Section 11 (2) (*h*) should be amended so as to put the allowance for doubtful debts on the same basis as the deduction for bad debts. It is interesting to note that until the 1955 tax year, the Federation of Rhodesia and Nyasaland had a provision similar to section 11 (2) (*h*) in its Income Tax Act, namely

[43] I.T.C. No. 449, 11 S.A.T.C. 98; I.T.C. 466, 11 S.A.T.C. 251; I.T.C. 342, 8 S.A.T.C. 368.

[44] See *C.I.R.* v. *Delfos*, 1933 A.D. 242; 6 S.A.T.C. 92.

section 13 (2) (*b*) (ii). With effect from the 1956 tax year, however, the allowance for doubtful debts was put on the same basis as the deduction for bad debts (section 13 (2) (*b*) (i)) in so far as the debt which is claimed to be doubtful must have been included in the income of the taxpayer either in the current year or in a previous year of assessment. In this manner the Federal Legislature has nipped possible future controversies in the bud.

The Commissioner will only grant an allowance in respect of debts which belong to the taxpayer on the last day of the year of assessment. The allowance is not granted in respect of the amount of any debts which have not been included in the taxpayer's income either in the current year of assessment or in any previous year of assessment. As stated above, it is doubtful whether this is correct law.

The Commissioner considers the grant of an allowance for doubtful debts, if applied for. Each debt must be examined and the allowance will be granted in respect of the portion of each such debt which the Commissioner regards as being doubtful.

The amount allowed is at the discretion of the Commissioner and as long as he has applied his mind to the matter and has acted *bona fide*, the courts will not interfere with that discretion. In one case, the Special Court refused to accept an arbitrary calculation by the Commissioner. The Court held that 'there must be an application of the mind as to what is the proper value' of doubtful debts.[45]

Whether a debt is doubtful or not must be decided at the time when the debt is returned as an accrual for the income tax year and according to the then existing circumstances of the debtor; subsequent events cannot influence the determination made in respect of that income tax year.[46] In practice the Department permits the taxpayer to take into account the knowledge existing as to the debts at the time when the financial accounts of the taxpayer are prepared.

Where cessation of business is due to the death or insolvency of the taxpayer, the Commissioner permits an allowance in respect of doubtful debts as at the date of death or insolvency. On the death or insolvency of the taxpayer it would appear to be the practice that the allowance granted as at the date of death or insolvency cannot subsequently be included in the income of any person, e.g. an heir or legatee who inherits the business or the executor or trustee who carries on the business. This results in a loss of revenue to the *fiscus* which can only be avoided if a doubtful debts allowance is not granted in the year of assessment in which there is a cessation of business due to death or insolvency.

§ 154. Lease premiums

Statutory provisions

In terms of section 11 (2) (*e*), an allowance is granted in respect of any premium or consideration in the nature of a premium paid by the taxpayer for —

[45] I.T.C. No. 273, 7 S.A.T.C. 232.
[46] See *C.I.R.* v. *Delfos*, 1933 A.D. 242; 6 S.A.T.C. 92.

(i) the right of use or occupation of land or buildings; or
(ii) the right of use of any plant or machinery; or
(iii) the right of use of any patent, design, trade mark or copyright,[47] or any other property which, in the opinion of the Commissioner, is of a similar nature.

The allowance cannot exceed for any year of assessment an amount represented by the total premium divided by the number of years for which the right of occupation or use of the asset is granted in terms of the lease. Where such period exceeds twenty-five years, the deduction must be calculated in terms of a period of twenty-five years. If the taxpayer is entitled to the right of use or occupation for an indefinite period, the Commissioner is entitled to fix the probable duration of such right for a period not exceeding twenty-five years. It is not clear from the section whether the taxpayer is entitled to a full year's allowance in a year of assessment during which the property was productive of income for only a portion of the year, e.g. in the year in which a lease commences. It merely provides that the 'allowance shall not exceed for any one year' the premium divided by the number of years of right of use or occupation. The writer has, however, experienced cases where a full year's allowance was granted to the lessee in a year in which he ceased to derive income from the leased property by virtue of the cancellation of the lease.

The words 'premium or consideration in the nature of a premium' in section 11 (2) (*e*) mean a consideration in the nature of rent passing from a lessee to a lessor.[48] Rent is clearly deductible under section 11 (2) (*a*) and in the absence of section 11 (2) (*e*) it might be held that the whole of the premium would be deductible under section 11 (2) (*a*) from the income received or accrued in the year in which the premium was paid. The deduction of only a portion of the premium is, therefore, provided for in section 11 (2) (*e*) because a premium, being in the nature of additional rent paid to the lessor, is paid in respect of the whole period of a lease. Thus, under section 11 (2) (*e*), if a premium is paid for a lease of ten years, one-tenth of the premium is deductible each year; if the lease is for a period of twenty years, one-twentieth of the premium is deductible each year.

The lessor who receives the premium is taxable in terms of section 7 (*d*) in the year of receipt or accrual on the full amount of the premium and is not entitled to claim that the premium be spread over the period of the lease.

Where a substituted lessee (the cessionary) has paid to a predecessor lessee (the cedent) a consideration for the cession or assignment of all right, title and interest in a lease, such consideration is not a 'premium or consideration in the nature of a premium' within the meaning of those words in section 11 (2) (*e*) since it has

[47] As defined in the Patents, Designs, Trade Marks and Copyright Act, 1916 (Act No. 9 of 1916).
[48] *Turnbull* v. *C.I.R.*, 1953 (2) S.A. 573 (A.D.); 18 S.A.T.C. 336.

not passed from the lessee to the lessor by way of additional rental but from the cessionary to the lessee. It is expenditure of a capital nature.[48] As regards the predecessor lessee or cedent who receives the consideration, it is a receipt of a capital nature in his hands.[49]

Section 11 (2) (*e*) applies to a sublessor and sublessee in the same way as it applies to a lessor and lessee since, having regard to the nature of a sublease, the premium is additional rent passing from the sublessee to the sublessor.

On the sale or other disposal of his rights under a lease, the lessee is in terms of section 11 (4) (*a*) taxable on any profit derived to the extent to which such profit represents a recoupment or recovery of allowances previously granted in terms of section 11 (2) (*e*) (see § 166).

Recommendations

The purpose of section 11 (2) (*e*) may be defeated by a taxpayer paying the premium by providing in the lease that it is for a period of one year only but the lessee is entitled to extend the period of the lease for a very much longer period on the expiration of the year. For example, a lessee who desires a ten-year lease may pay a premium of £10,000 for a one-year lease with a right to extend the lease for a further nine years on the expiration of the year. Under the present practice of the Commissioner, where a lease is for a certain period but the lessee has an option of renewal for a further number of years, the period for which the lessee is entitled to the use or occupation must be taken as the initial period only. Thus, in the example given, the lessee is entitled to deduct the £10,000 all in the one year. In determining the period for which a taxpayer is entitled to the right of use or occupation, it may be suggested that in a case where a lessee is entitled to extend the period of a lease by virtue of the exercise of an option granted in terms of the lease, the option period should properly be taken into account in addition to the original period provided for in the lease. For example, if a lessee enters into a five-year lease with an option to renew the lease for a further period of five years, since he had the right of use or occupation for ten years, any premium paid should be written off over ten years. This will safeguard the *fiscus* from abuse.

On a strict wording of section 11 (2) (*e*), it might be that the allowance continues to be claimable even though the lessee has become the owner of the leased property. It is submitted, however, that this could not have been the intention of the legislator who envisaged the grant of the annual allowance only to persons entitled to the use or occupation of property but not to persons entitled to full ownership in respect thereof. To remove any doubt, the section should be redrafted. Precedent for this recommendation is to be found in section 13 (2) (*e*) of the Income Tax Act of the Federation of Rhodesia and Nyasaland.

[49] *C.I.R.* v. *Myerson*, 1947 (2) S.A. 1243 (A.D.); 14 S.A.T.C. 300.

The provisions of section 11 (2) (*e*) apply to short leases as well as to leases in *longum tempus*. Thus, a lessee is entitled to deduct a premium paid for a ninety-nine-year lease over the period of twenty-five years specified in the Act. In essence, such a premium is the purchase price of the property and should not be deductible. It is true that the recipient of a premium for a ninety-nine-year lease is taxable thereon and this fact may effectively counter any abuse to which the section may be put. There may be circumstances, however, where the recipient is not taxable on the premium, e.g. it may be a building society or insurance company or a pension fund, which are all exempt from tax, or, it may be a taxpayer with an assessed loss. Apart from this factor, a lease for a lengthy period, e.g. fifty years or ninety-nine years, is for most practical purposes an alienation and it is considered wrong to treat a premium for the grant of such a lease in the same way as a premium for the grant of a five-year lease. In this regard, the recommendation made by the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland[50] should be borne in mind, namely that premiums for leases which are for a period of twenty-five years or less should continue to be taxable and deductible in full and that a portion only of premiums for leases which are for a period greater than twenty-five years should be taxable and deductible, such portion being the fraction which has as its numerator the number twenty-five and as its denominator a number equal to the number of years of the lease.

The Committee of Enquiry into the Income Tax Act paid considerable attention to the question of lease premiums[51] and was of the view that the principles underlying the taxation of lease premiums under the provisions of the present Act were fundamentally sound and should be adhered to. Unfortunately, at the time when the Committee considered the problem, the present practice of the Department, based upon *Myerson's* case,[49] was that any amount received by a lessee for the cession of his rights under a lease was not regarded as taxable in the hands of the cedent as a premium or like consideration for the right of use or occupation of premises whereas the cessionary by whom any such amount was paid was regarded as entitled to deduct any amount so paid over the remaining period of the lease. (*Turnbull's* case[48] was decided after the Committee examined the problem.) The Committee, being of the view that this arrangement whereby amounts received for the cession of lease rights are not taxable while a deduction is allowed to the cessionary is liable to lead to abuse and tax avoidance, made some rather complex proposals in regard to the taxation of lease premiums. If *Turnbull's* case had been decided at the time, there is no doubt that most of the Committee's proposals would have fallen away since it was in agreement with the principles underlying the provisions of the Act in regard to lease premiums.

[50] *Report of the Commission of Inquiry*, p. 33, para. 186.
[51] *First Report*, chap. 20, p. 98.

The Income Tax Commission[52] was of the opinion that the provisions of the Act in regard to lease premiums were open to considerable abuse. It recommended that only such amount given in consideration of the right of use or occupation of property as is paid in monthly or other periodic instalments at regular intervals of not more than one year should be taxed in the hands of the recipient and allowed to the payer.

With respect, a reversion to the position under the income tax law in force prior to 1917 whereby the recipient of a lease premium was not liable for taxation on the premium received and the payer was not allowed any deduction in respect of the amount paid, would not only be unsound and unjustifiable but would lead to considerable abuse and tax avoidance since lessors would stipulate for premiums instead of periodic rentals and thus avoid tax on amounts which truly constitute income. For it cannot be doubted that a premium for the right of use or occupation of property is just as much a fruit the lessor derives from his capital asset as is the periodic rent. In the writer's view, no special provisions are really necessary in the Act for the taxation and the deduction of lease premiums. If section 7(*d*) and section 11(2)(*e*) were not there, it is considered that a premium received by a lessor would in any event be taxable under the general definition of 'gross income', whereas the premium paid by a lessee who uses the property for the purpose of trade would be deductible in full under section 11(2)(*a*) (see *Turnbull's* case). In fact it may be justifiably asked why a lessee who pays a premium should not be entitled to deduct the entire premium in the year in which it is paid even though it is paid in respect of the whole period of the lease. Under the general deduction formula, as presently constituted, a taxpayer is entitled to deduct expenditure in the year in which it is incurred even though the benefits of the expenditure may extend into future tax years, e.g. a salary or a rental payable in advance (see § 140). Why should a distinction be made in the case of a lease premium?

The writer is of the view that, in the interests of the *fiscus*, the present provisions of the law in regard to the taxation and the deduction of lease premiums are satisfactory and that lessors should continue to be liable for tax on the premium they receive and lessees should continue to be entitled to deduct the amount of such premiums. On the cession of rights under a lease for a consideration, in terms of the principle established in the *Myerson* case, such consideration should continue to be not taxable in the hands of the cedent being a receipt of a capital nature, and should not be allowed as a deduction to the cessionary, being capital expenditure on the principle established in the *Turnbull* case.

§ 155. Lease improvements

In terms of section 11(2)(*e*)*bis*, an allowance in respect of expenditure incurred by a taxpayer in pursuance of an obligation to

[52] *First and Final Report*, p. 24, paras. 116-20.

effect improvements on land or to buildings under an agreement whereby the right of use or occupation of the land or buildings is granted, is deductible if such land or buildings are used for the production of income or if income is derived therefrom. The allowance may not exceed in any one year an amount equal to the amount stipulated in the agreement of lease as the value of the improvements or as the amount to be expended thereon, divided by the number of years for which the lessee is entitled to the use or occupation or twenty-five years, whichever is the lesser period. If no amount is stipulated as to the value of the improvements, it shall be the fair and reasonable value of the improvements as determined by the Commissioner. The aggregate of the allowances to be deducted shall not exceed the amount stipulated in the agreement of lease as the value of the improvements or as the amount to be expended thereon.

As regards the lessor it is provided in section 7 (*d*) *bis* that where in any year of assessment there has accrued to him the right to have improvements effected on the leased property by the lessee, there must be included in the gross income of the lessor the amount stipulated in the agreement of lease as the value of the improvements or as the amount to be expended thereon, or, if no amount is so stipulated, the fair and reasonable value, in the opinion of the Commissioner, of the improvements.

The accrual takes place in the tax year in which there has accrued to the lessor the right to have improvements effected. It is submitted that on a strict interpretation the accrual occurs on the date that the agreement is concluded notwithstanding the fact that the landlord has the right to demand that the lessee effects improvements only in a later year. Thus, if in terms of a lease entered into on 31st October, 1958, a lessee is required to effect improvements at any time within a period of three years, it is submitted that the date of accrual is 31st October, 1958, when the right to have improvements effected accrues. In practice, the Commissioner will probably regard the date of completion of the improvements by the lessee as the date of accrual in the case where the amount to be expended is not stipulated in the agreement and it is impossible to determine the value of the improvements at any date other than at the date of completion.

It was necessary for the legislator to insert a specific provision as to the date when the value of improvements is to accrue, as it has been held by the courts that in terms of the general rules only amounts which have an ascertainable money value can be included in 'gross income'. Thus, in the case of improvements effected to leased property by a lessee, as the lessor only obtains the benefit thereof, if any, at the expiration of the lease, there can be no ascertainable value or benefit to the lessor until the lease comes to an end.[53]

The full amount is taxable all in the one year when the lessor acquires the right to have the improvements effected, but, in terms

[53] *C.I.R.* v. *Butcher Brothers (Pty.), Ltd.*, 1945 A.D. 301; 13 S.A.T.C. 21. See also *Motala* v. *C.I.R.*, 1951 (1) S.A. 901 (N); 17 S.A.T.C. 246; I.T.C. No. 487, 12 S.A.T.C. 62.

of section 11 (2) (*e*) *ter*, the Commissioner has the power to make a special allowance to provide for the fact that the lessor has to wait until the termination of the lease before he gains the benefit of the improvements. In such cases, an appropriate discount may be allowed under this special provision. An attempt is, therefore, made to prevent the lessor from being taxed upon a value which may greatly exceed the benefit he will ultimately derive upon the termination of the lease. In practice, the Commissioner, in granting the allowance, usually reduces the value of the improvements to its present worth having regard to the period of time which must elapse before the landlord can exercise his right to receive the improvements as his absolute property. What should logically be taxed, however, is the present worth of the estimated value of the improvements as at the expiration of the lease.

The provisions of section 11 (2) (*e*) *bis* only apply where the improvement is undertaken by reason of an obligation imposed upon the lessee under the lease. They do not extend the improvements voluntarily undertaken by the lessee or at his option. Section 11 (2) (*e*) *bis* contemplates a situation in which the duty to effect improvements is a term of the contract of lease, a term with which the tenant is bound to comply.[54] If a lessor desires to avoid the tax payable on lease improvements, he should not impose an obligation on the lessee to effect the improvements. A lessor is not compelled to stipulate for lease improvements but can simply grant a permissive right to the lessee to effect improvements. Of course, in such a case, whereas the lessor will avoid tax on the value of the improvements, the lessee is not entitled to deduct such value over the period of the lease.

The remarks made in connection with section 11 (2) (*e*) in regard to where the lessee becomes the owner of the leased property, option periods and long leases apply *mutatis mutandis* to section 11 (2) (*e*) *bis* (see § 154).

On the sale or other disposal of his rights under a lease, the lessee is, in terms of section 11 (4) (*a*), taxable on any profit derived to the extent to which such profit represents a recoupment or recovery of allowances previously granted in terms of section 11 (2) (*e*) *bis* (see § 166).

§ 156. Housing expenditure for employees

In terms of section 11 (2) (*o*), a taxpayer who —

(i) during any year of assessment within the period of five years ending 30th June, 1958,

(ii) incurs expenditure in connection with the erection of any dwelling, or who,

(iii) for the purpose of financing in whole or in part the erection by any person of any dwelling, advances or donates to any person any amount, and

[54] *A* v. *C.O.T.*, 1954 (1) S.A. 38 (S.R.); 19 S.A.T.C. 291.

(iv) who satisfies the Commissioner that that dwelling will be occupied exclusively by persons or the households of persons who are his employees,

is granted an allowance in respect of such year of assessment amounting to 25 per cent of the expenditure incurred or of the amount advanced or donated.

It will be observed that the allowance is only granted in respect of the *erection* of a dwelling. It does not extend to a purchase of property already erected.

The following persons are not entitled to the concession:

(*a*) taxpayers who derive income from the sale of immovable property to persons who are not employed by them; and

(*b*) taxpayers who are carrying on mining operations or farming.

The aggregate of all the allowances made in respect of the erection of any one dwelling must not exceed £500. Thus, if to house ten of his employees an employer were to erect a block of ten flats which cost, say, £30,000, the maximum amount he can claim as a deduction is £5,000, viz. £500 in respect of the erection of each of the ten dwellings.

Employee does not include any person who is a relative of the taxpayer or who, if the taxpayer is a company, is a shareholder (or a relative of a shareholder) in that company or in any company which is associated with that company by virtue of shareholding.

Relative is not defined, but in terms of its ordinary meaning blood relatives to any degree as well as relatives by marriage would be included.

Employees who hold shares in a company solely because they are employed by that company and who will, in terms of the articles of association of that company, not be entitled to hold those shares after they cease employment are not to be regarded as shareholders.

Shareholder is defined in section 33(4) of the Act and includes not only a registered shareholder but also any other person who is entitled to participate in the profit-sharing rights attaching to any shares even though they are registered in the name of some other person.

If a company is mainly engaged in the provision of housing facilities for the employees of its sole or principal shareholder, the employees of such shareholder are deemed to be the employees also of the company. In such a case, it follows that the subsidiary company will be entitled to the allowance, although it would seem that the holding company, which makes an advance to the subsidiary company for the purpose of financing the erection of dwellings for its employees, is also entitled to the allowance in terms of the strict wording of the new paragraph. It is doubtful whether this could have been the intention of the Legislature. In practice the holding company is not permitted to deduct any allowance in respect of the money advanced, but the Department grants the allowance only to the subsidiary company which erects and owns the dwellings and hires them out to the employees of the holding company.

If in any year of assessment any dwelling in relation to the erection of which an allowance has been made to a taxpayer under the provisions of section 11 (2) (*o*), whether in the current or any previous year of assessment, is occupied by any person or by the household of any person who is not an employee of the taxpayer, there must be included in the income of the taxpayer for the current year of assessment the amount of the allowance less an amount equal to one-tenth of the allowance in respect of each completed period of one year, but not exceeding ten years, during which the dwelling in question was occupied by an employee or the household of an employee of the taxpayer.

A taxable recoupment also arises by virtue of the sale of an employee's house in excess of its written-down income tax value, or by virtue of the repayment of a loan by an employee (see § 166).

The deduction in section 11 (2) (*o*) is hedged in with so many restrictions that it is of small value to the business man. The tax year ending 30th June, 1958, is the last year in respect of which the allowance can be claimed.

§ 157. Scientific research expenditure

A taxpayer can deduct expenditure incurred in respect of scientific research in the following manner:

Revenue expenditure

Section 11 (2) (*j*) *bis* provides for the deduction of revenue expenditure incurred during the year of assessment by any taxpayer:

(i) for the purpose of scientific research undertaken by him for the development of his business; or

(ii) by way of contributions to any association, institute, college or university, to be used in scientific research relating to the taxpayer's own business provided that the Council for Scientific and Industrial Research certifies to the Commissioner that it approves the proposals of the association, etc., in regard to the research and that it is satisfied that the contributions will be used therefor.

It is to be observed that a certificate from the Council for Scientific and Industrial Research is not required in respect of the expenditure referred to in (i) *supra*.

Revenue expenditure in respect of scientific research includes the cost of materials, chemicals, etc., the salaries payable to chemists and others and the rental payable in respect of a laboratory that may be hired.

Capital expenditure

Section 11 (2) (*j*) *ter* provides that if the Commissioner is satisfied that capital expenditure has been incurred by a taxpayer for the purpose of scientific research undertaken by him for the development of his business, he may deduct 25 per cent of such expenditure in the year of assessment in which the research commenced and a further 25 per cent in respect of each of the next three tax years provided that —

(i) the Council for Scientific Research certifies to the Commissioner annually that in respect of each year of assessment in which a claim is made, research was carried on and was financed by the capital expenditure; and

(ii) if in any year of assessment the taxpayer discontinues research or if the Council for Scientific Research is unable to certify as in (i) *supra*, there must be included in income for that year of assessment the total of the deductions so far made in respect of capital expenditure *less* one-tenth of the total capital expenditure so far incurred in respect of every completed year, not exceeding ten, contained in the period during which the research was carried on.

Capital expenditure includes the cost of erection of a laboratory, machinery, etc.

It must be noted that the deduction is allowable for the first time in the year when research commences. This may be only after all expenditure has been incurred. The allowance is then calculated at 25 per cent per annum of the total certified expenditure incurred since commencement.

Scientific research is defined in section 1 and means any activity in the field of natural or applied science for the extension of knowledge. In the case of an architect who received an appointment to design certain hotel buildings and for that purpose went oversea to study new developments in hotel architecture, the Special Court held that the word *knowledge* in the definition of scientific research must be knowledge pertaining to the calling of the taxpayer in a general sense and not knowledge which he sets out to gain in order to equip himself with a greater degree of efficiency for carrying out a particular contract.[55]

Before a deduction can be made under section 11 (2) (*j*) *bis* (i) and section 11 (2) (*j*) *ter*, it must be shown that scientific research was *undertaken by the taxpayer*. Thus, in cases where research is undertaken by a person on behalf of another, it is submitted that the contribution made towards such research by the latter person is not deductible, although the deduction under section 11 (2) (*j*) *bis* covers the expenditure incurred in respect of the hire of services for the purposes of solving a particular difficulty relating to the business. The Committee of Enquiry into the Income Tax Act considered that where research is undertaken by a company on behalf of another, the contribution made towards such research by the latter company should, subject to suitable safeguards, be deductible.[56] This recom-

[55] I.T.C. No. 666, 16 S.A.T.C. 130.
[56] *First Report*, p. 29, para. 32.

mendation was rejected by the Income Tax Commission on the grounds that it would lead to abuse and evasion of tax.[57] The Commission considered that the Department will have no control over the expenditure and will not be able to satisfy itself whether the amount expended has been used for the stated purpose especially when the company conducting the research is resident outside the Union.

§ 158. Expenditure on entertainment

Expenditure on entertainment is clearly deductible in terms of section 11 (2) (*a*) and section 12 (*g*) if it can be shown that such expenditure has been incurred in the production of income, is not of a capital nature and has been wholly or exclusively laid out or expended for the purpose of trade.

It happens often that there is a direct connection between the entertainment expenditure incurred and the carrying on of the taxpayer's trade but the expenditure has not been incurred for the purpose of earning income but for the protection of income and cannot be deducted in terms of section 11 (2) (*a*) (see § 136). Thus, it has been held by the Special Court[58] that an accountant who incurs expenditure in entertaining business associates connected with his practice, including club subscriptions, is not allowed to claim such expenses as a deduction under section 11 (2) (*a*). One can also visualize the case of a professional man, e.g. an attorney, entertaining country correspondents. Although such expenditure is not incurred in the production of income, it is expenditure connected directly with his profession.

It was apparently to meet cases such as these that section 11 (2) (*p*) was introduced to permit as a deduction so much of the expenditure (including club subscriptions) but not exceeding £150 incurred by a taxpayer during the year of assessment in respect of entertainment as the Commissioner is satisfied was incurred directly in connection with his trade and which is not expenditure that can be deducted under section 11 (2) (*a*).

It would seem, therefore, that the effect of section 11 (2) (*p*) is to widen the allowance in respect of entertainment expenditure and to grant it in cases where it is necessary for the taxpayer in the course of his trade to belong to clubs, etc., and to incur entertainment expenses although such expenses are incurred in the protection of income and not in the production of income.

In view of the use of the word *trade* in section 11 (2) (*p*), which is defined in section 7 and includes 'any employment', it is submitted that there may be cases where a person receiving income from employment is entitled to a deduction provided that he can satisfy the Commissioner that the entertainment expenditure was connected directly with his employment.

[57] *First and Final Report,* p. 10, para. 39.
[58] I.T.C. No. 676, 16 S.A.T.C. 243.

The words 'as the Commissioner is satisfied' in section 11 (2) (*p*) confer on the Commissioner a discretionary power so that any decision by him, if properly and *bona fide* made, is not subject to review by the courts.

In practice, the Commissioner permits medical and dental practitioners to deduct entertainment expenses in terms of section 11 (2) (*p*) on the understanding that the amount deductible may not exceed $2\frac{1}{2}$ per cent of the gross fees earned for the particular year of assessment subject, however, to the maximum allowance of £150. If, in any case, $2\frac{1}{2}$ per cent of the gross fees is less than the maximum of £150, a higher amount may be deducted provided that the taxpayer can substantiate a claim to a higher deduction (not exceeding £150). This procedure also applies to other practitioners. For example, accountants, attorneys and advocates receive an allowance based on 5 per cent of the gross fees. Specialist doctors also receive 5 per cent.

Although a claim for the allowance must be made, the Department does not require the taxpayer to prove his claim. The requisite percentage is simply applied to the gross fees and the allowance is granted irrespective of whether entertainment expenditure has in fact been incurred within the limits laid down in the section. To many a professional man this allowance is something like a 'bonsella'. For example, if his marginal rate of tax is 8*s*. in the £, the grant of the maximum allowance will mean a reduction in tax amounting to £60.

§ 159. Contributions to pension, provident and benefit funds

Section 11 (2) (*i*) and 11 (2) (*i*) *bis* set out the extent to which employees and employers are permitted to deduct from their incomes any contributions which they make to pension funds, benefit funds and provident funds. This matter is dealt with fully in §§ 191 and 192.

§ 160. Special deductions to mining and shipping concerns

In terms of section 11 (2) (*f*), a capital expenditure redemption allowance, to be ascertained under the provisions of section 20, is granted to mining concerns and they are also entitled to a special deduction in respect of prospecting expenses in terms of section 11 (2) (*f*) *bis* (see Chapter 11, part III).

As regards Union shipowners, they are granted annually a 'straight line' allowance of 10 per cent on the cost of ships instead of the ordinary wear-and-tear allowance (section 11 (2) (*d*) *ter*), a special initial allowance of 40 per cent in respect of the cost of a ship (section 11 (2) (*d*) *quat*) and a reserve for expenditure on future repairs (section 11 (2) (*n*)). Provision has been made in section 11 (4) (*b*) for the placing to reserve and not taxing immediately any recoupment that might result from the loss, sale or disposal of a ship subject to the compliance with certain requisites.

§ 161. PENSIONS TO RETIRED EMPLOYEES AND THEIR DEPENDANTS

In terms of section 11 (2) (*i*) *ter*, a taxpayer can deduct from his income any amount paid by way of annuity during the year of assessment to former employees who have retired on grounds of old age, ill-health or infirmity or to the dependants of former employees subject to the limitations referred to in the section. See § 186 for a fuller discussion on this topic.

§ 162. DENTAL AND MEDICAL FEES

Statutory provisions

Section 11 (2) (*r*) entitles the taxpayer to a deduction, not exceeding £100 per annum, in respect of fees which the Commissioner is satisfied were paid during the year of assessment to dentists and medical practitioners for dental and medical services rendered to, or to any duly registered nursing-home or hospital in respect of the illness of, the taxpayer, his wife and children or stepchildren qualifying for the child rebate. Fees paid by the taxpayer during the year of assessment to any nursing-home in connection with the confinement of his wife also qualify for the allowance. In practice it would seem that fees payable to registered nursing-homes and hospitals in other countries qualify for the allowance.

It is to be observed that to qualify for deduction the dental and medical fees must have been *paid* during the year of assessment. It is not sufficient that the taxpayer has incurred a legal liability in respect of such fees during the year of assessment. Thus, if the cost of an operation performed on a taxpayer in June, 1958, is only paid by him in August, 1958, the deduction can be claimed only in the 1959 tax year and not in the 1958 tax year. To qualify for deduction, fees to hospitals and nursing-homes must also have been paid during the tax year. The effect of this requirement is that death-bed expenses are not deductible in the assessment up to the date of death if paid by the estate.

Fees paid for dental, medical and hospitalization services do not include chemist accounts and the cost of medicines, drugs, etc. Whereas a fee paid to an eye specialist for testing the taxpayer's eyes would qualify for deduction, the cost of acquiring spectacles from an optician, even if on the advice of the specialist, would not rank as a deduction. In practice, the Commissioner allows the cost of dentures as a deduction.

Taxpayers who are members of a medical benefit fund, can only deduct that portion of the fees for which they are liable and which have been paid by them during the tax year.

It must be noted that the taxpayer cannot claim the maximum allowance of £100 in respect of himself, his wife and each of his children qualifying for the child rebate. All the fees must be aggregated and allowed in full up to a maximum amount of £100.

On a strict interpretation, 'dentist' and 'medical practitioner' must be given the meaning those terms bear in the Medical, Dental and Pharmacy Act,[59] i.e. they must be persons registered as such under the Act. Thus, they do not include, for example, nurses, midwives and masseurs or physiotherapists, and it would seem that fees paid to these persons do not rank as a deduction in terms of section 11 (2) (*r*). In practice, however, the Department permits an allowance in respect of fees payable to doctors and dentists registered under the laws of other countries.

It is to be observed from the terms of section 11 (2) (*r*) that the Commissioner must be satisfied that the fees were paid for the dental, medical and hospitalization services set out in the section. The onus of proof is therefore on the taxpayer. Receipts or other proof of payment are required.

It is expressly provided that the deduction must be made notwithstanding the provisions of section 12 (*a*), (*b*) and (*g*) which ordinarily prohibit the cost incurred in the maintenance of the taxpayer, domestic or private expenses, and expenditure not wholly or exclusively laid out or expended for the purposes of trade.

In terms of the strict law, the allowance is only deductible from income derived from the carrying on of a trade (see § 128). In practice, the allowance is granted in cases where the taxpayer's income is derived from interest, pension, or annuity. The allowance cannot, however, be deducted from dividend income as it is only deductible in the normal tax assessment and not in the super tax assessment. It is not an essential requirement of the section that the expenditure must be incurred in the Union. Expenditure incurred outside the Union may rank as a deduction. Thus, non-residents are entitled to the allowance.

Criticisms

There are a number of criticisms which can be offered in regard to the deduction of medical and dental fees not exceeding £100. In its present form, the allowance gives unequal relief as between rich and poor. To the taxpayer earning £1,000 per annum, an allowance of £100 for medical expenses means a saving of some £10 in tax if he is married, and £12 if he is unmarried. On the other hand, to the taxpayer in the higher income groups, the saving in tax may be £37 10*s*. 0*d*. if his marginal rate is 7*s*. 6*d*. per £, £50 if the marginal rate is 10*s*. per £, and £62 10*s*. 0*d*. if he is subject to the maximum rate of 12*s*. 6*d*. per £. There is no good reason for favouring the wealthy taxpayer as against the less well-off taxpayer. The concession in effect means that to a taxpayer in the lower income group, a doctor's visit costing 15*s*. involves him in a liability of 13*s*. 6*d*. (the 1*s*. 6*d*. representing the saving in tax). To the rich taxpayer, however, who is subject to the maximum tax rate of 12*s*. 6*d*., a doctor's visit costs only about 6*s*. If the intention of the legislator was to grant some relief in respect of personal and domestic obligations, one wonders why the concession was given in the form of a deduction from income when all other personal concessions are given by way of

[59] Sec. 96(3) of the Medical, Dental and Pharmacy Act, No. 13 of 1928.

a rebate from the tax payable. All that was necessary was to increase the primary rebate of £31 in the case of a married person and £23 in the case of an unmarried person. This method would involve the Department in far less work and trouble since at present the assessors must of necessity call for and scrutinize the vouchers in support of the taxpayer's claim. It would also cause far less trouble to the taxpayer in having to obtain and preserve his receipts and to the doctor and the dentist who are being continually approached for copies of lost receipts.

The grant of an allowance in respect of medical and dental expenses is not without precedent. For example, in Australia, medical, dental and optical expenses, including not more than £30 for dental expenses, are deductible up to an amount not exceeding £150 on account of any one person. In Canada, an allowance is given for medical expenses equal to that portion of medical expenses in excess of 3 per cent of the taxpayer's income for the year limited to \$2,000 for married persons, \$1,500 for single persons and \$500 for dependants (with a limit of \$2,000 for all dependants). In the United States of America, the taxpayer can deduct only those permissible items of medical and dental expenses which exceed 3 per cent of his adjusted gross income subject to a specified maximum allowance. The method adopted in Canada and the United States of America follows the principle that there should be special allowances for abnormal expenditure, which is no doubt the correct approach, since the taxpayer needs the tax concession most when his expenses are abnormally high.

It is also worth mentioning that in the Federation of Rhodesia and Nyasaland an allowance in respect of medical and dental expenses is only granted in respect of expenditure exceeding £50. The allowance is in the form of a rebate deductible from the tax payable. The effect of the law is now also such that medical and dental fees incurred by a taxpayer before his death and defrayed out of his estate, are to be treated as having been defrayed by the taxpayer immediately before the date of his death. This is clearly equitable and should be followed in the Union.

§ 163. Disabled persons

Section 11(2)(*q*) authorizes a deduction, not exceeding £150 per annum, to any physically disabled person whose taxable income (before allowing this special deduction) and dividends do not exceed £1,500 per annum, in respect of expenditure, whether revenue or capital expenditure, as the Commissioner is satisfied was necessarily incurred by such person in consequence of his disability and for the purpose of carrying on his trade, and which is not expenditure deductible under any other paragraph contained in section 11(2). By virtue of this concession, a cripple, for example, would be able to deduct the cost of a wheel-chair. All expenditure which physically disabled persons have to incur to perform their work properly or even to retain it, appears to be deductible in terms of section 11(2)(*q*), subject to the limitation provided for. Thus, expenses incurred by a cripple on travelling from his residence to his place of business would be deductible. A claim for an allowance in respect of expenditure on spectacles will also be considered if accompanied by a certificate from an eye specialist or a qualified optician to the effect that the expenditure was necessarily incurred in consequence of defective sight and for the purpose of carrying on the taxpayer's trade.

§ 164. Post-graduate study course by doctors and dentists

Section 11(2)(*s*) provides that the Commissioner may allow as a deduction so much of any expenditure incurred by any dentist or medical practitioner in respect of whom the Dental Association of South Africa or the Medical Association of South Africa certifies, in such form as the Commissioner may prescribe, that such practitioner has practised his profession for not less than three years and has incurred such expenditure during the year of assessment in respect of the attendance by him of any post-graduate study course approved by such Association, to improve his qualifications for the carrying on of his profession in the Union. Expenditure in this regard will include the cost of travelling as well as living and subsistence expenses, but not the expenditure attributable to his wife or family who may accompany him. It is expressly provided that the deduction must be made notwithstanding the provisions of section 12(*a*) and (*b*) which ordinarily prohibit the cost incurred in the maintenance of the taxpayer and on domestic or private expenses.

The amount to be allowed is at the discretion of the Commissioner and as long as he has applied his mind to the matter and has acted *bona fide* his decision is not subject to review by the courts. The Departmental practice in respect of living expenses is to allow £5 per day in respect of Great Britain and Europe and £7 10*s*. per day in respect of America and Canada for the period of the taxpayer's attendance of the course. Where the course is attended in the Union at a centre other than that in which the taxpayer resides or practises the allowance is £2 5*s*. per day.

Apart from the expenditure specifically referred to in section 11(2)(*s*), no other expenditure incurred on refresher courses undertaken by professional practitioners and others in order to keep abreast of modern developments or for purposes of specialization or further qualification, is deductible. Medical congresses are not regarded as post-graduate study courses.

§ 165. Assessed losses

General principles

If, in any year of assessment, the amounts allowed to be deducted in terms of section 11 exceed the income in respect of which they are so admissible, there arises, in terms of section 11(3), an *assessed loss*.

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General principles

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An assessed loss incurred in any year of assessment can be carried forward to the next succeeding year of assessment and can be set off against any income derived from the carrying on of any trade in such succeeding year — section 11 (3) (*a*). In terms of section 11 (1), deductible amounts can only be deducted from or set off against income derived from the carrying on of any trade (see § 128). Thus, it was held in *S.A. Bazaars (Pty.), Ltd.* v. *C.I.R.*[60] that if in any year of assessment a taxpayer does not carry on a trade, he is not permitted to carry forward to this year any assessed loss established in respect of the immediately preceding year of assessment. In this way, a taxpayer loses his right for ever to carry forward such an assessed loss. The fact that he may start a trade in a later year does not disturb this position. If on 30th June, 1956, A had an assessed loss of £2,000, and in respect of the 1957 tax year he did not carry on a trade but commenced trading in the 1958 tax year when he derived a taxable income of £4,000, the position would be as follows:

1956 *tax year*: Assessed loss £2,000.
1957 *tax year*: NIL ASSESSMENT, i.e. no taxable income or assessed loss (the assessed loss of £2,000 established in 1956 cannot be carried forward as no trade was carried on in 1957).
1958 *tax year*: Taxable income £4,000.

The definition of 'trade' is a very wide one and includes a profession, employment, calling, occupation, any venture and the letting of property (see § 128). Thus, if a taxpayer ceases active business operations in one year having incurred an assessed loss in that year, he will be permitted to carry forward such assessed loss to the next year if, for example, he holds a directorship in a company, is in employment, or is letting property during such year. It is not essential that he must have carried on a *trade* during the whole of the year. Any period of trading during the year will suffice. In the *S.A. Bazaars* case[60] the Court did not decide the question as to whether a taxpayer must actually derive income from the trade carried on in order to be entitled to carry forward the previous year's assessed loss. The Special Court has, however, held that it is essential that a taxpayer derive income from the carrying on of a trade.[61] However, it is interesting to record that in another case[62] the Court considered that an unsuccessful endeavour to let fixed property constituted the carrying on of a trade and permitted the taxpayer to carry forward an assessed loss from one year to the next. During the year of assessment in question, the taxpayer owned certain fixed property but derived no rentals therefrom although he made certain endeavours to let the property. In this case it was not contended by the Commissioner that the taxpayer was not entitled to set off the loss merely because it had no income in the current year and the Court did not, therefore, decide this question.

60 1952 (4) S.A. 505 (A.D.); 18 S.A.T.C. 240.
61 I.T.C. No. 664, 16 S.A.T.C. 125.
62 I.T.C. No. 777, 19 S.A.T.C. 320.

In spite of its wide meaning, the definition of 'trade' does not embrace all the activities of a taxpayer which might be productive of income. For example, a person whose income consists solely of an annuity or pension or interest or dividends from the investment of surplus funds, is not carrying on a trade within the meaning of the definition in section 7. Accordingly, it would seem that if a taxpayer, having incurred an assessed loss in a business, stops trading and purchases an annuity with his capital, he is not entitled to set off the assessed loss incurred against the annuity since the set-off of the loss is only admissible against income derived from the carrying on of a trade, and as the mere receipt of an annuity does not constitute a trade, the set-off of the loss is not permissible.

In terms of the definition of *assessed loss*, an assessed loss must be established to the satisfaction of the Commissioner, and in the absence of proper books and records, it would indeed be difficult, if not impossible, for a taxpayer to convince the Commissioner that he has incurred an assessed loss. Although the Commissioner has the power to estimate the income of a taxpayer in terms of section 64(1), he has no power to estimate an assessed loss.

It is provided in section 11(3)(*b*) that where a taxpayer, either alone or in a partnership with others, incurs an assessed loss in one trade, he can set off that loss against any other income from trade that he may have derived during the same year of assessment. Thus, if in the 1958 tax year Z received a salary from employment of £1,000 and during the same year incurred an assessed loss of £250 from the carrying on of a hardware business, his taxable income is £750 (£1,000 *less* £250) for the year. Similarly, if Z, in respect of the 1958 tax year, has derived a taxable income of £1,500 from the carrying on of a profession, but is an equal partner in a farming business which has an assessed loss of £1,400 for the year, Z is entitled to set off his half-share in the partnership loss, viz. £700, against the taxable income of £1,500 derived from his profession, leaving a final taxable income of £800. It is, of course, clear that a shareholder in a company cannot claim as a deduction in the determination of his taxable income his proportionate interest in any assessed loss incurred by such company. This principle is reaffirmed in section 12(*i*) in so far as concerns shareholders in private companies.

Ordinarily, where a taxpayer in any year of assessment derives a taxable income from more than one trade, it does not matter against which particular trade an assessed loss incurred in the previous year is set off since the taxable income from the various trades must be aggregated and the tax levied on the taxable income taken as a whole. A problem does, however, arise where a taxpayer carries on mining operations and in addition exercises other trades. As different normal tax rates are prescribed for companies in respect of taxable income derived from mining operations, the question arises as to how an assessed loss incurred in a previous year must be dealt with in the next tax year in the case of such a company which derives a taxable income from mining as well as from other trades. It is submitted

In spite of its wide meaning, the definition of 'trade' does not embrace all the activities of a taxpayer which might be productive of income. For example, a person whose income consists solely of an annuity or pension or interest or dividends from the investment of surplus funds, is not carrying on a trade within the meaning of the definition in section 7. Accordingly, it would seem that if a taxpayer, having incurred an assessed loss in a business, stops trading and purchases an annuity with his capital, he is not entitled to set off the assessed loss incurred against the annuity since the set-off of the loss is only admissible against income derived from the carrying on of a trade, and as the mere receipt of an annuity does not constitute a trade, the set-off of the loss is not permissible.

In terms of the definition of *assessed loss*, an assessed loss must be established to the satisfaction of the Commissioner, and in the absence of proper books and records, it would indeed be difficult, if not impossible, for a taxpayer to convince the Commissioner that he has incurred an assessed loss. Although the Commissioner has the power to estimate the income of a taxpayer in terms of section 64(1), he has no power to estimate an assessed loss.

It is provided in section 11(3)(*b*) that where a taxpayer, either alone or in a partnership with others, incurs an assessed loss in one trade, he can set off that loss against any other income from trade that he may have derived during the same year of assessment. Thus, if in the 1958 tax year Z received a salary from employment of £1,000 and during the same year incurred an assessed loss of £250 from the carrying on of a hardware business, his taxable income is £750 (£1,000 *less* £250) for the year. Similarly, if Z, in respect of the 1958 tax year, has derived a taxable income of £1,500 from the carrying on of a profession, but is an equal partner in a farming business which has an assessed loss of £1,400 for the year, Z is entitled to set off his half-share in the partnership loss, viz. £700, against the taxable income of £1,500 derived from his profession, leaving a final taxable income of £800. It is, of course, clear that a shareholder in a company cannot claim as a deduction in the determination of his taxable income his proportionate interest in any assessed loss incurred by such company. This principle is reaffirmed in section 12(*i*) in so far as concerns shareholders in private companies.

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A similar problem arises in the case of a company which carries on a mining activity and other trade activities and which in respect of a year of assessment incurs an assessed loss in one trade but derives a taxable income from the mining activity and the other non-mining trades. The Special Court has held[63] that in such a case the assessed loss must be apportioned rateably between the income from mining and the income derived from the other non-mining activities. The question as to whether the assessed loss must be apportioned rateably between the incomes of the income-producing trades or between their taxable incomes did not appear to be an issue before the Court. As section 11(3)(*b*), read with section 11(1), requires that the assessed loss must be set off against the *income*, as defined by section 7, derived by the different trades, it is submitted that the assessed loss must be apportioned among the trades pro rata to the *income* derived from each.

Special provisions in regard to assessed losses

The following special provisions apply to an assessed loss incurred by a taxpayer:

(1) Where a taxpayer's estate has been voluntarily or compulsorily sequestrated and the sequestration order has not been set aside, any assessed loss incurred prior to the date of sequestration cannot be carried forward — section 11(3)(*a*)(i). Even if the taxpayer is subsequently rehabilitated, he is debarred from carrying forward the assessed loss incurred prior to sequestration.

(2) The amount or value of any benefit received by or accruing to a taxpayer during a tax year resulting from a concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, such liabilities having arisen in the ordinary course of trade, must, in terms of section 11(3)(*a*)(ii), be deducted from any balance of assessed loss. Such a benefit, it is submitted, is not subject to tax (see § 168) but must be utilized to reduce an assessed loss, and if the value of the benefit exceeds the assessed loss, the excess is not taxable. Thus, if the assessed loss, which is subject to reduction, is £10,000, and during the tax year in question creditors whose claims amount to £20,000 have agreed to accept 16*s*. in the

[63] I.T.C. No. 770, 19 S.A.T.C. 216.

£ in full settlement, the value of the benefit being £4,000 (4*s.* in the £ on £20,000), the assessed loss must be reduced to a sum of £6,000 (£10,000 *less* £4,000). If the creditors had compromised for 7*s.* 6*d.* in the £, the value of the benefit would have been £12,500 (12*s.* 6*d.* in the £ on £20,000), which would have meant that the assessed loss of £10,000 would have been wholly extinguished.

It is submitted that the provisions of section 11 (3) (*a*) (ii) do not only refer to a case where a debtor makes an arrangement with all his creditors as a body for releasing him wholly or partially from his debts. It applies also to cases where a creditor on his own initiative releases a debtor from either the whole or portion of a debt, e.g. in the case of a parent company and its subsidiary company, or where he makes a compromise with only some of his creditors.

Liabilities arising 'in the ordinary course of trade', it is submitted, refer to liabilities incurred on income or revenue account, e.g. debts incurred in respect of goods purchased for resale, and do not include liabilities incurred on capital account, e.g. moneys borrowed or debts incurred for the purchase of fixed capital assets such as factory buildings, plant and machinery, etc.

Section 11 (3) (*a*) (ii) only applies where creditors have definitely waived their right to claim either the whole or portion of the amounts owing to them. It cannot be invoked in a case where there has been no waiver or release by a creditor even though the creditor may choose to write off the debt as bad or irrecoverable in his books.

The Appellate Division has ruled[63a] that, in terms of section 11 (3) (*a*) (ii), it is the balance of assessed loss incurred in respect of a particular tax year that must be reduced to the extent of the value of any compromise benefit received during such tax year. It rejected a submission that it is the balance of assessed loss incurred by the taxpayer in a previous year which has been carried forward from the preceding year of assessment that must be reduced to the extent of the compromise benefit received in the current year and that section 11 (3) (*a*) (ii) does not apply to an assessed loss incurred in the same tax year in which the compromise benefit accrued. The Court held that the value of a compromise benefit received in one tax year must, in terms of section 11 (3) (*a*) (ii), go to reduce any balance of assessed loss incurred at the end of that year. It must not reduce the balance of assessed loss incurred at the end of the preceding year of assessment and which is carried forward to the year in which the compromise benefit is received. The Court did not find it necessary to decide whether section 11 (4) (*a*) is wide enough to include a compromise benefit as a tractable recoupment.

In the special circumstances set out in section 90 (1) (*b*), a company may be prohibited from setting off an assessed loss against other income derived by it (see § 274). This provision is necessary

[63a] *C.I.R.* v. *The Louis Zinn Organisation (Pty.), Ltd.* (Judgment delivered by the Appellate Division on 30th September, 1958 — at the date of going to press the case had not yet been reported in the S.A. Law Reports or in the S.A. Tax Cases.)

because the carry-forward of assessed losses, as authorized by section 11(3), lends itself to tax avoidance by the trafficking in assessed losses of companies.

Criticisms

It is manifestly inequitable that the temporary cessation of trade should preclude the taxpayer from carrying forward to a year when trade recommences any assessed loss which was incurred prior to such cessation of trade and which has not been utilized as a set-off against subsequent profits. Although income tax is an annual impost, it is fundamentally equitable that liability to tax should be measured by the net profits over the period of the life of the taxpayer. This principle should not be abandoned merely because of the temporary cessation of trade. In Canada, a taxpayer may deduct from income losses sustained in the five tax years immediately preceding the current tax year. In Australia, a taxpayer may deduct losses incurred during the seven years next preceding the year of income. Both in the United Kingdom and the Federation of Rhodesia and Nyasaland, losses can be carried forward indefinitely. The temporary cessation of trade is not a factor for determining whether the loss can be carried forward or not. The Committee of Enquiry into the Income Tax Act was of the opinion that the carrying forward of losses where the taxpayer ceases to carry on trade for any period should be permitted and that the period over which such assessed losses may be carried forward should not be limited.[64] For reasons which appear to be entirely unsatisfactory, the Income Tax Commission rejected this recommendation.[65] It considered that the Commissioner should have discretionary power, which should not be subject to objection and appeal, to decide whether any loss incurred by a company, which through no fault of its own has not been able to carry on business during the year, should be carried forward for set-off against the income of a later year. It is not understandable why the Commission concerned itself with companies only. Moreover, the Commission's reasoning leads one to the conclusion that it misunderstood the purpose and the effect of the proposal of the Committee of Enquiry.

The Union Act does not contain provisions for the carry-back of assessed losses so that a taxpayer who in earlier years has earned a taxable income and has paid tax thereon can obtain a refund of such tax if in a later year he has incurred an assessed loss. In the United Kingdom, provisions exist for losses to be carried back three years upon cessation of trade. In Canada a loss may be carried back one year in any case. No similar provisions exist in Australia and New Zealand. In the Federation of Rhodesia and Nyasaland, mining concerns can carry back capital expenditure redemption allowances to which they are entitled on the cessation of trade for a period of six years. The absence of provisions for the carry-back of assessed losses can cause serious hardship to a taxpayer. Take the case of a taxpayer who sells an asset acquired for speculation, payment to be

[64] *First Report*, p. 29, para. 33.
[65] *First and Final Report*, p. 11, para. 40.

made in a later tax year. He is taxable on the sale price in the year of accrual. If the debtor defaults and fails to pay, it is poor consolation for the taxpayer to know that he can claim the bad debt as an allowable deduction and thus create an assessed loss. He has paid tax on income which he has not received. In the writer's view, it is only equitable that he should be permitted to carry back the loss and claim a refund of the tax paid in the earlier year. The Committee of Enquiry into the Income Tax Act was unable to support a suggestion that taxpayers should be given the option to carry back losses for two years. In its opinion, as this would imply a repayment of tax assessed in respect of previous years, it must inevitably give rise to budgetary and administrative difficulties.[66]

From the definition of 'assessed loss', it will also be observed that only the deductions admissible under section 11 must be taken into account in order to arrive at the assessed loss of the taxpayer. Thus, it would appear that the special allowance granted to hire-purchase traders, in terms of section 22, does not come into the computation of assessed loss. In practice, the Commissioner's ruling is that the special allowance must be limited to an amount sufficient to reduce the taxable income to zero; it cannot be used to create or increase an assessed loss. What of the various deductions allowable to farmers in terms of the Third Schedule to the Income Tax Act? Are they to be taken into account in the computation of an assessed loss? It is submitted: Yes. Section 14 lays down that the taxable income of a farmer must be determined 'in accordance with the provisions of the Act but subject to the Third Schedule thereto'. Thus, in terms of section 11(1), read with section 14, a farmer is entitled to deduct from his income not only the amounts set out in section 11 but also all the amounts allowed to be deducted in terms of the Third Schedule. There is also nothing in the Third Schedule which can be held to exclude section 11(3) which deals with assessed losses.

The definition of 'assessed loss' would appear to raise a further difficulty. It means 'any amount, as established to the satisfaction of the Commissioner, by which the deductions admissible under this section (section 11) exceeded the income in respect of which they are so admissible . . .'. Now, in terms of section 11(1), the income in respect of which the deductions are permissible is only the trade income of the taxpayer and not his non-trade income. Strictly speaking, therefore, it would appear that non-trade income does not come into the computation of assessed loss although it is part of the taxable income as defined in terms of section 7, viz. 'the amount remaining after deducting from the income of any person all the amounts . . . allowed to be deducted or set off under this Chapter'. Anomalous results could possibly arise if this interpretation is correct. For example, take the case of a taxpayer who carries on a trade and derives income therefrom of £10,000 and incurs expenditure in respect thereof amounting to £15,000. In addition his non-trade

[66] *First Report*, p. 29, para. 33.

income amounts to £5,000. In terms of the definition of 'taxable income' there is no amount remaining after deducting from the income (£10,000 trade income *plus* £5,000 non-trade income) the allowable deductions (£15,000). Thus, the taxable income is nil. Yet, in terms of the definition of 'assessed loss', there is an assessed loss of £5,000 (the amount by which the deductions, viz. £15,000, exceed the income in respect of which the deductions are permissible, viz. £10,000). This is clearly an anomalous position which could never have been intended by the Legislature. The taxpayer's net income is nil and yet on the definition of 'assessed loss' it would appear that there is an assessed loss of £5,000 which can be carried forward to a subsequent tax year. If the non-trade income is, say, £8,000, the taxable income would be £3,000 (£10,000 trade income *plus* £8,000 non-trade income *less* £15,000 allowable deductions) whereas on the definition of 'assessed loss', there arises an assessed loss of £5,000. There is, therefore, another good reason for the deletion from section 11(1) of the words 'from carrying on any trade within the Union' (see § 128). Alternatively the definition of 'assessed loss' should be amended. Perhaps the best method is to deal with it in section 7 where the definition of 'taxable income' is to be found. It should be made clear that assessed loss is the difference between the taxpayer's total income (trade income as well as non-trade income) and all the permissible deductions (whether under section 11 or under any other section, i.e. the Third Schedule and section 22).

Assessed losses and undistributed profits tax

A further problem that arises in connection with assesed losses is how they should be dealt with in the computation of the 'total net profits' for undistributed profits tax purposes, as defined in section 50.

Since the *total net profits* must be calculated 'in the manner prescribed for the determination for normal tax purposes of taxable income' it is submitted that an assessed loss established for normal tax purposes in respect of a year of assessment is deductible from the total net profits in the next succeeding year of assessment. This does not appear to be the practice of the Department. Where the total net profits in respect of any year of assessment result in an excess of deductions over income, i.e. a loss, this is established as a loss for undistributed profits tax purposes and the company is permitted to carry forward this loss to the next tax year for set-off against the total net profits of such year. Since this loss takes into account items disregarded in the determination of taxable income, e.g. dividends and foreign income, it must follow that it is not necessarily the same as a loss established for normal tax purposes. Thus, the Commissioner differentiates between a loss established for normal tax purposes and a loss established for undistributed profits tax purposes.

As regards assessed losses incurred at 30th June, 1954, and which the company was entitled to carry forward for normal tax purposes to the 1955 tax year — the year of commencement of the undistributed profits tax — the Commissioner had ruled that such an assessed loss established at 30th June, 1954, could, subject to certain adjustments, be carried forward to the 1955 tax year as a set-off against the total net profits for the purposes of undistributed profits tax for that year.

The adjustments referred to were made on the basis of determining what the loss would have been had such loss, during the period over which it was built up, been determined in accordance with the definition of *total net profits*. This meant that the following adjustments were necessary in respect of the assessed loss established for normal tax purposes at 30th June, 1954:

(1) The loss had to be decreased by —

(*a*) the amount of any dividends received (*less* expenditure incurred in earning them) during the period over which the loss has been built up whether such dividends have been received from sources in or outside the Union;

(*b*) the amount of income received from sources outside the Union (*less* allowable expenditure) during the relevant period. Where, however, the allowable expenditure exceeded the income, for example a company may have incurred a loss from the carrying on of trading operations outside the Union, the loss at 30th June, 1954, must be increased to this extent;

(*c*) the amount of any income exempt from tax in terms of section 10(1)(*h*) and (*i*) received during the relevant period.

(2) The loss had to be increased by —

(*a*) the amount of any unrecouped expenditure (not of a capital nature) incurred during the relevant period and not allowed for normal tax purposes in terms of section 11(2)(*a*);

(*b*) any losses incurred from the carrying on of trading operations outside the Union (see (1)(*b*) *supra*).

It will be observed that all the above items must be taken into account in the determination of *total net profits* in terms of the definition in section 50.

In *C.I.R.* v. *African Properties & Industries, Ltd.*,[66a] the Court held that there was no warrant for the Commissioner's practice. The *ratio* of the decision was that in determining the 'total net profits' in respect of any year of assessment, there must be deducted any assessed loss as determined for normal tax at the end of the previous year. It would seem, therefore, that the Departmental practice of determining a separate assessed loss for undistributed profits tax purposes is not correct in law.

[66a] Decided by the Cape Provincial Division of the Supreme Court. So far not reported in S.A. Law Reports or in S.A. Tax Cases. For a detailed report, see 7 (1958) *The Taxpayer* 70.

The Court's interpretation, however, results in certain glaring anomalies. Since dividend income cannot be set off against an assessed loss for normal tax purposes, it must follow that a company with an assessed loss is able to accumulate dividend income free of all taxes for so long as it has an assessed loss. By way of illustration take the case of a company with the following history:

	Year I	*Year II*	*Year III*
Trade Loss	£10,000	——	——
Trade Income ..	——	£1,000	£1,000
Dividends	£10,000	£10,000	£10,000

In Year I, the total net profits for undistributed profits tax purposes is *nil* (£10,000 *less* £10,000). The assessed loss for normal tax purposes is, however, £10,000, i.e. the trading loss.

In Year II, the total net profits is £1,000 (£10,000 dividends *plus* £1,000 trade income *less* the assessed loss of £10,000 from Year I). The assessed loss for normal tax purposes is £9,000 (the assessed loss of £10,000 from Year I *less* the trade income of Year II).

In Year III, the total net profits is £2,000 (£10,000 dividends *plus* £1,000 trade income *less* the assessed loss of £9,000 from Year II).

It will be observed, therefore, that over the three years although the actual net income is £22,000, the total net profits for undistributed profits tax purposes is only £3,000! On the Departmental practice, the company would have total net profits of nil in Year I, £11,000 in Year II and £11,000 in Year III.

A further anomaly arising from the Court's interpretation and which benefits the *fiscus* concerns companies which sustain losses from the carrying on of business outside the Union. A loss from trading incurred outside the Union is not taken into account in the determination of an assessed loss for normal tax purposes. Let the case be taken of a company with the following history:

	Year I	*Year II*	*Year III*
Trading loss outside Union ..	£40,000	——	——
Dividends	£10,000	£10,000	£10,000

In Year I, the total net profits is *nil* since there is a net loss of £30,000.

In Year II, the total net profits is £10,000 since the loss of £30,000, not being an assessed loss, cannot be carried forward for normal tax purposes from Year I.

In Year III, the total net profits is £10,000.

Thus, it would appear that whereas over the three years the company had actually sustained a loss of £10,000, the total net profits for undistributed profits tax is £20,000! On the Departmental practice, the company would have total net profits of *nil* in Year I (a loss of £30,000 being carried forward to Year II for undistributed profits tax purposes), *nil* in Year II (a loss of £20,000 being carried forward to Year III), and *nil* in Year III (a loss of £10,000 being carried forward to Year IV).

There can be no quarrel with the Commissioner's practice which is both logical and equitable and overcomes the glaring anomalies described above. It is a matter for regret that so far suitable provision has not been made to embody the practice in the Act.

IV. Recoupment of Amounts Previously Deducted

§ 166. Nature of recoupments

In terms of section 11 (4) (*a*), there must be included in a taxpayer's income, and hence in his gross income (see section 7 (*b*)), all amounts allowed to be deducted under section 11 (whether the deductions occur in the current year or took place in any previous year of assessment), which have been recovered or recouped during the current year of assessment.

Some examples are:

(1) Recovery of a debt which has previously been written off as bad under section 11 (2) (*g*) (§ 152).

(2) Recoupment of wear-and-tear and new machinery allowances made in terms of section 11 (2) (*d*) and section 11 (2) (*d*) *bis*, by virtue of the sale or other disposal of an asset at a price in excess of its written down income tax value (see § 149 and § 150).

(3) Recoupment of lease premium allowances and allowances in respect of leasehold improvements, made in terms of section 11 (2) (*e*) (§ 154) and section 11 (2) (*e*) *bis* (§ 155), upon the cession or sale of a lessee's rights under a lease, at a price in excess of the written down income tax value of the lease.

(4) Recoupment of the allowance made in respect of employees' housing, in terms of section 11 (2) (*o*) (§ 156) by virtue of the sale of an employee's house at a price in excess of its written down income tax value, or by virtue of the repayment of a loan by an employee.

Section 11 (4) (*a*) expressly provides that the following recoupments must be excluded from its ambit and are, therefore, not taxable:

(*a*) recoupment of pension fund contributions by an employee even though such employee was entitled to deduct these contributions from his income in terms of section 11 (2) (*i*) (see § 191);

(*b*) recoupment of scientific research expenditure, whether revenue or capital expenditure, which a taxpayer was entitled to deduct under the provisions of section 11 (2) (*j*) *bis* and 11 (2) (*j*) *ter* (see § 157).

The principle underlying the taxation of recoupments is that an over-deduction must be adjusted and is, therefore, eminently fair. If the deductions from income which had been made in the past had been larger than they should have been, the income, has, therefore, been assessed at too low a figure. It is to make up for that loss of revenue in the past that section 11 (4) was inserted into the Income Tax Act.

It is immaterial whether the amount recovered or recouped is part of a receipt of a capital nature or not.[67] A recoupment of wear-and-tear allowances and new machinery allowances can result not only from a sale, 'trade-in' or other form of realization of the asset but also from a receipt of money derived from an insurance company representing compensation received upon the destruction of the asset by fire or some other hazard.[67a] Thus, if plant and machinery is destroyed by fire, and, say, £10,000 compensation is received from the insurer, then assuming that the income tax value of the asset is £6,000 and that £3,000 wear-and-tear allowances have been granted by the Receiver in previous years, it must follow that the recoupment to be taxed is £3,000. If the taxpayer has a high marginal rate of tax, a substantial portion of the recovery from the insurer may have to be paid away in tax owing to taxable recoupments.

In terms of the proviso to section 7 (*b*), all amounts required to be included in the taxpayer's income in terms of section 11 (4) (*a*) are deemed to have been derived from a Union source notwithstanding that the amounts may have been recovered or recouped outside the Union. This provision was necessary to prevent tax avoidance since without it taxpayers could arrange to sell their fixed assets, which have been subject to wear-and-tear allowances in previous years, in places outside the Union and possibly claim that any recoupment of such allowances accrues from a source outside the Union.

Section 11 (4) (*a*) includes a recovery or recoupment of amounts incorrectly deducted by the Commissioner owing to an erroneous interpretation of the law.[68]

It is important to remember that the recoupment is taxable in one sum in the year in which it occurs and that it is not competent for the taxpayer to elect that previous years' assessments be adjusted instead.[69] There is no provision in the Act for the reopening of assessments in such circumstances. This is indeed inequitable for it means that a taxpayer may be subject to a heavy progressive rate of tax on an amount which is taxable all in the one year. It is only fair and reasonable that the Commissioner should be given power to reopen assessments made in previous years. In this respect, the law in New Zealand (section 117), in terms of which the Commissioner is entitled to reopen past years' assessments for the purpose of subjecting to tax excess depreciation, is more satisfactory.

In the case of a 'lock-stock-and-barrel' sale of a business with depreciated assets where the purchase price is not allocated to any

[67] I.T.C. No. 559, 13 S.A.T.C. 306; I.T.C. No. 681, 16 S.A.T.C. 357; I.T.C. No. 699, 17 S.A.T.C. 98.
[67a] *Moorreesburg Produce Co., Ltd.* v. *C.I.R.*, 1945 C.P.D. 289; 13 S.A.T.C. 245.
[68] *Turnbull* v. *C.I.R.*, 1953 (2) S.A. 573 (A.D.); 18 S.A.T.C. 336.
[69] I.T.C. No. 681, 16 S.A.T.C. 357.

particular asset, the Commissioner is at liberty to place a reasonable value on the various assets sold in order to determine any recoupment of allowances for wear and tear. In one case, it was contended by the taxpayer that all the profit made on the realization of a business was on account of goodwill, but the Court found that in the absence of any stipulation in the agreement as to the amount that was to be paid for any goodwill, no portion of the profits could be attributed to goodwill, and that the Commissioner had acted reasonably in treating certain of the profits as being a recoupment of wear and tear previously allowed.[70] It may perhaps be advisable to have a special provision whereby the Commissioner is permitted to determine the value of any particular asset sold with other business assets for a lump-sum consideration for the purpose of determining any taxable recoupment. Precedent for such a provision is to be found in section 117(3)(*a*) of the New Zealand Act.

On the sale of an asset which was originally acquired for no consideration, e.g. by way of donation or inheritance, it is submitted that the proceeds are taxable in terms of section 11(4)(*a*) to the extent to which they represent a recoupment of wear-and-tear allowances previously made and that no account need be taken of the value of the asset at the date of acquisition. As the asset did not cost its owner anything, it must follow that the proceeds derived on a sale represent a recoupment or recovery of wear-and-tear allowances previously made. Only the excess of the proceeds over the allowances previously made would not be subject to tax. Thus, if an asset valued at £800 is inherited and used in a business and after wear and tear totalling £400 has been allowed as a deduction it is sold for £500, it is submitted that the recoupment taxable in terms of section 11(4)(*a*) is £400. Logically, what should be taxed is the excess of the sale price of the asset over its value at the date of acquisition as reduced by the wear-and-tear allowances but only to the extent of the allowances made. Thus, in the example given, only £500 *less* (£800 *less* £400), viz. £100, ought to be taxed.

On the other hand, where an asset was originally used elsewhere, e.g. for private or domestic purposes, but is subsequently used for trade purposes, on its ultimate disposal any recoupment or recovery of wear-and-tear allowances must be calculated with reference to its original cost and not to its value at the date when it was introduced into the business. For example, take the case of an asset costing £1,000 introduced into the business at a time when its value was £400. After the Commissioner had allowed £150 wear and tear in respect of this asset, it was sold for £800. It is submitted that there is no recoupment in terms of section 11(4)(*a*) since the taxpayer incurred a loss of £200 on the sale of the asset whereas only £150 was allowed by way of wear and tear. Logically, however, the £150 has been recouped, the asset having been sold for £800 whereas, when it was introduced into the business, its value was only £400.

[70] I.T.C. No. 565, 13 S.A.T.C. 330; see also I.T.C. No. 681, 16 S.A.T.C. 357.

As in the case of the calculation of the wear-and-tear and scrapping allowances in the circumstances mentioned above, it is only fair and equitable that the recoupment should be calculated with reference to the value of the asset at the date of donation or inheritance or in the case of an asset which has been used elsewhere and then brought into the business, with reference to its value at the date when such asset is introduced into the business (see § 151).

In the case of an asset used partly for trade purposes and partly for private purposes, the view has already been expressed that the scrapping allowance must be determined without reference to the fact that the asset has also been used for non-trading purposes (see § 151). This applies equally to the determination of any taxable recoupment, in terms of section 11 (4) (*a*), on the disposal of the asset. It is submitted that for the purposes of determining the recoupment, the entire cost of the asset, the wear-and-tear allowances granted by the Commissioner and the whole proceeds derived on the sale must be taken into account, notwithstanding that the asset was used partly for non-trade purposes.

§ 167. Acquisition of leased property

Section 11 (4) (*c*) provides that any amount which has been paid by a person for the right of use or occupation of any movable or immovable property, e.g. rent, or a premium as envisaged by section 11 (2) (*e*) or section 11 (2) (*e*) *bis*, and has been allowed as a deduction in the determination of such person's taxable income and which is upon the subsequent acquisition of such property by that or any other person applied in reduction or towards settlement of the purchase price of the property, must be included in the income of the person who acquires the property for the year of assessment during which he exercised his option to purchase or for the year of assessment during which he entered into the agreement to acquire the property. Thus, if X, the lessor, agrees to sell for £10,000 the leased property to Y, the lessee, or to any other person at an agreed price *less* whatever amount has been paid by way of rent by Y, say, £3,000, then Y or such other person as has acquired the property, is taxable on the amount of the rent previously allowed as a deduction to Y, viz. £3,000.

It may happen that there is no reduction in the purchase price by the amount of rental paid by the lessee but the property is acquired by the lessee or any other person for a consideration which in the opinion of the Commissioner is not an adequate consideration. In such a case, the difference between the fair market value of the property (as determined by the Commissioner) and the amount of the consideration not exceeding the amount paid for the right of use or occupation of the property, must be deemed to have been applied in reduction or towards settlement of the purchase price of the property and is taxable unless the Commissioner, having regard to the circumstances of the case, otherwise decides. Thus, if A, the lessor, has given B, the lessee, an option to acquire certain property at any time during the currency of the lease at a price of £10,000, and B exercises the option at a time when the market value is £15,000, B is taxable in the year in which he exercises the option on the difference between £15,000 and £10,000, viz. £5,000, or the aggregate amount he has paid for the right of use or occupation and allowed to him as a deduction in previous years, whichever is the lesser. Thus, if £3,000 has been allowed to him as deductions, only £3,000 is taxable. If £8,000 has been allowed to him, £5,000 is taxable. If B has ceded all his rights under the lease to C who exercises the option, it is C who will be taxable on the recoupment in terms of section 11 (4) (*c*), even though C received no deductions from his taxable income in respect of prior rentals paid.

Any decision of the Commissioner under section 11 (4) (*c*) is subject to objection and appeal.

It will be observed that section 11 (4) (*c*) provides for the taking into account of the rental or premium paid by *any* person and not necessarily the person who exercised the option to purchase or entered into the agreement to acquire the property. It was necessary for the legislator to insert this safeguard for otherwise it would have been a simple matter to circumvent the provisions by the person, who was entitled to claim the deduction for rent or premium while he was enjoying the right of use or occupation, not exercising the option to purchase or entering into the agreement to purchase the property but selling or donating his option to purchase to a third party, for example, a company in which he or a member of his family is the sole beneficial shareholder, at the agreed consideration.

The provision may, however, lead to anomalous results in that it may give rise to two taxable recoupments in the hands of two different taxpayers in respect of expenditure allowed only once. For example, take the case of X who hired business premises from Y and who, in addition to the annual rental provided for in the lease, had to pay a premium of £10,000. The lease was for ten years, say, from 1st July, 1952, to 30th June, 1962. X was given an option, exercisable by him at any time after the lease had been in force for five years, to purchase the property at a sworn appraised value *less* an amount equal to the premium of £10,000. On 1st July, 1957, X ceded his rights under the lease to Z for £12,000 and on 31st December, 1957, Z exercised the option and purchased the property for an amount equal to the sworn appraised value less the lease premium of £10,000 originally paid by X.

In the 1958 *tax year, X will be taxed as follows:*

Lease premium deductible in terms of section 11 (2) (*e*)		£10,000
Less allowances (5 years @ £1,000 per annum)	£5,000	
proceeds of cession	12,000	
		17,000
Profit from the income tax point of view		£7,000

Since this profit represents a recoupment of the five years' lease premium allowances deducted in terms of section 11 (2) (*e*), X is taxable on a recoupment of £5,000 in the 1958 tax year, in terms of section 11 (4) (*a*).

As Z exercised the option on 31st December, 1957, it may be that section 11 (4) (*c*) must be applied to the lease premium allowances of £5,000 granted to X in terms of section 11 (2) (*e*) as this amount formed part of the £10,000 by which the purchase price paid by Z was reduced. Thus, in the 1958 tax year, Z is taxable on a recoupment of £5,000 in terms of section 11 (4) (*c*) unless it can be held that for the purposes of section 11 (4) (*c*) the amount which 'has been allowed as a deduction' in the determination of X's taxable income is nil having regard to the recoupment of £5,000 which has been taxed in his hands.

The example shows, therefore, that in respect of the allowances of £5,000 granted to X in terms of section 11 (2) (*e*), two taxable recoupments may arise in the 1958 tax year. X is taxable on £5,000 in terms of section 11 (4) (*a*) and Z may be taxable on £5,000 in terms of section 11 (4) (*c*). It may be suggested that this amounts to double taxation and that there is a presumption in the Act against double taxation. But, as has been laid down in a number of cases, double taxation means the taxation of the same income over again or twice in the hands of the same person (see § 53). Section 11 (4) (*c*) should be clarified so that the anomaly cannot occur.

§ 168. COMPROMISE PROFIT — REMISSION OF LIABILITIES

It may happen in practice that creditors release a debtor, who is in financial difficulties, from the payment of his liabilities, either wholly or partially. For example, if a debtor owes £10,000 to his creditors, who accept a compromise at the rate of 10*s*. in the £, the debtor will be released from obligations to the extent of £5,000. The question arises whether the compromise benefit of £5,000 must be included in the debtor's gross income. It is submitted that the benefit so accruing to the debtor is one of a capital nature and is not taxable notwithstanding the fact that the liabilities were incurred in the ordinary course of trade and were previously allowed as deductions in the determination of his taxable income. In a Special Court case, it was held that a compromise benefit could not be looked upon as a receipt,[71] and was thus not taxable. It is furthermore submitted that the recoupment provision of section 11 (4) (*a*) is not wide enough to bring the compromise benefit within its ambit since the amount of the liabilities which has been remitted cannot be regarded as an amount which has been 'recovered or recouped'.

It should be borne in mind, however, that in terms of section 11 (3) (*a*) (ii), any balance of assessed loss incurred by the taxpayer must be reduced to the extent to which his liabilities incurred in the ordinary course of his trade have been remitted (see § 165).

If there is no assessed loss or if the assessed loss is less than the

[71] I.T.C. No. 214, 6 S.A.T.C. 67. See also I.T.C. No. 455, 11 S.A.T.C. 168.

amount of the liability that has been released, it must follow that the taxpayer avoids tax either entirely or partly. It is wrong that where a taxpayer has incurred a liability which has been taken into account in determining his taxable income and is released from such an obligation in a later year, the amount so remitted does not constitute taxable income.

The Committee of Enquiry into the Income Tax Act[72] was of the view that it is proper that the amount of a liability which has been extinguished to the taxpayer's advantage should be subjected to tax to the extent that it has been allowed as a deduction in the determination of his taxable income. It recommended that section 11(4) be redrafted to include within its ambit the amount of any liability, the payment of which has been extinguished whether by waiver or remission or in any other manner. With the adoption of this recommendation, it seemed to the Committee to be unnecessary to retain proviso (ii) to section 11(3)(*a*) under which the assessed loss must be reduced by the amount of any compromise benefit (see *supra*). The Income Tax Commission accepted this recommendation.[73]

§ 169. Avoidance of taxable recoupments

Capital profits on the sale of fixed assets are taxable, in terms of section 11(4)(*a*), to the extent to which they represent a recoupment of wear-and-tear and other allowances previously granted in respect of those assets. It is possible, however, for the parties to a transaction to avoid a taxable recoupment in the hands of the seller of a fixed asset thereby saving him tax and causing a loss of revenue to the Treasury. For example, A proposes to sell to B as follows:

(1) The goodwill of a business for	£10,000
(2) The immovable property (in respect of which no depreciation has been allowed as a deduction in terms of section 11(2)(*d*))	20,000
(3) Plant, machinery and equipment (in respect of which the income tax value is £2,000 after writing off depreciation to an aggregate amount of £3,000 allowed as a deduction in terms of section 11(2)(*d*))	6,000
(4) The lease of the business premises. (When A started the business originally he acquired the lease on payment of a premium of £2,000 and up to the present he had been allowed to deduct £1,000 by way of a lease premium allowance in terms of section 11(2)(*e*))	4,000
Proposed Selling Price	£40,000

If the transactions were to go through on the above terms, in terms of section 11(4)(*a*), there would be included in A's taxable income a recoupment of £3,000 in respect of wear and tear previously allowed on plant, machinery, etc., *plus* a recoupment of £1,000 in

[72] *Second and Final Report*, p. 42, paras. 28-31.
[73] *First and Final Report*, p. 39, paras. 89 and 90.

respect of the lease premium allowances previously granted. The inclusion of taxable recoupments totalling £4,000 all in one year's income could have a serious inflatory effect on the total taxation payable by the taxpayer. For example, if A's present income apart from the taxable recoupments were £3,000, his total taxable income for the year would be £7,000. On a taxable income of £3,000, the total taxes payable by a married Cape resident are £449. On a taxable income of £7,000, the total taxes are £2,237. It must follow, therefore, that the additional tax payable by virtue of the inclusion of the taxable recoupments of £4,000 in A's taxable income is £1,788 (£2,237 *less* £449). (The savings levy has been excluded in these calculations.)

To avoid this heavy tax liability, A and B, who are the parties to the transaction, may agree to sell and buy the plant, machinery, etc. and the lease at their respective fiscal values, i.e. at values which will not give rise to any taxable recoupment in terms of section 11(4)(*a*). This would be £2,000 for the plant, etc. and £1,000 for the lease. A could be compensated for the shortfall of £7,000 by either increasing the value of the goodwill by £7,000 or by increasing the value of the immovable property by this amount or by increasing the value of both the goodwill and the immovable property to make up the £7,000. B will naturally bear in mind that heavy transfer duty is payable in respect of the purchase price of immovable property. Whatever method is adopted, the £7,000 will be tax-free, being profits made on the sale of capital assets. In the end, A will receive the same amount of £40,000 except that there will be no taxable recoupment in terms of section 11(4)(*a*). B's position will be affected to the extent that whereas the plant, machinery, etc., cost him only £2,000, the Commissioner will be only prepared to allow him depreciation on the basis of £2,000. He will thus receive smaller annual deductions for depreciation than what he would otherwise receive on a purchase price of £6,000.

The above illustration reveals that by careful manipulation taxable profits may be converted into tax-free capital gains. The question of taxable recoupments also assumes importance when a taxpayer transfers his business to a company in which he might be the sole beneficial shareholder in order to reduce his tax liability (see § 26). To avoid a taxable recoupment on the sale of fixed assets which have been subject to depreciation in previous years, these assets must be sold to the company at their income tax or fiscal values so that a taxable recoupment does not arise. Where both the purchaser and the seller have agreed on the sale price of assets, it would be extremely difficult for the Commissioner to interfere with these values unless, of course, he can show by sworn appraised valuations that the values assigned to certain assets are considerably greater than or less than the market prices. The problem of donations tax may also then arise having regard to the provisions of section 54 *sex*(1) relating to property disposed of for inadequate considerations (see § 240). It is impossible, however, for the Commissioner to query the sale prices in respect of every transaction involving taxable recoupments. He may have to console himself with the thought that although he loses tax on what may otherwise have amounted to a taxable recoupment, the purchaser will receive a smaller depreciation allowance in respect of the reduced price payable for the fixed assets which are subject to wear and tear.

V. Allowable Deductions in the Super Tax Assessment

§ 170. Determination of income subject to super tax

Persons other than companies

To determine the income subject to super tax of a person, other than a company, there must, in terms of section 27, be taken the aggregate of:

(*a*) The taxable income of the taxpayer as determined for normal tax — section 27(*a*).

Where a taxpayer has an assessed loss for normal tax purposes which he can carry forward to the next year of assessment in terms of section 11(3)(*a*), he can, in terms of section 28(*b*), deduct such loss from any income subject to super tax, but such deduction is limited to an amount which is just sufficient to reduce the income subject to super tax to £2,300 and to relieve the taxpayer from liability to super tax.

(*b*) Any set-off against the income subject to super tax made in the last preceding year of assessment by virtue of the taxpayer having an assessed loss (see (*a*) above) — section 27(*c*).

(*c*) Dividends received or accrued from any company (whether public or private) from a source within or outside the Union and which have been excluded in the calculation of the taxable income in terms of section 10(1)(*k*) — section 27(*b*). Dividends which are exempt from super tax in terms of section 30 must, of course, be excluded.

From the aggregate of (*a*), (*b*) and (*c*) there must be deducted:

(i) Any expenditure or losses, other than those of a capital nature, incurred by the taxpayer in the production of any dividends included in his income subject to super tax in terms of (*c*) *supra* — section 28(*a*).

(ii) Any assessed loss, as determined for normal tax purposes, which the taxpayer can in terms of section 11(3) carry forward to the next year of assessment. But see (*a*) above for the limitation of the set-off — section 28(*b*).

Difficulties of interpretation are to be found in the super tax provisions. The rate and the amount of the super tax payable and the super tax abatement of £2,300 in terms of section 30(2)(*c*) must be determined with reference to the 'income subject to super tax' which is defined in section 25 as the amount determined in terms of section 27, i.e. before setting off the expenditure and balance of assessed loss as required by section 28. This could not have been the intention of the Legislature. In practice, the Department determines the ' income subject to super tax ' after taking into account the set-off under section 28. Section 25 should be amended so as to ensure that ' income subject to super tax ' is the amount determined in terms of section 27 as reduced by the set-off under section 28.

Stated briefly, income subject to super tax is determined as follows:

	(i) Taxable Income (as determined for normal tax purposes)	£0000
Plus:		
	(ii) Company dividends derived from all sources (excluding exempt dividends)	0000
	(iii) Amount deducted from income subject to super tax in preceding year in respect of assessed loss as determined for normal tax purposes	0000
		£0000
Less:		
	(iv) Expenditure incurred in the production of all dividends included above	0000
	(v) Set-off allowed to be deducted for current year in respect of assessed loss as determined for normal tax purposes ..	0000
Therefore, Income Subject to Super Tax		£0000

Where the expenditure in (iv) above exceeds the aggregate of (i), (ii) and (iii), the loss so determined cannot be carried forward to the next year for set-off in the super tax assessment. There is no provision in the Act for the determination of a loss for super tax purposes which can be carried forward to the next year of assessment. This appears to the writer to be grossly inequitable. If a loss can be carried forward for normal tax purposes, it should also be carried forward in the super tax assessment. If in Year I, a taxpayer earns £5,000 dividends but incurs £10,000 expenditure in the production of those dividends, the loss of £5,000 cannot be carried forward to the next tax year. If in Year II he earns £10,000 dividends but incurs £5,000 expenditure to earn them, he is subject to super tax on £5,000 in spite of the fact that over the tax years, his net earnings from dividends were nil. Although income tax is an annual impost, it is equitable that liability to tax should be measured by the net income over the period of the taxpayer's life. It is a matter for regret that the Committee of Enquiry into the Income Tax Act did not consider this problem at all. The matter requires rectification.

Companies

Since companies are exempt from super tax in terms of section 30 (2) (*a*), there is no need to determine their income subject to super tax unless they are private companies liable to non-resident shareholders' tax in terms of section 42(*e*) read with section 37 *bis* (see § 85). In the case of public companies, the determination of income subject to super tax is of no importance.

§ 171. Set-off of assessed loss

A taxpayer who has an assessed loss for normal tax purposes for a year of assessment is entitled to set off such loss against any income subject to super tax, e.g. dividends from companies, received during that same tax year. Where, however, the assessed loss is greater than an amount sufficient to relieve the taxpayer from liability to super tax, only such portion of the loss is utilized as is sufficient to give the necessary relief, i.e. to reduce the income subject to super tax to £2,300 (see section 30(2)(*c*)(ii)). Any portion of the assessed loss so utilized in a tax year is included in the income subject to super tax of the next succeeding tax year. Thus, if for the 1957 tax year a taxpayer has an assessed loss for normal tax purposes of £3,000 and he also receives dividends from companies amounting to £4,000, he will be entitled to use £1,700 of the assessed loss for set-off against the dividends of £4,000. This will leave him with an income subject to super tax of £2,300 which will relieve him from the payment of super tax. In the 1958 tax year, he will be entitled to carry forward the assessed loss of £3,000 for set-off against any trade income derived during that year and the £1,700, which he was entitled to deduct from dividends received during 1957, is included in his income subject to super tax for the 1958 tax year.

The above procedure is authorized by the provisions of sections 28(*b*) and 27(*c*) of the Income Tax Act, the purpose of which is to ensure:

(*a*) that in any tax year a taxpayer shall not be liable for super tax without having regard to any assessed loss incurred for normal tax purposes; and

(*b*) that by limiting the deduction of the assessed loss to an amount which will serve to reduce the income subject to super tax to £2,300, the taxpayer will be exempt from super tax on such an amount since it is only the difference between the income subject to super tax and £2,300 that is to be included in the income subject to super tax of the next succeeding tax year.

It is clear that in the first year of calculation the taxpayer is given relief since no super tax will be payable on such part of the assessed loss as may be utilized as a set-off in terms of section 28(*b*). The important point to remember is that apart from the statutory abatement of £2,300, the concession confers no reduction in the income subject to super tax of the taxpayer. The provisions of section 27(*c*) clearly see to it that what is allowed by way of deduction in one tax year is included in the income subject to super tax in the next year. The ultimate effect from the point of view of actual tax liability depends upon the income of the taxpayer in future years.

It has been held that in the case of a deceased taxpayer who has incurred an assessed loss in respect of the period of assessment terminating at the date of death, even though the loss cannot be carried forward, the set-off in section 28(*b*) operates and the assessed loss must be set off in the determination of income subject to super tax in respect of the period up to the date of death.[74]

The following example shows how the concession can work in favour of the taxpayer:

Year	*Trade Income*	*Admissible Expenditure*	*Dividends*
I	£1,000	£5,000	£5,000
II	£3,000	£1,000	Nil
III	£3,000	£1,000	Nil

YEAR I

Assessed loss (£5,000 *less* £1,000) to Year II..	£4,000
Dividends	£5,000
Less set-off of assessed loss — section 28(*b*)	2,700
Income subject to super tax	£2,300

Therefore no super tax payable.

YEAR II

Assessed loss from Year I	£4,000
Less taxable income (£3,000 *less* £1,000)	2,000
Assessed loss to Year III	£2,000
Set-off of assessed loss in Year I — section 27(*c*)	£2,700
Less set-off of assessed loss — section 28(*b*)	400
Income subject to super tax	£2,300

Therefore no super tax payable.

YEAR III

Assessed loss from Year II	£2,000
Less taxable income (£3,000 *less* £1,000)	2,000
	—
Income subject to super tax (set-off of assessed loss in Year II) — section 27(*c*)	£400

Therefore no super tax payable.

In the aggregate, by the application of the super tax concession, no super tax is payable. But for such concession, the taxpayer would have been liable for super tax (including provincial tax) in Year I amounting to approximately £700, based on 1958 rates of tax.

[74] *C.I.R.* v. *Estate Meiklejohn*, 1957 (1) S.A. 403 (A.D.); 21 S.A.T.C. 98.

A serious hardship, however, can fall upon the taxpayer who in the early years incurs trading losses and at the same time receives substantial company dividends. The set-off of the assessed losses, which will be deductible annually from the dividends, in terms of section 28(*b*), may accumulate to such an extent by virtue of the provisions of section 27(*c*), that when the taxpayer eventually extinguishes the assessed loss he may be faced with the prospect of paying super tax all in one year on a substantial income subject to super tax. What is more, if in the year in which the accumulated set-off is subject to super tax the taxpayer actually derives a taxable income, he is also faced with the prospect of paying maximum tax rates on such taxable income.

The following data, which are assumed to apply to a married Cape resident, illustrate the point that the 'concession' of section 28(*b*) can under certain circumstances severely penalize a taxpayer:

Tax Year	*Income*	*Admissible Expenditure*	*Dividends*
I	£5,000	£25,000	£5,000
II	£4,000	£10,000	£5,000
III	£10,000	£18,000	£5,000
IV	£20,000	£10,000	£5,000
V	£20,000	£18,000	£5,000
VI	£50,000	£28,000	£5,000

ASSESSMENTS BASED ON THE APPLICATION OF SECTIONS 28(*b*) and 27(*c*)

	Year I	*Year II*	*Year III*	*Year IV*	*Year V*	*Year VI*
Assessed loss	£20,000	£26,000	£34,000	£24,000	£22,000	—
Dividends	£5,000	£5,000	£5,000	£5,000	£5,000	£5,000
Set-off section 27(*c*) ..	—	2,700	5,400	8,100	10,800	13,500
	£5,000	£7,700	£10,400	£13,100	£15,800	£18,500
Less Loss set-off, section 28(*b*)	2,700	5,400	8,100	10,800	13,500	—
Income subject to super tax	£2,300	£2,300	£2,300	£2,300	£2,300	£18,500

Based on the 1958 rates of tax, in Year VI, the total taxes payable on an income subject to super tax of £18,500, is approximately £6,200 (excluding the savings levy portion).

Had the provisions of sections 28(*b*) and 27(*c*) not been applied, the following total taxes would have been payable:

> Year I to Year VI: Super tax (including provincial taxes) on £5,000 income subject to super tax (based on 1958 rates), 6 × £700, about £4,200.

As a result of the application of the provisions of sections 28(*b*) and 27(*c*), the taxpayer is worse off by about £2,000 (£6,200 *less* £4,200). If in Year VI, the admissible expenditure was £24,000, the taxable income for that year would be £4,000 (after deducting the assessed loss of £22,000 in Year V), and the income subject to super tax would be £22,500. It must follow, therefore, that the taxable income of £4,000 attracts maximum super tax rates.

§ 172. Expenditure incurred in the production of dividends

Section 28 (*a*) provides that there can be set off against the income subject to super tax as determined in terms of section 27 'any expenditure or losses, other than expenditure or losses of a capital nature, incurred by the taxpayer in the production of any dividends included in his income subject to super tax in terms of section 27 (*b*)'.

The following are examples of allowable expenditure in terms of section 28 (*a*):

Commission paid to agents for collection of dividends.

Where a taxpayer has a large number of shareholdings and it is necessary to maintain an office or staff, the expenditure incurred in connection with the maintenance of such office.

Interest on money borrowed to acquire the dividend-producing shares.

The following are examples of expenditure or losses not deductible:

Interest on money borrowed to acquire non-dividend producing shares.

Cost of registration of shares into the name of the taxpayer (capital expenditure).

Brokerage and marketable securities tax paid on the acquisition of the shares (capital expenditure).

Loss on the sale of the shares (loss of a capital nature).

In the case of a person whose business it is to deal in shares, the above items are all allowable as deductions in the determination of taxable income in terms of section 11 (2) (*a*).

It is an essential requirement that dividends must be included in the income subject to super tax before any expenditure incurred in earning them can be deducted. Thus, if in respect of any year of assessment, no dividends have been included in the taxpayer's income subject to super tax, expenditure incurred during such year for the purpose of earning dividends cannot be deducted.[75] This is indeed a hardship. If the dividends are received in a later tax year, they are subject to super tax without any deduction for the expenditure incurred in earning them. It is a fundamental principle of taxation that all expenditure laid out to produce income should be deductible. Section 28 (*a*), however, militates against this well-established rule. The deduction formula for normal tax purposes does not require as a prerequisite for the deduction of expenditure the actual receipt or accrual of income during the tax year in which the expenditure is incurred. As long as the expenditure is incurred for the purpose of

[75] I.T.C. No. 128, 4 S.A.T.C. 127.

earning income it is deductible. The fact that no income results is irrelevant. There is no good reason why this principle should also not apply to super tax. Unfortunately, the Committee of Enquiry into the Income Tax Act did not direct its attention to this unfortunate result for the taxpayer.

Although the inclusion of a dividend in the income subject to super tax is an essential requirement in order that there may be deducted the expenditure incurred in connection therewith, in a case where the taxpayer carried on a business of investment in shares the Special Court held that such business had to be taken as a whole and that as the business consisted entirely of investments in shares which were either dividend-producing or likely to produce dividends in the near future, any interest paid on money borrowed to acquire the shareholdings was deductible in full and would not be allocated between productive and non-productive shares.[76] The Commissioner applies this principle in practice.

In order to rank as a deduction in the super tax assessment the expenditure can only be claimed in the year in which it is incurred. The Special Court was of the opinion that the words in section 28 (*a*) 'any expenditure or losses incurred in the production of any amounts included in the taxpayer's income' mean the relative expenditure incurred in producing the income received in the tax year. Thus, where shares acquired did not yield a dividend for several years, the court held that the taxpayer could not accumulate the interest paid in those years and set the accumulated amount off against a dividend when received. The Commissioner's action in limiting the deduction in the year in which a dividend was received to the amount of interest actually incurred in the particular year of assessment was upheld.[77]

Where expenditure has been incurred in the production of any dividend included in the taxpayer's income subject to super tax, the full amount of the expenditure is deductible even though it exceeds the amount of the dividends. The excess amount may therefore be utilized as a set-off against any other income subject to super tax, e.g. the taxable income (section 27 (*a*)) or the super tax set-off allowed in the previous year (section 27 (*c*)). The dividend received may be only £1, yet the full expenditure incurred can be deducted in the super tax assessment. The effect of this is that if a taxpayer borrowed money with which to buy shares and paid £1,000 interest on the loan but only received a dividend of £100 during the year in addition to a salary of £1,500 received in the same year, his income subject to super tax would be £600 (the salary of £1,500 *plus* the dividend of £100 *less* the interest paid of £1,000). If no dividends were received the income subject to super tax would be £1,500, i.e. the interest paid would not be allowed as a deduction. Where a taxpayer holds shares in a private company of which he is the controlling shareholder and has paid interest on money borrowed to

76 I.T.C. No. 383, 9 S.A.T.C. 442.

77 I.T.C. No. 608, 14 S.A.T.C. 370; see also I.T.C. No. 326, 8 S.A.T.C. 252.

acquire the shares, it will clearly pay him from the tax point of view to declare some dividend from the company so that the interest can rank as a deduction in the super tax assessment. For example, if he draws a salary from the company of £4,000 and has paid £1,500 interest on the loan, if he receives no dividend from the company he will be subject to super tax on the salary of £4,000 but if he draws a dividend even if it is only a nominal amount, say, £100, it would seem that the requirements of section 28(*a*) are fulfilled and that the interest of £1,500 is then properly deductible in the super tax assessment. In that case the income subject to super tax would be £2,600 (the salary of £4,000 *plus* the dividend of £100 *less* the interest paid of £1,500).

§ 173. Investment companies

Since a company is exempt from the payment of super tax in terms of section 30(2)(*a*) and as dividends do not form part of the taxable income it must follow that any dividends received by the company are free of normal and super taxes, and expenditure incurred in the production of such dividends is not deductible. Thus, in the case of an investment holding company which derives dividend income as well as other investment income which is subject to normal tax, e.g. rents and interest, the expenditure incurred in the earning of the dividend income cannot rank as a deduction from the other income derived. Where the expenditure has been incurred for the benefit of the company's investment business as a whole and not in respect of a particular class of income, e.g. directors' fees, rent, audit fee, etc., it is the Commissioner's practice to apportion such expenses over the various types of income. The basis of allocation is usually according to the extent of the income received in respect of each class. Thus, if in respect of a tax year, an investment company received £10,000 dividends and £5,000 interest, and incurred expenditure totalling £3,000 for the benefit of the business as a whole, the expenditure of £3,000 is likely to be apportioned over the two types of income, viz. dividends $\frac{10}{15} \times$ £3,000 and interest $\frac{5}{15} \times$ £3,000. The taxable income is determined as follows:

Interest	£5,000
Less: Expenditure apportioned ($\frac{5}{15}$ths of £3,000) ..	1,000
Taxable Income	£4,000

Where a company whose assets consisted partly of dividend-producing shares and partly of interest-producing loans received only interest during a particular tax year, the Special Court held that even though no dividends were received during that year, the whole of the general management expenses could not be deducted in the normal tax assessment but that some reduction had to be made in the expenditure as portion of it was incurred for the purpose of producing dividends.[78]

[78] I.T.C. No. 832, 21 S.A.T.C. 320.

In the case of a company which is an investment dealing company, i.e. its investments constitute its stock-in-trade, any expenditure incurred in carrying on the business is allowed as a deduction in the normal tax assessment. An interesting exception to this rule is provided in the case of *C.I.R.* v. *Rand Selections Corporation, Ltd.*[79] Here an investment dealing company acquired shares in another company about to be liquidated at a cost represented for convenience by, say, £X. On the liquidation of this latter company, the taxpayer company received a distribution on winding up of, say, £Y of which an amount of £Z constituted a dividend within the meaning of para. (*a*) of the definition of *dividend* in section 1 (see § 44). The amount of £Y received by the taxpayer company formed part of its gross income as the company was dealing in shares, but as the portion represented by £Z constituted a *dividend*, it was exempt from normal tax in terms of section 10(1)(*k*). Thus, only £Y *less* £Z formed part of the company's 'income' and the question before the Court was how much of the original cost of £X the company could deduct from its income.

The Court held that the company could deduct from its income in terms of section 11(2)(*a*) an amount represented by

$$£X \times \frac{Y \textit{ less } Z}{Y}.$$

The appellant company's contention was that entire cost of acquisition, viz. £X should be deducted from the 'income' portion of the liquidation dividend received, viz. £Y *less* £Z. If it had been successful, it would have been allowed to deduct from its income a substantial fictitious loss since the income portion was considerably less than the cost of acquisition.

It was contended on behalf of the company that if the company in which it held the shares had declared an ordinary dividend equivalent to £Z and had immediately thereafter gone into liquidation and declared a liquidation dividend no part of which was a 'dividend' as defined, then the company would have been entitled to deduct the whole of the purchase price of the shares, viz. £X, and there would have been a substantial 'loss' for tax purposes. Centlivres, C.J., held that assuming that this was the case, the loss would be due to the form the transaction took. 'It is well known that in income tax cases the form of a transaction has somewhat startling effects: If one form is adopted tax is attracted but if another form is adopted no tax is attracted, although the actual result in money accruing to the taxpayer may be the same.'

§ 174. Rebate of foreign tax paid — set-off of assessed loss

Where a taxpayer has an assessed loss in respect of any year of assessment which he can carry forward and set off for normal tax purposes against his taxable income for the next succeeding year of assessment, he is entitled to set off such loss against his income subject to super tax for such year of assessment in terms of section

[79] 1956 (3) S.A. 124 (A.D.); 20 S.A.T.C. 390.

28 (*b*). It is, however, expressly provided in section 28 (*b*) that in the event of the assessed loss exceeding an amount sufficient to relieve the taxpayer from liability to super tax in respect of the year of assessment under charge, the amount set off must be limited to a sum sufficient to give such relief (see § 171).

In ordinary cases no difficulty is experienced in the application of the proviso to section 28 (*b*). A taxpayer is relieved from liability to super tax if his income subject to super tax does not exceed £2,300 or if the calculated super tax payable is not more than £285. Where, however, a taxpayer is in receipt of dividends from non-Union sources and is entitled to an additional super tax rebate in respect of foreign tax paid on such dividends, difficulty may be experienced in the application of the proviso to section 28 (*b*). It is clear that in such a case ' an amount sufficient to relieve the taxpayer from liability to super tax in respect of the year of assessment under charge ' will not be merely an amount sufficient to reduce the income subject to super tax to £2,300, having regard to the additional rebate which the taxpayer is entitled to in respect of foreign tax paid. The correct approach, it is submitted, is to determine at what amount of income subject to super tax the calculated super tax payable (before deducting the rebates) will equal the total rebates provided for in section 29, i.e. the £285 *plus* the rebate in respect of any foreign tax paid. If the total rebates amount to £349 (i.e. the primary rebate of £285 *plus* a rebate in respect of foreign tax amounting to £64), it must follow that the amount sufficient to relieve the taxpayer from liability to super tax will be an amount which leaves an income subject to super tax on which the calculated super tax will be £349, i.e. an income subject to super tax of £2,720. If the total rebates amount to £438, the amount sufficient to relieve the taxpayer from liability to super tax will be an amount which leaves an income subject to super tax of £3,268.

A complication arises as regards the rebate in respect of the foreign tax paid. As this is the lesser of the actual foreign tax paid or the Union super tax attributable to the inclusion of the foreign dividends, it is best to determine the total rebates provided for in section 29 by resorting to a mathematical formula. The following example attempts to explain the problem:

Example

Assessed loss for normal tax purposes, 1958 tax year, £5,000.
Income subject to super tax, 1958 tax year —

Union dividends	£3,000
Foreign dividends	£1,000

£150 foreign tax was paid in respect of the foreign dividends of £1,000. It is necessary to determine the total rebates provided for in section 29 assuming that the super tax attributable to the inclusion of the foreign dividends is less than the actual foreign tax paid on such dividends.

Let x be the calculated super tax (before deducting the rebates) on an income subject to super tax which will relieve the taxpayer from liability to super tax.

$$\therefore \pounds 285 + \frac{1,000}{4,000}x = x$$
$$\therefore 1,140 + x = 4x$$
$$\therefore 3x = 1,140$$
$$\therefore x = \pounds 380$$

This means that the rebate in respect of foreign tax paid is £95 (£380 *less* £285). Note that if the rebate in respect of the foreign tax paid determined in accordance with the formula above exceeded £150, the rebate would be limited to £150 so that x will then be equal to £435. All that is now necessary is to determine the income subject to super tax which will produce a calculated super tax amounting to £380.

Let y = the income subject to super tax.

$$\therefore \frac{y(24 + \frac{1}{400}(y - 1))}{240} = \pounds 380$$
$$\therefore y(24 + \frac{1}{400}(y - 1)) = \pounds 91,200$$
$$\therefore y(9,600 + y - 1) = \pounds 36,480,000$$
$$\therefore 9,599y + y^2 = \pounds 36,480,000$$
$$\therefore y = \pounds 2,915$$

Since the total dividends amount to £4,000, and the amount on which no super tax is payable is £2,915, it is submitted that the set-off of the normal tax assessed loss of £5,000 must be limited to £1,085 in terms of the proviso to section 28(*b*).

Proof:

Union dividends		£3,000 0 0
Foreign dividends		1,000 0 0
		£4,000 0 0
Deduct set-off of normal tax loss (as determined above)		1,085 0 0
∴ *Income subject to Super Tax*		£2,915 0 0
Calculated Super Tax (on £2,915)		£379 19 8
Less Rebates:		
Primary	£285 0 0	
Credit in respect of foreign tax £150 or $\frac{1,000}{4,000} \times$ £379 19*s*. 8*d*. whichever is the lesser	94 19 11	
		379 19 11
Super Tax Payable		Nil

The problem is indeed a complex one and the legislator would be well advised to simplify the position.

CHAPTER TEN

TAXATION OF BENEFITS FROM EMPLOYMENT AND SERVICES

§ 175. Introduction

The South African Income Tax Act has cast the net very widely indeed in regard to the taxation of benefits derived from employment and services rendered. Just about every type of benefit connected with employment and services is taxable under the all-embracing provisions of section 7 (*b*), 7 (*b*) *bis*, 7 (*b*) *ter*, 7 (*c*), 7 (*e*) and section 9 (8). These provisions are considered in the ensuing paragraphs.

§ 176. Amounts received in respect of services rendered

Effect of section 7 (b)

Any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered must be included in gross income (section 7 (*b*)). There must be a causal relationship between the amount received and the services rendered.[1]

Voluntary awards in respect of services rendered, e.g. Christmas or other bonuses, gratuities on retirement, are all taxable. The question whether there is any contractual obligation is irrelevant. As long as the amount is awarded to an employee in respect of services rendered, it is taxable whether the amount be payable under a contract of service or not.[2]

The following are examples of amounts received or accrued in respect of services rendered:

Pension or retiring allowance received by an ex-employee, whether payable in terms of a service contract or awarded voluntarily by an employer.[3]

Salary in lieu of leave.[4]

Salary in lieu of notice.[5]

Amount received for services rendered by a promoter on the formation and registration of a company.[6]

Prize won by an insurance agent for securing the payment of the largest premiums during the year.[7]

[1] *R.* v. *C.O.T.*, 1949 S.R. 41, 16 S.A.T.C. 151.
[2] I.T.C. No. 689, 16 S.A.T.C. 501.
[3] I.T.C. No. 267, 7 S.A.T.C. 156; I.T.C. No. 341, 8 S.A.T.C. 366; I.T.C. No. 599, 14 S.A.T.C. 272.
[4] *De Villiers* v. *C.I.R.*, 1929 A.D. 227; 4 S.A.T.C. 86; I.T.C. No. 39, 2 S.A.T.C. 70.
[5] I.T.C. No. 143, 4 S.A.T.C. 220.
[6] I.T.C. No. 430, 10 S.A.T.C. 424.
[7] I.T.C. No. 117, 4 S.A.T.C. 70.

Amount received by a secretary of companies for passing on information to a promoter of companies that certain claims were about to fall open for pegging.[8]

Climatic allowance received by civil servant.[9]

Allowance for upkeep of garden paid by employer to employee being in respect of house belonging to employer but occupied by employee.[10]

Amount received for information supplied which led to the conclusion of a successful financial deal.[11]

An amount received by a racehorse trainer from the owner of a horse following the winning of a race by such horse. (It has been held, however, that an amount received by a trainer from a successful backer of a winning horse is not in respect of services rendered, where there is no evidence to show that the trainer has supplied the punter with information relating to the horse's prospects.)[12]

Commission received for underwriting shares in a company.[13]

Amounts received by way of 'tips', however small the service might be.

Executors' fees, administrators' and trustees' commission.

Fee received by director for guaranteeing bank overdraft of company.

Awards in respect of services rendered are taxable in the year of receipt or accrual irrespective of the period to which the services relate. The expression 'services rendered' does not mean services rendered during the tax year. They refer to the total period, long or short, of the service of the taxpayer.[14] An exception to this rule is contained in the proviso to section 7(*b*) which lays down that any amount received by or accrued to an employee, upon and because of the termination of his services, by way of bonus, gratuity or compensation, is deemed to be received or to accrue in three successive equal annual instalments in such a manner that the first instalment is calculated on the date of receipt or accrual of the bonus or gratuity and the subsequent instalments on the anniversary of that date. Certain conditions have to be complied with before an employee is entitled to spread a bonus or gratuity over three years:

(i) The termination of the employee's services must be due to superannuation, ill-health or infirmity; or

(ii) the Commissioner must be satisfied that the circumstances of the case warrant the concession.

Thus, if on 31st March, 1958, an employee received a gratuity of £3,000 on the termination of his services due to ill-health, in terms of the proviso to section 7(*b*), £1,000 is deemed to accrue on

[8] I.T.C. No. 319, 8 S.A.T.C. 176.
[9] I.T.C. No. 470, 11 S.A.T.C. 263.
[10] I.T.C. No. 179, 5 S.A.T.C. 253.
[11] I.T.C. No. 779, 19 S.A.T.C. 326. See also I.T.C. No. 319, 8 S.A.T.C. 176.
[12] I.T.C. No. 701, 17 S.A.T.C. 108.
[13] I.T.C. No. 453, 11 S.A.T.C. 110; I.T.C. No. 173, 5 S.A.T.C. 174.
[14] I.T.C. No. 143, 4 S.A.T.C. 220.

31st March, 1958, and another £1,000 is deemed to accrue on 31st March, 1959, and the balance of £1,000 on 31st March, 1960.

It is to be observed that the employee cannot elect to have the entire bonus or gratuity taxed in the year of accrual. Should the employee die before the anniversary date of any instalment, it is submitted that there is no provision in the Act in terms of which the outstanding instalments not yet taxed can be subjected to tax.

The right to spread a bonus, gratuity or compensation is confined only to an 'employee'. It is submitted that an agent who is an independent contractor and not a full-time employee of a principal, does not qualify for the concession.

In the writer's view, it is not a requirement of section 7(*b*) that the amount in respect of services rendered must be paid by an employer in order that the employee can be subject to tax in respect thereof.[15] For example, an amount received by an employee of a company from a shareholder being in respect of services rendered by such employee to the company would, it is submitted, fall within section 7(*b*). It is submitted, however, that before an amount is taxable in terms of section 7(*b*), it is a requirement that the recipient must have rendered the services. For example, if on the death of an employee, an employer awards a gratuity to the widow of the deceased employee, the widow is not taxable on the gratuity as she rendered no services to the employer. Thus, *ex gratia* payments to widows and dependants of deceased employees are not taxable unless in the form of an annuity when it is taxable in terms of section 7(*a*). Even if the employer has agreed, in terms of a service agreement, to pay a gratuity into the estate of an employee on his death (cf. *Hersov's Estate* v. *C.I.R.*[16]), it is submitted that the estate is not taxable on the gratuity as it rendered no services to the employer. If these views are correct, it may well be that if an employer wishes to make a gratuity (in respect of which he is under no obligation to make) to an employee for services rendered but desires to assist the employee so that he is not subject to tax thereon in terms of section 7(*b*), he can donate the money to a member of the employee's family, for example, one of his children, or he can donate it to a trust for the benefit of the employee's family or he could even donate it to a company in which his employee is a beneficial shareholder. The position may thus be that in all these cases, the recipient is not taxable on the donation as no services were rendered by him to the employer.

The use of the words 'services rendered or to be rendered' in section 7(*b*) means that the recipient is taxable on the full amount received or which accrues to him even though the services will only be rendered in a later tax year. Thus, an express provision exists[17] for including in gross income the full amount of a salary payable in

[15] *Verrinder, Ltd.* v. *C.I.R.*, 1949 (2) S.A. 147 (T); 16 S.A.T.C. 48.

[16] 1957 (1) S.A. 471 (A.D.); 21 S.A.T.C. 106.

[17] It has already been held that the definition of gross income is wide enough to include a salary payable in advance (I.T.C. No. 702, 17 S.A.T.C. 206).

advance, even though the services may only be rendered in a later year. It is furthermore submitted that any amount received by an employee as consideration for entering into a service agreement is an amount received in respect of 'services to be rendered' and falls into gross income.

Remuneration in kind

An amount received in respect of services rendered may be in a form other than cash. In such a case the recipient is taxable on the value of the benefit received. These benefits may take a variety of forms, e.g.:

1. An employer may supply his employee with goods free of cost in terms of a service agreement. These goods must be valued and included in gross income.
2. An employer may, in terms of a service agreement, discharge certain obligations belonging to the employee, e.g. his income tax assessment or premiums payable on a life insurance policy. The value of these benefits is taxable.
3. A promoter or an employee of a company may be allotted, say, 5,000 shares of the nominal value of 5*s.* each fully paid-up for services rendered. The shares must be valued for tax purposes.[18] If at the date of allotment the shares are worth 10*s.* each the recipient is taxable on £2,500 (the *market value* of the shares).
4. In a reported case[19] an employee in consideration for services rendered received the option to 'call' 7,500 shares in a certain company at 5*s.* per share and to 'put' them at 10*s.* per share. It was held that as the employee could have made a gain of £1,875 in taking the shares at 5*s.* and putting them back at 10*s.* immediately, the value of the accrual was £1,875 which was taxable.
5. For services rendered to a company, an employee or other person may receive the right to subscribe for shares in such company at the par value when the market value is considerably higher. The difference between the market value and the par value is an amount to be included in gross income.
6. For services rendered, a person may receive a plot of land or other immovable property or certain mining claims or rights. These assets must be valued and the value included in gross income.

In all the above cases, the asset or right received in respect of services rendered must be valued at the date of receipt or accrual. If, after having received the asset, the owner subsequently decides to dispose thereof, the proceeds partake of the nature of capital as he is disposing of a capital asset. The connection between the amount

[18] I.T.C. No. 32, 2 S.A.T.C. 58; I.T.C. No. 430, 10 S.A.T.C. 424. See also *Ochberg* v. *C.I.R.*, 1931 A.D. 215; 5 S.A.T.C. 93, and I.T.C. No. 319, 8 S.A.T.C. 176.

[19] I.T.C. No. 691, 16 S.A.T.C. 505.

ultimately received on the sale of the asset or right and the services originally rendered is too remote to regard the proceeds as consideration for services rendered. The position would, of course, be different if the owner deals or trades in that kind of asset and it is merged into his profit-making business. The proceeds would then form part of the gross income.[20]

Excessive remuneration

A recipient must be taxed on the full amount received in respect of services rendered even though the Commissioner has disallowed portion thereof in the hands of the payer as not having been incurred in the production of income (see §§ 27 and 145).[21] It does not follow that because any particular amount is not allowed as a deduction from the income of the payer, it is not taxable in the hands of the recipient.[22] A recipient is not entitled to claim that portion of his salary or remuneration be disallowed as excessive on the grounds that his services are not worth the whole of the remuneration received.[23]

§ 177. Compensation for loss of office, etc.

Amounts received or accrued in respect of any loss of office or employment (whether contractual or non-contractual) must be included in gross income (section 7(*b*)*bis*). There must also be included any amount (including any voluntary award) received or accrued in respect of the relinquishment, termination, repudiation, cancellation or variation of any office or employment or of any appointment (or right or claim to be appointed) to any office or employment. It is expressly provided that the provisions of section 7(*b*)*bis* do not apply to any lump-sum award from any pension, provident or benefit fund.

The term *employment*, it is submitted, must be taken to signify the case where an employee is employed by an employer under a relationship analogous with the position of master and servant, i.e. where there is a control by the employer of the conduct of the work in respect of which the employee is employed and a corresponding duty on the employee to carry out the work in accordance with the instructions of the employer given from time to time.[24] Thus, in the case of an agent who is carrying on the business of a commission agent for a number of principals and is an independent contractor, it is submitted that he is not exercising an employment in respect of any one of his principles.[25]

As regards the term *office*, the Special Court has held that an auditor of a company holds an office, and adopted the meaning attri-

20 I.T.C. No. 726, 18 S.A.T.C. 90; I.T.C. No. 369, 9 S.A.T.C. 310; I.T.C. No. 411, 10 S.A.T.C. 238.

21 I.T.C. No. 792, 20 S.A.T.C. 98.

22 *W. F. Johnstone & Co., Ltd.* v. *C.I.R.*, 1951 (2) S.A. 283 (A.D.); 17 S.A.T.C. 235.

23 *Director* v. *C.O.T.*, 1949 (2) S.A. 751 (S.R.); 16 S.A.T.C. 146.

24 I.T.C. No. 566, 13 S.A.T.C. 332; see also I.T.C. No. 544, 13 S.A.T.C. 191.

25 See I.T.C. No. 627, 14 S.A.T.C. 535; see also I.T.C. No. 644, 15 S.A.T.C. 247.

buted to the term by the English courts, viz. 'an office or employment which was a subsisting, permanent, substantive position, which had an existence independent of the person who filled it, which went on and was filled in succession by successive holders'.[26] A director of a company, in his capacity as such, holds an office.

It is submitted that the following amounts would fall within the terms of section 7(*b*) *bis*:

1. Amount received by employee from employer for a breach of a contract of employment.
2. Payment made by a company to its managing director in consideration of his resignation from the company.
3. Payment made by a company to its managing director for his agreeing to accept a smaller salary in the future or to surrender his future rights to a pension.
4. Compensation paid to prospective employee being in respect of a breach of contract on the part of the employer to enter into a service agreement.
5. Amount received by a director for surrendering his right to a permanent directorship.

Amounts received in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment must be distinguished from the case where an employee receives a payment from his employer on the termination of his employment in consideration of his undertaking not to engage in certain employments or occupations in a defined area for a specified period of time. It is submitted that such a payment does not fall within section 7(*b*) *bis* and is not taxable, being a receipt of a capital nature. The amount is received as consideration for agreeing to a restraint of trade and not in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment. This may constitute a loophole for avoidance of tax since, instead of taking from his employers a payment which will fall into the ambit of section 7(*b*) *bis* and thus be subject to tax in respect thereof, an employee may be tempted to negotiate for a payment in respect of a restraint of trade, for example, he may agree not to exercise an employment or trade in a certain area for a number of years. Such a payment being of a capital nature is not subject to tax. In this manner, the employee may convert the equivalent of what would otherwise constitute taxable income into an accrual of a capital nature.

§ 178. Commutation of amounts due under service contracts

Any amount received or accrued in commutation of amounts due under any contract of employment or service must be included in gross income (section 7(*c*)).

[26] I.T.C. No. 570, 13 S.A.T.C. 450.

The Special Court has held that the words 'amounts due' do not only refer to amounts presently due but also to amounts which, in terms of the contract, will fall due in the future in respect of services to be rendered,[27] and has invoked section 7(*c*) in the following cases:

1. Lump-sum payment received by employee for breach of contract of employment by employer based on the unexpired portion of the service agreement.[28] It has been held that such a payment is also taxable as income under the general definition of gross income being compensation for the loss of income which would have been received under the contract.[29]
2. Lump-sum payment received from employer in lieu of notice required to be given in terms of service agreement.[30]
3. Lump-sum payment to employee on retirement being in lieu of leave privileges in terms of service agreement.[31] Sums payable to widows or dependants representing payments in lieu of leave not taken by a deceased employee are not taxable.

Having regard to the wide scope of section 7(*b*) *bis*, it may seem that there is really little need for section 7(*c*) (which was enacted many years before section 7(*b*) *bis*) since amounts received in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment will usually include a commutation of amounts due under a contract of employment. Section 7(*b*) *bis*, however, refers to 'any office or employment', whereas section 7(*c*) refers to 'any contract of employment or service', which latter words may be wider in scope than the former words.

§ 179. Free perquisites in respect of employment

The annual value of any quarters or board or residence or of any other benefit or advantage granted in respect of employment must be included in gross income (section 7(*e*)).

The other benefits or advantages referred to would include, for example, the free issue of clothing or uniform to an employee. But for section 7(*e*), it would seem that the annual value of the benefits referred to would not be taxable since it does not constitute money's worth and it has been held that the tax cannot be levied on amounts which do not constitute money's worth or cannot be turned into money (see § 257).[32]

It is submitted that the privileges and benefits referred to in section 7(*e*) must be confined to such as the employee is entitled to demand in terms of his service agreement. Whereas section 7(*b*) and section 7(*b*) *bis* expressly include voluntary awards, section 7(*e*) does not.

[27] I.T.C. No. 517, 12 S.A.T.C. 263.
[28] I.T.C. No. 222, 6 S.A.T.C. 148; I.T.C. No. 517, 12 S.A.T.C. 263; see also I.T.C. No. 414, 10 S.A.T.C. 249.
[29] I.T.C. No. 75, 3 S.A.T.C. 67.
[30] I.T.C. No. 63, 2 S.A.T.C. 253.
[31] I.T.C. No. 517, 12 S.A.T.C. 263; I.T.C. No. 65, 2 S.A.T.C. 257.
[32] *C.I.R.* v. *Delfos*, 1933 A.D. 242; 6 S.A.T.C. 92.

In determining the annual value it is the benefit to the employee and not the value or cost to the employer which is the deciding factor. It has been held that where quarters are occupied by an employee under the terms of his contract of service, the annual value of these quarters for the purposes of section 7(*e*) is their value to the employee for the purposes of occupation irrespective of their cost to the employer or the latter's estimate of their letting value.[33] Another case[34] concerned an employee in the police department of a municipality who was entitled to the free issue of a uniform. The Commissioner in terms of section 7(*e*) included in the employee's income the cost of the uniform to the municipality. The Court held that the true measure of the value of the accrual to the employee was the amount saved by him through not having to purchase civilian clothing as a result of uniform having been issued to him.

Section 10(1)(*n*) exempts from tax members of the Union Defence Forces in respect of allowances received for uniform, ration or lodging in time of war or during a period of three months thereafter.

§ 180. EXCESSIVE TRAVELLING AND ENTERTAINMENT ALLOWANCES TO EMPLOYEES

Section 9(8) deals with cases of where an amount can be taxed in the hands of an employee even though it was not a payment made in respect of services rendered. It is provided that so much of any amount which has been paid by any person as an allowance or advance to a director, manager, employee or other person in respect of expenses of travelling, entertainment or other service, as, in the opinion of the Commissioner, was not actually expended by the recipient in this manner, is deemed to be part of the taxable income of the recipient. A simple illustration of the operation of section 9(8) is the case of an employer who grants an employee, in addition to his salary, a fixed allowance, say, £360 per annum to meet expenditure in connection with his duties. If the Commissioner is of the opinion that only £240 was actually laid out by the employee to meet the expenditure, he is entitled to include an amount of £120 (£360 *less* £240) in the taxable income of the employee.

Subject to the provisions of section 9(8), *bona fide* allowances made to an employee to meet expenditure incurred by him in connection with his duties are not income receipts and do not form part of his gross income. It must be clear, however, that the allowance is made or awarded to meet expenditure incurred by the employee in the ordinary course of his duties and is not in the nature of an allowance or remuneration for services rendered.[35] If, in truth, the allowance is a cloaked payment of remuneration, the Commissioner is entitled to invoke the provisions of section 9(8) and tax the employee on the full amount thereof or alternatively he may assess

[33] I.T.C. No. 210, 6 S.A.T.C. 59.
[34] I.T.C. No. 602, 14 S.A.T.C. 282.
[35] I.T.C. No. 392, 9 S.A.T.C. 483.

the parties in accordance with the true position without invoking the provisions of section 9(8).

Section 9(8) vests in the Commissioner a discretionary power to determine what portion of any advance or allowance paid to an employee in respect of expenses should be deemed to be part of the taxable income of the recipient. As long as the Commissioner has applied his mind to the matter and acts *bona fide*, his decision is not subject to review by the courts. The Committee of Enquiry into the Income Tax Act recommended that the Commissioner's discretionary power should be made appealable.[36] The Income Tax Commission rejected this recommendation.[37]

§ 181. Allowances to public servants

In the case of persons employed in the public service or railway and harbour service of the Union, the Commissioner is not entitled to invoke the provisions of section 9(8) in regard to allowances received by such persons since, in terms of section 19, it is expressly provided that payments made to meet expenditure incurred by such persons in connection with their official duties must be wholly excluded from their taxable incomes. It has been held that the term 'public service' was not restricted to the definition of that term as contained in the Public Service Act but included any employment in the service of the State.[38] Thus, members of the House of Assembly and Senate are included. In this respect, it may be pointed out that in terms of the South Africa Act Amendment Act, No. 66 of 1951, certain specified proportions of the allowances payable to members of Parliament are deemed to represent payments made to meet expenditure incurred in connection with their official duties. As such, these proportions are not taxable in terms of section 19.

These proportions are as follows:

Members of both Houses of Parliament ..	£700 per annum
Speaker of the House	£1,200 per annum
Leader of the Opposition	£1,080 per annum
President of the Senate	£960 per annum

As regards the salaries of the Prime Minister and other Ministers of State, provision has been made that £1,200 of the salary per annum is an allowance made to meet expenditure incurred and is thus not taxable.

In the case of members of provincial councils, it is also provided that a certain portion of their salaries must be regarded as a reimbursive allowance and therefore exempt from tax, viz.:

Members of the Executive Committee ..	£700 per annum
Ordinary members of the Council	£294 per annum

As regards the Administrators of the Provinces, 30 per cent of their salaries is regarded as a reimbursive allowance and therefore free of tax, viz. £975 is exempt.

36 *First Report*, p. 35, para. 70.
37 *First and Final Report*, p. 11, para. 43.
38 *McCusker* v. *C.I.R.*, 1947 (3) S.A. 190 (A.D.); 14 S.A.T.C. 322.

It has been held that a deputy-sheriff carries out the duties of his office for the State and where he receives an allowance from the State in respect of reimbursement of travelling expenses, the amount so received falls within section 19 and is not taxable. However, in regard to allowances received from outside parties and not from the State, e.g. reimbursement of travelling expenses in connection with civil and insolvency work, these do not fall within the exception provided by section 19 and are taxable.[39]

§ 182. Benefits exempt from tax

Certain persons are exempt from tax on salaries and emoluments payable to them for services rendered, viz.:

(i) The Governor-General (section 10(1)(*j*)(i)).

(ii) Any person who holds office in the Union as an official of any foreign government (except the Administration of the Territory of South West Africa), provided such person is stationed in the Union for that purpose and is not ordinarily resident in the Union.[40] This would include diplomats, consuls and High Commissioners representing foreign countries (section 10(1)(*j*)(ii)).

(iii) Any person not ordinarily resident in the Union in respect of services rendered by him outside the Union for the Union Government (including the Railway Administration) or any provincial administration or local authority in the Union or the South African Tourist Corporation, if his remuneration is chargeable with income tax in the country in which he is ordinarily resident, and the tax is borne by himself and not paid by the Government, etc. (section 10(1)(*p*)). In terms of section 9(1)(*c*) such remuneration is deemed to be from a Union source (see § 183).

Certain gratuities received by employees are also exempt from tax:

(i) So much of any gratuity received by or accrued to any person from his employer as the Commissioner deems to be a grant made because such person had obtained a University degree or diploma or had been successful in some examination and not remuneration, or any portion of remuneration, for services rendered or to be rendered (section 10(1)(*q*));

(ii) any gratuity (other than a leave gratuity) received by or accrued to any person from public funds upon his retirement from any office or employment under the Union Government (including the Railway Administration) or any provincial administration provided that the Treasury declares such gratuity to be free of tax (section 10(1)(*t*)).

[39] I.T.C. No. 659, 15 S.A.T.C. 503.
[40] See I.T.C. No. 327, 8 S.A.T.C. 254.

§ 183. SOURCE OF INCOME FROM EMPLOYMENT AND SERVICES

Like all other income, benefits in respect of employment and services are only taxable if derived from a source within or deemed to be within the Union. The source of income from employment and other services rendered is the services irrespective of where the contract is made or the remuneration paid. The source is to be found where the services are rendered. See § 16. It should be mentioned, however, that in terms of double taxation agreements negotiated with certain other countries,[41] residents of such countries are exempt from Union tax on remuneration derived from services rendered in the Union to the extent set out in the agreements.

In certain instances, however, the source is deemed to be within the Union irrespective of the place where the services are rendered.

Services rendered in the carrying on of a Union trade (section 9(1)(b))

An amount is deemed to be from a source within the Union if it accrues to a person by virtue of any service rendered or work or labour done by such person in the carrying on in the Union of any trade, whether the payment for such service or work or labour is made or is to be made by a person resident in or out of the Union and wherever payment is to be made.

The intention is to tax such remuneration even though the service is rendered or the work or labour is done outside the Union provided it be rendered or done in the carrying on of any trade in the Union. *Trade* is defined in section 7 and includes 'any employment' (see § 128)). The services may be rendered entirely outside the Union, yet because they are done in the carrying on in the Union of any trade, the remuneration is deemed to be from a Union source. It has been held that there must be some close link between the work done outside the Union and the carrying on of a trade in the Union, a link closer than the mere fact that the taxpayer is carrying on a trade in the Union and that the work done outside the Union is in the way of such trade or of the same nature as the work done by the taxpayer in the Union[42] (see also § 16).

In *Millin* v. *C.I.R.*[43] it was held that section 9(1)(*b*) is applicable only to payments for services rendered or work or labour done to order and does not apply to an amount realized by the disposal of an article created by that labour.

If a taxpayer carries on a trade both in and outside the Union, and the services rendered outside the Union are performed in the carrying on of the trade outside the Union, section 9(1)(*b*) cannot apply since the services are not rendered in the carrying on of the Union trade, but in respect of the trade outside the Union.

[41] At present there are such agreements with the United Kingdom, United States of America, Sweden, Canada and the Federation of Rhodesia and Nyasaland.

[42] I.T.C. No. 749, 18 S.A.T.C. 319.

[43] 1928 A.D. 207; 3 S.A.T.C. 170.

Services oversea for Union Government and other bodies (section 9(1)(c))

An amount is deemed to be from a source within the Union when it accrues to a person by virtue of any services rendered or work or labour done by such person under a contract of employment for the Union Government (including the Railway Administration) or any provincial administration or local authority (as defined in section 1) in the Union or the South African Tourist Corporation notwithstanding that the services or the work is done outside the Union. An exception is provided in the case of employees of the Union Government (including the Railway Administration) who are stationed in South West Africa.

In the case of employees falling within the scope of section 9(1)(*c*), if their remuneration is chargeable with income tax in the country of their residence and the tax is borne by them and not refunded by the employer, it is exempt from Union tax in terms of section 10(1)(*p*) (see § 182).

Services rendered by Union seamen or airmen (section 9(1)(c)bis)

An amount is deemed to be from a source within the Union when it accrues to a person by virtue of any services rendered or work or labour done by such person, being a person ordinarily resident in the Union, as officer or member of the crew of any Union ship or aircraft, referred to in section 9(1)(*a*)*ter*, notwithstanding where the services are rendered or the remuneration paid. Thus, a salary paid to a pilot ordinarily resident in the Union by an aircraft company controlled in the Union is deemed to be from a Union source in terms of section 9(1)(*c*)*bis* even though the pilot renders most of his work outside the Union.

Directors' fees

The Special Court has held that a director's services in his capacity as such are deemed to be rendered at the head office of the company where the board of directors ordinarily transacts the business, so that if the head office is in the Union, the fees are derived from a Union source irrespective of where the director resides and performs the services.[43a]

If the board of directors meets in the Union, a director ordinarily resident outside the Union would be subject to tax in respect of his fees. If he shares his fees with an alternate director in the Union, he will be subject to tax on the portion accruing to him.

On the other hand, a director ordinarily resident outside the Union may be paid a fee in respect of services rendered outside the Union as a member of a local board or committee set up outside the Union. In such a case, it is submitted that the fee is derived from a source outside the Union.

[43a] I.T.C. No. 106, 3 S.A.T.C. 336; I.T.C. No. 250, 7 S.A.T.C. 46; I.T.C. No. 77, 3 S.A.T.C. 72; I.T.C. No. 235, 6 S.A.T.C. 262.

On the above principles, if a director resident in the Union receives a fee from a company whose head office is outside the Union, the income is from a non-Union source, but if he receives it as a member of a local board or committee set up in the Union, it is from a Union source.

A director may, of course, also render services for his company in a capacity other than that of director, e.g. he may be appointed to manage the day-to-day affairs of a company or he may assist in the company's buying or selling operations on a full-time basis. In such a case, where a director holds a salaried appointment, it is submitted that the source of his remuneration must be determined in accordance with the general rule.[44]

§ 184. Retirement pensions — determination of source

Governmental services

An amount is deemed to be from a source within the Union when it accrues to a person by virtue of any pension or annuity granted to such person (wherever payment is made or the funds from which payment is made are situate) by the Union Government (including the Railway Administration) or a provincial administration or any local authority (as defined in section 1) in the Union — section 9(1)(*d*)(i). It does not matter where the recipient has rendered the services.

Non-Governmental services

In terms of section 9(1)(*d*)(ii), any pension or annuity, irrespective of its source, is deemed to have been derived from a source within the Union if the services in respect of which that pension or annuity was granted were performed in the Union for at least two years during the ten years immediately preceding the date on which the pension or annuity first accrued. Only a portion of any such pension or annuity must be deemed to have been derived from a Union source if that pension or annuity was granted in respect of services which were rendered partly within and partly outside the Union. Such portion of the pension or annuity must bear to the total pension or annuity the same ratio as the period during which the services were rendered in the Union bears to the total period during which the services were rendered.

The liability for income tax in respect of pensions granted by private employers is not dependent upon whether the grantor resides or carries on business in the Union or whether the recipient is resident in the Union. Section 9(1)(*d*)(ii) provides that such pensions are deemed to be derived from a Union source as long as the recipient has rendered at least two years' services during the ten years immediately preceding the date from which the pension first became due. Thus, if Mr. X ordinarily resident in Australia pays a pension to Mr. Y also resident in Australia in respect of services rendered in the Union,

[44] See I.T.C. No. 77, 3 S.A.T.C. 72; I.T.C. No. 266, 7 S.A.T.C. 151.

Mr. Y is subject to tax in the Union in respect of such pension to the extent set out in section 9(1)(*d*)(ii). Since Mr. Y is outside the jurisdiction of the Union courts and no means of enforcement of the obligation which section 9(1)(*d*)(ii) imposes upon him are available to the Commissioner, it must follow that the present provisions are unsound and impracticable where both the grantor and the recipient of the pension are not resident in the Union.

The provisions of section 9(1)(*d*)(ii) do not apply to pensions or annuities payable by the Union Government, a provincial administration or a local authority in the Union which, in terms of section 9(1)(*d*)(i), are deemed to be wholly from a source within the Union, irrespective of where the services are rendered.

Double taxation agreements

It should be pointed out that in terms of double taxation agreements entered into with certain other countries, pensions derived by non-residents and falling within the scope of section 9(1)(*d*) may be exempt from tax.[45]

Illustrations showing the operation of section 9(1)(*d*)(ii)

(1) X received an annual pension of £600 with effect from 1st September, 1955, being in respect of services rendered as follows: In the Union 1st April, 1934, to 30th June, 1944. Outside the Union 1st July, 1944, to 31st August, 1955. Since no services were rendered in the Union for at least two years during the last ten years of service, the provisions of section 9(1)(*d*)(ii) do not apply and the annual pension of £600 is not taxable.

(2) Y received an annual pension of £480 with effect from 1st April, 1955, being in respect of services rendered as follows: In the Union 1st April, 1930, to 30th June, 1935. Outside the Union 1st July, 1935, to 30th June, 1950. In the Union 1st July, 1950, to 31st March, 1955. As services were rendered in the Union for four and three-quarter years during the last ten years of service, the provisions of section 9(1)(*d*)(ii) apply but having regard to the fact that services were rendered partly in and outside the Union, only a portion of the pension is deemed to be from a Union source, viz.:

$$\frac{\text{Period during which the services were rendered in the Union}}{\text{Total period during which services were rendered}} \times \text{Total Pension}$$

$$= \frac{10}{25} \times £480$$

$$= £192$$

Thus only £192 of the annual pension is deemed to be from a Union source.

[45] At present there are such agreements with the United Kingdom, United States of America, Sweden and the Federation of Rhodesia and Nyasaland.

§ 185. Deduction of benefits paid for employment and services

All amounts connected with employment or services rendered and payable by an employer to an employee in terms of a service agreement, are deductible from income as long as they are reasonable in amount. If the amounts payable are excessive, the Commissioner is entitled to disallow portion thereof as not having been incurred in the production of income (see §§ 27 and 145). Payments to an employee in lieu of leave or notice are deductible and so is the cost of any other benefits payable to an employee in terms of his service contract, e.g. the employee's income tax and life assurance premiums paid by an employer. The cost of food and other rations provided by an employer to his staff during tea and lunch intervals is allowed in practice. Advances or allowances to employees to cover expenses reasonably incurred by them in promoting the employer's business are deductible.

If, in terms of his service agreement, an employee is entitled to compensation for the loss of his office, or in the event of his contract terminating before the expiry date, or if he is entitled to a pension on retirement, the amounts paid by the employer in carrying out these obligations are proper deductions from income.[46]

In regard to voluntary awards or *ex gratia* payments by an employer to an employee not provided for in a service contract, whether they are deductible or not depends upon the circumstances of the case. For example, reasonable annual bonuses paid to staff are allowed in practice even though payable out of profits which have already been earned since the motive is usually to secure a happy and contented staff and so spur them on to greater efforts. Where, however, a bonus was payable to employees relative to services rendered over a number of prior years, the Court refused to allow the deduction.[47]

Ex gratia awards to retired employees in respect of services rendered are not deductible unless it can be clearly established that it is the generally accepted policy of the employer to make gratuities on retirement.[48] The same principle applies to gratuities made to dependants of retired or deceased employees, e.g. a gratuity paid to a widow of a deceased employee is not deductible.[49] Annuities payable to such persons are, however, deductible to the extent set out in section 11(2)(*i*)*ter* (see § 186). The Committee of Enquiry into the Income Tax Act recommended[50] that a lump-sum payment made *ex gratia* by an employer to an employee who has retired from his employ on the grounds of old age, ill-health or infirmity, should be an allowable deduction subject to a suitable safeguard. The Committee considered that the Commissioner may determine that such

[46] See I.T.C. No. 414, 10 S.A.T.C. 249.
[47] I.T.C. No. 618, 14 S.A.T.C. 480.
[48] *W. F. Johnstone & Co., Ltd.* v. *C.I.R.*, 1951 (2) S.A. 283 (A.D.); 17 S.A.T.C. 235; *Provider* v. *C.O.T.*, 1950 S.R. 161; 17 S.A.T.C. 40.
[49] I.T.C. No. 618, 14 S.A.T.C. 480; I.T.C. No. 609, 14 S.A.T.C. 374; I.T.C. No. 590, 14 S.A.T.C. 133.
[50] *First Report*, p. 36, para. 76.

payments should be deducted in a series of instalments. This recommendation was acceptable to the Income Tax Commission provided that it was made clear in the law that to be allowed the payment must be in recognition of past services.[51]

Other examples of payments which may be made in connection with employment or services, are those made to get rid of an onerous agency contract in order to relieve the employer from making future commission payments under the contract, or damages paid for the cancellation of a contract of employment for the purpose of relieving the employer from making onerous salary payments in the future. It is submitted that these payments are not deductible as they are incurred for the purpose of avoiding or reducing expenses in the future and not in the production of 'income' as defined in section 7 (see § 134).

Damages paid to an employee for the cancellation of his service contract on the closing down of his employer's business, it is submitted, are not deductible in terms of section 11 (2) (*a*). The same applies to a non-contractual gratuity paid to an employee as compensation for loss of office.

A shareholder in a company is not entitled to deduct from his income any gratuity or other remuneration payable by him to an employee of such company even though it has been laid out to produce income for the company;[51a] neither can the company claim such expenditure as a deduction since it has not incurred it.[52]

It is not a necessary requirement that the services must be rendered in the Union in order that the payer can claim the remuneration payable for such services as an allowable deduction. As long as the remuneration has been incurred for the purpose of earning the taxpayer's income, it is deductible even though the services are rendered outside the Union.[53]

Irrecoverable advances to employees are not deductible unless voted as remuneration thereby extinguishing the debt due to the employer. The employee is taxable on the loan so extinguished.

§ 186. DEDUCTION OF PENSIONS TO RETIRED EMPLOYEES AND THEIR DEPENDANTS

In terms of section 11 (2) (*i*) *ter*, a taxpayer can deduct from his income any amount paid by way of annuity during the year of assessment to —

(i) a former employee who has retired from the taxpayer's employ on grounds of old age, ill-health or infirmity; or

(ii) any person who is dependent for his maintenance upon a former employee or, where such former employee is deceased, was dependent upon the former employee immediately prior to his death, e.g. a widow of an ex-employee.

[51] *First and Final Report*, p. 11, para. 44.
[51a] I.T.C. No. 630, 15 S.A.T.C. 95.
[52] I.T.C. No. 38, 2 S.A.T.C. 68.
[53] I.T.C. No. 345, 9 S.A.T.C. 46.

As regards the deduction under (i) there is no limitation as to the amount to be deducted, but in the case of (ii) the deduction is limited to a sum of £300 in respect of each retired or deceased employee irrespective of the number of persons dependent upon such retired or deceased employee.

The words 'amount paid by way of annuity' clearly rule out voluntary pensions terminable at the will of the employer or lump-sum gratuities. Such payments made to employees on retirement are not deductible in terms of section 11 (2) (*i*) *ter*. Moreover, they cannot be deducted under section 11 (2) (*a*) as being expenditure incurred in the production of the income unless it is the generally accepted policy of the taxpayer to pay gratuities or pensions on the retirement of his employees.[54] Where, however, an employer agrees to pay to a retired employee or to a dependant of a deceased employee a pension either for life or for a fixed term of years, this constitutes an amount paid by way of annuity and is subject to deduction in terms of section 11 (2) (*i*) *ter*.

Section 11 (2) (*i*) *ter* does not provide that the annuity must be paid by the particular trade from which the employee had retired. The employer may have ceased carrying on that particular trade. He is, however, not prevented from deducting the annuity from any other trade which he is carrying on as long as all the conditions of section 11 (2) (*i*) *ter* have been complied with. A problem is, however, created by section 12 (*g*) which, notwithstanding the deductions set out in section 11, prohibits the deduction of any moneys 'not wholly or exclusively laid out or expended for the purposes of trade'. How could it be said — so the argument may be — that annuities now paid by a taxpayer to former employees of a business no longer carried on, are expenditure for the purposes of trade. If this argument is drawn to its logical conclusion it would mean that even if the business was still being carried on it cannot be said that annuities paid to retired employees are expended for the purposes of trade. It must follow from this argument that no deduction can be made in respect of annuities paid to ex-employees which would be in direct conflict with the provisions of section 11 (2) (*i*) *ter*. As was held in one Special Court case[54a] 'one cannot attribute such an inelegance to the Legislature, namely to provide that an annuity so paid shall be allowable, and then immediately thereafter nullify the effect of it by prohibiting it in the very next section'. Section 11 (2) (*i*) *ter* should provide that the deduction authorized by it is allowable notwithstanding the provisions of section 12 (*g*).

The present provisions of section 11 (2) (*i*) *ter* are unsatisfactory and may lead to abuse particularly in the case of family companies. There may be nothing to prevent a taxpayer from employing his aged father in his business for even a limited period and thereafter on retirement paying him an annuity or allowance for the rest of his

[54] *W. F. Johnstone & Co., Ltd.* v. *C.I.R.*, 1951 (2) S.A. 283 (A.D.); 17 S.A.T.C. 235; *Provider* v. *C.O.T.*, 1950 S.R. 161; 17 S.A.T.C. 40.

[54a] I.T.C. No. 729, 18 S.A.T.C. 96.

life. It would also appear that annuities to former business employees are not excluded even though the business was not carried on for the purpose of producing income as defined, unless section 12(*g*) prohibits this kind of deduction.

The present provisions need to be tightened up. Section 78(1)(*c*) of the Australian Act may provide guidance in this respect. It provides for the deduction of allowances to persons 'who are or have been employees or dependants of employees, to the extent to which, in the opinion of the Commissioner, those sums are paid in good faith in consideration of the past services of the employees in any business operations which were carried on by the taxpayer for the purpose of gaining or producing assessable income'.

§ 187. Retirement benefit schemes

From the above examination of the various provisions dealing with the taxation of benefits from employment and services, it will be clearly seen that the Legislature has left no stone unturned in its endeavour to tax all amounts accruing from employment and services. In this field, tax avoidance devices are very rare indeed so that the employee is not placed in the same fortunate position as the trader or industrialist who is able to take advantage of the loopholes in the income tax law in so far as concerns the taxation of business profits. In one respect, however, the legislator has granted some latitude to employees and that is in regard to the provisions of the Act dealing with retirement benefit and pension schemes.

The importance of pension schemes as a method of encouraging employees to remain in the service of their employers throughout their working lives is well known indeed. Not only is it a method of providing additional remuneration for the employees — the employer invariably makes invaluable contributions to the scheme — but most modern taxing systems also permit the employee to receive the benefits with the minimum of tax liability. As regards the lowly paid employees, it is not so much the tax benefits but the benefits on death or retirement that weigh so much with them. On the other hand, in the case of the more highly paid employees, a scheme which enables them to receive substantial benefits at the expense of the tax-gatherer is an advantage of great importance.

In the South African Income Tax Act three classes of benefit schemes have received recognition. The legislator refers to them as pension funds, provident funds and benefit funds.

§ 188. Pension funds

Definition of pension fund

Employees and employers are permitted to deduct from their incomes, subject to certain restrictions, any contributions which they make to a pension fund (section 11(2)(*i*) and section 11(2)(*i*)*bis*). It is only those contributions made to a pension fund which conforms with the requirements of the definition of *pension fund* in the Income Tax Act, that can rank for deduction.

Pension fund, as defined in section 1, means —

'a superannuation, pension, provident, widows', or orphans' fund established by law and any fund not established by law which is approved by the Commissioner in respect of the year of assessment in question: Provided that the Commissioner may approve a fund subject to such limitations or conditions as he may determine, and shall not approve a fund unless, in respect of the year of assessment in question, he is satisfied that —

(1) the fund is a permanent fund *bona fide* established for the purpose of providing annuities for employees on retirement from employment or for widows, children, dependants or nominees of deceased employees, or mainly for the said purpose and also for the purpose of providing benefits other than annuities for the persons aforesaid; and

(2) the rules of the fund provide —

(i) that all annual contributions of a recurrent nature to the fund shall be in accordance with specified scales;

(ii) that membership of the fund throughout the period of employment shall be a condition of the employment by the employer of all persons of the class or classes specified therein who enter his employment on or after the date upon which the fund comes into operation;

(iii) that persons who immediately prior to the said date were employed by the employer and who on the said date fall within the said class or classes may, on application made within a period of not more than twelve months as from the said date, be permitted to become members of the fund on such conditions as may be specified in the rules;

(iv) that not more than one-third of the total value of the annuity or annuities to which any employee becomes entitled, may be commuted for a single payment, except where the annual amount of such annuity or annuities does not exceed thirty pounds;

(v) for the administration of the fund in such a manner as to preclude the employer, except in the case of a local authority, from controlling the management or assets of the fund, and from deriving any monetary advantage from moneys paid into or out of the fund; and

(vi) that the Commissioner shall be notified of all amendments of the rules; and

(3) the rules of the fund have been complied with.'

The requirement that pension funds, other than those established by law, must be approved of by the Commissioner in respect of each year of assessment, is not strictly adhered to in practice. The rules of the fund are very thoroughly examined when they are first sent to the Commissioner for approval. Unless the Commissioner has been notified of any amendments of the rules (see para. (2) (vi) of the definition *supra*), a fund, once it has been recognized, is not usually re-examined in respect of each tax year. So far, the Commissioner has not delegated his power to approve of pension funds to local receivers of revenue. All pension funds not established by law must, in terms of the present practice, be submitted to the Commissioner's head office in Pretoria for approval. In due course the various receivers of revenue are advised of all funds which have been so approved.

Pension funds not established by law, it is submitted, refer to funds which come into existence not through the operation of some law, e.g. the pension funds of the public service, but which are established voluntarily by agreement between an employer and trustees for the benefit of the employees.

It will be seen from the definition that the power to approve of a fund rests entirely with the Commissioner, whose decision, if made properly and *bona fide*, is not subject to review by the courts.

As regards the requirement that the fund must be a *permanent* one, the Commissioner insists that the fund must be a separate legal *persona* as distinct from the employer. In practice, this is usually achieved by the appointment of trustees or a committee to manage and administer the fund in accordance with the rules thereof.

In terms of para. (2) (v) of the definition, *supra*, the employer (except in the case of a local authority) must be precluded from controlling the management or assets of the fund. To overcome this requirement, most pension funds provide that the administration and control of the affairs of the fund are to be in the hands of one or more persons appointed by the employer and an equal number of persons elected by the employees. Para. (2) (v) also provides that the employer must not derive any monetary advantage from moneys paid into or out of the fund. This contemplates that the moneys or other assets of the fund cannot be used by the employer for his own advantage. The contributions that he is obliged to make to the fund must actually be paid over to the fund for disposal in terms of the rules of the fund. It is not sufficient for the employer merely to credit an account in his books acknowledging his idebtedness to the fund.

Para. (1) of the definition lays down that to rank as a pension fund the fund must be established in the main for the purpose of providing annuities for employees on retirement from employment or for widows, children, dependants or nominees of deceased employees. In terms of para. (2) (iv), the rules of the fund must not provide that more than one-third of the total value of annuities to which an employee becomes entitled on retirement can be exchanged for a lump sum. This restriction does not apply where the annuity does not exceed £30 per annum. There is therefore a definite limitation on the amount which an employee can receive by way of a lump sum on retirement. In practice, such a restriction in the rules of a fund has, in the writer's experience, not always found favour with employees who may prefer to receive lump-sum payments on retirement or at least prefer a rule which reserves to the trustees of the fund the right to decide whether an employee shall be paid a lump sum or a pension or a portion of each. This preference on the part of employees accounts for the fact that so many pension schemes fail to qualify for recognition as a pension fund. As will be seen in § 189, however, such funds may qualify as provident funds.

In terms of para. (2) (i) of the definition, it is not a requirement that both employer and employee must contribute to the fund. A fund which provides that all contributions are required to be made by the employer only or the employees only, qualifies for recognition.

An interesting point that arises is whether a pension fund to be recognized as such for income tax purposes must be established for the benefit of *all* the employees of the employer. The definition, although it does not say so in express terms, is wide enough, it is submitted, to allow the Commissioner to approve of a fund for the benefit of a particular class of the employees. This view is strengthened by the reference to 'class or classes' in para. (2) (ii) and (iii) of the definition, *supra*. In practice, the Commissioner accepts this interpretation but insists in regard to membership that the class or classes of employees eligible for membership must be clearly stated in the rules of the fund. The Commissioner does not regard as a class persons selected by the employer. The underlying idea is that membership must not be discriminatory. The class or classes of employees eligible to join the fund must be defined, and all future employees who fall within any of these categories must as a condition of employment be admitted to membership (para. 2(ii) of the definition). Present employees who fall within any of these categories, i.e. those in employment when the fund is inaugurated, *may* join the fund and they have twelve months in which to make a decision (para. (2) (iii) of the definition).

Although the Commissioner insists that the 'class or classes' must be clearly defined in the rules, the writer has experienced that in practice the Commissioner places a very wide interpretation on these words. Apart from the more usual cases of funds which confine membership to a particular race or sex or age-group, and which are readily approved of by the Commissioner, it is considered likely that the Commissioner will accept the following categories of employees as constituting a class:

(*a*) Employees who have rendered a certain number of years service to the employer. For example, an employer might desire to extend benefits only to those employees who have, say, been with him for at least five or ten years.

(*b*) Employees earning over a certain salary limit. For example, the fund might provide that only employees who earn a salary in excess of, say, £1,000 per annum are eligible for membership.

(*c*) Employees engaged in a particular type of function. For example the rules might provide that only employees who are engaged in a productive capacity can become members, or in the case of a wholesale business, the fund might stipulate that only salesmen are eligible for membership.

Notwithstanding the Commissioner's liberal interpretation of the meaning of the words 'class or classes', he may not approve of a fund which restricts membership to one or more directors in the high-income brackets who are also the shareholders of the company. As such an arrangement would exclude the ordinary employees, it is possible that the Commissioner may exercise his discretionary power and refuse to recognize the fund. However, merely from examining the rules of the fund, the Commissioner cannot tell who will be the members falling into the respective classes. It is necessary for him to call for the names of members falling into each class if he wishes to ascertain whether the ordinary employees are excluded or not.

In practice, the Commissioner does not insist that in order to be recognized a pension fund must be established by the employer himself. It happens often in practice that a holding company establishes a pension fund for the benefit not only of its own employees but also for the benefit of the employees of its subsidiary or associated companies. The Commissioner raises no objection to this procedure.

Types of pension funds

The types of retirement pension schemes utilized in practice vary considerably. Most schemes, however, comprise (*a*) pension benefits and (*b*) life cover. The scheme usually commences with effect from a fixed date. The normal pension date on which each member will normally be entitled to retire and receive his pension is the 65th birthday. Usually, both the employer and the member are required to contribute to the scheme in accordance with specified scales. For example, a member may be required to contribute $7\frac{1}{2}$ per cent of his salary and the employer a like amount. Members' contributions are usually deducted by monthly instalments from their salaries.

A common procedure with most funds is for the trustees to use the contributions to purchase an endowment assurance policy on the life of the member. Legal ownership in the policy vests in the fund and not in the member who usually has no rights of ownership therein. On retirement at normal pension date, the proceeds of the assurance will be used to purchase the most suitable type of pension for the employee concerned. The pension is usually guaranteed for a fixed number of years (five years is the normal guarantee) and the life of the employee thereafter. Alternative types of pension may usually be taken depending on the member's circumstances at the time of retirement. For example, the pension may be either on the life of the member himself, or he may elect to have a reduced pension on the joint lives of himself, his wife and his children or one or more of his dependants.

It is often provided that either the whole or a certain portion of the proceeds may be taken by the employee in the form of a capital sum and only the balance applied in the purchase of an annuity. It must not be overlooked, however, that for the fund to be recognized as a 'pension fund', not more than one third of the entire proceeds of the assurance shall be paid to the employee in the form of a lump sum.

The total pension to which each member will be entitled on retirement is calculated according to specified scales and are usually adjusted to conform to changes in his salary. The calculation may for example depend upon the salary at the date of retirement and the total number of years of service which the employee has completed from the date of entering the employer's service to retirement.

The rules of the fund invariably provide for what is to happen should a member leave the employment. A member is usually entitled to the following benefits:

(*a*) As regards that part of the assurance secured by his own contributions, he may have the following options:
  (i) to keep it in force by carrying on with the payment of premiums direct to the assurance company; or
  (ii) to convert it into a fully paid up policy with no further premiums to be paid; or
  (iii) to surrender it for its cash surrender value.

(*b*) As regards that part of the assurance secured by the employer's contributions:
  (i) the same options as above, if the member's services are not being terminated by the employer for fraud or misconduct or if he is not leaving the employer of his own free will; or
  (ii) if the member's services are being terminated for fraud or misconduct or if he is leaving the employer of his own free will, the disposal of the assurance will be at the employer's discretion.

Other matters commonly dealt with in typical pension schemes concern early retirement by a member, late retirement and the right of the employer to discontinue or amend the scheme.

§ 189. Provident funds

Employers, only, are permitted to deduct from their incomes, subject to certain restrictions, contributions made to a provident fund (section 11(2)(*i*)*bis*). Like pension funds, it is only those contributions made to a provident fund as defined in section 1 of the Act, that can rank for deduction. This definition is as follows:

> '"provident fund" means any fund (other than a pension fund or benefit fund) which is approved by the Commissioner in respect of the year of assessment in question: Provided that the Commissioner may approve a fund subject to such limitations or conditions as he may determine, and shall not approve a fund unless, in respect of the year of assessment in question, he is satisfied that—
>
> (1) the fund is a permanent fund *bona fide* established for the purpose of providing benefits for employees on retirement from employment, or mainly for the said purpose and also for the purpose of providing benefits for widows, children, dependants or nominees of deceased employees; and

(2) the rules of the fund contain provisions similar in all respects to those required to be contained in the rules of a pension fund in terms of sub-paragraphs (i), (ii), (iii), (v) and (vi) of paragraph (2) of the definition of " pension fund "; and

(3) the rules of the fund have been complied with.'

From this definition, it will be seen that a provident fund is defined in the same way as a pension fund (see § 188), with the single exception that the rules of a provident fund can permit the payment of lump sums instead of annuities to employees on retirement. In practice, it is often preferred to have a retirement scheme which provides that employees should be paid a lump sum on retirement instead of periodical pensions or which includes a right, vested in either the employer or the trustees, to decide whether an employee shall be paid a lump sum or a pension or a portion of each. This type of fund cannot be recognized as a pension fund (it fails to comply with para. (2)(iv) of the definition of *pension fund*) although in all other respects it complies with the terms of the definition. Provision has, therefore, been made to regard such a fund as a provident fund.

As in the case of pension funds, the power to approve of a provident fund rests entirely with the Commissioner whose decision, if made properly and *bona fide*, is not subject to review by the courts.

The remarks made by the writer in connection with pension funds (see § 188) apply *mutatis mutandis* to provident funds.

§ 190. Benefit funds

Employers, only, are permitted to deduct from income, subject to certain restrictions, contributions made to a benefit fund (section 11(2)(*i*)*bis*). Like pension funds and provident funds, it is only those contributions made to a benefit fund as defined in section 1, that can rank for deduction. This definition is as follows:

'" benefit fund " means any fund (other than a pension fund or provident fund as defined in this section) which, in respect of the year of assessment in question, the Commissioner is satisfied is a permanent fund *bona fide* established for the purpose of providing sickness, accident or unemployment benefits for its members or for providing benefits for the widows, children, dependants or nominees of deceased members.'

Unlike pension and provident funds, the definition of benefit fund does not insist that the rules of the fund comply with certain specified requirements. In this respect the conditions attaching to the recognition by the Commissioner of benefit funds are less severe than pension or provident funds. Unlike pension funds and provident funds, the Commissioner is not entitled to approve of a benefit fund subject to such limitations or conditions as he may determine. He must, however, satisfy himself in respect of each year of assessment that the fund complies with the requirements of the definition. The exercise of his discretionary power, if made properly and *bona fide*, is not subject to review by the courts.

It will be observed from the definition that a fund which provides benefits 'for the widows, children, dependants or nominees of deceased members' is also regarded as a benefit fund. It would seem, therefore, that funds providing sickness, accident and unemployment benefits are not the only funds which may be recognized as benefit funds. For example, it would appear that the fund could take out policies of insurance on the lives of its members, the proceeds to be payable to the family or dependants upon the death of a member. As contributions to the fund ordinarily cease at retirement age, a suitable type of life policy to effect on the life of a member would probably be one with limited premium payments. Thus, it could be provided that premiums on the policy would cease on retirement age when the member's contributions cease. At retirement, the fund would continue to hold the policy in trust until the death of the employee when the proceeds would be payable to his family or dependants. Through a benefit fund, therefore, it may be arranged that the annual premium on a life policy taken out on an employee's life (including a working director who may also be a beneficial shareholder in the company) and payable on his death to members of his family, is deductible for tax purposes.

§ 191. Contributions by employees to pension funds

In terms of section 11 (2) (*i*), there can be deducted from income —

> 'any sum contributed during the year of assessment by way of current contribution to any pension fund by any person holding any office or employment, where the making of such a contribution is a condition of the holding of such office or employment: Provided that the deduction to be allowed in respect of contributions to a pension fund not established by law shall not exceed the sum of two hundred pounds.'

It will be noted that only current contributions are deductible. Arrear contributions appertaining to a previous tax year are clearly not deductible.[55] 'Any person holding any office or employment' is entitled to the allowance. These words are sufficiently wide to include the managing director of a company even though he is the sole beneficial shareholder.

It is important to remember that an employee can deduct contributions to an *approved* pension fund only. If the fund has been recognized as a provident fund or benefit fund, although the employee cannot deduct from his income the contributions he makes, he is permitted to claim the 'insurance' rebate of 1*s.* 3*d.* per £ in terms of the provisions of section 13 (2) (*b*) (ii) (see § 120).

Although section 11 (2) (*i*) stipulates a maximum deduction of £200 in respect of contributions to a pension fund not established by law, an employee can in effect 'dodge' the section by arranging with his employer to accept an irrevocable reduction in his remuneration in consideration of his employer paying into the pension fund on his

[55] I.T.C. No. 220, 6 S.A.T.C. 143; I.T.C. No. 386, 9 S.A.T.C. 461; I.T.C. No. 762, 19 S.A.T.C. 107.

behalf an amount equivalent to the amount of salary forgone. For example, if one took the case of a married Cape resident with a salary income of £7,500, the total tax payable would be £2,508 leaving a net amount of £4,992 after payment of tax. If he forgoes £2,500 of this salary, his taxable income will be £5,000. The total tax payable would be £1,258 leaving a net amount remaining of £3,742. Thus, the effective cost to the employee of the retirement benefits purchased with the amount of salary forgone, viz. £2,500, is only £1,250 (£4,992 *less* £3,742).

The procedure of forgoing salary can also be adopted in respect of contributions by an employee to a provident or benefit fund. The employer pays into the fund an amount equivalent to his own contribution *plus* the amount of the salary forgone by the employee. The employee is taxable on the salary actually received. If he had not forgone portion of his salary, he would have been taxable on his gross salary since contributions to a benefit or provident fund are not deductible by the employee in terms of section 11 (2) (*i*).

It must be borne in mind, however, that as the employee has given up all rights to the amount of salary forgone, the contributions made to the fund are employer's contributions and not contributions made by the employee himself. The Commissioner may, therefore, not be prepared to allow the employer to deduct the full amount of the contribution in terms of section 11 (2) (*i*) *bis* (see § 192). Apart from this factor, there is no change in the employer's financial position. Although the employer is paying the increased contribution on behalf of the employee, he is being compensated by the amount of the salary forgone by the employee. The effect of the forgoing plan is to benefit the employee who obtains substantial retirement and death benefits at the expense of the *fiscus*.

§ 192. Contributions by employers to pension, provident or benefit funds

The right of employers to deduct from income contributions to pension funds, provident funds or benefit funds, is governed by the provisions of section 11 (2) (*i*) *bis*.

In respect of any lump-sum contribution, this is deducted in a series of annual instalments, so that only a portion thereof is deducted in the year of assessment in which it is contributed, and the residue in such subsequent years of assessment, and in such proportions as the Commissioner may determine, until the contribution is extinguished — section 11 (2) (*i*) *bis* (i).

The period of ' writing off ' and the amount of the annual instalment, are, in the writer's experience, usually agreed between the Receiver and the employer. In practice, the spread is usually limited from three to five years having regard to the relation of the lump-sum payments to the annual contributions, the net income of the concern, the report of the actuaries, etc. The proportion of the lump-sum payment to be allowed each year is in the discretion of the

Commissioner, whose decision, if *bona fide* and properly made, is not subject to review by the courts.

As regards current contributions, if the contributions (including any lump-sum payments) made by the taxpayer in respect of any employee during any year of assessment exceed 10 per cent of the 'approved remuneration' of such employee for such year, and the Commissioner is satisfied that the aggregate of such contributions and the total remuneration accrued during such year of assessment to such employee in respect of his employment by the taxpayer is excessive or unjustifiable in relation to the value of the services rendered by such employee to the taxpayer and having regard to other benefits, if any, derived by him from his employment by the taxpayer, only so much of such contributions as appears to the Commissioner to be reasonable, but not less than ten per cent of the approved remuneration of such employee for such year of assessment, is allowable — section 11 (2) (*i*) *bis* (ii). 'Approved remuneration' in relation to any employee for any year of assessment means 'so much of the total remuneration accrued to such employee during such year of assessment in respect of his employment by the taxpayer concerned as the Commissioner considers to be fair and reasonable in relation to the value of the services rendered by such employee during such year of assessment to the taxpayer and having regard to other benefits, if any, derived by him from his employment by the taxpayer'. Any decision of the Commissioner in the exercise of his discretionary powers is subject to objection and appeal.

It would seem, therefore, that current contributions to any pension fund, provident fund or benefit fund are allowed in full unless it appears to the Commissioner that contributions made by an employer on behalf of any employee in respect of any year of assessment are excessive or unjustifiable, in which event only so much of such contributions (not being less than 10 per cent of the employee's total remuneration as the Commissioner may consider reasonable and justifiable), as the Commissioner may consider reasonable, is allowable as a deduction in the determination of the employer's taxable income for that year of assessment. The writer understands that in practice, the Department does not usually call for details from employers showing the salaries earned by employees and the contributions made on their behalf by the employers, which in effect means that the employers' contributions may be automatically allowed as a deduction from income. Such a passive attitude on the part of the Department could possibly lead to the abuse of the section, particularly in regard to the practice of forgoing salary in lieu of making contributions by employees (see § 191).

The contributions to the pension, provident or benefit fund must be for the benefit of the employees of the taxpayer in terms of section 11 (2) (*i*) *bis*. In practice, a fund for the benefit of a particular class of employees is acceptable to the Commissioner. In this respect, see the reference to 'class or classes' in para. (2) (ii) and (iii) of the definition of *pension fund* and the writer's remarks in § 188. Where the class eligible for membership comprises a few selected employees in the higher-income brackets, who are also the directors and shareholders of a company, the Commissioner, in such circumstances, may possibly refuse the deductions on the ground that he is not prepared to recognize the fund in terms of the definitions of pension fund and provident fund in section 1. In this respect it should be pointed out that the Commissioner has not got the same wide powers of approval under the definition of benefit fund as he has under the definition of pension fund or provident fund.

The Committee of Enquiry into the Income Tax Act considered that there should be no limit concerning the allowance granted in respect of contributions made by employers to pension funds. As regards the allowance in respect of contributions by an employer to a benefit fund, this should be limited in any year to an amount which does not exceed 10 per cent of the total remuneration paid by such employer.[56] The Income Tax Commission could not agree that there should be no limit as regards annual contributions by employers to pension funds but recommended that the limit for contributions to pension and benefit funds be raised from 10 per cent to 12½ per cent of the total remuneration paid to employees who are members of such funds.[57] It must be pointed out that at the time these proposals were made, the allowance in respect of both pension and benefit fund contributions could not exceed 10 per cent of the total remuneration paid by the employer. There was also no definition of *provident fund* in the law at the time.

Where, on retirement or resignation from employment, an employee is entitled, in terms of the rules of the fund, to a lump-sum payment from any provident or pension fund, such amount is taxable to the extent set out in section 7(*b*)*ter* (see § 193). Section 11(4)(*a*) expressly excludes as a taxable recoupment the recovery of pension fund contributions previously allowed as a deduction to an employee.

If it should happen that an employer's contributions to a pension, provident or benefit fund are returned to him, such an amount would be regarded as a taxable recoupment in terms of section 11(4)(*a*). The point, however, appears to be of academic interest only, in so far as concerns pension funds and provident funds, since, in terms of para. (2)(v) of the definition of *pension fund*, it does not seem possible for an employer to obtain a refund of his contributions to an approved pension or provident fund. In practice, some funds provide that in the case of resignation from employment by an employee, the employer's contributions in respect of such employee can be utilized by the trustees in reduction of the next current contribution by the employer. The Commissioner does not appear to regard such a provision as a breach of the requirement of para. (2)(v) that an employer must not derive any monetary advantage from moneys paid into or out of the fund. In such a case, of course, the employer

[56] *First Report*, p. 28, paras. 28 and 29.
[57] *First and Final Report*, p. 10, paras. 35 and 36.

can only claim as a deduction, in terms of section 11(2)(*i*)*bis*(ii), the reduced amount of the contribution.

§ 193. Payments from a pension or provident fund

Effect of the statutory provisions

Section 7(*b*)*ter* brings into a taxpayer's gross income all lump-sum amounts received by or accrued to him in any year of assessment as a member of any provident fund or as a member of any pension fund. Lump-sum payments from a benefit fund are expressly excluded, as well as payments from a pension fund established by law.

Pension fund, provident fund and *benefit fund* must be given the meaning they bear in section 1 (see §§ 188, 189 and 190).

Annuities from any such funds are taxable in terms of section 7(*a*). It is expressly provided that in the case of a pension fund, single payments in commutation of any annuities or portions of annuities which conform to the provisions of para. 2(iv) of the definition of ' pension fund ' do not form part of the gross income.

The purpose of section 7(*b*)*ter* is to discourage 'top-hat' schemes formed with the object of providing substantial tax-free gratuities for senior executives on retirement. In the words of the Minister of Finance on the Income Tax Bill when he introduced this section: ' What happened was this, the employer did not lose because he could deduct his contribution to the fund from his income and not pay tax thereon, and on the other hand the senior executive also escaped tax on the lump sum he received. The only man who got hurt in the process was the *fiscus*. He lost on this deal, and it has been found necessary to put that matter right.'[58]

From the gross amount of the lump-sum payment so taxable in terms of section 7(*b*)*ter*, the recipient is allowed to deduct:

(1) the total contributions made by him to the fund concerned; and

(2) 4 per cent of the total contributions in respect of each completed year during which contributions were made by him to the fund; and

(3) the greater of £2,000 or an amount equivalent to £150 in respect of each completed year in the period of employment which, in terms of the rules of the fund, is taken into account for the purpose of determining the amount of his benefits under the fund.

It will be observed that the tax-free portion is calculated on a very generous scale. If an employee had, for 20 years, contributed £100 per annum to the fund, he will be entitled to a tax-free amount of £6,600 (£2,000 under (1) *plus* £1,600 under (2) *plus* £3,000 under (3)). If the contribution had been, say, £200 per annum over 40 years of service, the tax-free portion of the benefit would be £26,800 (£8,000 under (1) *plus* £12,800 under (2) *plus* £6,000 under (3)).

[58] House of Assembly Debates (Hansard), No. 19, 4th June to 9th June, 1956, cols. 6862 et seq.

If it is proved to the satisfaction of the Commissioner that the aggregate of the deductions under (1), (2) and (3) *supra* is less than the amount which would, in terms of the rules of the fund, have accrued for the benefit of the recipient on 30th June, 1955, if such fund had been liquidated on that date, this latter amount must be deducted from the lump-sum payment received in lieu of the aggregate of (1), (2) and (3) — proviso (iv) to section 7 (*b*) *ter*.[59]

When the aggregate of the deductions under (1), (2) and (3) exceeds the gross amount of the lump-sum payment, provision is made for a reduction in the amount of the deductions so that they do not exceed the amount received. Thus, such an excess cannot rank as a deduction — proviso (iii) to section 7 (*b*) *ter*.

To prevent the recipient's rates of tax being unduly inflated owing to the inclusion in his income in any year of assessment of a lump-sum benefit from a fund, it is provided in proviso (v) to section 7 (*b*) *ter* that for the purpose only of calculating the rates of normal and super tax for such year, there must be deducted from his taxable income and income subject to super tax the amount so included but the rate of tax so determined may not be less than that applicable to the first pound of taxable income or income subject to super tax. It must be remembered that this relief involves only a reduction in the rates of tax and not a reduction in the taxpayer's income subject to tax.

The above provisions apply whether the lump-sum payment is received by the employee on retirement or on resignation from employment. Early withdrawals from a fund due to an employee leaving his employment, fall within section 7 (*b*) *ter*.

It is expressly provided in proviso (ii) to section 7 (*b*) *ter* that the provisions of section 9 (1) (*d*) (see § 184) apply *mutatis mutandis* in the case of any amount taxable in terms of section 7 (*b*) *ter*. It must follow, therefore, that where a recipient of a lump-sum payment from a fund has rendered less than two years' services in the Union during the last ten years of his employment, the taxable portion in terms of section 7 (*b*) *ter* is not deemed to be from a Union source. If at least two years' services have been rendered in the Union during the last ten years and the employee has rendered services partly in and outside the Union, the payment must be apportioned in the ratio that the period during which the services rendered in the Union bears to the total period during which the services were rendered.

Where the recipient is a member of more than one fund or receives benefits from the same fund in different tax years, the deductions referred to in (1), (2) and (3) above cannot be claimed more than once but adjustments must be made for allowances granted in previous tax years. In this respect, it is provided that where a person

[59] Sec. 7 (*b*) *ter* was introduced with effect from the year of assessment ending 30th June, 1956, and the purpose of proviso (iv) was to meet the case of persons who would retire within a short time and who might be prejudicially affected by the new amendment.

is a member of more than one fund, periods of membership running concurrently must be regarded as a single period.

As regards the deduction under (3), *supra*, it is provided that the amount allowed to be deducted in any one year may not exceed the difference between the greater of £2,000 or the amount of £150 per annum in respect of each completed year in the period of employment attributable to each fund from which lump-sum payments have been derived during the current or any previous tax year (any period of employment common to two or more funds being taken into account in respect of one of such funds only), and the aggregate of the amounts allowed to be deducted under (3) in previous tax years — proviso (i) to section 7(*b*) *ter*.

In the event of the death of the employee, his benefits from the fund usually extend to his dependants or heirs who are not liable for tax on payments received from the fund unless they partake of the nature of an annuity.

Illustration showing the working of section 7(b) ter

Total lump-sum benefit from Provident Fund received on 15th April, 1958	£10,550
Contributions by employee to Fund	£2,400
Contributions by employer to Fund	£2,400
Period of membership of Fund to date of accrual of benefit 1st February, 1948 — 15th April, 1958.	
Employee's interest in Fund at 30th June, 1955	£3,200
Period of employment taken into account by the rules of the Fund for purpose of determining benefits — 1st October, 1940 — 15th April, 1958.	
Other income received during 1958 tax year:	
Salary	3,200
Interest	200
	£3,400

Required: Calculate the employee's taxable income and income subject to super tax for the 1958 tax year and his rates of normal and super tax.

Lump-sum payment		£10,550
Less (1) total contributions by employee ..	£2,400	
(2) (4% of £2,400) for ten completed years	960	
(3) £2,000 or (£150 × 17) whichever the greater	2,550	
		5,910
Taxable in terms of section 7(b) ter		£4,640

NOTES

(i) Whereas for the purpose of determining the number of completed years in respect of the deduction under (2), there is taken into account the period during which contributions were made to the fund, for the purpose of determining the number of completed years under (3) there must be taken the period of employment which in terms of the rules of the fund must be taken into account for the purpose of the determination of the benefits due to an employee. As the above illustration reveals, the two periods are not necessarily the same.

(ii) The employee's interest in the fund at 30th June, 1955, viz. £3,200, is less than the aggregate of the deductions, viz. £5,910. The larger amount is, therefore, deducted. If his interest at 30th June, 1955, had been £7,500, this amount must replace the deductions under (1), (2) and (3). In such a case the amount taxable would be £3,050 (£10,550 *less* £7,500).

Taxable income and income subject to super tax:

Portion of lump-sum payment — section 7(*b*)*ter* ..	£4,640
Salary	3,200
Interest	200
	£8,040

Rates of normal and super tax must be determined with reference to a taxable income and income subject to super tax of	£3,400
Thus, if employee is married —	
rate of normal tax 18·399*d.* per £ on	£8,040
rate of super tax 32·4975*d.* per £ on	£8,040

If, in the above example, the recipient's other income consisted of a salary of £3,400 but he incurred an assessed loss of £4,000 from farming, his taxable income and income subject to super tax would be:

Portion of lump sum — section 7(*b*)*ter*	£4,640
Salary	3,400
	£8,040
Less Assessed loss from farming	4,000
	£4,040

In determining the rates of normal and super tax, it is observed that the amount on which they must be calculated is a negative amount, i.e. £4,040 *less* £4,640. In such a case, the minimum rates apply, i.e. 15*d.* on a taxable income of £4,040 and 24*d.* on an income subject to super tax of £4,040.

§ 194. CRITICISMS OF THE PRESENT PROVISIONS REGARDING RETIREMENT SCHEMES

The present provisions encourage the formation of 'top-hat' schemes, i.e. retirement schemes for the benefit of managing directors or executive directors and senior members of the staff receiving high salaries. It has already been stated that the Commissioner is bound to recognize a scheme for the benefit only of employees earning over a certain salary limit. Not only does the scheme enable such directors and employees to receive substantial benefits but the obtaining of these benefits at the expense of the tax-gatherer confers an additional advantage which is denied to other taxpayers, e.g. self-employed persons. The procedure of forgoing salary by an employee, as explained above, also permits an employee — often he is the sole or main beneficial shareholder in a company — to obtain even substantially increased retirement and death benefits at the expense of the Treasury.

The tax benefits presently enjoyed by employees, including directors of companies, in regard to retirement benefit schemes should be extended to all taxpayers not now covered by schemes, e.g. professional men. They should be entitled to belong to group schemes or to make individual arrangements which could be approved of by the Commissioner. It is manifestly unfair that a managing director of a company, in which he is the sole beneficial shareholder, is entitled to secure, say, £20,000 life insurance through a pension scheme, arranged by his company, in terms of which the contribution of, say, £200 made by him and the £200 contributed by his company are used to pay for the annual premium on such insurance, say £400. The income tax law permits the whole premium to rank as a deduction from income. The company can claim the £200 it contributes as a deduction from its income whereas the managing director is also entitled to deduct the £200 from his salary. If a self-employed person, e.g. an individual trader or a professional man, were to take out a policy on his life for £20,000, the annual premium of £400 is not deductible from his income. It is a matter for regret that this important issue was not considered by the Committee of Enquiry into the Income Tax Act.

Sections 22 and 23 of the Finance Act, 1956, of the United Kingdom, passed into law certain of the recommendations made by the Millard Tucker Committee on the Taxation Treatment of Provisions for Retirement[60] with regard to retirement benefits for self-employed persons. In particular, the sections apply to professional men, individuals and partners in business, and to employees who are not entitled to any benefits under pension or retirement schemes set up by their employers. Broadly, the main features of the provisions are as follows:

(i) Relief from tax is granted in respect of 'qualifying premiums' paid under an annuity contract approved by the Commissioners of Inland Revenue.

(ii) A 'qualifying premium' is defined as a premium payable under an annuity contract approved by the Commissioners as having for its main object the provision for the individual of a life annuity in old age.

[60] Cmd. 9063 published by Her Majesty's Stationery Office, London.

(iii) The annuities, which shall not be capable of surrender, commutation or assignment, must be for the life of the annuitant but it must not commence before the age of 60 or after the age of 70.

(iv) The annuity contract must be made with persons lawfully carrying on the business of granting annuities in the United Kingdom but relief may also be given in respect of premiums paid under an approved trust scheme set up in the United Kingdom, e.g. a scheme established for the benefit of individuals engaged in or connected with a particular occupation for the purpose of providing retirement annuities for them, their families or dependants.

The United Kingdom has gone a long way towards the removal of a substantial injustice to those persons not able to make provision out of untaxed income for an annuity to be enjoyed during retirement. Very recently, New Zealand widened its definition of a 'superannuation fund' to enable funds established for professional persons and others who are not employees to be recognized. It is hoped that the Union will follow the example set by these countries.

CHAPTER ELEVEN

SPECIAL PROVISIONS AFFECTING PARTICULAR TAXPAYERS

I. Farmers

§ 195. Introduction

Section 14 of the Income Tax Act provides that the taxable income of any person carrying on pastoral, agricultural or other farming operations must, in so far as it is derived from such operations, be determined in accordance with the ordinary provisions of the Act but subject to the special provisions set out in the Third Schedule to the Act.

Apart from the special provisions set out in the Third Schedule, farmers are taxed in the same manner as all other taxpayers. The taxable income derived from the carrying on of farming operations, in the case of individuals, is included with the income derived from other sources and the total taxable income is then subject to normal tax and super tax at the ordinary rates applicable to individuals. In the case of companies, the taxable income derived from farming is subject to tax at the ordinary rates applicable to companies.

§ 196. Definition of 'farming operations'

There is no definition of 'farming operations' in the Act. Section 14 merely refers to persons carrying on 'pastoral, agricultural or other farming operations'. The question as to whether a person is carrying on farming operations or not, is one of fact.

The term 'farming operations' includes market-gardening, dairy-farming, sugar-planting, wattle-farming, the growing of timber, and rearing day-old chicks. There is no provision in the Act that a person must occupy lands of a certain size or extent before he can be regarded as carrying on farming operations. As long as there is a genuine intention to develop land as a farming proposition in the hope that an ultimate profit will be derived, this, it is submitted, constitutes the carrying on of a farming operation. Thus, where a person whose principal occupation was that of a teacher, was also the owner of a smallholding of about 25 morgen upon which he had during the particular year of assessment grown certain crops and had planted certain fruit trees, the Special Court held that the operations carried on, while not on a scale at present productive of profit, were of the nature of farming operations for the development of an ultimately paying proposition.[1]

[1] I.T.C. No. 208, 6 S.A.T.C. 55.

In the case of a company which carried on the business of livestock auctioneers, produce brokers and estate agents, and which embarked upon certain further activities consisting of the acquisition of cattle of a particular type known as store cattle, grazing them on a farm for periods varying between six weeks and six months and thereafter selling them, the Special Court held that the company was carrying on farming operations.[2]

Where a person lets a farm and in return receives a cash rental, he is clearly not carrying on a farming operation. The rental he receives is not derived from farming operations, but from the ownership of the land.[3] However, in a case where the consideration for the letting of a farm consisted of a percentage of the produce, i.e. crops or livestock, and not a cash payment, the lessor was regarded as carrying on farming operations.

> 'Here the landlord has a direct interest in the farming operations because he has the right to a proportion of the proceeds of the crops grown thereon, therefore, in our opinion, he is a person who derives his income from farming operations. . . .'[4]

It must follow from this decision that where a landlord of a farming property stipulates a cash rental he is not entitled to claim as a deduction the allowances in respect of capital improvements in terms of para. 17 of the Third Schedule since he is not regarded as carrying on farming, whereas if his rental is fixed by way of a percentage of the produce of the farm he is regarded as a farmer and is entitled to the deductions specified in para. 17.

A farmer engaged in the breeding of thoroughbred horses and who also races the horses he breeds for stakes, carries on two businesses, one the industry of breeding horses which is a farming operation and the other the business of horse-racing which is not a farming operation.[5]

§ 197. Livestock and produce on hand

All farmers must include in their returns rendered for income tax purposes the value of all livestock or produce held and not disposed of at the beginning and end of each year of assessment (para. 6).

The value of livestock or produce held and not disposed of at the end of the year of assessment is included in income for that year of assessment whereas there is allowed as a deduction from income the value of livestock or produce held and not disposed of at the beginning of the year of assessment (para. 7(1)).

A farmer is, therefore, obliged at the end of his accounting year to take stock of all the animals and produce on hand. The value of such livestock or produce is included in his income for that year and, in terms of para. 8(1)(*a*)(i), becomes the opening stock for the next

[2] I.T.C. No. 586, 14 S.A.T.C. 123.
[3] I.T.C. No. 166, 5 S.A.T.C. 85; I.T.C. No. 732, 18 S.A.T.C. 108.
[4] I.T.C. No. 166, 5 S.A.T.C. 85.
[5] I.T.C. No. 639, 15 S.A.T.C. 226.

succeeding year of assessment, and is allowed as a deduction from income in that next year.

It is seen, therefore, that in respect of their livestock and produce, farmers are assessed on a general trading basis subject to this important exception, that all the livestock and produce are regarded as floating capital irrespective of the purpose for which they have been acquired. If a farmer were to purchase livestock not for the purpose of resale at a profit, but to assist him in the carrying on of his farming operations, for example to be held as breeding stock or draught animals or to produce milk or other produce, all such livestock would be regarded as floating capital in terms of the provisions of the Third Schedule. But for these provisions, they would clearly be regarded as fixed capital assets. The money laid out on their purchase would be deductible as an expense in terms of section 11 (2) (*a*). Any profit made on a subsequent disposal, even if made on the abandonment of farming operations, would be taxable, and any loss incurred would be deductible. In this respect, the Third Schedule appears to vary the ordinary provisions of the Act. The Third Schedule abolishes the importance or necessity of inquiring into the purpose with which the farmer has acquired his livestock or what his scheme or method of profit-making is, and treats all the farmer's livestock and produce as his floating capital. '. . . the farmer is treated, willy-nilly, as an ordinary trader for income tax purposes. Dependent upon the difference in the value of his livestock at the commencement and the close of each year, there is either an accrual or a loss of his floating capital; if the former this forms part of his income, if the latter the loss is deducted from his income. His sales during each year of his livestock of whatever category, whether of part or the whole of his herd, form part of his income and his losses, whether mortality or other losses, are deducted from his income. This basis of computation for income tax purposes has been imposed compulsorily upon the farmer by legislation, and the Commissioner of Taxes and the courts are no longer concerned to inquire whether in a particular farming business the farming livestock can be treated as fixed capital, because it must now be treated as part of the stock-in-trade of his farming business.'[6]

It is only the value of *livestock and produce* on hand at the beginning and end of each tax year that must be brought into account in terms of the Third Schedule for the purpose of computing the taxable income of the farmer. What of the value of consumable stocks and stores on hand at the end of the tax year, e.g. produce purchased by a farmer for use as feed for his livestock such as forage, mealies, etc., fertilizers and manure, seeds, packing materials? It is submitted that as the Third Schedule makes no provision for

[6] Per Lewis, J., in *Farmer* v. *C.O.T.*, 1944 S.R. 80; 13 S.A.T.C. 158. In this case the High Court of Southern Rhodesia had to consider the effect of sec. 17 of the now repealed Income Tax Act, Chapter 134 of the laws of Southern Rhodesia, the main provisions of which dealing with livestock and produce were essentially the same as the corresponding provisions in the Union Act; see also I.T.C. No. 716, 17 S.A.T.C. 344.

the inclusion in taxable income of the value of the opening and closing stocks of these items and as the provisions regarding trading stock applicable to ordinary traders (section 11 (5)) do not apply to farmers, the value of these stocks on hand at the beginning and end of each tax year must not be taken into account in the determination of the farmer's taxable income. It would appear that the Commissioner accepts this position in practice although where a farmer does include the value of such stocks in his return of income, objection is not taken to this procedure. The exclusion of opening and closing stocks of consumable stores from the farmer's taxable income is a serious omission and should be rectified. Not only does it mean that a farmer's income for tax purposes does not coincide with the commercial or accountancy concept of profit but it also creates a loophole for tax avoidance, since if a farmer feels that his taxable income is going to be too high for a particular tax year, all he need do is to purchase before the end of the tax year stocks of consumable stores, e.g. mealies, packing materials, etc., which will rank as an allowable deduction from income. If a farmer's produce on hand must be brought into account, there is no valid reason why his consumable stores should not likewise be brought into account. This anomaly may further prejudice the Revenue in that it would appear that should the farmer donate the consumable stores in a year subsequent to that in which they were purchased, there may be no means whereby the cost of such stores can be included in the assessment. Para. 10 provides that the current market price of *produce* donated must be included in income and it would seem that farm stores do not fall within the ambit of para. 10. See also the writer's remarks in regard to donations of trading stock in § 254.

§ 198. VALUATION OF LIVESTOCK

Persons other than companies

The value to be placed upon livestock (other than livestock acquired by purchase for stud purposes) is the *standard value* applicable to the livestock (para. 12(*a*)).

The standard value applicable to any class of livestock is —

(*a*) such standard value as may be fixed by regulation under the Act;[7] or

(*b*) such other standard value as the farmer may adopt for that class of livestock (para. 13).

Farmers are, therefore, given the option of classifying and valuing their livestock at either the standard classification and values fixed by regulation or at their own classification and valuation. Once the farmer exercises his choice as to the classification and values he wishes to adopt, he is not permitted at a later date to alter these classifications and values without the consent and approval of the Commissioner and upon such terms as he may require (para. 14). It

[7] Standard values have been fixed by regulation — see Government Notice No. 845, published in *Government Gazette* No. 5452 of 22nd April, 1955.

is submitted, however, that the restriction applies only as long as the farmer is carrying on farming operations. If he ceases farming and recommences at a later date he is entitled to elect new standard values in terms of para. 13.

If in any year the farmer includes for the first time a class of livestock in respect of which no standard value has previously been elected, he must then elect a standard value in respect of that class of livestock which becomes binding subject to the provisions of para. 14.

The value to be placed upon livestock acquired by purchase for stud purposes is the purchase price paid for that livestock (para. 15). The phrase 'acquired by purchase for stud purposes' must be construed as meaning acquired by purchase for breeding purposes.[8]

It is expressly provided in the proviso to para. 12(*a*) that the value to be placed on livestock on hand at the date of death or insolvency of a farmer shall be the price which in the opinion of the Commissioner is the current market price of the livestock and not the standard values adopted by the farmer.

As regards the term 'standard value', it has been held that the word *standard* governed and qualified the word *value*, and that the word standard in its adjectival sense meant 'fixed' or 'permanent' or 'constant'.

> 'The object of applying standard values seemed to be to obtain a fair average value per head of stock which could be applied at any time to the whole herd or flock, and so give a comparison of its value between any two dates, which ignored all market fluctuations in value. This method made it easy to obtain a fair estimate of the increase of wealth which had accrued to the farmer from the natural increase of his livestock and the growth of his previous years increase to maturity. If the value of each head of stock on hand at each end of the tax year were kept the same, then the two figures balanced each other, and the annual profit or loss on unsold stock was due to the increase or decrease of the numbers. It was true that every farmer must know the number of his sheep and cattle, if only to guard himself against loss, but it was not every farmer who could give a value to his sheep or cattle at any given date. By the standard values he was saved from the trouble of trying to do so.'[9]

Until 30th June, 1958, a farmer could elect any standard value he desired. It does not necessarily follow that the adoption of high values will yield tax advantages. It is impossible to predict the effect on the farmer's tax position should he choose a high or low standard value. The result of adopting high values may mean that a farmer could be mulcted in heavy taxation in respect of natural increases or the purchase of animals at prices far below the elected values. The farmer who chooses low standard values may have the opportunity of creating losses for tax purposes in respect of animals purchased at prices far in excess of the values elected. Having regard,

[8] I.T.C. No. 753, 18 S.A.T.C. 420.

[9] Per Maritz, J., in I.T.C. No. 55, 2 S.A.T.C. 176.

however, to the provision in para. 12 (*a*) (see § 212), that on the death of a farmer the value to be placed on livestock held at the date of death is the current market value and not the elected standard value, there may be serious prejudice from the tax point of view in the period of assessment up to the date of death if the elected values are low and the current market price is considerably in excess of these values.

With effect from 1st July, 1958, farmers are no longer entitled to elect any standard value which they may wish to place on their livestock. The proviso to para. 13 provides that no standard value adopted by the farmer shall be more than 20 per cent higher or lower than the standard value fixed by Regulation in respect of livestock of the class in question. It is, however, provided that where a farmer classifies any animal into a class not provided by Regulation, he may adopt in respect of the class so elected such a standard value as may be approved by the Commissioner with due regard to the values fixed by Regulation. As regards elections made before 1st July, 1958, these are not affected and the farmer may continue to use them for the purpose of valuing his livestock on hand at the beginning and end of each tax year. The Commissioner's discretionary power has not been made subject to objection and appeal and as long as he acts *bona fide* and applies his mind properly to the question, his decision is not subject to review by the courts.

Partnerships

Since a partnership is not a taxable *persona*, it is not entitled to elect standard values which may be applicable to the firm or to the individual partners. Each partner in a partnership business carrying on farming operations must elect his own standard values which must be applied to his share of the livestock and produce on hand at the beginning and end of the tax year and used in the partnership business. In this respect the legal rights of the respective partners to the ownership of the livestock used in the business must be borne in mind. It must follow, therefore, that if the individual partners choose different standard values, their respective shares of the taxable income or assessed loss from the partnership farming will also differ. It may happen that a farmer joins a partnership firm and is also carrying on farming for his own account in respect of which he has already elected standard values. In such a case, he is not entitled to choose new standard values differing from those elected in respect of his private farming venture. It would seem from the terms of para. 14, that he must elect only one set of standard values which must be applied to his livestock in respect of all the farming ventures carried on, whether in a partnership carrying on farming operations or for his own account. On this principle, the converse must also apply, namely, that if he commences farming as a partner in a firm carrying on farming and elects his standard values, those values must also apply to any separate farming venture subsequently embarked upon.

Companies

Companies are not entitled to elect standard values for the valuation of livestock on hand at the beginning and end of each tax year.

Livestock acquired by a company (other than livestock acquired by purchase for stud purposes) is to be valued as follows:

(i) If acquired by purchase, either the purchase price paid or the price which in the opinion of the Commissioner is the current market price of the livestock. It would seem that the company has the option to choose either the purchase price or the market value in respect of each animal on hand at the end of the tax year; or

(ii) if acquired otherwise than by purchase, the price which in the opinion of the Commissioner is the current market price of the livestock — para. 12(*b*).

Livestock acquired by purchase for stud purposes must be valued on the basis of cost (para. 15).

§ 199. Mortality allowance

The value of the livestock held at the end of a year of assessment must be reduced by a mortality allowance against the possible loss of livestock by death. The Commissioner is required to fix this allowance at an amount which he considers fair and reasonable having regard to the risk of mortality of such livestock — para. 9.

In granting the mortality allowance the Commissioner (with effect from the 1955 tax year) draws a distinction between livestock acquired by purchase for stud purposes and other livestock. In regard to animals acquired by purchase for stud purposes, the farmer is entitled on application being made for this concession to write off the entire cost of the animal over a period of ten years in equal annual instalments. In practice this is achieved by granting a mortality allowance of 10 per cent in the year of purchase, 20 per cent in the second year, 30 per cent in the third year and so on. As regards animals acquired prior to the 1955 tax year, previous assessments are not reopened but the cost thereof is written off over a period of ten years with effect from the 1955 tax year. In the case of all other animals, the mortality allowance for all classes of livestock is fixed at 10 per cent. If the farmer does not make application for the special allowance in respect of stud animals, these animals are merged with all the others and the ordinary 10 per cent allowance is granted.

As it is the value of the livestock on hand at the end of the tax year that must be reduced by the mortality allowance, it must follow that since the closing stock at the end of one tax year becomes the opening stock for the next year, the mortality allowance allowed at the end of the previous year is automatically deducted from the opening stock.

The mortality allowance is not made in respect of the value of livestock on hand at the date of death or insolvency of a farmer;

neither is it granted in respect of livestock held at the date of commencement or recommencement of farming operations.

Companies are not entitled to a mortality allowance.

§ 200. Valuation of produce

The value to be placed upon produce included in any return is such fair and reasonable value as the Commissioner may fix (para. 16). This basis of valuation applies also to companies. *Produce* is not defined in the Act. It is submitted that crops that have not reached the stage of being converted into produce which has a saleable or marketable value, cannot be regarded as 'produce held' for the purposes of the Third Schedule. Only produce that has been gathered and that is marketable must be included in the return. Thus, growing crops and wool on the sheep's back must not be returned. In terms of the present practice of the Commissioner, produce on hand need not include produce grown and reaped by a farmer and held by him for the specific purpose of feeding his livestock. Where, however, a farmer does include the value of such produce as stock on hand, the Commissioner is not likely to object to this procedure.

Para. 16 clearly confers a discretionary power on the Commissioner as regards the valuation of produce and as long as he acts *bona fide* and applies his mind properly to the matter, the courts are not entitled to review his decision. In practice, the Commissioner requires that produce be valued at or about average cost of production or market value whichever is the lower, although in the case of companies they are permitted to value produce either at cost or market value, at their option. Usually there exists a substantial gap between the market value and the cost of production of produce and it may, therefore, be effectively argued that by insisting upon the valuation on the basis of cost of production when the market value is considerably greater, the Commissioner is not placing a 'fair and reasonable' value on the produce and is thus not exercising a proper discretion. It is interesting to mention that in the Income Tax Act of the Federation of Rhodesia and Nyasaland, there is a provision for the valuation of a farmer's produce which is identical with para. 16 (see section 26(7)) but the Commissioner insists that in the case of all crops raised for sale and which have been gathered and are marketable at the end of the tax year, these must be brought in at the full realizable value less an allowance for selling and other expenses directly connected with the proceeds of sale. In the case of all reaped crops on hand at the end of the tax year, which have been grown for use on the farm and not for resale, these must be valued at cost of production whereas the Commissioner insists that as regards growing crops these must be brought in and valued at cost.

§ 201. Natural increases and losses of livestock

Natural increases in livestock during a tax year are automatically brought to account by being included in income if sold during the tax year or, if not sold, by being included in the stock on hand at the end of the tax year.

Losses of livestock due to death or theft during a tax year are automatically allowed as a deduction from income since the stock on hand at the end of the tax year does not include such livestock. It is interesting to compare this with the ordinary trader who is not entitled to deduct losses of trading stock due to theft or burglary (see § 255).

§ 202. LIVESTOCK AND PRODUCE PRIVATELY CONSUMED

Livestock and produce used by the farmer for himself, his family or servants employed by him in his home during a tax year will result in a smaller quantity of stock on hand at the end of that year, and, in the absence of a special provision in the Act, it would seem that neither the cost nor the market value of the livestock and produce so consumed is taxable. In practice, farmers are called upon to pay tax on the estimated *value* of the livestock and produce consumed. It would appear that the Commissioner bases his practice on the provisions of section 12(*a*) and (*b*), but as pointed out when discussing this practice in relation to goods privately consumed by ordinary traders (see § 253) it is doubtful whether this practice will stand the test of the law. The provisions regarding the opening and closing stock of livestock and produce in relation to a farmer is dealt with in the Third Schedule and since livestock and produce privately consumed results in a smaller quantity of stock on hand at the end of the year, the Third Schedule would be the best place to provide for the taxation of livestock or produce privately consumed. In regard to livestock consumed for domestic or other private purposes, it is suggested that an amount based on the standard values elected by the farmer should be included in the gross income of the farmer. In regard to produce consumed, the fair and reasonable value should be included in the gross income. Cost price is not recommended as in the majority of cases farmers will not be in a position to determine the cost of livestock and produce consumed.

As regards the value of livestock and produce used by the farmer as rations for his farm employees, this is not taxable. The cost of providing rations for farm workers is deductible in terms of section 11(2)(*a*) of the Act. If livestock and produce are used as rations it is, therefore, only correct that no adjustments must be made to the farmer's taxable income.

§ 203. DONATION AND REMOVAL FROM THE UNION OF LIVESTOCK AND PRODUCE

Livestock or produce donated by a farmer, whether to charitable institutions or to any other person, must result in a smaller quantity of stock on hand at the end of the year.

Para. 10 provides that if during any year of assessment livestock or produce has been donated by any farmer, there must be included in the income of the farmer for that year of assessment an amount equal to the price which in the opinion of the Commissioner is the current market price of such livestock or produce. It is to be observed, therefore, that it is not the cost price of the donated livestock or produce that must be included in the farmer's income but the *market* value as determined by the Commissioner. As long as he acts *bona fide* and applies his mind properly to the matter, his decision is not subject to review by the courts.

The taxation of livestock or produce donated on the basis of market value results in a very serious anomaly in so far as concerns the farmer donor. Not only is he subject to income tax on the value of the donation, but he is also liable to donations tax in respect of the fair market value of the livestock or produce so donated, which means that both the ordinary income taxes as well as donations tax may be payable in respect of the same taxable amount. It could not have been intended that a taxpayer should be liable to the donations tax on the same property in respect of which ordinary income tax is payable. The Act should provide that the value of a donation of livestock or produce in excess of the cost price thereof which has been allowed as a deduction from income, is exempt from donations tax if such amount is required to be included in the gross income of the donor in terms of para. 10 of the Third Schedule (cf. section 54 *quat*(1)(*k*)).

It will be observed that para. 10 only deals with the case of where livestock or produce has been *donated* by any farmer and does not deal with the case of livestock or produce not sold in the ordinary course of farming operations and which is disposed of for a consideration less than the fair market price to a purchaser with whom the seller is not at arm's length. As the section stands at the moment, a farmer may successfully contend that the giving of some *quid pro quo* for the livestock or produce transferred to another prevents the disposal from falling within para. 10 thus defeating the purpose of the provision. For example, he may dispose of livestock worth £50,000 for £35,000 to a relative and contend that as no donation is involved, para. 10 does not apply. If the relative commences farming with this stock, he is entitled to claim as a deduction, by the choice of suitable standard values, the fair market value of the animals (see § 205). On this basis, the *fiscus* may be prejudiced. The farmer may also dispose of his livestock to a company in which he is the sole beneficial shareholder at a price bearing little relation to the current market price and considerably less than the standard values elected. It must be remembered that farmers who elected their standard values prior to 1st July, 1958, are entitled to retain their elected values and if high values were elected it must follow that on a sale to a company at a nominal value, the farmer could create a substantial artificial loss for tax purposes. It is, therefore, necessary that para. 10 should include within its ambit disposals of livestock or produce at prices below market value where the parties are not at arm's length (see also § 256 in regard to disposals of trading stock at prices below market value). This will act as an effective counter to the creation of large artificial losses for tax purposes.

If a farmer for purposes other than that of the production to him of income from Union sources removes his livestock from the Union during any year of assessment, there must be included in the income of the farmer for such year of assessment an amount equal to the price which in the opinion of the Commissioner is the current market price of such livestock or produce — para. 10. Thus, it will not avail farmers purchasing livestock in the Union, claiming it as a deduction for tax purposes and thereafter transferring them to a neighbouring country for sale therein so that the proceeds would be stamped with a non-Union source.

§ 204. Livestock and produce acquired by existing farmers by way of donation or inheritance

In respect of livestock or produce acquired by a farmer during the year of assessment otherwise than by purchase or natural increase or in the ordinary course of farming operations, for example livestock or produce acquired by donation or inheritance, if the farmer merges the animals or produce into his general farming activities it follows that, when sold, the proceeds of such livestock or produce are included in his income, and if unsold and on hand at the end of the year the value thereof will be included in the closing stock.

In terms of para. 8 (1) (*a*) (ii) and (*b*) (ii), the Commissioner must allow an existing farmer to deduct from his income such value as he thinks fit in respect of the livestock or produce acquired by way of donation or inheritance. The deduction takes the form of an addition to the value of the livestock or produce on hand at the beginning of the year of assessment. In terms of the present practice, livestock or produce acquired by donation or inheritance is valued at a fair market price at the date of donation or inheritance. The Commissioner's practice is fair and equitable. In the case of an ordinary trader, section 11 (5) (*d*) provides that if any trading stock has been acquired for no consideration, the taxpayer shall be deemed to have acquired such trading stock at a cost equal to the current market price at the date of acquisition. The farmer is not entitled to claim that the allowance must be made on the basis of the standard values elected by him. Para. 8 (1) (*a*) (ii) and (*b*) (ii) clearly provide that it must be 'such value as the Commissioner may allow'. Moreover, para. 12 which defines the value to be placed upon livestock, namely the standard value, excludes from its ambit livestock referred to in para. 8 (1) (*a*) (ii) and (*b*) (ii). If the allowance was granted on the basis of standard values, anomalies would arise since, if such allowance is lower than the current market price, the farmer could, in effect, be taxed on portion of his original capital. On the other hand, if the value based on standard values is higher than the market price, the taxpayer is entitled to deduct an artificial loss. The Commissioner's determination of the value is not subject to review by the courts as long as he has applied his mind to the matter and has acted *bona fide*.

If the livestock or produce received by way of donation or inheritance is not brought on to the taxpayer's farm or is not used for the purpose of farming but is immediately disposed of, it is submitted that the proceeds are in the nature of capital being the realization of a capital asset. In such a case the allowance provided for in para. 8 does not apply. The provisions of para. 8, it is submitted, apply only to cases where the livestock or produce received by way of donation or inheritance is used or held for the purpose of farming.

§ 205. LIVESTOCK AND PRODUCE AT COMMENCEMENT OR RECOMMENCEMENT OF FARMING

Para. 8 (1) (*b*) (i) of the Third Schedule provides that in the case of any person commencing or recommencing farming operations during a year of assessment, the opening stock of livestock or produce for that year of assessment must be deemed to be the value of the livestock or produce held and not disposed of by the farmer at the date of commencement or recommencement of farming operations. In other words, the value of any livestock or produce held and not disposed of at the date of commencement or recommencement is allowed as a deduction for that year of assessment. In regard to produce, the Commissioner allows as a deduction the fair market value at the date of commencement or recommencement. In the case of livestock, this must be valued in accordance with the method of valuation prescribed in para. 12, viz. the standard values elected by the farmer. The mortality allowance is not granted in respect of livestock held at the date on which farming is commenced or recommenced — para. 9.

It is submitted that para. 8 (1) (*b*) (i) includes persons who receive livestock by way of donation or inheritance and who commence farming therewith for the first time. It would also include a deceased estate in whom vests the livestock belonging to the deceased and which commences farming from the date of death. Para. 8 (1) (*a*) (ii) and (*b*) (ii) take care of those cases where livestock and produce are acquired by existing farmers by way of donation or inheritance (see § 204).

In the writer's view, it is wrong that the livestock held at the commencement or recommencement of farming should be valued on the basis of the standard values elected. It is only fair and equitable that a farmer should be allowed to deduct the current market price at the date of commencement or recommencement of farming since that constitutes the value of his capital at that date. If the value on the basis of the elected standard values is lower than the market price it must follow that on a sale, the farmer will, in effect, be taxed on a portion of his original capital. On the other hand, an artificial loss will be incurred if the allowance based on standard values is higher than the current market price.

There is no valid reason why in the case of livestock acquired by inheritance or donation in the case of an existing farmer the opening debit should be based on current market price whereas the allowance should be determined on the elected standard values in the case of livestock acquired by inheritance or donation by a person who commences farming for the first time. In this latter case, avoidance may be invited since an estate, for example, may elect high values which will permit of an allowance large enough not only to free from tax the proceeds derived from the sale of livestock but also to cause a tax-free accrual in respect of produce or any other income derived by the estate during the period of winding-up. With effect from 1st July, 1958, however, farmers are limited in their choice of values (see § 198).

§ 206. Disposal of livestock and produce at cessation of farming

On the cessation of farming operations during a year of assessment, the farmer is taxable on all amounts received or accrued in respect of the disposal of livestock or produce during such year of assessment.[10] Where a farmer has discontinued farming operations during any year of assessment and has not disposed of all his livestock or produce by the last day of that year of assessment, the value of livestock (as reduced by the mortality allowance) or produce held and not disposed of at the end of that year of assessment must be included in his income for that year (para. 7(2)). If the balance is disposed of in the next tax year, the proceeds derived less the value of the previous year's closing stock, are taxable in that year. Where the previous year's closing stock exceeds the proceeds, an assessed loss arises.

On the cessation of farming, a farmer may not sell his livestock but may let it out for a rental. Depending on the circumstances, such an act on the part of a farmer may have the effect of converting his livestock from floating capital into a fixed capital asset. In the year of cessation of farming, the value of the livestock on hand at the end of such year must be included in income in terms of para. 7(2), even though the farmer has let the animals. When such livestock is eventually sold, the proceeds partake of the nature of capital if the farmer can prove that he held the livestock as a capital asset. If the animals are let until a suitable opportunity for a sale arises, it is submitted that the proceeds are of the nature of income.

On the disposal of his farm as a going concern, the amount realized by a farmer for standing crops, i.e. crops not gathered and marketable, is not taxable as long as no price is specifically allocated to growing crops. The full proceeds received for the sale of the farm with the crops growing on it, it is submitted, are of a capital nature and are not taxable. In such circumstances the purchaser of the farm is not entitled to claim as a deduction such proportion of

[10] *Farmer* v. *C.O.T.*, 1944 S.R. 80; 13 S.A.T.C. 158; I.T.C. No. 716, 17 S.A.T.C. 344; I.T.C. No. 638, 15 S.A.T.C. 225.

the purchase price as is attributable to the standing crops.[11] The acquisition of the growing crops cannot be divorced from the acquisition of the land and since the purchase of the land is of a capital nature the acquisition of the standing crops which is portion of the realty is likewise of a capital nature. The fact that the growing crops may be the most valuable portion and that they induced the purchase of the farm cannot affect the legal position.[12]

The above principles do not apply to plantation farmers in respect of the sale or purchase of a farm together with a plantation growing thereon. Paras. 19, 20 and 21 have the effect of including in the gross income of a farmer who disposes of a plantation together with the land on which it is growing, the value or selling price of the plantation. Conversely, a purchaser is allowed to deduct the cost of acquisition of such a plantation (see § 215). There is no good reason why these provisions should not be extended to standing crops. As the law stands at present, a farmer who has spent, say, £5,000 on cultivating a crop standing on the land is entitled to claim this as an allowable deduction from income. Yet should he sell the farm with the crop standing thereon, the entire proceeds are free of tax. The purchaser, on the other hand, who may have paid in full for the value of the standing crops is not entitled to claim that part of the purchase price attributable to the standing crops. The present provisions are clearly inequitable.

Where, however, a farm is sold as a going concern, and the seller and the purchaser agree on a price for the growing crops included in the sale as distinct from a price for the bare farm, the agreed price is taxable in the hands of the vendor and is allowable as a deduction to the purchaser.[13] It, therefore, lies within the power of the purchaser and the seller to decide whether the value of the standing crop is taxable in the hands of the seller and, therefore, deductible to the purchaser.

The case of *Crowe* v. *C.I.R.*[14] provides an interesting example of how a farmer who buys a farm with a mature crop standing on it can avoid tax on the proceeds derived from the sale of the crop by arranging, prior to the acquisition of the farm, for some third person to purchase the crop in the event of his acquisition of the farm. In that case, a taxpayer, who was a wattle farmer, was anxious to acquire a farm on which there was standing a matured wattle plantation. He was unable to provide the capital necessary for its purchase. He was aware, however, that two companies, one of which dealt in wattle-bark and the other in timber, were anxious to secure the produce of the plantation although they were not prepared to purchase the property itself. He thereupon approached the two companies, and obtained from them agreements to purchase the wattle-bark and timber in the event of his acquisition of the property, and he also

[11] I.T.C. No. 127, 4 S.A.T.C. 125.
[12] See *C.I.R.* v. *George Forest Timber Co. Ltd.*, 1924 A.D. 516; 1 S.A.T.C. 20.
[13] I.T.C. No. 757, 18 S.A.T.C. 431; I.T.C. No. 828, 21 S.A.T.C. 197.
[14] 1930 A.D. 122; 4 S.A.T.C. 133.

secured a contract for the felling and stripping of the wattle trees at a remuneration. Having obtained these contracts, he purchased the plantation farm, and then proceeded to do the felling and stripping of the plantations, delivering the bark and timber to the companies which had purchased them. The proceeds received for the bark and timber were paid over immediately to the seller of the farm on account of the purchase price. The Commissioner included in his gross income the amount realized by him for the sale of the bark and the timber and refused to allow any deduction in respect of the amount paid for the acquisition of the plantation. The Appellate Division held that under the circumstances of the transaction, the plantation was sold as a portion of the capital asset acquired, and the amount received by the taxpayer was consequently a realization of a portion of his capital and not a receipt on income account.

In view of the provisions of para. 19(1) of the Third Schedule, in terms of which any amount received by or accrued to a farmer in respect of the disposal of a plantation is deemed to be gross income, whether such plantation is disposed of separately or with the land on which it is growing (see § 215), the decision in *Crowe's* case is no longer of application in so far as concerns plantation farmers. The principle might, however, apply to other farmers, e.g. a farmer who acquires a farm on which there is standing a mature crop and who sells the crop as portion of the capital asset acquired.

§ 207. Farming expenditure

The expenditure which a farmer may claim as a deduction in the determination of his taxable income is governed by the ordinary provisions of the Act subject to the Third Schedule. The Third Schedule makes provision for the deduction of expenditure incurred on development and improvements (see § 208) and there are also special provisions for the deduction of capital expenditure incurred by plantation farmers (see § 215).

Apart from these special provisions, the allowable expenditure in the case of a farmer is subject to the same rules as apply to all other taxpayers. Thus, he is entitled to claim the special statutory allowances granted to all other taxpayers (see Chapter Nine), e.g. an allowance for repairs (see § 148), wear and tear (see § 149), scrapping allowance (see § 151), lease premium allowances (see § 154), etc. As regards wear and tear, it is the practice of the Department to allow 20 per cent per annum in respect of farming implements, machinery and equipment.

On the other hand, a farmer is not entitled to claim as a deduction any personal or domestic expenditure, e.g. repairs or additions to private homestead, wages and rations to domestic servants, etc.

Special mention should be made of the following items:

Livestock purchased

There is no limitation on the amount allowable as a deduction. It is immaterial whether the livestock is acquired for resale or to use as capital assets on the farm, e.g. trek oxen and animals acquired for stud. This result flows from the fact that the Third Schedule treats all the farmer's livestock as floating capital irrespective of the purpose for which they have been acquired (see § 197).

Wages to farm employees

Where wages are paid to employees used on the construction of the capital works set out in para. 17 (see § 208), the amount thereof cannot be claimed as revenue expenses but must be regarded as part of the cost of the capital works deductible to the extent set out in terms of para. 17.

Seeds, plants and the cost of planting

In practice, the cost of seeds and plants is allowed as a deduction even in cases where the annual cropping does not involve the destruction of the plant. For example, the cost of sugar-cane, pineapple and strawberry plants as well as the cost of planting are deductible in practice. The cost of trees, and the planting thereof, is deductible in terms of para. 20 (see § 215). In the case of orchards and vineyards, however, the cost of trees, and the planting thereof, is deductible to the extent set out in para. 17 (see § 208). The replacement of trees in an established plantation, orchard or vineyard is allowed as a deduction in practice.

The deduction of the cost of establishing a pineapple or sugar-cane plantation bestows a very valuable concession. The costs involved are usually substantial and as some time must elapse before the plantation can become productive, the farmer is able to build up a substantial assessed loss which can be set off against other non-farming taxable income. When the plantation becomes productive, the farmer could sell his farm whereupon the entire proceeds received would be of a capital nature. In practice the Commissioner does not regard pineapples or sugar-cane as falling within the definition of plantation. Thus, the special provisions affecting plantation farmers (see § 215) do not apply to a pineapple or sugar-cane farmer. This does not appear to be a very satisfactory arrangement since it can lead to abuse with a resultant loss of tax revenue to the Treasury. It is considered that a pineapple or a sugar-cane farmer should be dealt with in the same manner as plantation farmers, i.e. if they sell their farm together with the plantation grown thereon, the value of the plantation must be included in gross income.

Cost of clearing and preparing land

In the case of the cost of clearing land for the purpose of commencing farming operations, the present practice appears to be that such expenditure is deductible from income provided that in the year in which the expenditure is incurred income is derived from farming operations. In the writer's view, this is a most unsatisfactory basis for which there appears to be no authority in the Act. Except in the case of expenditure incurred in respect of the establishment of orchards and vineyards, the eradication of noxious plants, and the establishment of plantations, the Third Schedule does not permit any deduction in respect of the cost of clearing and preparing land for the purpose of embarking on farming operations. Thus, such expenditure is only deductible if it complies with the requisites of section 11(2)(*a*), namely that it must be incurred in the production of income and must not be of a capital nature. Strictly speaking, therefore, the expenditure is not deductible being in the nature of capital expenditure. If it is considered that this kind of expenditure should be deductible, special provision should be inserted into the Act (cf. section 26(8)(*a*) of the Income Tax Act of the Federation of Rhodesia and Nyasaland which permits the deduction of expenditure incurred on 'the stumping and clearing of lands'). The deduction should not depend upon whether or not a farmer's income is derived during the year in which the expenditure is incurred as this can easily lead to abuse — it is not a difficult matter to arrange for the accrual of a small amount of farming income so that a heavy capital expenditure on clearing and preliminary work can be deductible. Moreover, there is no valid reason why one farmer should get the deduction simply because he derived some farming income during the same year whereas another farmer is deprived of the allowance because he happened to earn his farming income in the next tax year and not in the year in which the farming expenditure was incurred.

§ 208. Expenditure on development and improvements

Effect of the statutory provisions

Para. 17(1) provides that a farmer may deduct in the determination of his taxable income the expenditure incurred by him during the year of assessment in respect of —

(*a*) dipping-tanks;

(*b*) dams, irrigation schemes, boreholes and pumping-plants ('Irrigation schemes' would cover expenditure on water furrows, pipe-lines, etc.);

(*c*) fences;

(*d*) the eradication of noxious plants;

(*e*) the prevention of soil erosion;

(*f*) the erection of buildings used in connection with farming operations other than those used for the domestic purposes of persons who are not employees of such farmer;

(*g*) the establishment of orchards and vineyards;

(*h*) the building of roads and bridges used in connection with farming operations;

(*i*) the carrying of electric power from the main transmission lines to the farm apparatus.

Para. 17(2) provides that where a deduction has been allowed in respect of any buildings, machinery, plant or other articles, etc., under para. 17(1), the allowance for capital expenditure in respect of scientific research in section 11(2)(*j*)*ter*, the wear-and-tear allowance in terms of section 11(2)(*d*), and the 'scrapping' allowance in terms of section 11(2)(*j*), cannot be deducted. Thus, wear-and-tear allowances and scrapping allowances are not deductible in respect of pumping-plant and other machinery and plant used in irrigation, the cost of which is deductible under the provisions of para. 17(1).

The expenditure referred to in para. 17(1) and incurred by the farmer must be in connection with his own farming operations. The Legislature did not intend that a farmer who at his own expense incurs development expenditure not for his own use but for the use of another farmer should be entitled to deduct the expenditure incurred from his own income.[15]

Para. 17(3) places a limitation upon the total amount allowable as deductions to a farmer under items (*a*), (*b*), (*c*), (*f*), (*g*), (*h*) and (*i*) (see § 210). As regards expenditure incurred in respect of the eradication of noxious plants (item (*d*)) and the prevention of soil erosion (item (*e*)), this is deductible in full in the year in which it is incurred, and is not subject to the limitation in para. 17(3).

It will be observed from the terms of para. 17(1), that no deduction is authorized in respect of expenditure incurred on farming implements, machinery and vehicles, except to the extent set out in para. 17(1)(*b*). Thus, in respect of these items the farmer is entitled to claim the ordinary wear-and-tear and scrapping allowances. Even though the farmer is able to show that the equipment or vehicles are used directly in connection with the construction of dams or boreholes or the establishment of orchards and vineyards, etc., this will not entitle him to claim the cost of such equipment or vehicles in terms of para. 17. It is submitted that expenditure in respect of the capital works set out in para. 17 refer to the cost directly incurred in the carrying out of these works, e.g. cost of labour and materials, and not to expenditure incurred in the acquisition of equipment, vehicles, etc., with which to carry out the works. Thus, the cost of a boring machine, it is submitted, cannot be regarded as expenditure incurred on a borehole for the purposes of para. 17. Similarly, the cost of a tractor acquired specially for the construction of a dam or the establishment of an orchard is not deductible in terms of para. 17. The farmer is, however, entitled to deduct wear-and-tear allowances in respect of such assets and also the cost of repairing and maintaining them in terms of section 11.

The deductible expenditure on development and improvements, as set out in para. 17, must be incurred by the farmer personally. He cannot claim to deduct expenditure incurred by any other person. Thus, where an agricultural co-operative society erected certain packing-sheds on its own property and defrayed the cost by a pro rata deduction from the amount payable to the farmer members for the sale of their fruit, the Special Court refused to allow as a deduction from the incomes of members the contributions made by them.[16]

[15] *Ernst* v. *C.I.R.*, 1954 (1) S.A. 318 (A.D.); 19 S.A.T.C. 1.
[16] I.T.C. No. 280, 7 S.A.T.C. 251.

It is not a requirement of para. 17 that a farmer must be the owner of the farming property in order that he may be entitled to the allowances in respect of development and improvements. A lessee or usufructuary of farming lands may claim the capital allowances if the expenditure has been incurred by him even though the buildings or improvements are to revert to the landlord or the bare-*dominium* holder on the termination of the lease or usufruct.

In terms of the strict wording of para. 17(1)(*f*), expenditure incurred in respect of buildings in the course of construction at the end of the tax year is not deductible since the buildings were not used during that year of assessment. However, this would mean that the expenditure can never be allowed since, in the next tax year, although the buildings are used during that year, the expenditure has not been incurred during that year as is required by para. 17(1). In practice, the Commissioner allows the expenditure on a building in the course of construction at the end of a tax year in the year in which it is incurred as long as the intention is to use it in connection with farming operations when completed. The law, in this respect, requires clarification.

As regards any amount received or accrued by way of grant or subsidy in respect of any of the matters mentioned in items (*a*) to (*i*) of para. 17(1), it is expressly provided that this must be included in the farmer's gross income (section 7(*g*)*ter*).

Recoupments

The allowances in respect of development and improvements are authorized by the provisions of para. 17 of the Third Schedule and not in terms of section 11 of the Act. Thus, if they are recovered or recouped on the sale or other disposal of the farm lands, it follows that the recoupment provision of section 11(4)(*a*) is not applicable since its terms extend only to amounts deducted under the provisions of section 11. On the other hand, the purchaser of a farm with bore-holes or dams or works for the prevention of soil erosion, etc., on it, is not entitled to claim the purchase price thereof as a deduction since they have not been constructed by him as, it is submitted, is required by the terms of para. 17. However, the cost of any pumping-plant and machinery, forming part of an irrigation scheme, acquired by the purchaser, is deductible in terms of para. 17(1)(*b*).

There is no justification for excluding from the ambit of taxable recoupments the recovery or recoupment of deductions allowed to farmers in respect of para. 17 of the Third Schedule. In the case of all other taxpayers, expenditure previously allowed as a deduction and subsequently recouped is in most cases taxable and it may, therefore, be said that they are being discriminated against. On the present basis, a farmer is entitled to plough back all his farming income into farm improvements, e.g. irrigation schemes, dams, etc., and thus without being subject to one penny's worth of tax can ultimately be in possession of a farm valued at a substantial figure. Let it be assumed that a farmer buys a farm for £10,000 and earns a net farming income of £10,000 per annum which is ploughed back into deductible improvements each year so that no tax is payable. Aften ten years his farm may be valued at, say, £100,000. He sells the farm and receives £100,000 on which no tax whatsoever is payable. The result is startling indeed. A serious anomaly also arises where the farmer has deducted the cost of pumping-plant and machinery forming part of an irrigation scheme and subsequently sells these assets. The purchaser is entitled to deduct the cost of these items. This, in effect, means that a double deduction is allowed in respect of the same expenditure. To carry the anomaly further, if the purchaser is a company in which the seller is the sole beneficial shareholder, the deduction would in reality, although not legally, be granted twice to the same taxpayer.

The Committee of Enquiry into the Income Tax Act[17] gave consideration to the question of taxable recoupments in the case of farmers but came to the conclusion that the present position should continue although it felt that the position should be watched 'and should it appear that the generous treatment extended to farmers, whereby such costs are allowed as a deduction for tax purposes in the first place, and in the second place, are not chargeable with taxation upon their recoupment, is being made the means of tax avoidance at the expense of other members of the taxpaying community, steps should be taken to withdraw or modify the concessions so granted'. The Committee based its conclusions firstly on the grounds that if provision were made for the taxation of recoupments some hardship would be created in certain cases as, for example, where on the disposal of the improved farm the proceeds are again immediately invested in another farm of perhaps greater value. Secondly, the Committee was of the view that the restriction of the deduction on development and improvements to the net income derived from farming was a satisfactory safeguard against abuse of the section. In the writer's view, the enormous advantage derived by farmers as compared with all other taxpayers in regard to taxable recoupments makes the Committee's reasoning, with respect, unconvincing.

§ 209. Employees' housing expenditure

Apart from the overall limitation referred to in para. 17(3) in regard to expenditure on development and improvements, there is also a limitation on the amount which a farmer can claim in respect of expenditure incurred on housing for employees and which falls for deduction under item (*f*).

Para. 17(1)(*f*) permits the deduction by a farmer of expenditure incurred in respect of the erection of buildings used in connection with farming operations other than those used for the domestic purposes of persons who are not employees of the farmer, subject, however, to the following limitations:

[17] *First Report*, p. 77, para. 48.

(1) *In the case of individuals carrying on farming operations*

(i) The aggregate of all the deductions to be allowed in respect of the erection of any buildings used for the domestic purposes of any one employee is not to exceed £2,000 — para. 17(5). It is submitted that this provision entitles a farmer to claim up to a maximum of £2,000 in respect of any one employee irrespective of the number of buildings erected. Thus, if a single building costing £5,000 is used for the domestic purposes of two employees, the farmer is entitled to a deduction of £4,000. Similarly, if a farmer builds a block of flats on his farm costing, say, £20,000, which will house six of his employees, an amount of £12,000 (6 × £2,000) will be deductible from his income; and

(ii) the employee must not be a relative of the farmer — para. 17(4)(*a*). *Relative* is not defined but in terms of its ordinary meaning blood-relatives to any degree as well as relatives by marriage would not be included.

It is submitted that where both husband and wife are employees, the farmer is entitled to claim £2,000 in respect of each. The writer understands that in practice the Commissioner allows £2,000 to each employee and his family.

(2) *In the case of companies carrying on farming operations*

(i) The aggregate of all the deductions to be allowed in respect of the erection of any buildings used for the domestic purposes of any one employee is not to exceed £2,000 — para. 17(5); and

(ii) the employee must not be a shareholder or a relative of a shareholder in the company or in any other company associated with the first-mentioned company by virtue of shareholding — para. 17(4)(*a*). Thus, it will not avail the sole beneficial shareholder of a farming company to transfer all his shares to a new company and thereafter cause the farming company to erect a house for him for the purpose of claiming the expenditure as a deduction. It is true that he is no longer a shareholder in the farming company but he is a shareholder in the associated company. Employees who hold shares in a company solely because they are employed by that company and who will, in terms of the articles of association of that company, not be entitled to hold those shares after they cease employment are not to be regarded as shareholders — para. 17(4)(*b*). *Shareholder* is defined in section 33(4) of the Act and includes not only a registered shareholder but also any other person who is entitled to the profit-sharing rights attaching to shares even though such shares may be registered in the name of some other person.

In addition to the above limitations, there is also a 'recoupment' provision which provides that if in any year of assessment a building, in relation to which a deduction has been allowed to a farmer under para. 17(1)(*f*), is no longer used for the domestic purposes of an employee, there is to be included in the farmer's income the amount originally deducted *less* one-tenth thereof in respect of every completed year (not exceeding ten years) during which the building was used by an employee — para. 17(6).

Both the £2,000 limitation and the exclusion of relatives have as their purpose the prevention of abuse. As regards the £2,000 limitation it may justifiably be asked why there should be a limitation on housing expenditure when there is no limitation on the other deductible items of capital improvements, e.g. dams, irrigation schemes, dipping-tanks. Housing employees is equally as important and necessary to a farmer as constructing a dam or building a packing-shed. The exclusion of employees who are relatives is also manifestly inequitable. The effect thereof is that from the tax point of view it suits the farmer better to employ strangers rather than his own family. A common feature of farming in this country is that the children take their place side by side with their parents on the farm. Who can deny that one's own family is the most reliable labour force? There may have been cases, prior to the passing of the present law,[17a] where private companies carrying on farming operations claimed under the existing provision the deduction of substantial amounts representing the cost of residences for their farm managers who were also their managing directors and sole beneficial shareholders. But surely this was no justification for depriving the entire farming community of a concession which they have enjoyed for many years. If certain farmers were abusing the provisions, there are other methods of countering such abuse. In this instance the legislator has sacrificed fairness in order to prevent abuse. What he should have done was to check effectively the abuse.

§ 210. LIMITATION OF ALLOWANCE FOR DEVELOPMENT AND IMPROVEMENTS

Para. 17(3) limits the allowance which a farmer can claim in respect of expenditure incurred on development and improvements as follows:

(i) The total amount allowable as deductions to a farmer in any year of assessment in respect of all the items of capital expenditure specified in (*a*), (*b*), (*c*), (*f*), (*g*), (*h*) and (*i*) of para. 17(1) may not exceed *the taxable income derived from farming operations*[18] (as determined before the deduction of the items mentioned) during such year of assessment.

(ii) If the deductible capital expenditure incurred by the farmer during a year of assessment exceeds the taxable

[17a] The limitation was first introduced with effect from 19th September, 1952. Previously there was no limitation in respect of employees' housing expenditure.

[18] As to what constitutes taxable income derived from farming operations, see § 211.

income derived from farming operations for that year, the excess is to be carried forward to the next succeeding year of assessment and is deemed to be expenditure incurred during that next year in terms of para. 17 (1).

It follows, therefore, that the expenditure or balance of expenditure which is not covered by taxable income derived from farming operations in any year of assessment cannot be deducted from any taxable income that may be derived from sources other than farming in respect of that year. Such expenditure must be carried forward from year to year until it is completely absorbed by taxable income derived from farming operations in such years. The restriction, therefore, ensures that the amount to be deducted in respect of improvements will be allowed against net income from farming so that there is no danger of persons deriving income from farming and other sources taking advantage of the concession in terms of para. 17 in order to avoid taxation on income so derived from other sources.

As stated in § 208, expenditure incurred on the eradication of noxious plants (item (*d*)) and on the prevention of soil erosion (item (*e*)) is deductible in full in the year in which it is incurred.

It is submitted that having regard to the fact that the undeducted balance of capital expenditure is carried forward from one year to the next in terms of para. 17 (3), it must follow that if a farmer ceases farming operations and during the next tax year does not carry on any farming operations for such year, he is no longer entitled to carry forward the undeducted balance of capital expenditure since he is not assessable in terms of the Third Schedule and para. 17 (3) applies only to persons assessed in terms of the Third Schedule. Even if such a farmer recommences farming in a subsequent year, it is submitted that he is not entitled to carry forward the undeducted balance of capital expenditure to such later year.

§ 211. TAXABLE INCOME DERIVED FROM FARMING OPERATIONS

The yardstick for measuring the amount to be deducted in respect of expenditure incurred on development and improvements by a farmer for a year of assessment is the *taxable income derived from farming operations* for that year of assessment (para. 17 (3)). The word '*derived*', it is submitted, should be treated as synonymous with 'arising' or 'accruing'. Interest and rent accruing from the investment of surplus funds are not uncommon items of taxable income accruing to a farmer but as they are clearly not derived from farming operations they do not come into the computation for the determination of the capital expenditure allowance. But what of:

(i) The value of livestock and produce on hand at the beginning and end of a tax year;

(ii) livestock and produce consumed by the farmer and his family;

(iii) the value of livestock or produce donated by a farmer and included in his income in terms of para. 10;

(iv) amounts included in a farmer's income in terms of section 11(4) and representing wear-and-tear allowances on farming assets now recouped;

(v) grazing-fees;

(vi) rentals from the hiring out of farming assets;

(vii) subsidies?

It is submitted that as regards items (i), (ii), (iii) and (iv), as these amounts must form part of the taxable income and as they all have their source or origin in the farming operations carried on, they constitute taxable income derived from farming operations.

As regards subsidies received, if they are received in respect of farming products produced or exported, it is submitted that they constitute taxable income derived from farming operations. On the other hand, if they accrue by virtue of the construction of capital works, e.g. dams, boreholes, soil erosion works, etc., and are included in gross income in terms of section 7(*g*) *ter*, it is submitted that they do not arise from a farming operation. In practice, however, it would appear that all subsidies are regarded as having been derived from farming.

Grazing-fees received and rentals received from the hiring out of farming assets are not received because of any farming operation carried on but by virtue of the farmer's ownership of the land or the farming assets. These items, it is submitted, do not form part of the taxable income derived from farming operations. In practice, however, the writer has experienced cases where grazing-fees have been regarded as having been derived from farming operations. In exceptional cases one can conceive cases where a grazing-fee might constitute taxable income from farming, namely where the owner of the land lays down grass on suitable areas of land, manures and tends the land so as to produce a good crop of grass and then arranges for the seasonal eating-off of the grass by cattle brought on to the land. In such circumstances, it is submitted that the business of farming is being carried on and that the moneys received for the grant of the grazing rights constitute taxable income derived from farming.

It is submitted that rentals received from the letting out of livestock do not constitute taxable income derived from farming operations and must not be taken into account in the determination of the allowance in respect of improvements and development. In this respect they are not different from rentals received from the hiring out of any other farming asset.

An interesting point arises in the case of a farmer carrying on farming operations and who uses the produce of his farm for the purpose of conversion into a manufactured article produced in a separately run factory. For example, a fruit farmer may transfer all his fruit to his factory for conversion into jam or canned fruit or a dairy farmer may use all the milk produced on his farm for the purpose of conversion into cheese in a separate factory. In such circumstances it would seem that the farmer's taxable income is not derived from the carrying on of farming operations but from the disposal of a manufactured product. If this contention is correct it must follow that the farmer is not entitled to claim capital expenditure on development and improvements since there is no taxable income derived from farming operations. The writer understands that in practice the Department generally permits a farmer in such circumstances to draw up separate profit and loss accounts for his farming operations and for his manufacturing business and to charge out the farming product to the manufacturing department at a current market price as if the two departments were conducted by two distinct taxpayers. In this way the farmer will show a taxable income derived from farming operations and can, therefore, claim the allowances in respect of improvements and developments.

A further point that arises is whether the *taxable income derived from farming operations* during a year of assessment must be determined exclusive of any assessed loss incurred in the immediately preceding year of assessment and carried forward to the next year and exclusive of any assessed loss incurred by the farmer in the carrying on of another trade during the same year of assessment. It is suggested that since in the determination of the taxable income derived from any trade there must be set off any assessed loss incurred in the previous year (section 11(3)(*a*)) as well as any assessed loss incurred during the same year in the carrying on of any trade (section 11(3)(*b*)), the taxable income derived from farming must be determined after taking into account any such assessed losses. Thus, if a farmer in Year I has incurred an assessed loss of £8,000 from farming and in Year II has derived a net income of £10,000 from farming, spent £6,000 on improvements deductible in terms of para. 17 and has received interest income amounting to £6,000, the taxable income for Year II should be determined as follows:

Net income from farming	£10,000
Less assessed loss from Year I	8,000
Taxable income from farming (before deducting development expenditure)	£2,000
Less development expenditure limited to	2,000
Taxable income from farming (after deducting development expenditure)	NIL
Taxable income from interest	£6,000
Total taxable income	£6,000

The farmer is entitled to carry forward to the next tax year £4,000 (£6,000 *less* £2,000) development expenditure not yet deducted. The writer has, however, experienced a number of cases where the Revenue has determined taxable income from farming for a particular tax year exclusive of any assessed loss incurred in the previous year or incurred in another trade carried on during the same tax year. On the basis of the figures given above, the taxable income would be determined as follows:

Net income from farming	£10,000
Less development expenditure	6,000
	£4,000
Add interest	6,000
	£10,000
Less assessed loss from Year I	8,000
Total taxable income	£2,000

The meaning of *taxable income derived from farming operations* should be clearly set out in the Act.

§ 212. Death of a farmer

When a farmer dies during a year of assessment, it is necessary to determine his taxable income derived from farming operations for the period from the beginning of the year of assessment to the date of his death.

It is, therefore, necessary for the executor to take stock of all livestock and produce on hand at the date of death, since the return of income which he has to make up to the date of death must include the value of livestock and produce at the beginning of the year of assessment and at the date of death (para. 6 read with para. 1). Para. 7 read with para. 1 provides that the value of livestock or produce held at the date of death must be included in income whereas there must be allowed as a deduction from income the value of livestock or produce held at the beginning of the year of assessment.

In the case of a farmer who has died during a year of assessment, in view of the clear wording of para. 1 it cannot be suggested that the value of livestock or produce on hand at the date of death is not taxable but that only the value of livestock or produce held at the *end of the year of assessment* is taxable in terms of paras. 6 and 7. Para. 1 of the Schedule provides that 'in this Schedule, a reference to the end of a year of assessment includes, where the period assessed is less than twelve months, a reference to the end of the period assessed'. There is thus clear authority for including in the income of a farmer in respect of the period of assessment terminating at the date of his death, the value of livestock or produce on hand at the date of his death.

As regards the valuation of livestock on hand at the date of death, para. 12(*a*) provides that 'the value to be placed on livestock held and not disposed of by any such farmer at the end of the period of assessment terminating at the death of the farmer shall be the price which in the opinion of the Commissioner is the current market price of the livestock'. It follows, therefore, that whereas the livestock on hand at the beginning of the year of assessment in which the farmer dies must be valued on the basis of the standard values elected by the farmer during his lifetime, the livestock on hand at the date of death must be valued on the basis of current market values. If, however, the livestock on hand at the date of death includes any animals acquired by purchase for breeding purposes, these must be valued at *cost* price in view of the express provisions of para. 15: 'the value to be placed upon livestock acquired by purchase for stud purposes shall be the purchase price paid for that livestock'.

The mortality allowance which is granted to all farmers in respect of the value of livestock held at the end of the year of assessment, is not made in respect of the value of livestock held at the end of any period of assessment terminating at the death of a farmer (para. 9). Thus, whereas the value of livestock on hand at the beginning of the tax year in which the farmer dies must be reduced by the mortality allowance granted to him in respect of the previous tax year (para. 8 (*a*)), no reduction can be made from the value of livestock held at the date of death.

As regards the valuation of produce on hand at the date of death, para. 16 continues to apply, i.e. the value must be such fair and reasonable value as the Commissioner may fix. In practice, the Commissioner requires that produce must be valued at or about average cost of production or market value, whichever is the lower. Only produce that has been gathered and that is marketable must be included in the return. Thus, growing crops at the date of death are not taxable and need not be returned (see § 200).

In view of the principle that the income earned by a deceased estate from the date of death until the winding-up of the estate is taxable in the hands of the estate and not in the hands of the heirs (see § 260), it must follow that where the executors carry on the deceased's farming operations from the date of death, they are required to elect standard values to be applied in respect of the farming operations carried on by the estate from the date of death until the date of confirmation of the account. When the estate is finally wound up and the farming operations are transferred to the heirs or beneficiaries, such heirs or beneficiaries are required to elect new standard values to be applied in respect of the farming operations carried on by them from the date of the winding-up of the estate, unless they are existing farmers who have already elected values. The writer has expressed the view (see § 260) that where estate assets are handed over to an heir or legatee prior to the winding-up of the estate, the heir or legatee is taxable on the income from the date that the asset is transferred to him. In the case of a farm which is handed over in this way, it must follow that the heir or legatee must elect standard values to be applied in respect of the farming operations carried on from the date of the handing over of the farm.

§ 213. Livestock sold on account of drought or disease

Para. 18 provides relief in cases where farmers are compelled, owing to drought or livestock diseases, to dispose of substantial numbers of animals.

Where it is proved to the satisfaction of the Commissioner that a farmer has in any year of assessment sold livestock on account of drought or stock disease, and has within four years after the close of the said year of assessment purchased livestock to replace the livestock so sold, he will be allowed when restocking his farm to elect whether he will deduct the cost of the livestock so purchased from the income in that year of purchase, or from the income for the year in which he disposed of his animals. The claim to deduct the cost of the replaced livestock must be made within five years after the close of the year in which the farmer was compelled to dispose of the livestock. If the cost of livestock purchased in a subsequent year to the livestock sales is allowed as a deduction in the year of the sales, it will not be allowed again in the year of purchase. Every farmer who desires to claim the deduction in the year of sale must furnish with his return of income for the year of assessment in which he sold the livestock full particulars of the livestock sold.

Until proof of restocking has been submitted to him, the Commissioner must assess and recover any tax payable by a farmer in respect of any year of assessment in which livestock has been sold on account of drought or disease, as if the abovementioned provisions had not been enacted. As soon as proof is submitted to the satisfaction of the Commissioner, he must revise the assessment concerned and refund to the farmer so much of the amount paid by him as exceeds the amount payable after allowing the cost of restocking as a deduction in the year of sale.

The purpose of para. 18, no doubt, is to ensure that the refund of tax can be utilized to finance the restocking. The ultimate benefit to the farmer is, however, problematical. If taxation rates are lower in the year when restocking takes place than the drought year in which the bulk sales took place, a saving of tax may result if the farmer decides to make an election in terms of para. 18. On the other hand, if taxation rates are on the increase, the farmer may be worse off if he makes the election. The size of the farmer's income in the relevant years may also be material. Each case must be decided on its own merits before an election is made.

§ 214. Concession to sugar-cane farmers

Para. 22 makes provision for the prevention of an undue increase in the rates of normal and super tax payable by a farmer in respect of any year of assessment because of abnormal accruals of income arising from the disposal of sugar-cane damaged by fire.

A farmer whose sugar-cane fields have been damaged by fire can claim that for the purpose only of calculating the rates of normal and super tax payable in respect of any year of assessment, there must be deducted from his taxable income and income subject to super tax so much of that taxable income as is proved to the Commissioner's satisfaction to have been derived from the disposal of sugar-cane as a result of fire in his cane fields and which but for such fire would not have been derived by him. It must be emphasized that the relief aims at a reduction in the rates of normal and super tax due to the abnormal accrual of income in the current year. It does not relieve a farmer from liability for tax on any portion of his taxable income. Thus, if a farmer has a taxable income of £10,000 of which £4,000 represents compensation received in respect of damage to his sugar-cane fields by fire and which but for such fire would not have been derived by him, the rates of normal and super tax would be determined on a taxable income of £6,000 but the rates so determined must be applied to the whole of the taxable income of £10,000. It is expressly provided that the rate of tax may not be less than that applicable to the first one pound of taxable income or income subject to super tax.

§ 215. Plantation farmers

Special provisions applicable to plantation farmers

The growing of timber constitutes the carrying on of farming operations. Special provisions affecting plantation farmers are to be found in paras. 19, 20 and 21 of the Third Schedule. Apart from these special provisions, plantation farmers are taxed in a manner identical with all other farmers.

'Plantation' is defined in para. 21 and 'means any artificially established tree as ordinarily understood or any forest of such trees and includes any natural extension of such trees'. Pine trees, gum trees and wattle trees clearly fall within the definition being trees as ordinarily understood. In practice, the Commissioner does not regard pineapples or sugar-cane as falling within the definition of 'plantation'. Thus, the special provisions affecting plantation farmers do not apply to a pineapple or sugar-cane farmer (see also § 207).

Para. 19(1) provides that any amount received by a farmer in respect of the disposal of plantation, whether such plantation is disposed of separately or with the land on which it is growing, forms part of such farmer's gross income. Para. 19(2) sets out the basis of valuation of the plantation where it is disposed of by the farmer together with the land on which it is growing. If a separate price is allocated to the plantation as distinct from the land, such price must be included in the gross income. Thus, it is within the power of the purchaser and the seller to determine how much of the value of the plantation should be taxable in the hands of the seller and deductible to the purchaser. If no separate price is allocated by the parties to the agreement, the Commissioner is given a discretionary power to determine what proportion of the total consideration represents the price payable for the plantation.

Para. 20(1)(*a*) permits the deduction in the determination of the taxable income of a farmer of any expenditure incurred by him during a year of assessment in establishing and maintaining plantations. Thus, the actual cost of the trees and the cost of planting them and all subsequent expenditure incurred in the tending and maintenance of the trees rank as a deduction in the year in which the expenditure is incurred even though no income has been derived during such year.

Prior to 1st July, 1948, it was the practice of the Commissioner to allow the costs of establishment and maintenance of a plantation as a deduction only in the year in which the plantation started producing income and then only in the ratio that the area sold bore to the total area of the plantation.[19] The accumulated expenditure on establishment and maintenance at 30th June, 1948, not yet allowed to be deducted, ranks for deduction in subsequent years but the amount allowed to be deducted in respect of any year of assessment must not exceed the gross income derived by the farmer from the plantation in that year of assessment — para. 20(1)(*b*). Thus, if the undeducted accumulated expenditure at 30th June, 1948, amounted to £10,000, and the farmer derived gross income from the sale of the plantation to the extent of £3,000 in the 1955 tax year, £5,000 in the 1956 tax year and £20,000 in the 1958 tax year, he is entitled to deduct the accumulated expenditure of £10,000 as follows:

1955 tax year	£3,000	(limited to gross income from plantation)
1956 „ „	5,000	(„ „ „ „ „ „)
1958 „ „	2,000	(balance)
	£10,000.	

As regards the cost of acquisition of a plantation purchased by a farmer, whether before or after 1st July, 1948, para. 20(1)(*b*) provides that the amount allowed to be deducted in respect of such cost may not exceed for any year of assessment the gross income derived from the plantation for such year of assessment. Thus, the cost of acquisition is carried forward from year to year and is allowable as a deduction each year according to the gross income derived in such year from the disposal of the plantation. The term *purchased* as used in para. 20(1)(*b*) means purchased in its ordinary, everyday mercantile sense, that is, bought for money under a contract of sale. Where a partner as a result of a dissolution of the partnership received a share in a plantation on a basis of partition, the Court refused to grant the allowance under para. 20(1)(*b*) as the plantation had not been acquired under a contract of sale.[20] Thus, heirs or donees who have acquired a farm with a standing plantation thereon are not entitled to deduct any amount from the ultimate sale of the timber in respect of the value of the standing plantation at the date of inheritance or donation (see § 285).

Where a plantation is acquired by a farmer together with the land on which it is growing, para. 20(2) provides that the cost of acquisition of the plantation must be determined in accordance with the provisions in para. 19(2). If a separate price is allocated to the plantation in the agreement, such price represents the cost of acquisi-

[19] See I.T.C. No. 201, 6 S.A.T.C. 31.
[20] *Badenhorst & others* v. *C.I.R.*, 1955 (2) S.A. 207 (N); 20 S.A.T.C. 39.

tion. If no separate price is allocated, the Commissioner must decide what proportion of the total consideration represents the price payable for the plantation.

It will be seen, therefore, that as regards plantation farmers, the principle established in the *George Forest Timber* case (see § 130) is not applicable.

Averaging of rates of tax

Para. 20(3) makes provision for the prevention of an undue increase in the rates of normal and super tax payable by a farmer in respect of any year of assessment because of abnormal accruals of income arising from the disposal of plantation or forest produce during that year of assessment. For the purpose only of calculating the rates of normal and super tax, there must be deducted from the taxable income and income subject to super tax of such farmer the amount by which the taxable income derived by him in that year from the disposal of plantation and forest produce exceeds the annual average taxable income derived by him from that source over the three years of assessment immediately preceding the said year of assessment. In other words, for the purpose of calculating the normal and super tax rates there must be substituted for the current year's taxable income derived from plantation the annual average taxable income derived from plantation over the previous three tax years. It must follow that if no taxable income was derived from plantation during the three previous tax years, the whole of the current year's taxable income from plantation must be excluded for the purpose of determining the rates of tax in the current year.

'Forest produce' is defined in para. 21 and 'means anything which is derived from trees and includes trees, timber, wood, bark, leaves, seeds, gum, resin and sap'.

Para. 20(3) only applies if the Commissioner is satisfied that the disposal of the plantation in the current year forms part of the normal farming operations of the farmer. It is submitted that where a farmer sells his farm together with the plantation standing thereon, a disposal of the plantation in such circumstances does not form part of the normal farming operations of the farmer and, therefore, the concession provided for in para. 20(3) does not apply.

The Commissioner's determination as to what portion of a farmer's taxable income is derived from the disposal of plantation and forest produce is final and conclusive (proviso (i) to para. 20(3)).

It must also be emphasized that the concession aims at a reduction in the rates of normal and super tax due to the abnormal accrual of income in the current year. It does not relieve a farmer from liability for tax on any portion of his taxable income (see proviso (ii) to para. 20(3)).

It is expressly provided that the rate of tax may not be less than that applicable to the first one pound of taxable income or income subject to super tax (proviso (ii) to para. 20(3)). Thus, where the substitution of the annual average taxable income over the last three tion. If no separate price is allocated, the Commissioner must decide what proportion of the total consideration represents the price payable for the plantation.

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It is expressly provided that the rate of tax may not be less than that applicable to the first one pound of taxable income or income subject to super tax (proviso (ii) to para. 20(3)). Thus, where the substitution of the annual average taxable income over the last three years results in an assessed loss, the rates of tax for the current year mut be 15*d.* in respect of normal tax (18*d.* in the case of an unmarried person) and 24*d.* in respect of super tax.

II. Insurance Business

§ 216. General principles

The taxable income derived from the carrying on of the business of insurance must, in so far as it is derived from such business, be determined in accordance with the provisions of the First Schedule to the Act. Any income derived otherwise than from the business of insurance must be returned and is subject to the ordinary provisions of the Act — section 18(1) and para. 1 of the First Schedule.

The taxable income derived from insurance may be reduced by the set-off of assessed losses incurred in other businesses or of any balance of loss so incurred and carried forward from the preceding tax year, in terms of section 11(3) — section 18(1). There is, however, no provision in the Schedule whereby a loss incurred in carrying on the business of insurance can be set off against any income derived from any other business.[21] There appears to be no valid reason why a loss incurred in respect of insurance business cannot be set off against the taxable income derived from other business. The anomaly should be rectified.

All companies carrying on the business of insurance, and subject to assessment in terms of the First Schedule, are regarded as public companies for income tax purposes — section 33(2)(*e*). They are subject to normal tax at the ordinary rate applicable to companies. Like all other companies they are exempt from super tax — section 30(2)(*a*). Dividends distributed by them are not subject to non-resident shareholders' tax in the hands of non-residents — section 48. They are exempt from the payment of undistributed profits tax — section 51(*c*).

Section 18(1), read with the First Schedule, provides a particular method of determining the taxable income of insurance companies. The words *taxable income* in section 18(1), as is shown by the First Schedule, do not have the technical meaning given to these words in section 7 of the Act.[22] The First Schedule is independent of what is contained in the general rules, for example section 7 and section 11. Thus, the admissible deductions in section 11 do not apply to insurance companies. The allowable deductions applicable to insurance companies are confined to those contained in the First Schedule.[23]

The First Schedule sets out the basis of taxation of insurance companies under two heads:

[21] See the remarks of Neser, J., in *African Guarantee & Indemnity Co., Ltd.* v. *C.I.R.*, 1946 T.P.D. 256; 14 S.A.T.C. 201.

[22] *Afrikaanse Verbond Begrafnis Onderneming Bpk.* v. *C.I.R.*, 1950 (3) S.A. 209 (A.D.); 16 S.A.T.C. 401.

[23] *African Guarantee & Indemnity Co., Ltd.* v. *C.I.R.*, 1946 T.P.D. 256; 14 S.A.T.C. 201. See also I.T.C. No. 79, 3 S.A.T.C. 78.

Mutual Insurance Companies.
Non-Mutual Insurance Companies.

For the purpose of the Schedule, the term *company* includes any association of two or more persons or an individual carrying on insurance — para. 1.

§ 217. Mutual insurance companies

Mutual insurance companies are those carrying on the business of insurance in the Union and which do not derive profit or gain (other than from investments) out of transactions with persons other than their members, and in which only the holders of policies issued by such companies can derive the benefit of any profits or gains derived by the companies whether from investments or otherwise — para. 2. They are entitled to the following tax exemptions:

(*a*) Such companies are exempt from tax on the receipts and accruals derived from the business of life insurance and the granting of annuities — section 10(1)(*d*).

(*b*) They are exempt from tax on the receipts and accruals derived from all other kinds of insurance, viz. fire, marine, etc., as the First Schedule makes no provision for the taxing of such income.

(*c*) They are exempt from tax on income from investments arising from the business of life insurance and the granting of annuities — section 10(1)(*d*).

Mutual insurance companies are, therefore, liable to tax only on receipts from investments arising from all kinds of insurance other than life insurance and the granting of annuities. The method of determining the taxable income derived from such investments is set out in paras. 5, 6 and 7, and may be summarized as follows:

$$\text{Taxable Income} = \left(A \times \frac{B}{C} \right) - D$$

Where A = total dividends, interest and other amounts received by or accrued to the company during the year of assessment from all investments in respect of non-life branches. In practice, income arising from deposits made in terms of the Insurance Act in respect of the non-life branches is included. In the writer's view such deposits cannot be regarded as 'investments in respect of insurance'.[24] Thus, the income is not assessable in terms of the First Schedule but in accordance with the ordinary provisions of the Act. The practice, however, is to regard such income as having been received from investments in respect of the non-life branches.

B = premiums received (before deduction of re-insurance premiums) in the Union in respect of

[24] See I.T.C. No. 57, 2 S.A.T.C. 181.

the non-life branches. 'Received in the Union' is defined in para. 2 and means in the case of a company having its head office in the Union received at the head office of the company without the intervention of any agent, or received by or through any agent of the company in the Union, and in the case of a company whose head office is not in the Union received by or through any agent in the Union. Premiums due but not received by the end of the tax year do not come into the computation.

C = total premiums received (before deduction of reinsurance premiums) by the company in respect of the non-life branches.

D = an allowance for the expenses of management to be ascertained thus:

$$X \times \frac{Y}{Z}$$

where X = total management expenses of the company (excluding commissions)

Y = proportionate part of the total receipts from investments as determined above,

i.e. $A \times \frac{B}{C}$

Z = total receipts derived from investments.

'Total dividends, interest and other amounts' includes investment income exempt from *normal* tax in terms of section 10 of the Act, e.g. dividends and interest on Union Government tax-free loans.[25] There is no valid reason why these exemptions should not be given to mutual insurance companies. The Committee of Enquiry into the Income Tax Act recommended that the provisions of the Act whereby certain income is exempt from tax should be extended to insurers.[26] The Income Tax Commission accepted this recommendation.[27]

The First Schedule does not define the term 'expenses of management'. In practice the ordinary rules apply in determining the allowance for management expenses, e.g. they include advertising costs and wear-and-tear allowance on furniture but do not include donations, income tax paid and expenditure of a capital nature.

If 'management expenses' include a wear-and-tear allowance, which is nothing more than an annual allowance of the capital expenditure incurred in respect of the capital asset, then the whole of such capital expenditure should also qualify as a management

[25] I.T.C. No. 79, 3 S.A.T.C. 78.
[26] *First Report*, p. 82, para. 45.
[27] *First & Final Report*, p. 21, para. 94.

expense in the year in which it is incurred. Although section 11 prohibits the deduction of capital expenditure, it must be remembered that the First Schedule is independent of what is contained in section 11 so that the allowable deductions applicable to insurance companies must be limited to those authorized by the First Schedule. It may, therefore, be argued that the term 'management expenses' embraces capital expenditure incurred in respect of fixed assets used in the management of the insurance business. The Legislature, in order to nip possible controversies in the bud, should either define 'management expenses' or expressly exclude expenditure of a capital nature.

If the management expenses exceed the proportion of receipts from investments, the loss can be carried forward to the next year and can be set off against receipts from investments in that year — paras. 6 and 8.

§ 218. Non-mutual insurance companies

Non-mutual insurance companies are those carrying on the business of insurance in the Union and which are not mutual insurance companies — para. 2. The determination of the taxable income of such companies is set out in para. 4 of the Schedule.

For tax purposes non-mutual insurance companies may be divided into two heads:

1. Those persons carrying on life, funeral and annuities insurance including:
   - (i) Life, funeral and annuity insurance carried on by a company, as defined in section 1 (Act 31 of 1941).
   - (ii) Life and annuity insurance carried on by an association of two or more persons or by an individual.

   The determination of the taxable income of companies in (i) above is set out in para. 4(*a*) of the First Schedule (see § 219).

   In the Schedule it appears that no special provision has been made for life insurance business carried on by an individual or association of individuals (refer (ii) above). It would seem that such persons fall outside the scope of the taxing net in respect of their insurance business.[28]
2. Those persons carrying on fire, accident, marine, fidelity and miscellaneous branches, including funeral insurance carried on by any individual or association of two or more persons. The determination of the taxable income of such persons is set out in para. 4(*b*) of the First Schedule (see § 220).

As regards funeral insurance, it will be observed that if the business is conducted by a company, the taxable income derived therefrom is assessable in terms of para. 4(*a*). If the business is

[28] See I.T.C. No. 351, 9 S.A.T.C. 76.

conducted by a person other than a company, it is assessable in terms of para. 4(*b*).

§ 219. Life business of non-mutual insurance companies

The method of determining the taxable income of non-mutual insurance companies in respect of their life, funeral and annuity business is set out in para. 4(*a*) of the First Schedule and may be summarized as follows:

$$\text{Taxable Income} = A \times \frac{B}{C}$$

Where A = dividends distributed to shareholders during the year of assessment out of the profits derived from life and annuity business;

B = amount of the premiums received in the Union in respect of life insurance *plus* the amount of the annual payments made in the Union in respect of annuities;

C = amount of the premiums received from all sources in respect of life insurance *plus* the amount of the annual payments wherever made in respect of annuities.

Where the business of a non-mutual insurance company includes, with life insurance and annuities, other branches of insurance, any dividend distributed must be deemed to have been distributed out of profits derived from life insurance and annuities in the proportion that the profits derived from those sources bear to the profits derived from all branches of insurance during the period since the last preceding declaration of a dividend.

Since the profit or loss incurred in transacting life insurance business for any period is found by comparing the liabilities as on the last day of the period, as calculated actuarially, with the funds on hand as on that day, the Department relies on the insurer's actuarial determination of profit for the purpose of para. 4(*a*).

It is to be observed that the basic factor for determining the taxable income is the dividends distributed to shareholders during the year of assessment. If no dividends have been distributed there is no taxable income. It therefore lies within the power of the insurer to determine liability to or freedom from taxation by either declaring dividends or refraining from declaring dividends. Moreover, bearing in mind that an insurance company is recognized as a public company in terms of section 33(2), it is entitled to capitalize its undistributed profits by the issue of bonus shares to shareholders which would not only be free of super tax in the hands of shareholders but would also not constitute a 'dividend distributed' for the purpose of determining the taxable income of the company in terms of para. 4(*a*) of the First Schedule. In effect, therefore, by the issue of bonus shares an insurance company can, under the present law, capitalize its profits free of both normal tax and super tax. This is a most unsatisfactory basis. The recommendations of the Committee of Enquiry into the Income Tax Act that all insurers carrying on life business should be taxed on any increase in the amount of the actuarial surplus as compared with the amount of such surplus as at the date of the last actuarial valuation, are to be welcomed (see § 222).

It is submitted that income derived from the investment of the subscribed capital of a company and not from the investment of premiums received is not assessable in terms of the First Schedule but in accordance with the ordinary provisions of the Act as being income not derived from the business of insurance.[29] In practice, however, interest received on deposits made in terms of the Insurance Act is regarded as part of the profits derived from the life and annuity business.

No provision is made for assessing or deducting losses incurred in the business of life assurance carried on by a non-mutual insurance company and where such a loss is incurred it does not constitute a deduction or set-off against the profits made by it in other branches of insurance business.[30]

For the purpose of apportioning the dividend in the ratio that the Union premiums bear to the total premiums, the gross premiums must be taken before deduction of reinsurance premiums. *Received in the Union* must be given the meaning it bears in para. 2. Premiums due but not received by the end of the tax year do not come into the computation.

For the purpose of apportioning the dividend in the ratio that the profits derived from the life and annuity business bear to the profits derived from all branches, *profits*, it is submitted, include any income from investments as well as profits derived from the sale of investments arising from the business of insurance. Thus, investment income which is exempt from tax in terms of section 10, e.g. dividends, must be included. The Committee of Enquiry into the Income Tax Act recommended that the provisions of the Act whereby certain income is exempt from tax should be extended to insurers.[31] The Income Tax Commission accepted this recommendation.[32]

§ 220. Non-life business of non-mutual insurance companies

Method of determining taxable income

The method of determining the taxable income of non-mutual insurance companies in respect of their non-life branches of insurance (including funeral insurance carried on by individuals) is set out in para. 4(*b*) of the First Schedule and may be summarized as follows:

[29] See I.T.C. No. 57, 2 S.A.T.C. 181.

[30] *African Guarantee & Indemnity Co., Ltd.* v. *C.I.R.*, 1946 T.P.D. 256; 14 S.A.T.C. 201.

[31] *First Report*, p. 82, para. 45.

[32] *First & Final Report*, p. 21, para. 94.

factory basis. The recommendations of the Committee of Enquiry into the Income Tax Act that all insurers carrying on life business should be taxed on any increase in the amount of the actuarial surplus as compared with the amount of such surplus as at the date of the last actuarial valuation, are to be welcomed (see § 222).

It is submitted that income derived from the investment of the subscribed capital of a company and not from the investment of premiums received is not assessable in terms of the First Schedule but in accordance with the ordinary provisions of the Act as being income not derived from the business of insurance.[29] In practice, however, interest received on deposits made in terms of the Insurance Act is regarded as part of the profits derived from the life and annuity business.

No provision is made for assessing or deducting losses incurred in the business of life assurance carried on by a non-mutual insurance company and where such a loss is incurred it does not constitute a deduction or set-off against the profits made by it in other branches of insurance business.[30]

For the purpose of apportioning the dividend in the ratio that the Union premiums bear to the total premiums, the gross premiums must be taken before deduction of reinsurance premiums. *Received in the Union* must be given the meaning it bears in para. 2. Premiums due but not received by the end of the tax year do not come into the computation.

For the purpose of apportioning the dividend in the ratio that the profits derived from the life and annuity business bear to the profits derived from all branches, *profits*, it is submitted, include any income from investments as well as profits derived from the sale of investments arising from the business of insurance. Thus, investment income which is exempt from tax in terms of section 10, e.g. dividends, must be included. The Committee of Enquiry into the Income Tax Act recommended that the provisions of the Act whereby certain income is exempt from tax should be extended to insurers.[31] The Income Tax Commission accepted this recommendation.[32]

§ 220. NON-LIFE BUSINESS OF NON-MUTUAL INSURANCE COMPANIES

Method of determining taxable income

The method of determining the taxable income of non-mutual insurance companies in respect of their non-life branches of insurance (including funeral insurance carried on by individuals) is set out in para. 4(*b*) of the First Schedule and may be summarized as follows:

[29] See I.T.C. No. 57, 2 S.A.T.C. 181.

[30] *African Guarantee & Indemnity Co., Ltd.* v. *C.I.R.*, 1946 T.P.D. 256; 14 S.A.T.C. 201.

[31] *First Report*, p. 82, para. 45.

[32] *First & Final Report*, p. 21, para. 94.

Take the premiums received in the Union (less any premiums paid on reinsurances) in respect of such branches		£0000
Received in the Union must be given the meaning assigned to it in para. 2. If the premiums are not *received in the Union*, they are not assessable.		
Add other amounts received in the Union from the carrying on of the business of insurance, e.g. salvage receipts, investment income. Dividends are, however, expressly excluded[33]		0000
Received in the Union must be given the meaning assigned to it in para. 2. If the amounts are not *received in the Union*, they are not assessable.		
		£0000
Deduct (1) the actual losses (after deduction of reinsurances received) incurred in the Union in respect of such branches. Provision for losses not yet incurred cannot be deducted	£0000	
(2) the actual expenses incurred in the Union in respect of such branches. Thus expenditure incurred outside the Union is not deductible[34]	0000	
		0000
TAXABLE INCOME		£0000

It is expressly provided that no amount set aside for unearned premiums can be allowed as a deduction in arriving at the taxable income.

If the determination of the taxable income results in a loss, the loss can be carried forward to the next tax year and is deductible from income derived in such year — para. 8.

It is submitted that income derived from the investment of the subscribed capital of a company and not from the investment of premiums received is not assessable as 'other amounts received from the carrying on of the business of insurance' but must be assessed in accordance with the ordinary provisions of the Act as being income not derived from the business of insurance.[35] In practice, however, interest received on deposits made in terms of the Insurance Act is regarded as taxable in terms of para. 4(*b*).

[33] But other income exempt from tax in terms of sec. 10 must be included. The Committee of Enquiry into the Income Tax Act recommended that the exemptions from tax in terms of sec. 10 should be extended to insurers (*First Report*, p. 82, para. 45). The Income Tax Commission accepted this recommendation (*First & Final Report*, p. 21, para. 94).

[34] I.T.C. No. 329, 8 S.A.T.C. 261.

[35] See I.T.C. No. 57, 2 S.A.T.C. 181.

Criticisms

The method of taxation of non-mutual insurance companies in respect of their non-life business reveals serious defects and has resulted in the taxable income being determined not on the true profits derived from insurance business. This divergence between taxable income and actual profits is due to the following:

(*a*) Tax liability is based upon premiums and other amounts *received in the Union*. It is unsound to make receipt within the Union the sole test of the taxability of premiums and investment income since it is an easy matter for the insurer to arrange for the receipt of the premiums and the investment income to take place in a country outside the Union. The provision invites avoidance and can lead to a substantial loss of tax revenue. There is no valid reason why, in addition to premiums received in the Union, there should also not be subject to tax all premiums payable even though not received at the end of the tax year. The Committee of Enquiry into the Income Tax Act, unfortunately, did not raise this issue but the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland made some valuable recommendations in regard to this problem, viz.:[36]

'It seems to us that to make receipt within the Federation the sole criterion of the taxability of premiums is unsound. It certainly leads to loss of tax revenue which, in our opinion, properly belongs to the Federation. The scope of the taxability of premiums should be wider so as to include therein not only premiums received in the Federation but also premiums under all insurance contracts which are sufficiently connected with the Federation to make the claim of the Federation to levy tax fair and reasonable.'

'As to the premiums which should be included in the income of a person carrying on the business of non-life insurance, the conclusion to which we have come is that they are:

1. Premiums paid or payable under any insurance contract at any office of the person within the Federation or to any agent of the person within the Federation.
2. Premiums payable under any insurance contract, wheresoever made, if at the time that the contract is made the insured is ordinarily resident within the Federation.
3. Premiums payable under any insurance contract, wheresoever made and with whomsoever made, if at the time that the contract is made the insured property is situate within the Federation or if the insured event is one which can happen only within the Federation.
4. Premiums payable under any reinsurance contract, wheresoever made, if at the time that the contract is made the reinsurer is ordinarily resident within the Federation.

The fact that premiums are payable in the Federation appears to us to furnish a sufficient link with the Federation to warrant their being

[36] *Report of the Commission of Inquiry*, pp. 39 and 40, paras. 207, 210 and 213.

taxed in the Federation. The contracts in the second and third cases appear to us to be so closely connected with the Federation that the premiums are justifiably taxed in the Federation. The second and third cases have been adapted from section 142(1) of the Australian Act.'

'It may be thought that it is impracticable to tax premiums in the second and third of the cases mentioned. We recognize that in some cases the fiscus might not learn of the accrual of taxable premiums and that in other cases the fiscus might be unable to enforce payment of tax in respect of known taxable premiums. We do not believe, however, that such cases are likely to be frequent, and, in any event, we do not regard them as justifying the failure to impose Federal tax upon income the true source whereof we consider to be the Federation.'

As regards 'other amounts received in the Union from the carrying on of the business of insurance' there is no reason why the taxation of these amounts should not be determined in accordance with the general rules, i.e. they should be from a source within the Union and should be subject to tax whether received or accrued. There is no justification for making receipt within the Union the criterion of liability to tax.

(*b*) Premiums on reinsurance effected with other insurers are only deductible if paid during the particular year of assessment. If a reinsurance premium is payable at the end of the tax year, there is no good reason why it should not be deductible in computing the taxable income.

(*c*) What may be charged against the premiums and other amounts received are the 'actual losses (after deduction of reinsurances received) and expenses incurred in the Union'. Thus, only losses which were settled are deductible. Reserves for outstanding losses not yet settled are not deductible since a loss is not actually incurred until there is a definite legal liability to pay a definite sum. Prudent accounting procedure, however, dictates that if at the end of the financial year claims have been notified to an insurer arising out of events which occurred before the end of such year, a provision for outstanding claims should be written off in the accounts notwithstanding that the actual amount of the insurer's liability may not have been determined by the end of the year. The recommendation of the Committee of Enquiry into the Income Tax Act is, therefore, to be welcomed, namely that an allowance in respect of outstanding claims should be made as seems reasonable in the circumstances, the amount of such allowance in any year to be included as income in the next year of assessment.[37]

It will be observed that whereas the insurer is entitled to deduct actual losses incurred in the Union, the amount so deductible must be reduced by reinsurances *received*. If the reinsurance has not been received by the end of the year but is owing, it does not come into the computation of the taxable income for that year. Thus, if

[37] *First Report*, p. 82, para. 44.

by the end of the tax year the insurer has settled a claim for £10,000 in respect of which he is entitled to a refund of £5,000 from a reinsurer which is only received in the following tax year, from the income tax point of view, £10,000 must be deducted from his income in the year when the claim was settled. The reinsurance sum of £5,000 is deductible from losses incurred in the next tax year since it was only received in such year. This procedure is clearly in conflict with accepted accountancy principles which lays down that since £5,000 of the loss of £10,000 is recoverable from the insurer, only £5,000 is a proper charge against profits.

There is also no valid reason why only losses and expenses incurred in the Union are deductible. It is not unusual for insurers to incur expenses outside the Union which relate to the business carried on in the Union. The provisions of section 11 (2) (*b*) permit all other taxpayers to deduct expenditure incurred outside the Union at the discretion of the Commissioner and it is only reasonable that this provision should be extended to insurance companies as was recommended by the Committee of Enquiry into the Income Tax Act[38] and the Income Tax Commission.[39]

(*d*) Provisions for unexpired risks are not deductible. It is common practice for insurance companies to set aside as a reserve for unexpired risks a proportionate part of the premiums derived according to the unexpired periods of the policies. This conforms to well-established accountancy and business principles. The Committee of Enquiry into the Income Tax Act recommended that there should be deductible from the premium income a provision for unexpired risks, the deduction so allowed to be included in the income of the succeeding year of assessment.[40]

§ 221. Reinsurance profits

The Committee of Enquiry into the Income Tax Act[41] considered the question of the taxation of income accruing to non-Union reinsurers in respect of the reinsurance of Union risks and correctly, with respect, came to the conclusion that the source of the income accruing to a non-Union insurer is not in the Union unless the reinsurer has a place of business within the Union and accepts such reinsurance risks in the Union. Since, in the majority of the cases, treaty reinsurances are registered at the head office of the reinsurer which is usually outside the Union, the Committee was of the view that no provisions are necessary for the taxation of profits from reinsurance since they do not arise from Union sources.

In the case of a Union reinsurance company accepting risks outside the Union, it must follow that the reinsurance profits are

38 *First Report*, p. 82, para. 46.
39 *First & Final Report*, p. 21, para. 94.
40 *First Report*, p. 82, para. 42.
41 *First Report*, p. 82, para. 48.

taxable if the reinsurer has a place of business within the Union and accepts the contracts for the reinsurance risks in the Union.

The result of the present law is that whereas the Union insurer is entitled to deduct from his income the premiums paid on reinsurance, the non-Union insurer is not taxable on the reinsurance premiums so received. It may, therefore, be validly contended that the *fiscus* is not collecting its fair share of tax revenue from the profits derived from insurance business in the Union. In fact this point was a very pertinent issue with the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland, namely whether premiums on reinsurance effected with persons not resident in the Federation should continue to be deductible. It held as follows:[42]

> 'It seems to us that the present position ought not to be allowed to continue and that in order to protect the fiscus premiums on reinsurance effected with non-residents should not be a permissible deduction. In Australia such premiums are not deductible, unless the insurer elects to the contrary, in which event the insurer is taxed as agent of the non-resident reinsurer at a flat rate. Section 148. Obviously, if premiums on reinsurance are not deductible it would be unfair to allow as a deduction not the gross losses but only the net losses, that is losses after deduction of losses recoverable on reinsurances. In fact in Australia (unless the insurer has elected to deduct premiums on reinsurance) the gross losses are allowed as a deduction.'
>
> 'In so far as the reinsurer is concerned, we think that a non-resident reinsurer should not be taxable in the Federation upon reinsurance premiums but that a resident reinsurer should be. The source of income in the form of reinsurance premiums would ordinarily be the country in which the reinsurer is resident, for that is where the business of reinsurance is localizable.'

§ 222. RECOMMENDATIONS OF THE COMMITTEE OF ENQUIRY IN REGARD TO LIFE INSURANCE BUSINESS

The Committee of Enquiry into the Income Tax Act made some far-reaching changes in regard to the taxation of income derived from the carrying on of life insurance business.[43] These may be broadly summarized as follows:

(1) There should be no discrimination between mutual and non-mutual insurance companies.

(2) Insurers carrying on life business should be taxed on any increase in the amount of the actuarial surplus as compared with the amount of such surplus at the date of the last actuarial valuation.

(3) Dividends and other amounts which are exempt from tax in terms of section 10 of the Act should be excluded from the actuarial surplus for tax purposes.

(4) Where the business extends beyond the Union, and the insurer is unable to render separate returns showing the results from the Union business, the Union taxable income should be such a

[42] *Report of the Commission of Inquiry*, p. 39, paras. 208 and 209.
[43] *First Report*, Chapter 13, Part II, p. 80.

proportion of the increase in the actuarial surplus as the premium income from Union sources bears to the total premium income.

(5) Where actuarial valuations are not made annually, the insurer should be taxed each year on an estimate of the actuarial surplus. Differences between the actual surplus and the estimated yearly surpluses should be adjusted in the year in which the differences are determined.

(6) Losses arising from the life business representing a diminution in the amount of the actuarial surplus, should be carried forward to be set off against future taxable income from the life business only and not against income from other sources.

The Income Tax Commission, although it accepted the Committee's recommendation that for income tax purposes there should be no discrimination between mutual and non-mutual insurance companies, was of the view that the system recommended by the Committee would not provide any substantial increase over the tax yield from the present system and suggested that in view of the complexity of the problem the Department be required to submit to the Treasury proposals for the taxation of profits derived from the life business. Until these proposals are submitted, the present system should continue.[44] For these reasons, the Commission also felt that the recommendation of the Committee of Enquiry in regard to the deduction of a reserve to cover unexpired risks and the allowance of a provision for outstanding claims at the end of a tax year, relative to the taxation of non-life insurance business, should be held over for later consideration.

III. Mining Operations

§ 223. Introduction

The terms 'mining operations' and 'mining' are defined in section 1 to include every method or process by which any mineral is won from the soil or from any substance or constituent thereof. 'Mineral' is not defined. There is, however, much judicial authority as to the meaning of the term.[45]

The winning of gold, silver, coal and copper clearly constitutes the carrying on of mining operations and other common examples include mining for tin, manganese, tungsten, marble, limestone and salt. The excavation of fireclay constitutes the carrying on of mining operations,[46] but the winning of clay for brickmaking, slate, stone and sand is not regarded as falling within the terms of the definition.

The taxable income derived from the carrying on of mining operations is to be determined in accordance with the ordinary provisions of the Act but subject, however, to the special provisions

[44] *First and Final Report*, p. 20, paras. 90 and 91.

[45] See *Marshall* v. *Registrar of Mining Rights*, 1904 T.H. 210, and *New Blue Sky G.M. Co., Ltd.* v. *Marshall*, 1905 T.S. 363.

[46] *Boksburg Brick & Fireclay Co., Ltd.* v. *C.I.R.*, 1941 T.P.D. 232; 12 S.A.T.C. 225.

in section 7(*f*), section 11(2)(*f*), section 11(2)(*f*)*bis*, section 20 and section 21 of the Act. These special provisions concern the deduction of a capital expenditure redemption allowance in respect of income derived from mining operations and do not apply in the case of other non-mining activities. No doubt the reason for this differentiation is that a mine is a wasting asset. Unlike some other countries, for example Canada and the Federation of Rhodesia and Nyasaland, no depletion allowance is granted to a mining concern. Shareholders receiving dividends from mining concerns are not entitled to any allowance in respect thereof on the grounds that portion of what they receive by way of dividend represents a return of capital, the mine being a wasting asset. In Canada, shareholders receiving dividends from mining companies receive depletion allowances in respect thereof granted as a deduction from income. These allowances vary between 10 per cent and 20 per cent depending upon the proportion of the company's total income derived from mining.

In the case of individuals carrying on mining operations, the taxable income derived from mining is included with the income derived from other sources and the total taxable income is then subject to normal tax and super tax at the ordinary rates applicable to individuals. In the case of companies, however, the taxable income derived from mining for gold and diamonds is not subject to normal tax at the ordinary rates applicable to companies but special rates are prescribed for them. The rates of tax payable by gold- and diamond-mining companies have always been higher than the rate of tax payable by the ordinary commercial and industrial company and by other mining companies. Although differential rates of taxes to different enterprises are unsound in principle, higher tax rates for gold- and diamond-mining companies may be regarded as the settled policy of the Government.

In regard to undistributed profits tax, mining companies are exempt from this tax in terms of section 51(*c*). A company in which shares representing not less than 75 per cent of its issued capital is held by one or more mining companies, is also exempt from the undistributed profits tax in terms of section 51(*j*).

The profits of mining made under a lease granted under section 46 of the Precious and Base Metals Act, 1908 (No. 35 of 1908), of the Transvaal, are exempt from tax — section 10(1)(*l*).

§ 224. The capital expenditure redemption allowance

Calculation of the allowance

Persons carrying on mining operations are allowed to deduct from income from mining each year a certain amount of the capital expenditure incurred by them in the carrying on of such mining operations — section 11(2)(*f*). This is in lieu of —

(i) the wear-and-tear allowance — section 11(2)(*d*);

(ii) the new machinery allowance — section 11(2)(*d*)*bis*;

(iii) the lease premium allowance — section 11 (2) (*e*);

(iv) the scrapping allowance — section 11 (2) (*j*).

Section 20 (1) sets out the manner in which the annual redemption allowance is to be determined. But there are special provisions relating to gold- and diamond-mines (see § 226).

Section 11 (2) (*f*) clearly provides that the redemption allowance ranks for deduction only *in respect of income from mining operations*. Thus, where a mine has not yet reached the production stage, no portion of the capital expenditure incurred can be deducted. The expenditure is accumulated from year to year until production commences. It is in the year in which income from mining is derived for the first time that the miner is entitled to start deducting the accumulated capital expenditure.

The amount to be deducted each year in terms of section 20 (1) in respect of income derived from mining operations must be determined as follows (subject to the special provisions applicable to gold- and diamond-mining concerns — see § 226):

Start with the balance of the capital expenditure unredeemed at the beginning of the year of assessment	£0,000
Deduct any recoupments from capital expenditure received during the year	0,000
	£0,000
Add capital expenditure incurred on the mine during the year	0,000
AGGREGATE AMOUNT	£0,000

The aggregate amount is divided by the *life of the mine* and the resulting quotient is the redemption allowance for the year of assessment. In terms of section 20 (9), where a taxpayer carries on mining operations on mines that are not contiguous, the redemption allowance must be calculated separately in respect of each mine.

After deducting the allowance from the aggregate amount, the portion remaining represents the unredeemed balance of capital expenditure and is carried forward to the next year of assessment to form the basis of a fresh calculation for that year.

The aggregate amount is divided by the life of the mine reckoned from the commencement of the year of assessment. Where, however, the production commences during a year of assessment, the aggregate amount is divided by the life of the mine as at the date of commencement of production and the actual allowance so determined is reduced in the ratio that the period of production for that year bears to twelve months. Similarly, where the period of assessment is for less than twelve months, the allowance is also proportionately reduced.

This appears to be in accordance with the present practice of the Commissioner although it is doubtful whether the Act authorizes a proportionate reduction in the annual allowance.

Since capital expenditure is written off over the life of the mine it must follow that in a case where the life of a particular item of equipment is less than the life of the mine, the unredeemed balance of capital expenditure ranking for redemption will include an amount for an item of equipment which is not being used in mining operations at all. It will be observed that it is not a requirement that to qualify for the redemption allowance, the equipment must be used during the particular year of assessment (cf. the grant of the wear-and-tear allowance in section 11(2)(*d*)).

Where mining operations are carried on on more than one mine and equipment is transferred from one mine to the other, it is submitted that the unredeemed balance of capital expenditure of the transferring mine remains undisturbed. The value of the equipment transferred, it would seem, cannot be regarded as a recoupment since there has been no change of ownership. A person cannot sell something to himself. It must also follow that as regards the transferee mine the value of the equipment transferred cannot be regarded as capital expenditure incurred and cannot rank for deduction. In respect of this item of equipment, it must follow, therefore, that the annual redemption allowance must be granted to the transferor mine and not to the transferee mine which actually employs it in the carrying on of the mining operations. In practice, no doubt, the Revenue will probably be prepared to regard the transfer of the item of equipment as if it were a sale at a price equivalent to the unredeemed balance of the cost of the equipment. This is the correct approach and should be accorded statutory authority. The difficulty seems to be that under the law as it stands at present a miner is entitled to the amortization of the unredeemed balance of capital expenditure carried forward from one year to the next notwithstanding that individual items of capital expenditure forming part of that balance are no longer used in the carrying on of mining operations. For example they may have been transferred to another mine, or transferred to an associated company, or donated. It would seem that section 20 needs tightening up.

Definition of capital expenditure

'Capital expenditure' is defined in section 20(10) and means —

(*a*) expenditure on shaft-sinking and equipment including any single renewal or replacement of equipment which, together with the accessories thereto, exceeds in cost twenty thousand pounds; and

(*b*) expenditure on development, general administration and management (including any interest and other charges payable after 31st December, 1950, on loans utilized for mining purposes) prior to the commencement of production or during any period of non-production;

(*c*) in the case of a *deep-level gold-mine* (as defined in section 1) an amount of 5 per cent per annum on the aggregate of the expenditure referred to in (*a*) and (*b*) (but excluding any interest and other charges referred to in (*b*)) plus any amount allowed to rank as capital expenditure in terms of section 21 (see § 227) for the period not extending beyond the year of assessment immediately preceding that in which the determination of the taxable income does not result in an assessed loss.

'Expenditure on shaft-sinking' includes the expenditure on sumps, pump-chambers, stations and ore bins accessory to a shaft;

'expenditure' means net expenditure after taking into account any rebates, recoupments, or returns from expenditure.

What is and what is not included in 'equipment' is not easy to determine. Generally all the apparatus that is necessary for carrying on mining operations may be called the equipment of a mine.[48] In practice, the Department regards buildings necessary for the carrying on of mining operations as part of the equipment of a mine. The term 'development' does not also appear to have any definite meaning and the Act gives no definition.

In terms of the above definition of capital expenditure, it follows that the cost of mining claims, options and goodwill does not form part of the capital expenditure ranking for redemption. As regards the cost of prospecting, section 11 (2) (*f*) *bis* permits the deduction (either in one amount or in yearly instalments, as the Commissioner may determine) from the income of any person carrying on mining operations of any expenditure incurred by such person in prospecting any area in the Union in respect of which a mining lease has not been granted by the State. In all other cases, prospecting expenses must be included in the balance of capital expenditure which is deductible from the income of the particular mine in the same manner and to the same extent as is all other capital expenditure. Diamond-mining concerns are entitled to write off the cost of prospecting in full in the year in which it is incurred.

It will be observed from the terms of para. (*a*) of the definition that any single renewal or replacement of equipment not exceeding £20,000 in cost cannot be regarded as capital expenditure which, in effect, means that it must be dealt with as a revenue expense deductible from income in the year in which it is incurred. Presumably the deduction of single renewals or replacements of equipment not exceeding £20,000 must be under section 11 (2) (*a*). It would perhaps be better to follow the procedure in the Federation of Rhodesia and Nyasaland where section 13 (2) (*g*) expressly authorizes the deduction, if the taxpayer so elects (which election shall be

[48] As to what may be called the equipment of a mine, see *Union Government* v. *Nourse Mines Ltd.*, 1912 T.P.D. 924.

binding), of expenditure incurred on any single renewal or replacement of equipment. It is interesting to observe that in the Federation the exclusion of single items of equipment from the capital expenditure is made optional to the taxpayer who may elect either to include such expenditure in the capital expenditure ranking for redemption or to deduct such expenditure in full in the year in which it is incurred.

Since the cost of replacement of an item of equipment not exceeding £20,000 is written off to revenue and does not form part of the capital expenditure ranking for redemption, it must follow that the proceeds derived upon a sale thereof cannot be regarded as a recoupment deductible from the unredeemed balance of capital expenditure but must be treated as a recoupment under section 11 (4) (*a*) and must be included in income to the extent to which they represent a recoupment of the amount allowed as a deduction. Where the recoupment exceeds the original cost, the balance over and above the cost is not taxable being a receipt of a capital nature; neither can it be deducted from the unredeemed balance of capital expenditure.

The capital expenditure redemption allowance is granted in lieu of *inter alia* the lease premium allowance in terms of section 11 (2) (*e*). Yet premiums payable for the use of land, buildings, machinery, patent rights, etc., are not included in the definition of capital expenditure ranking for redemption. This is an anomaly which should be rectified. The Committee of Enquiry into the Income Tax Act recommended that section 20 of the Act should be amended to include in the definition of 'capital expenditure' any premiums paid for the right of use or occupation of the various classes of property referred to in section 11 (2) (*e*) provided that no amount in respect of any premiums paid for mining rights should be included.[49] This recommendation was rejected by the Income Tax Commission who considered that the allowance of premiums paid for the classes of property referred to in section 11 (2) (*e*) would be of no real importance to the mines and the ramifications of such a concession could not be foreseen.[50]

A person carrying on mining operations is entitled to complete redemption of the balance of capital expenditure ranking for redemption where operations have permanently ceased due to the life of the mine having expired, or, in the case of a mine worked under a concession, due to the concession having come to an end. It may happen, therefore, that on the closing down of a mine, a heavy loss is sustained owing to the balance of the unredeemed capital expenditure all being allowed as a deduction in the year of cessation of mining. There is no provision in the Act whereby this loss can be spread back over the previous years of the life of the mine so as to adjust the capital expenditure redemption allowance in respect of these years. Thus, no relief is granted to the mining concern who may have paid heavy

[49] *First Report*, p. 83, para. 5.
[50] *First & Final Report*, p. 22, para. 95.

tax in the years previous to closing down and who has sustained a heavy loss in the year of cessation. In the Federation of Rhodesia and Nyasaland, section 21 of the Income Tax Act recognizes this possible hardship which may fall on mining concerns and in the circumstances mentioned permits the loss incurred in the year of cessation to be spread back over the last six years of the life of the mine by way of a revision of the redemption allowances granted in respect of those years.

The life of the mine

The life of the mine is the estimated number of years during which mining operations may be expected to continue.

The life of the mine must be determined by the Government Mining Engineer whose determination is subject to objection and appeal to the Special Court.

Where the estimated number of years representing the life of the mine exceeds thirty years, the life of the mine must be calculated on a period of thirty years.

The life of the mine is subject to revision at the instance of the taxpayer or of the Commissioner, whenever any material alteration takes place in any circumstances relating to the mine or its working which affects the life of the mine. Otherwise the life of the mine is subject to revision in every third year after the last preceding determination. Previous assessments may not, however, be reopened as a result of any revision in the life of the mine.

If the company carries on mining operations in mines that are not contiguous, the allowance for redemption of capital expenditure must be computed separately according to the estimated life of each mine. If two mines are adjacent, i.e. if they have a common boundary, for the purpose of calculating the capital expenditure redemption allowance they are regarded as being one mine.

§ 225. Recoupments from capital expenditure

Recoupments from capital expenditure received during the year go to reduce the balance of capital expenditure unredeemed at the commencement of the year of assessment. These include moneys received from the sale of equipment, plant, machinery, etc.

Where the recoupments from capital expenditure in any year of assessment exceed the sum of the unredeemed balance of such capital expenditure at the beginning of that year and additions during that year, such excess is included in gross income in terms of section 7(*f*) of the Act and is taxable.

The whole sum realized from the disposal of the capital asset must be brought into account in determining the balance of redeemable capital expenditure even if the recoupment exceeds the cost of the capital asset originally acquired.

In *Grootvlei Proprietary Mines, Ltd.* v. *C.I.R.*[51] a company which carried on gold-mining operations purchased in 1941 a winder

[51] 1952 (4) S.A. 440 (A.D.); 18 S.A.T.C. 231.

for £13,131 for use on its mine. It sold the winder for £60,000 during 1949. The Commissioner regarded the whole sum of £60,000 as being a recoupment from capital expenditure in terms of section 20 and brought it into account in determining the balance of redeemable capital expenditure. The company lodged an objection on the ground that only £13,131 of the sum of £60,000 was a recoupment, the balance of £46,869 being a receipt of a capital nature. The Appellate Division upheld the Commissioner's assessment. Centlivres, C.J., held:

> 'What the Legislature intended by section 7(*f*) and section 20(1) was that when a taxpayer, who derived income from mining operations, realized such assets as are referred to in section 20(10) the proceeds of such realization should be regarded as reducing *pro tanto* the total balance of unredeemed capital expenditure and that if such proceeds should exceed such balance tax should be payable in respect of the excess amount. The Legislature never intended that in arriving at such an excess a detailed inquiry should be made as to what the original cost of each particular asset was. What it intended was that on one side of the account would appear the total balance of unredeemed capital expenditure and on the other side the amount realized on the disposal of either a particular asset or (as the case may be) the amount realized on the disposal of all the assets.'

The purpose of section 7(*f*) is to adjust an over-deduction in the past.[52] For example if the total cost of capital expenditure was £10,000 and redemption allowances totalled £7,000, then the present unredeemed balance of capital expenditure is £3,000. If the equipment is sold for £4,000, it is only correct that £1,000 should be taxable in terms of section 7(*f*), since, as things have turned out, only £6,000 should have been allowed by way of redemption allowances (the £10,000 actually spent *less* the recoupment of £4,000). On the other hand, section 7(*f*) could regard as income an amount which is in reality a profit of a capital nature. If, in the above example, the equipment was sold for £13,000, section 7(*f*) would treat as income an amount of £10,000, although only £7,000 was previously deductible by way of redemption allowances. The facts of the case of *Grootvlei Proprietary Mines, Ltd.* v. *C.I.R.* (*supra*), provide a further interesting example of where section 7(*f*) can subject a true capital profit to tax. In this respect, mining concerns are worse off than non-mining concerns who are not subject to tax on profits derived on the sale of fixed capital assets over and above such portion of the profits as represent a recoupment of wear-and-tear and other allowances previously made.

§ 226. Gold- and diamond-mines — redemption of capital expenditure

New gold-mines

'New gold-mine' is defined in section 1 and means 'an independent workable proposition in respect of which the Governor-

[52] *C.I.R.* v. *Wolf*, 1928 A.D. 177; 3 S.A.T.C. 153.

General or the Minister of Mines, as the case may be, on the recommendation of the Mining Leases Board, has, after the twenty-eighth day of February, 1946, signified in writing his decision to grant a lease of the right to mine for gold, and any other gold-mine which, in the opinion of the Government Mining Engineer, is an independent workable proposition which was established as such after the said date '.

New gold-mines are allowed to deduct, in respect of the year of assessment during which they commence producing gold, the total amount of capital expenditure incurred up to the end of that year of assessment. Thereafter, in respect of each subsequent tax year, they may deduct from the income derived from gold-mining the actual capital expenditure incurred during that year — section 20(2)*bis*(*a*).

New gold-mines which fall within the definition of *deep-level gold-mines* are entitled to add to their capital expenditure ranking for redemption, in terms of section 20(10)(*c*), a special allowance (see § 224).

Other gold-mines

Gold-mines which commenced producing gold after 31.12.1935 (other than those carrying on gold-mining operations on new gold-mines) are entitled to an allowance determined as follows:

(i) As regards the capital expenditure incurred prior to the date of commencement of production, this is redeemed over a period of ten years, or, if the life of the mine is less than ten years, over such lesser period — section 20(3). Where production commences during a year of assessment or where the period of assessment is less than twelve months, the annual redemption allowance is granted in full and is not proportionately reduced.

(ii) As regards the unredeemed balance of capital expenditure incurred subsequent to production, there is allowed to be deducted an amount equivalent to 27½ per cent of the sum of the unredeemed balance of capital expenditure at the beginning of the year of assessment and the capital expenditure incurred during that year, or the quotient resulting from dividing the said sum by the life of the mine, whichever is the greater — section 20(2)*ter*(*b*).

As regards those gold-mines which commenced producing gold prior to 31.12.1935, the provisions of section 20(3) do not apply in respect of the pre-production capital expenditure which, as in the case of the capital expenditure incurred subsequent to production, is subject to the provisions of section 20(2)*ter*(*b*) above (see (ii) *supra*).

Diamond-mines

Diamond-mines are allowed to deduct, in respect of the year of assessment during which they commence producing diamonds, the total amount of capital expenditure incurred up to the end of that year of assessment. Thereafter, in respect of each subsequent tax year, they may deduct from the income derived from gold-mining the actual capital expenditure incurred during that year — section 20(2).

It is seen, therefore, that new gold-mines and all diamond-mines may write off all capital expenditure before becoming liable to tax whereas other existing gold-mines are entitled to redeem such capital expenditure at the rate of 27½ per cent of the unredeemed balance or over the life of the mine whichever is the greater. Other mining concerns have their capital expenditure redeemed over the life of the mine and it may, therefore, be justifiably claimed that gold- and diamond-mines are favoured in that the redemption of allowable capital expenditure is permitted over a very much shorter period notwithstanding that the life of the mine may be for a very long period. The Committee of Enquiry into the Income Tax Act gave consideration to this problem and came to the conclusion that some reasonable limitation of the period of redemption of capital expenditure below the present 30 years for persons engaged in mining for minerals other than gold should be fixed by the Government[53] after consultation with its economic and technical advisers. The Income Tax Commission agreed in principle with this recommendation.[54]

§ 227. Change of ownership of mining property

Whenever there takes place a change of ownership of a mining property, the amount to rank as capital expenditure for redemption by the new owner is the effective value to him, at the time the change of ownership takes place, of the preliminary surveys, boreholes, shafts, development and equipment included in the assets passing by such change of ownership. However, if in a case in which consideration is given, the effective value of the specified assets so passing exceeds the consideration paid for all the assets passing, the amount allowed to rank for redemption by the new owner must be such proportion of the consideration as such effective value of the preliminary surveys, boreholes, shafts, development and equipment bears to the effective value of all the assets passing — section 21(1). Whatever amount is allowed to rank as capital expenditure for redemption by the new owner is deemed to be a recoupment from capital expenditure by the previous owner for the purposes of section 7(*f*) and for the purpose of determining the unredeemed balance of capital expenditure of the seller — section 21(2).

If the value of the consideration given or of the property passing where no consideration is given is in dispute, it may be fixed by the Commissioner if the new owner consents thereto; otherwise the value must be determined in the same manner as if transfer duty were payable — section 21(3).

The effective value, at the time the change of ownership takes place, of the assets passing, must be determined by the Government Mining Engineer, but it would appear that this determination relates only to the assets specified in section 21(1).

[53] *First Report*, p. 84, para. 9.
[54] *First & Final Report*, p. 22, para. 97.

The Committee of Enquiry into the Income Tax Act recommended that upon the change of ownership of a mining property the valuation of all the assets passing, and not only of the assets specified in section 21(1) should, if required, be made by the Government Mining Engineer.[55] This proposal was accepted by the Income Tax Commission.[56] According to the Committee, under the present law, whereas the effective value of the specified assets passing must be determined by the Government Mining Engineer, the further determination of the effective value of all the assets passing in a case where the effective value of the specified assets passing exceeds the consideration paid for all the assets passing, must be made by the Commissioner. The Committee felt that this further determination should also be made by the Government Mining Engineer.

IV. Co-operative Societies

§ 228. Special provisions affecting co-operatives

At present, the provisions relating to the taxation of co-operatives registered under the Co-operative Societies Act, 1939 (Act No. 29 of 1939), are to be found in three Acts of Parliament, namely the Co-operative Societies Act, the Finance Act, No. 46 of 1944, and the Income Tax Act, No. 31 of 1941. It is, therefore, understandable that the Committee of Enquiry into the Income Tax Act should recommend that the taxation of co-operatives should be dealt with under the Income Tax Act only.[57]

Societies or companies registered under the Co-operative Societies Act, 1939, are recognized as public companies for income tax purposes — section 33(2)(*d*). They pay the ordinary rate of normal tax applicable to companies. They are exempt from the payment of super tax — section 30(2)(*a*). They are also exempt from the payment of undistributed profits tax (section 51(*b*)), which means that after payment of normal tax, if any, they may accumulate their profits free of any other taxes. Any dividends distributed by them to persons not ordinarily resident nor carrying on business in the Union are exempt from the non-resident shareholders' tax — section 48.

The more common types of co-operative societies and companies that may be registered under the Co-operative Societies Act and the special provisions affecting the determination of their taxable income are as follows:

(*a*) *Co-operative Agricultural Societies and Companies and Farmers' Special Co-operative Companies*

The function of co-operative agricultural societies and companies is to dispose of members' agricultural products to anyone and to supply members only with agricultural requisites and

[55] *First Report*, p. 85, para. 18.
[56] *First & Final Report*, p. 22, para. 99.
[57] *First Report*, p. 89, para. 30. The Income Tax Commission agreed (*First & Final Report*, p. 23, para. 104).

services. They must have at least seven members and may be registered with unlimited liability (co-operative societies) or limited liability (co-operative companies).

The functon of farmers' special co-operatives is generally to carry on business as dealers in agricultural products, livestock, implements and other farming requisites, e.g. manures, seeds, trees. They must have at least seven members and may be registered with limited liability only. These co-operatives may also undertake the manufacturing of agricultural products. They may become fruit sprayers, packers, shippers and cold storage proprietors to the agricultural industry. They may deal with non-members, but the value of such business may not exceed the value of business with members unless special permission is obtained from the Minister of Agriculture.

The receipts and accruals of the above societies or companies derived from transactions with persons who are their members, including income from investments derived from members, are exempt from income tax. Receipts or accruals derived from transactions with persons who are not members, including income derived from investments with non-members, are subject to tax — section 99(2)(*a*) of the Co-operative Societies Act.[58]

Receipts from non-members arising from the sale of products of members are deemed to be receipts from members and transactions arising out of certain Wine and Spirit Control Acts, the War Measures Act and the Marketing Act, are also deemed to be receipts from members. Receipts which have been derived from the handling on behalf of purchasers of any produce sold on behalf of its members, are deemed to be receipts derived from transactions with members — section 97(5) and section 99(3) of the Co-operative Societies Act.[58]

For the purpose of determining the taxable income derived from transactions with non-members, the company or society must submit a statement showing its trade income and investment income derived from non-members. Only so much of its total expenditure as was incurred in the production of that income is deductible in terms of section 11 of the Income Tax Act.

As regards the taxation of members of these co-operatives, they are taxed on any bonuses received where such bonuses can be regarded as additional consideration for produce delivered to the co-operative, or as a reduction in the charge made to them for farming requisites, other than capital assets which they have purchased, in terms of section 11(4)(*a*). Dividends received by members on their shares are subject to super tax if they are ordinarily resident or carrying on business in the Union.

58 See I.T.C. No. 730, 18 S.A.T.C. 101, and I.T.C. No. 655, 15 S.A.T.C. 487, for cases dealing with the application of the provisions of sec. 99(2)(*a*), sec. 99(3) and sec. 97(5).

(*b*) *Co-operative Trading Societies*

The function of co-operative trading societies, which may be registered with limited liability only, is to purchase consumable goods in any market and to supply them to members only or to members and non-members. These societies must have a minimum membership of twenty-five. For income tax purposes, they are divided into two classes:

(i) *Societies which are 'closed societies' in terms of section 97*

A *closed* trading society is one in respect of which the Registrar is satisfied that it does not deal with persons who are not members to a greater extent than, in his opinion, is in the particular circumstances of the case essential to the proper carrying out of the objects for which it has been established. The Registrar issues a certificate to this effect which certificate is conclusive.

The ordinary income tax rules apply; the receipts and accruals derived from transactions, whether with persons who are members or with persons who are not members, are subject to tax except that the amount of any bonus distributed in any year of assessment to members is allowed as a deduction from the income of the society in so far as that bonus does not exceed one-tenth of the aggregate value of the business done with its members during that year of assessment — section 99 (2) (*b*). The bonus, in practice, is allowed as a deduction against the profits out of which it is distributed and not against the income earned during the year in which it is distributed.

(ii) *Societies which are not 'closed societies' in terms of section 97*

These societies include all trading societies which do not fall within the definition of *closed societies*. They are taxed in a similar manner to 'closed societies', the only difference being that they are not allowed as a deduction the amount of any bonus distributed to members in any year of assessment — section 99 (2) (*b*).

As regards the taxation of members of co-operative trading societies, the bonus distributed is regarded as a rebate to the members on the purchases they have made from the co-operative, and where such rebate is connected with goods purchased for domestic use, it is not taxed in the hands of the members. Where the rebate is related to goods purchased for trading purposes, it is subject to tax as a recoupment in terms of section 11 (4) (*a*) since the original purchase was allowed to be deducted in terms of section 11. Dividends received by members on their shares are subject to super tax if they are ordinarily resident or carrying on business in the Union.

§ 229. Criticisms

Under the present law, co-operative societies or companies (other than co-operative trading societies) are exempt from taxation except in respect of receipts and accruals derived from transactions with persons who are not members. This may invite avoidance since the farmer-members who dispose of their livestock or produce to the co-operative may agree to take a smaller purchase price so that a larger tax-free profit can accumulate in the hands of the co-operative. There would be a natural temptation on the part of members to reduce their own individual profits so that a larger profit can be earned by the co-operative. In this way, the reserves and undistributed profits of the co-operative can be built up with a resultant increase in the value of the shares held by members in the co-operative. On a member's resignation or on his death, if the value of the shares is paid out to him or to his estate this would partake of the nature of capital. In this way, much tax revenue can be lost to the Treasury. It must also be borne in mind that as a co-operative society is recognized as a public company in terms of section 33 (2) (*d*) it is entitled to capitalize its undistributed profits by the issue of bonus shares to shareholders which would be free of super tax in the hands of the shareholders (see § 44).

The Committee of Enquiry into the Income Tax Act[59] was of the view that as in the case of 'closed' trading co-operatives, any surplus not distributed by a co-operative to its members should be taxable in the hands of the co-operative. The Committee pointed out that the co-operative was a separate legal entity and that the income not distributed among members legally belonged to the co-operative. The Committee's recommendation, it is true, does involve the taxation of profits arising out of dealings with members but the view that the element of mutuality excluded the notion of taxability is no longer generally accepted. There are many instances in the tax laws of other countries where tax is imposed upon transactions with members. For example, in terms of sections 119 and 120 of the Australian Act, co-operative societies are taxed on all income including income derived from their members although they may deduct so much as is distributed among its shareholders as interest or dividends on shares or as rebates or bonuses based on business done by shareholders with the company. Section 444 of the United Kingdom Act sets out special provisions as to companies and societies trading with their members and provides that 'profits or gains shall be deemed to include a reference to a profit or surplus arising from transactions of the company or society with its members which would be included in profits or gain . . . if those transactions were transactions with non-members . . .'. Section 145 of the New Zealand Act provides a further precedent of where the element of mutuality does not exclude tax liability.

The Income Tax Commission did not think that any change

[59] *First Report*, p. 89, para. 25.

from the present system of taxing co-operatives was justified and recommended that the present basis of taxation of these companies or societies should not be disturbed and that they remain liable only on the receipts or accruals derived from non-member dealings.[60]

As regards co-operative trading societies which are 'closed', they are entitled to deduct from their income the amount of any bonus distributed among members. Many of these societies carry out the functions of the ordinary trader and are in direct competition with private firms. Thus, any tax concession granted to such a society permits it to gain an advantage over the ordinary trader. The same problem arises with farmers' special co-operatives which are not taxable on profits derived from transactions with members. Both these types of co-operatives may have dealings with non-members. In the case of farmers' special co-operatives, it may, therefore, be effectively argued that the continued exemption from tax of amounts placed to reserve permits them to obtain an unjustified advantage over the ordinary trader in that the exempt profits can be used to build up the business thereby undermining the competitive position of the ordinary trader. Having regard also to the loss of tax revenue to the State, it would seem that there is much force in the Committee's recommendations that all the profits of co-operatives including the profits arising from transactions with members should be taxable.

To prevent abuse, it should be provided that if in any year of assessment the non-member business of the co-operative exceeds a specified percentage of its total business then it should for that year be deemed not to be a co-operative company or society. Australia, for example, has a provision in its taxing Act (section 118) whereby a company is deemed not to be a co-operative company if less than 90 per cent of its business is transacted with members.

V. Hire-purchase Trading

§ 230. Special concession to hire-purchase traders

If a taxpayer has entered into an agreement with another person in respect of any movable property the effect of which is that the ownership in such property will only pass from the taxpayer to such other person upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, then, in terms of section 22:

(*a*) The whole of the amount stipulated in the agreement is deemed to have accrued to the taxpayer on the day on which the agreement was entered into;

(*b*) the Commissioner, bearing in mind the circumstances attaching to the trade of the taxpayer, may make an allowance each year as seems to him reasonable in respect

[60] *First and Final Report*, p. 22, para. 101.

of all amounts which are deemed to have accrued under the hire-purchase or other agreements but which have not been received at the close of the taxpayer's accounting period. In making this allowance, the Commissioner is required to take into consideration any allowance he has made under section 11 (2) (*b*) in respect of doubtful debts;

(*c*) the special allowance made in terms of (*b*) (*supra*) must be included in the taxpayer's income in the next succeeding tax year, at the end of which year a fresh allowance is calculated.

The provisions of section 22, it is submitted, apply only to property that is sold subject to a suspensive condition that ownership of the property will only pass after the whole or part of the purchase price has been paid, and are not applicable to leases with an option to purchase, i.e. agreements of hiring and letting, in terms of which the lessee has an option to purchase the subject-matter of the lease, or to unconditional sales where ownership is not suspended even though the sale price is payable in instalments. Sales subject to a resolutive condition, for example where it is agreed that a sale shall be regarded as cancelled if the purchase price is not paid by a certain date, do not fall within section 22.

Where a hire-purchase or other contract falling within the terms of section 22 stipulates a sale price made up of the aggregate of the cash selling price and finance charges, and where the sale price is expressed as an amount payable in instalments, it is submitted that the cash selling price as well as the finance charges are deemed to accrue in terms of section 22 at the date of the conclusion of the agreement notwithstanding that the agreement provides that the purchaser has the right to anticipate the due dates of instalments by paying off in full what is owing, in which event he will receive a credit in respect of the finance charges not yet due and payable. Where, however, the agreement provides that interest is to be paid on instalments not paid on the due date, such interest cannot be deemed to have accrued at the time the agreement is entered into in terms of section 22. The amount referred to as payable in section 22 must be certain and does not include interest payable from time to time and which is conditional on future events. Such interest will only become part of the taxpayer's gross income in the year of receipt or accrual.[61]

In practice, the special allowance to hire-purchase traders (see (*b*) *supra*) is calculated by the Commissioner as follows:

(i) The instalments owing under the hire-purchase or other agreements at the end of the financial year after excluding therefrom all amounts written off as bad debts in terms of section 11 (2) (*g*) are aggregated;

[61] *Enem Finance & Investment Co. (Pty.), Ltd.* v. *C.I.R.*, 1945 N.P.D. 179; 13 S.A.T.C. 233.

(ii) there is then deducted from the total so arrived at any doubtful debts allowance made in terms of section 11(2)(*b*);

(iii) the special allowance is determined by taking a percentage of the total outstanding instalments as determined in (ii) *supra*.

The percentage is calculated with reference to the ratio which the gross profit derived on the year's hire-purchase trading bears to the year's turnover in respect of hire-purchase trading, i.e. all hire-purchase transactions are viewed collectively. Thus, if the gross profit for the year on hire-purchase trading is £15,000 and the total hire-purchase sales for the year is £45,000, the percentage to be applied for the purpose of calculating the special allowance is $33\frac{1}{3}$ per cent $\left(\frac{15,000}{45,000} \times 100\right)$. If the outstanding hire-purchase instalments at the end of the year total £18,000, the special allowance to be granted will be £6,000 ($33\frac{1}{3}$ per cent of £18,000). The allowance, therefore, ensures that a hire-purchase trader is subject to tax only on such portion of the gross profit that he has received in cash.[62]

The percentage, once determined, is not usually varied in subsequent years provided that the actual percentage gross profit to turnover for such years does not differ from the accepted percentage by more than 2 per cent in either direction.

In practice, the special allowance granted in any one year is limited to an amount which serves to reduce the taxable income from all sources to zero, i.e. the allowance cannot be used to create an assessed loss or to increase an assessed loss. This procedure is of little consequence to the taxpayer as in any event the allowance granted in respect of one year must be included in income in the next year so that the carry-forward of an assessed loss will confer no particular advantage.

The grant of the special allowance, it is to be noted, is at the Commissioner's discretion having regard to the circumstances attaching to the trade of the taxpayer. The Commissioner's discretion, once properly and *bona fide* exercised, is not subject to review by the courts.

The provisions of section 22 require that the Commissioner, if appropriately requested to do so, must apply his mind to the question whether in fact special circumstances exist which justify an allowance such as is authorized by the section. Where the Commissioner does not do so, the taxpayer is entitled to ask the Court that his case be considered by the Commissioner.[63]

[62] The previous hardships experienced by hire-purchase traders in not having their reserves for unearned profits and unearned finance charges allowed for tax purposes have thus been removed. See I.T.C. No. 431, 10 S.A.T.C. 429; I.T.C. No. 404, 10 S.A.T.C. 126; I.T.C. No. 252, 7 S.A.T.C. 51; I.T.C. No. 139, 4 S.A.T.C. 212.

[63] *Enem Finance & Investment Co. (Pty.), Ltd.* v. *C.I.R.*, 1945 N.P.D. 179; 13 S.A.T.C. 233.

Where cessation of business is due to the death or insolvency of the taxpayer, the Commissioner, in practice, grants the special allowance in respect of outstanding instalments at the date of death or insolvency. It would also appear to be the present practice of the Commissioner not to include the allowance, in any subsequent tax year, in the taxable income of any person. Where, on the cessation of trade, the taxpayer sells his hire-purchase debts, the special allowance granted in respect of the previous tax year is taxable in the current year and no fresh allowance can be made since there are no outstanding amounts at the end of the current year.[64] Where the debts are not sold but retained by the taxpayer, the Departmental ruling is that the allowance, at the rate applicable to the last tax year during which active trading was carried on, must continue to be granted in respect of all the outstanding debts at the end of each financial year.

§ 231. Criticisms

The special allowance conferred by section 22 places hire-purchase traders in a singularly fortunate position in the year in which they commence business operations because it could mean complete freedom from tax in that year. For example, if in the first year a profit of £10,000 has been derived and the outstanding hire-purchase debts at the end of the year total £44,000, then if the percentage of gross profit to turnover is, say, 25 per cent, it must follow that there is no taxable income, since the special allowance of £11,000 (25 per cent of £44,000) will extinguish the taxable income derived from the business. It is true that the allowance must be included in income in the next tax year, but then it should be remembered that the taxpayer is entitled to a fresh allowance at the end of that year which may be either more or less than the previous year's allowance. If the allowance is more, it means that the profit for the second year will be reduced; if it is less, the profit will be increased to this extent. Whereas it is clear that a big benefit will result in the initial year when the allowance is claimed, the effect in future years cannot be predicted. For example, if the business is sold in a subsequent year there must be included in income the full amount of the allowance granted at the end of the previous year with the resultant effect that the taxes may be substantially increased owing to the inclusion of the whole allowance in the income for that year. The Departmental practice to grant the allowance where the cessation of business is due to the death of the taxpayer must result in a loss of revenue to the *fiscus* since the allowance cannot be included in the income of any taxable entity although allowed as a deduction in the final assessment up to the date of death. In the writer's view, the allowance should not be granted in the year of assessment where there is a cessation of business due to death as this confers an unjustifiable advantage on the taxpayer as compared with another taxpayer who is taxable on the full reserve in the year in which he sells his business.

[64] See I.T.C. No. 748, 18 S.A.T.C. 316.

The benefits conferred by the special allowance are not extended to unconditional sales where ownership in the property is not postponed even though the sale price is payable in instalments extending over many years. In terms of the *Lategan* doctrine (see § 236), the whole *quid pro quo* accrues at the time the seller becomes entitled to claim payment irrespective of when the payments have to be made. The seller is, however, entitled to deduct an amount calculated to reduce the face value of the outstanding instalments to their present-day value. The allowance is included in income in later tax years. It may be justifiably asked why hire-purchase traders should be treated more favourably than traders who sell their goods on terms under an unconditional sale. A trader who sells a commodity under a hire-purchase contract is in no worse position than the trader who sells the same commodity under an unconditional sale, the purchase price being payable in instalments. On the contrary, having regard to the fact that the hire-purchase trader enjoys the security of the asset, which legally belongs to him, and to the protection offered to him by the Hire Purchase Act, it could justifiably be argued that the trader who sells on terms under an unconditional contract and who merely has a right to claim the instalments as and when they fall due is financially less secure and should at least be entitled to receive whatever tax concessions are granted to hire-purchase traders. The hardships imposed on taxpayers by the necessity to finance taxation payable on profits which have accrued but which are received over a lengthy period of time, concern traders who sell on terms under unconditional sale agreements as much as hire-purchase traders. Both the Committee of Enquiry into the Income Tax Act[65] and the Income Tax Commission[66] considered that in the case of transactions involving the sale of goods, whether movable or immovable property, under suspensive sale conditions or by hire-purchase agreements there should be granted an annual allowance for unearned profits. The allowance recommended was substantially in accordance with the present Departmental practice. The position of traders who sell their goods on terms under unconditional sale agreements was not considered.

VI. Land Dealers and Township Owners

§ 232. Special concessions to land dealers and township owners

Section 22 provides *inter alia* that in the case of immovable property which has been sold subject to the condition that transfer shall only be passed upon or after receipt of the whole of the purchase price or a certain portion thereof, the whole of the purchase price is deemed to have accrued to the seller on the day the agreement has been entered into. The section then provides that in respect of all

[65] *First Report*, p. 102, para. 9.
[66] *First & Final Report*, p. 25, paras. 121-3.

amounts which are deemed to have accrued but which are unpaid at the end of the year, the Commissioner, taking into consideration any allowance he has made in respect of doubtful debts under section 11 (2) (*b*), may make a further allowance as under the special circumstances of the taxpayer's trade seems to him reasonable. Finally, it is provided that any allowance so made must be included in the taxpayer's income for the following year.

The extent of the special allowance referred to in section 22 is entirely at the Commissioner's discretion. The present practice is to grant a twofold allowance in the case of land dealers and township owners:

1. An allowance on outstanding debts.
2. An allowance in respect of contingent development expenditure.

Allowance on outstanding debts

The allowance is in the form of a percentage calculated on the outstanding instalments at the end of the financial year after deducting the Commissioner's allowance in respect of doubtful debts in terms of section 11 (2) (*b*). The percentage represents an estimate of the ratio which the expected gross profit to be derived from the sale of all available plots will bear to the total proceeds to be derived from the sale of all the plots. The Commissioner determines this percentage by a formula which can be expressed as follows:

$$w = \frac{x - (y + z)}{x} \times 100$$

where w = the percentage;

x = an estimate of the aggregate proceeds to be derived from all the saleable plots in the township;

y = the actual cost of the entire property included in the township;

z = an estimate of the development expenditure to be incurred, e.g. expenditure on roads, lighting, water supply, and other amenities.

The ratio expressed as a percentage which the estimated gross profit will bear to the estimated gross proceeds is fixed at the commencement of operations. It will not be varied as long as the saleable plots, as determined at the commencement, do not vary by an increase or a decrease of the area of the land reserved for public purposes.

An allowance in respect of contingent development expenditure

Whereas the allowance on outstanding debts applies only to the case where the immovable property is sold on terms, the contingent development expenditure allowance applies whether the property is sold on terms or for cash, the only condition being that the seller is under an obligation to incur development expenditure, i.e. to provide roads, water, electricity, etc. Invariably the expenditure for these services is only incurred subsequent to the sale of the plots and often many years after the date of sale. The purpose of the allowance is, therefore, to allow the township owner each year, by way of a reserve, a deduction for contingent development expenditure applicable to the number of plots sold by the end of the tax year in question. The following formula serves to illustrate how the Commissioner arrives at the allowance:

$$r = \frac{m}{n} (d - a)$$

where r = the annual allowance;

m = the number of plots sold from date of acquisition to the end of the current year;

n = the total number of plots on sale. This will exclude any land set aside for public purposes, e.g. roads, schools, parks, etc.

d = an estimate of the development expenditure to be incurred;

a = actual development expenditure incurred from date of acquisition to the end of the current year.

The estimate of the contingent development expenditure is fixed at the commencement of operations. It will be varied only in very special circumstances. The calculation of the allowance is not affected by repossession of plots and their resulting resale. Where a sale has been cancelled and the plot has been repossessed, this does not affect the contingent development expenditure allowance. The *m* in the formula (*supra*) will always include the sale of that plot as if no cancellation or repossession had taken place. When the repossessed plot is eventually sold, the sale will be excluded from *m*. From the above it follows that up to the end of each tax year the estimated cost of development expenditure appertaining to the total number of plots sold is allowed as a deduction. Thus, the township owner will receive in the years in which no development expenditure has been incurred an allowance therefor, this being the proportion which can be related to the total number of plots sold.

§ 233. Criticisms

As the allowance for contingent development expenditure bears no relation to the outstanding instalments at the end of a year, it is conceivable that the two allowances could exceed the outstanding instalments at the end of the year. In practice the two allowances are deducted in full and are not limited to the outstanding debts at the end of the financial year. As section 22 specifically provides 'that the Commissioner . . . may make such further allowance . . . in respect of all amounts which are deemed to have been accrued under such agreements but which have not been received at the close of the taxpayer's accounting period . . .', it is considered that by permitting a deduction for an allowance in excess of the outstanding debts the Commissioner is going beyond the terms of the section. Moreover, the special allowance contemplated by section 22 should strictly speaking apply only to traders who sell their assets on terms. In practice the contingent development expenditure allowance applies to all township owners whether they sell their property for cash or on terms, the only limitation being that the allowances are limited to an amount which will serve to reduce the taxable income from all sources to zero. The allowances cannot be used to create an assessed loss or to increase an assessed loss. This limitation imposes no hardship on the taxpayer because of the provision in section 22 that whatever is allowed by way of an allowance in one year is to be included in his income in the next succeeding tax year.

The effect of granting the allowance on outstanding debts is that a township owner pays tax on his profits only when they are received in cash. This is an advantage which is denied to all other taxpayers who sell their stocks on terms although not under hire-purchase agreements (see § 231 for a fuller discussion on this aspect). The anomaly arising on the death or insolvency of the taxpayer whereby the allowance is granted at the date of death or insolvency but cannot be included in the taxable income of any person in a subsequent tax year, has been discussed in § 231.

As regards the allowance in respect of contingent development expenditure, the Department apparently justifies its practice by virtue of the provisions of section 22 of the Income Tax Act but that section merely authorizes an allowance in respect of amounts which are deemed to have accrued under hire-purchase agreements but which have not been received at the close of the taxpayer's accounting period. It has no reference to an allowance in respect of expenditure still to be incurred in the future.

No other taxpayers are allowed to claim as deductions for tax purposes provisions in respect of deferred or anticipated expenditure even though they are obliged to incur such expenditure in terms of a contract for the sale of goods or for the rendering of services. Such expenditure can only be claimed in the year in which it is incurred. Township owners are, therefore, in a singularly fortunate position as regards the deduction of deferred expenditure which is denied to all other taxpayers. If the legislator desires to benefit township owners to the exclusion of other taxpayers, there should be clear provision for this in the Income Tax Act. The practice should not be in conflict with the law.

The Committee of Enquiry into the Income Tax Act[67] recommended that an estimate of the costs which a township owner will be obliged to incur in respect of development expenditure should be taken into account in determining the expenditure to be allowed in respect of the cost of the township. The Income Tax Commission pointed out[68] that this was current practice and that the principle

[67] *First Report*, p. 37, para. 86.
[68] *First & Final Report*, p. 11, para. 47.

of incorporating departmental rules in the law is not favoured as they would become inelastic. With respect, the Commission seemed to overlook the fact that the allowance is not authorized under any section of the Income Tax Act. The Commissioner's practice must have its limits. It does appear as though the Commissioner's practice here is usurping the place of the law.

CHAPTER TWELVE

PARTICULAR ASPECTS

I. Assessment on the Basis of Receipts or Accruals

§ 234. Levy of tax on both receipts and accruals

In terms of section 7, *gross income* is defined as including both receipts and accruals. The tax is levied in respect of income 'received by or accrued to' the taxpayer during the year of assessment. Before a taxpayer can be taxed on any amount, there must be a receipt or an accrual of income. This is the general rule although there are instances in the Act where a person is subject to tax on amounts which have neither been received by him nor which have accrued to him. For example, income received by a minor child is, in the circumstances set out in section 9(3), deemed to be the income of the parent (see § 58). A farmer is subject to tax on the market price of livestock or produce donated by him (see § 203). Donors are, in the circumstances mentioned in section 9(5) and (6), subject to tax on income received by or accrued to the trustees or the beneficiaries (see §§ 70 and 71). A husband is taxable on the income received by or accrued to his wife (see § 93).

In *C.I.R.* v. *Delfos*,[1] it was held that the words 'received by or accrued to' in the definition of *gross income* in section 7 confer on the Commissioner the right to tax all amounts received by the taxpayer or accrued to him in the tax year, i.e. the Commissioner can regard as gross income all amounts actually received during the tax year, whenever they may have originally accrued, and also all amounts accruing during a tax year whenever they may be received. There is, however, a necessary implication that an amount which accrues to a taxpayer, and is received by him in the same year, cannot be taxed twice; neither can it be taxed in the year of accrual and again in the year when it is received since this would result in double taxation (see § 53).

In the *Delfos* case the taxpayer was the managing director of a company which entitled him to a salary and fee of £3,200 per annum. The company was unable to pay the full salary over a certain period of years and during these years the taxpayer was assessed on the amounts he actually received and the unpaid salary was treated as a bad debt. In a later tax year, he received from the company the full amount of the arrears. It was held that though the salary for each year had accrued to him in those particular years, the accumulated amount when received fell within the gross income of the year in which it was received.

[1] 1933 A.D. 242; 6 S.A.T.C. 92.

The effect of the decision in the *Delfos* case is that where for any reason tax has not been imposed on any amount in the year in which the income has been earned or has accrued, the Commissioner is entitled to tax that amount in the year of receipt.[2] This is probably a reason why the legislator added the receipts basis in the definition of *gross income*. Another reason why the receipts basis was added was in order to act as a safeguard in case the amount taxed on the accrual basis is less than the income actually received later on. For example, if a primary producer was to sell his products in the United States for dollars, the equivalent Union currency at the date of accrual forms part of his gross income. If, subsequently, the dollars are actually remitted and the taxpayer receives Union currency in excess of the amount taxed on the accrual basis, such excess is taxable on receipt. If goods are sold and delivered not for cash but, say, on two years' credit, then there accrues to the seller in the year of sale not the full amount of the purchase price but the present value of the purchase price at the end of that year.[3] Upon receipt of the purchase price in a later year, the seller is then taxable on the difference between the receipt and the amount taxed in the year of sale.

Both the 'receipt' and the 'accrual' bases are independent of each other by virtue of the disjunctive words 'received by *or* accrued to' in section 7. A taxpayer has, therefore, to return everything received by him in the year of assessment, as well as everything that has accrued to him in that year. Where both the receipt and the accrual occur in the same year, he need only return the amount once, since, as stated above, there is a necessary implication against double taxation.

It is submitted that where an amount has accrued during a particular year of assessment and the taxpayer has included such amount in his return for that year, the Commissioner is bound to include that amount in the taxpayer's gross income for that year and is not entitled to postpone assessment until the amount is received in a later tax year. In such circumstances it is the duty of the Commissioner to tax on an 'accrual' basis.

The general principle of imposing tax on the basis of the amounts received by or accrued to the taxpayer during the year of assessment has formed part of the Income Tax laws of the Union since 1914. The Committee of Enquiry into the Income Tax Act considered that the principle is sound and should not be departed from.[4]

§ 235. TAXPAYERS ASSESSED ON A 'RECEIPTS' BASIS

It is the practice of the Commissioner to levy tax on an 'accrual' basis although his practice in the past was to allow certain taxpayers, mainly professional men, to return their income on the basis of cash

[2] *Baxter* v. *C.O.T.*, 1937 S.R. 48; 9 S.A.T.C. 1; I.T.C. No. 430, 10 S.A.T.C. 424; I.T.C. No. 525, 12 S.A.T.C. 424; I.T.C. No. 521, 12 S.A.T.C. 408.
[3] *Lategan* v. *C.I.R.*, 1926 C.P.D. 203; 2 S.A.T.C. 16.
[4] *Second & Final Report*, p. 6, para. 7.

receipts only. Although such taxpayers have been permitted to continue this practice, the Commissioner insists with regard to all new professional men that they render their returns on the 'accrual' basis. Once a person is taxed on a 'receipt' basis, he is not permitted to have previous assessments reopened and to be reassessed on an 'accrual' basis.[5] When a taxpayer who has been permitted to render returns on a 'receipt' basis dies, no machinery exists in the Act whereby the amount of any untaxed accruals relating to tax years prior to that in which death takes place can be included in the deceased's taxable income for the final period up to the date of death. The Commissioner, it is submitted, has the power in terms of section 66 to reopen previous assessments and include in the relevant years all untaxed accruals appertaining to these years. In practice, earlier assessments are not reopened and tax is not levied on income earned but not received at the date of death.

In such cases, therefore, there is a considerable danger of loss of revenue to the State. The problem is further aggravated where such taxpayers, who have been permitted to render returns on a 'receipt' basis, sell their practices or businesses including the book debts. The Commissioner, in practice, usually includes the amount received for the sale of the debts in the taxpayer's income in the year in which the sale occurs and so recoups himself for the amount of any untaxed accruals. No machinery exists in the Act for such a procedure. It must not be overlooked that an amount received for the sale of book debts on cessation of trading is in the nature of capital. It would seem that in practice taxpayers do not object to this procedure owing to the fact that the Commissioner has the power in terms of section 66 to reopen previous years' assessments and to include in the relevant years all untaxed accruals appertaining to those years.

The Committee of Enquiry considered that the Commissioner should refrain in the future from permitting taxpayers to render returns of income derived from trade or from fees for services, on a basis of receipts. In addition, provisions should, in its opinion, be enacted to enable the position of those taxpayers who have been rendering returns on the receipts basis to be brought into line with that of taxpayers whose returns are based on accruals. In framing such provisions, suitable safeguards should be included to avoid any undue hardship upon the taxpayers concerned resulting from the application of the changed basis of assessment. It recommended as follows:[6]

'(1) The taxable income of any taxpayer who has hitherto rendered returns and been taxed on the basis of receipts in respect of any trade, business or profession shall, with effect from the year of assessment in respect of which such provisions are made operative, be determined on the basis of all amounts accrued to the taxpayer in respect of such trade, business or profession;

[5] *Marais* v. *C.I.R.*, 1943 C.P.D. 150; 12 S.A.T.C. 190; I.T.C. No. 498, 12 S.A.T.C. 144; I.T.C. No. 518, 12 S.A.T.C. 266.

[6] *Second & Final Report*, p. 7, para. 16.

(2) any amounts which accrued to the taxpayer during any previous years of assessment and which were not included in his taxable income for such previous years of assessment shall be included in the taxpayer's income for the first year of assessment in respect of which such provisions are made operative, subject to the proviso that the amount so included shall not be taken into account for purposes of determining the progressive rates of normal and super taxes payable by the taxpayer;

(3) no super tax shall be chargeable on the amount of any accruals of previous years which are so included in the taxpayer's taxable income and the rate of normal tax thereon shall be a flat rate of 1*s.* 6*d.* per £ in the case of married persons and 1*s.* 9*d.* per £ in the case of unmarried persons and companies;

(4) where the taxpayer has an assessed loss, he be permitted the option of either paying the tax at the rates referred to in sub-paragraph (3) on the amount of the untaxed accruals or of having his assessed loss reduced by such amount; and

(5) if the Commissioner is satisfied that the circumstances of the case warrant it, the amount of the tax chargeable at the rates referred to in sub-paragraph (3) shall be spread so as to become payable as to one-third with the assessment for the current year and one-third with the assessments for each of the two succeeding tax years, any balance remaining unpaid upon the death or insolvency of the taxpayer before the full amount has been assessed and paid to rank as a claim against the deceased or insolvent estate.'

That the taxation of accruals may afflict hardships upon taxpayers because the income received in any tax year may be considerably less than the amounts that have accrued to him is well known. There is no good reason, however, why one class of taxpayer, e.g. professional men, should be given preferential treatment or why one professional man should be taxed differently from another. For example, when a professional man on commencing practice enters into partnership with another professional man who has always rendered his return on the cash received basis, the Department insists that the partnership submits both an income and expenditure account showing all fees accrued as well as a receipts and payments account showing only fees received. The taxable income of the new partner is determined in accordance with the income and expenditure account whereas the taxable income of the existing practitioner is determined in accordance with the receipts and payments account. As has been pointed out, upon the death of the taxpayer revenue may be lost to the *fiscus* in respect of untaxed accruals. It should also be pointed out that the hardship is to some extent alleviated by the allowances in respect of bad and doubtful debts (section 11 (2) (*g*) and (*h*)).

The Income Tax Commission accepted the recommendations made by the Committee of Enquiry.[7] It is a matter for regret that the Act has so far not yet been altered.

[7] *First & Final Report*, p. 27, paras. 14-18.

§ 236. Date of accrual in terms of the 'Lategan' principle

General principles

It is only income that has been received by or accrued to a taxpayer during a particular year that is subject to tax in that year. Each tax year stands by itself, and, where the rates of tax or rebates change from one year to the next, it becomes important from the point of view of both the taxpayer and the tax-gatherer to ensure that all amounts received or accrued during a particular tax year are included in the assessment for that year. In this respect, received income presents no difficulty because it is easy to ascertain whether an amount has been received in a particular tax year. The difficulty usually lies with accrued income.

In *Lategan* v. *C.I.R.*[8] it was held that income can only accrue when the taxpayer becomes entitled to such income even though the time for payment has not yet arrived. Lategan was a wine-farmer who sold and delivered in May, 1920, wine for a certain sum of money. Part of the amount was payable in the 1920 tax year and the balance was to be paid in instalments in the 1921 tax year. The taxpayer contended that the amount payable in the 1921 tax year should be excluded from his income in the 1920 tax year and should be taxed in the 1921 tax year. The Court held that as he had become entitled to the income in the 1920 tax year, that year fixed the date of accrual. The words in the Act 'has accrued to or in favour of any person' merely means 'to which he has become entitled'.[9] Per Watermeyer, J.: 'So far as a debt was concerned which was payable in the future and not in the year of assessment, it might be difficult to hold that the *cash* amount of the debt had accrued to the taxpayer in the year of assessment. He had not become entitled to a right to claim payment of the debt in the year of assessment but he acquired a right to claim payment of the debt in the future. This right had vested in him, had accrued to him in the year of assessment, and it was a valuable right which he could turn into money if he wished to do so. . . .'

In *Lategan's* case, the Court held that although the instalments had to be regarded as gross income something had to be deducted from their face value to allow for the fact that they were not payable at the close of the year of assessment. The value to be fixed was the present worth of the instalments at the end of the year, i.e. 30th June, 1920.[10] In all cases, therefore, the receipt or accrual of an amount of income other than money must be valued and such value included in the gross income. If goods are sold and delivered not for cash but, say, on two years' credit then there accrues to the seller in the year of sale not the full amount of the purchase price but the present value of the purchase price at the end of that year. Upon receipt

[8] 1926 C.P.D. 203; 2 S.A.T.C. 16.

[9] Approved of by Wessels, C.J., in *C.I.R.* v. *Delfos*, 1933 A.D. 242; 6 S.A.T.C. 92.

[10] See also *Ochberg* v. *C.I.R.*, 1933 C.P.D. 256; 6 S.A.T.C. 1, and I.T.C. No. 437, 10 S.A.T.C. 456.

of the purchase price in a later year, the seller is then taxable on the difference between the receipt and the amount taxed in the year of sale. This case must, however, be distinguished from the case where goods are sold under a hire-purchase agreement and which falls within the provisions of section 22. Here the full purchase price is deemed to accrue on the day on which the agreement is entered into but a special allowance is granted to provide for the fact that the full price may not be paid at the end of the tax year. The principle established in *Lategan's* case does not, therefore, apply to hire-purchase traders falling within the terms of section 22 and who are governed by special rules (see § 230).

It has been held that where goods are sold on credit subject to a rebate or discount if payment is made within a specified period, the amount accruing for tax purposes is not the full selling price. The debt has to be valued bearing in mind the discount the customer is entitled to should he pay within the specified period.[10a] Thus, provision for discounts in respect of debts outstanding at the end of the financial year are to be taken into account in the determination of taxable income.

Examples illustrating the 'Lategan' doctrine

The date of accrual of a salary is the date it becomes due, of rent or interest the due date, of a bonus or gratuity for services rendered the date the employer or payer makes the promise or decision,[11] of the proceeds of the sale of an asset the date when the right to claim payment arises in terms of the contract and of dividends the date when shareholders become entitled to the dividend. Interest on fixed interest-bearing securities, e.g. Government loans, municipal stocks, etc., accrues on the date that the interest is due in accordance with the conditions of issue of the securities and not from day to day.[12] In all cases, it is necessary to fix that moment of time when the taxpayer becomes entitled to the income irrespective of the date when it is payable. If an amount of income is in dispute and is only determined or ascertained in a later year, the accrual takes place in the year in which the amount is actually determined and when the taxpayer has an enforceable right to claim an ascertainable amount of income.[13]

The following examples illustrate the principle involved in the determination of the date of accrual as established in the *Lategan* case:

(*a*) A merchant sells goods for £100 on 17th May. In terms of the contract of sale, he undertakes to deliver on 15th July following. The £100 clearly accrues on 15th July when delivery takes place because, until that event takes place, the taxpayer is not entitled

[10a] I.T.C. No. 563, 13 S.A.T.C. 319.
[11] I.T.C. No. 689, 16 S.A.T.C. 501.
[12] I.T.C. No. 268, 7 S.A.T.C. 159.
[13] I.T.C. No. 525, 12 S.A.T.C. 424; I.T.C. No. 402, 10 S.A.T.C. 111, and I.T.C. No. 521, 12 S.A.T.C. 408.

to the income.[14] The Special Court has held[15] that the words of Watermeyer, J., in the *Lategan* case, ' he had not become entitled to a right to claim payment of the debt in the year of assessment but he acquired a right to claim payment of the debt in the future' seem to refer to a definite right *in praesenti* to claim payment *in futuro*, but where there is as yet no delivery the right to claim payment does not arise until the delivery is made. A provision in an agreement that a right to claim payment arises on or after the day when delivery is made means that there can be no accrual of the purchase price for tax purposes until and when delivery has been made in terms of the agreement.

(*b*) A speculative builder of machines completed a machine on 1st June. The machine cost £3,000. At 30th June the fair market value of the machine was £4,000. The machine was sold and delivered on 10th July for £4,100. There is no accrual until 10th July when the seller for the first time clearly becomes entitled to the income. At 30th June, although the machine was already worth £4,000, there was no accrual since at that date the seller was not entitled to anything. An unrealized appreciation in the value of stock-in-trade is therefore not taxable until the seller has an enforceable right to claim payment of the proceeds.[16]

(*c*) A fixed deposit is made on 1st January with a building society for twelve months. The date of accrual is here the date of maturity of the deposit, viz. 31st December. The depositor is only entitled to the interest at the date of maturity of the deposit. The interest does not accrue from day to day.[17]

(*d*) A company declares a dividend on 10th June payable on the following 15th July. The date of accrual of a dividend is the date of declaration, viz. 10th June, when the shareholder becomes entitled to it.

(*e*) A company declares a dividend on 10th June payable to shareholders registered on the share register on 1st July. The dividend is actually paid on 15th July. Here, in terms of *Lategan's* case, the date of accrual is 1st July when shareholders are required to be registered in order to participate in the dividend. It is only on 1st July that it can be said that a shareholder is entitled to the dividend.[18] In all cases one must, having regard to the *Lategan* doctrine, look to the terms of the company's resolution embodying the declaration of the dividend in order to determine when the shareholders are entitled to the dividend. As the example shows, this is not necessarily the date of declaration or the date of payment of the dividend. Where a dividend is declared payable to shareholders registered at the date of

[14] I.T.C. No. 316, 8 S.A.T.C. 166; I.T.C. No. 424, 10 S.A.T.C. 338.
[15] I.T.C. No. 424, 10 S.A.T.C. 338.
[16] I.T.C. No. 110, 4 S.A.T.C. 59.
[17] I.T.C. No. 268, 7 S.A.T.C. 159.
[18] See *C.I.R.* v. *King*, 1947 (2) S.A. 196 (A.D.); 14 S.A.T.C. 184; see also I.T.C. No. 436, 10 S.A.T.C. 453. It is submitted that the decision in *Lawrie* v. *Beaton*, 1938 T.P.D. 260, is not applicable since in that case the question of accrual under the Income Tax Act did not arise.

declaration, then the dividend accrues on that date. In the case of an interim dividend, it has been held that it may be recalled or cancelled by the directors of the company at any time before payment.[19] If this is so, it must follow that the amount of an interim dividend can only be included in gross income when received.

The above views, it must be emphasized, are based on the *Lategan* principle. In *New Union Goldfields, Ltd.* v. *C.I.R.*,[20] Schreiner, J.A., held that in the case of a dividend payable on a certain date to shareholders registered on an earlier date it has not been decided by the Appellate Division whether accrual of the dividend takes place on the date when the shareholders entitled to the dividend are ascertained or on the date when the dividend becomes payable to them.

(*f*) In terms of a building contract, 10 per cent of the contract price is to be retained as 'retention moneys' until a final certificate is issued by the engineer after a period of six months after the completion of the building. The building was completed on 28th February but the builder only received the retention moneys on 31st August when the engineer issued his final certificate. Here the date of accrual is the date of the engineer's final certificate, viz. 31st August, because prior to that date the builder was not entitled to the retention moneys.[21]

§ 237. CONSEQUENCES OF 'HERSOV'S ESTATE' CASE

The effect of the decision

In *Hersov's Estate* v. *C.I.R.*[22] the facts were that in the event of certain persons dying while they held the office of permanent directors of a company, a balance sheet shall be made as on the date of death, and a sum equal to 2½ per cent of the surplus assets of the company shall be paid to the estate of the deceased within two months after the making out of the balance sheet. The Court held, in the case of one of the directors who had died, that it was not competent for the Commissioner to include in the income earned by the deceased up to the date of his death the sum referred to as it had not accrued to the taxpayer during his lifetime.

Since it did not arise for decision, a question left open was whether remuneration earned by a deceased in his lifetime, but accruing after his death and paid to his executors is taxable in the hands of his estate. It is submitted that such an amount constitutes a capital receipt in the hands of the executors and is not taxable. It cannot be considered as an amount received in respect of services rendered in terms of section 7(*b*) since no services are rendered by the executors. They receive the amount as the reward for the services rendered by the deceased during his life. If this view is correct, it must follow that

19 *Lagunas Nitrate Co. Ltd.* v. *Schroeder* (1901), 85 L.T. 22.
20 1950 (3) S.A. 392 (A.D.); 17 S.A.T.C. 1.
21 *Building Contractors* v. *C.O.T.*, 1941 S.R. 233; 12 S.A.T.C. 182; I.T.C. No. 155, 4 S.A.T.C. 306.
22 1957 (1) S.A. 471 (A.D.); 21 S.A.T.C. 106.

some earnings from employment and services escape the income tax net since all a company director need do is to work for a smaller salary plus an undertaking by the company that on his death the company will pay to his estate a certain proportion of the value of the company's net assets as was the position in *Hersov's Estate* case. A similar problem arose in the case of *Purchase* v. *Stainer's Executors*[23] where the House of Lords was of the view that the executors of the late Leslie Howard Stainer were not assessable to tax on certain sums which had been earned by him in the course of his profession as a film actor and producer but which only accrued after his death. Australia has tried to solve the problem by including a specific provision dealing with income of a deceased received after death. Section 101A provides as follows:

> 'Where in the year of income, the trustee of the estate of a deceased person receives any amount which would have been assessable income in the hands of the deceased person if it had been received by him during his lifetime, that amount shall be included in the assessable income of that year of the trust estate and shall be deemed to be income to which no beneficiary is presently entitled.'

The authors of Gunn's *Commonwealth Income Tax Law and Practice*[24] are of the opinion that section 101A applies only to receipts earned by the deceased in his lifetime or which fell due or accrued prior to his death but which were received after death. They are of the view that if the case of *Purchase* v. *Stainer's Executors* (*supra*) had been decided under the Commonwealth Act, section 101A would have applied with the result that the sums received would have been taxable in the hands of the estate. They also quote a case where payments received pursuant to the *Wool Realisation* (*Distribution of Profits*) *Act*, 1948, by the executors of a deceased farmer who had submitted wool for appraisement in his lifetime but who died before the 1948 Act was promulgated, were held taxable in terms of section 101A.

The meaning of 'accrued'

A more serious consequence of *Hersov's Estate* case is the grave doubts with which it leaves its reader as to the correctness of the principle established in the *Lategan* case in regard to the meaning of *accrued*. Centlivres, C.J., held as follows:

> 'Hersov was assessed by the Commissioneer on the basis that a right to receive £60,183 had accrued to him prior to or at his death. In my opinion this was not the correct basis. In my view there was no accrual of any right to Hersov to receive that amount: the accrual was in favour of his estate and that accrual did not take place before the death of Hersov. It may be that the accrual only took place when the amount became due and payable, i.e. after two months after the making of the balance sheet required by clause 2(*c*) of the 1938 agreement. See the concluding words of that clause. I am aware of the fact that this suggested date of accrual conflicts with the decision

[23] [1952] A.C. 280; 32 T.C. 367.
[24] *Fifth Edition*, p. 834.

in *Lategan* v. *Commissioner for Inland Revenue*, 1926 C.P.D. 203.[25] In that case Watermeyer, J., with whom Benjamin and Louwrens, JJ., concurred, held that where a taxpayer in the course of his trade sold goods and agreed that part of the purchase price was payable in one tax year and the remaining part in the next tax year, he could be assessed on the basis that the whole of the purchase price had accrued to him in the first tax year but that a deduction should be made from the face value of the instalment of the purchase price which was payable in the next tax year, the value being the present worth of that instalment at the end of the first tax year. On p. 209 Watermeyer, J., said:

> "In my opinion, the words in the Act (section 6 of Act 41 of 1917) 'has accrued to or in favour of any person' merely mean 'to which he has become entitled'."

In effect the learned Judge held that those words did not mean "has become due and payable". Prima facie there seems to me to be a sound reason why the Legislature in the definition of "gross income" in section 6 of Act 41 of 1917 used the words "received by or accrued": It seems to have intended that the "gross income" should consist not only of amounts actually received by a taxpayer but also of amounts due and payable in the year of assessment but not actually paid in that year. If only the word "received" had been used there would have been no need for a taxpayer to include in his "gross income" amounts not received but due and payable nor would there have been any necessity to make provision for the deduction of bad debts. Hence the provision in section 21 (2) (*e*) of the 1917 Act for the deduction of such debts

> "as proved to the satisfaction of the Commissioner to be bad or doubtful, deductions for doubtful debts being made according to a value estimated by the Commissioner".

. . . *Commissioner for Inland Revenue* v. *Delfos*, 1933 A.D. 242,[26] was a case under Act 40 of 1925 which in so far as the present inquiry is concerned was almost identical with Act 31 of 1941 as it was worded at the time of Hersov's death. Wessels, C.J., at 251, apparently accepted *Lategan's* case, *supra*. De Villiers, J.A., at 260, held that

> "an account accrues under section 7 at the moment when it becomes due and payable, irrespective of the financial position of the debtor".

Stratford, J.A., at 262, agreed with the view taken by de Villiers, J.A. Curlewis, J.A., at 255, said that he agreed in the main on the ground set out in the judgment of Wessels, C.J. Beyers, J.A., at 267-8 seems to indicate that he agreed with de Villiers, J.A. Bearing in mind the differences of opinion and in view of the fact that there does not seem to be a majority view in favour of the decision in *Lategan's* case I do not think that it can be said that *Lategan's* case was accepted by this Court in *Delfos's* case as correctly laying down the law. In *Commissioner for Inland Revenue* v. *Butcher Brothers (Pty.), Ltd.*, 1945 A.D. 301[27] at 318, *Lategan's* case was quoted only for the proposition that the word "amount" as used in para. (*d*) of section 7 (1),

[25] 2 S.A.T.C. 16.
[26] 6 S.A.T.C. 92.
[27] 13 S.A.T.C. 21.

of the 1925 Act means an amount having an ascertainable money value. In *Pyott Ltd.* v. *Commissioner for Inland Revenue*, 1945 A.D. 128[28] at 135, and in *Sacks's* case, *supra*, at 43, *Lategan's* case was quoted only for the purpose of being distinguished. If on the proper interpretation of the word "accrued" in the definition of "gross income" in section 7 of Act 31 of 1941 that word means "became due and payable" then it is clear that there was no accrual of the amount paid under clause 2(*c*) of the 1938 agreement until some time after Hersov's death. It is, however, not necessary to arrive at a definite conclusion that this is so, because in my opinion it is clear that there was no accrual in favour of Hersov during his lifetime.'

If the correct law is that income accrues under section 7 only when it becomes due and payable, taxpayers, by the simple device of arranging for their income to be due and payable at certain times, can regulate their tax liability to the detriment of the *fiscus*. Moreover, the income earned by a taxpayer can be made due and payable on his death in which event, having regard to the principle established in the *Hersov's Estate* case, such income is never taxable. The position can also arise of taxpayers selling their book debts before they become due and payable and then claiming that what they receive is not income but in the nature of a capital accrual. There is no doubt that the most effective test of accrual from the point of view of the *fiscus* is: Has the taxpayer become entitled to the income, notwithstanding that it has not yet become due and payable? Put in another way: Has the taxpayer obtained an enforceable right to claim payment of the income whether immediately or at some future date? In the writer's view, because of the uncertainty of the meaning of the term *accrued* in the light of the *Hersov's Estate* case, the language of section 7 should be amended so as to make it quite clear that accrual does not mean 'due and payable' but that it bears the meaning 'to which a taxpayer has become entitled' as was held in the *Lategan* case. In this way the legislator would have nipped possible future controversies in the bud.

At the same time, the legislator should also consider the fate of section 8 which sets out some special circumstances in which income is deemed to have accrued to a taxpayer, viz.:

(i) Income that has been invested, accumulated or otherwise capitalized by the taxpayer;

(ii) income that is due and payable to a taxpayer notwithstanding that such income has not been actually paid over to him;

(iii) income that has been credited in an account or reinvested or accumulated or capitalized or otherwise dealt with in the name of the taxpayer.[29]

The taxpayer is required to include in his returns of income to the Commissioner each year a complete statement of all such income.

[28] 13 S.A.T.C. 121.
[29] See *C.I.R.* v. *Polonsky*, 1942 T.P.D. 249; 12 S.A.T.C. 11, where sec. 8 was invoked.

The precise meaning to be attributed to section 8 is obscure. In *Lategan's* case, Watermeyer, J., did not seek to apply it in coming to his decision as regards the meaning of the term 'accrued'. In *Delfos's* case, de Villiers, J.A., was of the opinion that the word 'accrued' wherever used in section 7 means 'becoming due and payable' and considered that this view was supported by the language of section 8 which uses the words 'due and payable' in connection with all accruing income. In a Special Court case,[30] it was held that in view of the obscurity of section 8 as revealed by its previous history, it was of no assistance in determining the meaning of the term 'accrued'.[31]

II. Donations Tax

§ 238. Effectiveness of the donations tax as an anti-avoidance measure

Subject to certain exemptions (see section 54 *quat*), donations tax is payable on the cumulative taxable value of all property disposed of (whether directly or indirectly and whether in trust or not) under donations which take effect on or after 24th March, 1955, by any person who —

(i) in the case of any person other than a company, is ordinarily resident in the Union; or

(ii) in the case of a company, is registered, managed or controlled in the Union — section 54 *bis*.

Non-resident individuals are, therefore, not liable to donations tax even though the subject-matter of the donation is property situated within the Union. Companies registered in the Union but resident outside the Union are, however, subject to donations tax.

Although the donations tax provisions appear in the Income Tax Act, they have nothing to do with the taxation of income being a tax on the disposal of capital and designed to prevent the avoidance of estate duty and income tax (see § 62). No doubt the tax has been incorporated into the Income Tax Act for administrative reasons and more particularly to obtain the benefit of the provisions for the payment and the recovery of tax which already exist in regard to ordinary income tax.

Section 54 *quat* prescribes the exemptions from donations tax which *inter alia* include gifts between spouses, donations to charitable, educational or ecclesiastical institutions, gifts to the donor's children subject to certain conditions (see § 63), casual gifts not exceeding £500 during any calendar year and *bona fide* contributions towards maintenance.

The donations tax is payable on the *cumulative taxable value* of a taxpayer's donations which is defined as the sum of all donations

[30] I.T.C. No. 563, 13 S.A.T.C. 319.
[31] See *Liberman* v. *C.I.R.*, 1923 C.P.D. 233; I.T.C. No. 189, 5 S.A.T.C. 284; I.T.C. No. 206, 6 S.A.T.C. 46.

made by him on or after 24th March, 1955, excluding any exempted amount in terms of section 54 *quat.* Section 54 *dec*(1) provides how the various types of property donated are to be valued. Generally, the basis of valuation is the fair market value of the property as at the date upon which the donation takes effect. Where the property consists of annuities, fiduciary, usufructuary or other limited interests, the valuation must be in accordance with actuarial tables. In the case of farming properties, the donor may elect either the fair market value or the Land Bank valuation of the farm.

One of the avowed purposes of the introduction of the donations tax was to prevent taxpayers from reducing their income tax by means of donations of assets so that the income derived from such assets is spread over a greater number of taxpayers, thus nullifying the effect of the progressive rate of tax. It is doubtful whether the donations tax will attain this object. As the writer has attempted to show in this treatise, income may be spread among a number of taxable entities by a transfer of assets not involving a donation at all, e.g. a purchase and a sale, lease, a partnership or a loan. A father, who is carrying on a lucrative business, can admit his sons into partnership and as long as a *bona fide* partnership has been created, the income from the business will now be spread among a number of taxpayers. A grandfather, who is paying heavy super tax on certain company dividends, can sell his shareholdings to members of his family, e.g. his grandchildren, and in this manner he can spread his dividend income among a number of taxpayers. These transactions are not hit by the donations tax since they do not involve gratuitous transactions (see § 64). On the other hand, genuine donations not connected with tax avoidance are hit by the donations tax so that the innocent have to suffer for the sins of the guilty. In this respect the donations tax, which was introduced to protect the Revenue, has sadly misfired. Here is another case where the plug does not fit the hole.

Like the undistributed profits tax, the donations tax is not designed to produce revenue directly. One of its main objects is to prevent the avoidance of income tax by transfers of capital (see § 62). If it is working effectively, the less revenue the tax produces the more successful will its object be. In view of the fact that non-gratuitous transactions are not hit by the tax, it does not necessarily follow that because trifling amounts of the tax are collected each year (in the 1957/58 financial year £31,395 was collected) it has been successful in its object. As has been indicated, income-producing assets may be transferred in a manner without involving a donation at all.

§ 239. Definition of 'property'

Property is defined as any right in or to property wherever situated and whether movable or immovable, corporeal or incorporeal — section 54 *ter*(1). The definition is a very wide one indeed. It includes personal as well as real rights as long as they are rights in or to property. It is clear from the definition that donations tax is not limited to donations of property situated in the Union. As long as the donor is a person ordinarily resident in the Union or, in the case of a company, is registered, managed or controlled in the Union, liability for the tax arises irrespective of the situation of the donated asset. The only exception to this rule is provided by section 54 *quat*(1)(*g*) which exempts from the tax donations of immovable property situated outside the Union provided the donor acquired it —

(i) not less than ten years before the date upon which the donation takes effect; or

(ii) before the donor for the first time became ordinarily resident in the Union (in the case of any person other than a company) or was for the first time registered, managed or controlled in the Union (in the case of a company); or

(iii) by inheritance.

No doubt the above conditions were imposed in order to prevent Union residents from taking advantage of the exemption by purchasing immovable property outside the Union and thereafter making a donation thereof. The exemption refers only to *immovable* property. Movable property acquired in the same way is not exempt.

It seems clear from the definition of 'property' that a person's wits, energies or labours do not constitute property so that he may give his labour or render services for no reward without attracting donations tax. Perhaps the legislator was wise to exclude a person's exertions or skill from the definition of 'property' since the difficulties of valuing the benefits derived from the rendering of services free of charge would be considerable.

It is submitted that a loan granted free of interest or a purchase price owing for the sale of assets left free of interest does not involve 'any right in or to property' and, therefore, falls outside the definition of 'property'. Thus, whereas the free use of a house falls within the definition, the free use of money does not. In the former case, the ownership of the property never passes and the right of use constitutes 'a right in or to property'. That rights to the use or occupation of property constitute 'property' is clear from the exemption contained in section 54 *quat*(1)(*m*) which exempts from the tax 'rights (other than a fiduciary, usufructuary or other like interest) to the use or occupation of property used for farming purposes, for no consideration or for a consideration which is not an adequate consideration, and the donee is a child of the donor'. In the case of a loan of money, the same money need not be returned although the same amount must be repaid. Ownership of the money lent, therefore, passes so that a loan free of interest does not, in the writer's view, involve 'a right in or to property'. If the benefit derived by a borrower or a debtor from an interest-free loan or debt attracted donations tax, the Treasury would be assured of a very fruitful source of revenue, since this type of transaction is indeed common, particularly in the case of transactions between members of a family, 'controlled' companies and their shareholders, and holding companies and subsidiary companies. Moreover, it would hit at many tax avoidance schemes involving the transfer of income-producing assets from one taxpayer to another and where the purchase price is left free of interest. For example, if Mr. X transfers his dividend-producing shares to a Union company in order to avoid super tax, it will not usually pay him to take interest on the outstanding balance of the purchase price since whereas he will be subject to normal and super tax on such interest, the company will not obtain any tax benefit from the interest which it has to pay since a company is exempt from normal and super tax on dividends received. If the benefit derived by the company from the interest-free purchase price attracted donations tax, Mr. X may possibly be deterred from carrying out the avoidance device.

§ 240. Definition of ' donation '

Donation means any gratuitous disposal of property including any gratuitous waiver or renunciation of a right — section 54 *ter* (1). It is submitted that the ' right ' referred to in the definition must be a right in or to property as defined. The gratuitous waiver or renunciation of a usufructuary or fiduciary interest, therefore, constitutes a donation for the purposes of donations tax. The gratuitous release by a creditor of an amount owing to him by his debtor also amounts to a donation.

The definition of ' donation ', which conforms to the meaning of donation in common law, namely that the gift must be liberality at the expense of the donor, an act whereby the donee is enriched and the donor correspondingly impoverished,[32] is not the final test for determining liability to donations tax. Where any property has been disposed of for a consideration which, in the opinion of the Commissioner, is not an adequate consideration, that property, in terms of section 54 *sex* (1), is deemed to have been disposed of under a donation. In the determination of the value of such property a reduction must be made of an amount equal to the value of the consideration. The effect of this provision is that if X purports to sell an asset to Y, say, worth £10,000 for say £1,000, the asset will be deemed to have been disposed of by X under a donation which is to be valued at £9,000 for the purpose of determining the tax payable by him.

The object of section 54 *sex* (1) is clear, viz. to prevent the success of any contention that the giving of a *quid pro quo* for the property transferred to another prevents the disposal from falling within the definition of *donation* in terms of section 54 *ter* (1) which refers to ' any gratuitous disposal of property '.

Any decision by the Commissioner on the question whether the consideration is an adequate consideration or not, is not subject to review by the courts as long as the Commissioner has applied his mind to the matter and has acted in good faith.

If the donations tax were not to be easily avoided, it was obviously necessary for the legislator to introduce a provision such as

[32] *Estate Sayle* v. *C.I.R.*, 1945 A.D. 388; 13 S.A.T.C. 170.

section 54 *sex*(1) and deem certain transactions to be donations. But the way the section reads, it would seem to the writer that the Commissioner can apply the section in every case where the consideration is inadequate irrespective of whether or not there is an intention to donate, unless it could be held that the section is not applicable in the case of innocent transactions where there is no intention to avoid tax. If the true interpretation of the section is that it is not confined to transactions entered into *animo donandi* or with an intention to avoid tax, the provision can have severe repercussions on many of the day-to-day commercial transactions which may have no connection with a donation.

A taxpayer, for some reason or other, may desire to carry on his business through a company in which he is the sole beneficial shareholder and transfers his assets to the company at cost price, say £*x*, although the market price is £*y*. In truth, he is no better off or worse off financially, since the benefit gained by the company as a result of the transfer of the assets, viz. £*y less* £*x*, accrues to him in the form of an appreciation in the value of the shares held by him in the company. Yet, in terms of section 54 *sex*(1), the Commissioner may possibly argue that as the assets have been disposed of for an inadequate consideration, he is entitled to exact donations tax on the value of the benefit to the company, namely £*y less* £*x*. Similar transfers may be effected between holding companies and their wholly owned subsidiary companies or vice versa or between associated companies which have the same shareholders.

Another example of where the provisions of section 54 *sex*(1) could possibly apply is in the case of an allotment of shares by a company. In *C.I.R.* v. *Estate Kohler*[33] it was held by a majority judgment that where a company allots shares at par when their value is in excess of par this amounted to a donation by the company under section 3(6) of the now repealed Death Duties Act. The 'watering-down' of the value of shares in a company by the issue of new shares at par to other persons provides an easy method of reducing estate duty if not regarded as a dutiable donation. It may be that the provisions of section 54 *sex*(1) are wide enough to include an allotment of shares at par when their value is in excess of par and it is thus possible that an allotment of shares to existing shareholders pro rata to their shareholding could be regarded as falling within section 54 *sex*(1) if the shares are worth more than par even though financially the shareholders are no better or worse off than before.

No cases have come to the writer's notice where the Commissioner has sought to tax transactions involving inadequate considerations where there has been no intention to donate and it can, therefore, be expected that the Commissioner will not interfere with ordinary commercial transactions which do not have tax avoidance as their motive. Nevertheless it is felt that the section should be clarified so as to ensure that it can only be applied to transactions entered into *animo donandi* and not to ordinary commercial transactions where

[33] 1953 (2) S.A. 584 (A.D.); 18 S.A.T.C. 354.

there is no intention to donate. No doubt many business men will quite innocently be involved at one time or another in transactions involving an inadequate consideration not knowing whether their case falls within the ambit of section 54 *sex*(1). It is interesting to note that the income tax return forms (I.T.12 for individuals and I.T.14 for companies) require the disclosure of donations given or received but do not call for information concerning transactions which may amount to donations in terms of section 54 *sex*(1). How is the Commissioner able to determine the question whether a consideration is adequate or not unless the taxpayer discloses such transaction in his income tax return and how is the taxpayer to know whether the Commissioner would consider the consideration adequate or not? On the other hand, it is a physical impossibility for the Department to examine the transactions of every taxpayer in respect of each tax year with a view to ascertaining whether any of them call for the application of section 54 *sex*(1). This may account for the silence of the income tax return forms in regard to details of transactions involving inadequate considerations.

§ 241. Donations by a company

Donations tax is payable in respect of donations made by a company which is registered, managed or controlled in the Union — section 54 *bis*. In order to protect the *fiscus* against attempts by taxpayers to donate property through their companies and so avoid the payment of high rates of donations tax, section 54 *quin*(2) provides that donations made by a body corporate at the instance of any person are deemed to be donations by that person and will therefore be included in the value of such person's taxable donations. Any tax so payable by such person may be recovered by him from the assets of the company. This right of recovery also extends to the Commissioner should the taxpayer fail to pay the tax.

Section 54 *quin*(3) prescribes the conditions under which a donation made by a company is to be deemed to have been made at the instance of any person, viz. if the Commissioner is of the opinion —

(*a*) that the donation was not made in the ordinary course of the normal income-earning operations of the company; and

(*b*) that the selection of the donee (as defined in section 54 *ter*(1)) who benefited by the donation was made at the instance of that person.

Any decision of the Commissioner in regard to this matter is subject to objection and appeal in terms of section 54 *dec*(6).

Section 54 *quin*(2) was no doubt introduced mainly to prevent the making of donations by private companies to the families or relatives of the controlling shareholders. Whether a donation was made in the ordinary course of the normal income-earning operations of the company and whether the selection of the donee is made at the instance of any person are questions of fact depending upon the circumstances surrounding the donation. In the writer's view, however, section 54 *quin* (2) does not adequately protect the *fiscus* since, as it reads at present, it can only be applied to cases of donations by bodies corporate made at the instance of *one* person. If a donation is made at the instance of more than one person, for example a board of directors consisting of three persons, it is submitted that the section cannot be invoked. If this is not the correct view, then it follows that the property must be deemed to have been disposed of under a donation by more than one person with a consequent apportionment of the value of the donation among the different parties. There is nothing in the section to suggest such a procedure. For example, if A holds 75 per cent of the shares in a private company and B holds the remaining 25 per cent and they decide to donate property valued at £10,000 to C, a brother of A and B, it must follow that the selection of C who benefited by the donation was made at the instance of both A and B and not at the instance of any *one* person. It is submitted that in such a case section 54 *quin* (2) does not apply so that the donation is taxable in the hands of the company. If this view is not correct, it is difficult to see how the Commissioner can apply the section unless he apportions the value of the donation between A and B. The question then arises as to whether the donation must be apportioned equally between A and B or pro rata to their shareholding. The section does not refer to any basis of apportionment which strengthens the view that it only applies to donations made at the instance of *one* person.

If the correct interpretation of section 54 *quin* (2) is that it applies only to donations by bodies corporate at the instance of *one* person, it must follow that taxpayers can avoid the payment of high rates of donations tax by donating property through a series of companies at the instance of more than one person so that the tax is always payable at the lowest rate, thus nullifying the effect of the progressive rate of tax. Moreover, taxpayers could even go further and donate property through their companies which are not registered, managed or controlled in the Union. If in such cases the donation is effected at the instance of more than one person, it is altogether free of the donations tax. It may be suggested that section 54 *quin* (2) can only apply where, but for the deeming provision, the body corporate would be liable for donations tax, i.e. its application must be limited to companies registered, managed or controlled in the Union. The section, however, uses wide terms, namely 'if any property is disposed of under any donation by any body corporate . . .' and it is, therefore, submitted that where a company, which is not registered, managed or controlled in the Union, donates property at the instance of a person ordinarily resident in the Union, such person is liable for donations tax.

§ 242. DATE OF TAKING EFFECT OF DONATION

A donation is deemed to take effect on the date on which all the legal formalities for a valid donation have been complied with — section 54 *ter* (2).

Prior to the passing of the General Law Amendment Act (No. 50 of 1956) the legal formalities for a valid donation which exceeded £500 were registration of transfer in the deeds office of a landed property, or, in the case of other assets, the execution of a notarial deed, irrespective of the date of delivery of the donated assets. In the case of a promise to give immovable property, if the property had not been transferred to the donee, the embodiment of the promise to give in a notarial deed satisfied the requirements of registration.[34] If the donation did not exceed £500, no legal formalities were necessary and therefore the donation took effect on the date of the making of the contract, irrespective of the date of delivery of the donated asset. Thus, a donation which had not been registered or notarially executed was invalid in regard to the excess over £500 and if delivery had not been made the donee could not claim the excess amount from the donor. If there had been delivery, the donor had a right to recover the excess over £500 which right was prescribed in ninety days in terms of section 3 (2) (*a*) of the Prescription Act.[35]

It is provided in section 54 *ter* (2) that where property has been delivered under a donation which has not been registered or notarially executed, the date on which the donor's right of recovery of the excess in value over £500 becomes prescribed determines the date when the donation takes effect.

The provisions of section 5 and section 16 of the General Law Amendment Act, 1956 (No. 50 of 1956), which came into force on 22nd June, 1956, are as follows:

Section 5. 'No donation concluded after the commencement of this Act shall be invalid merely by reason of the fact that it is not registered or notarially executed: Provided that no executory contract of donation entered into after the commencement of this Act shall be valid unless the terms thereof are embodied in a written document signed by the donor.'

Section 16. '(1) Section *three* of the Prescription Act, 1943, is hereby amended by the deletion of paragraph (*a*) of sub-section (2). (2) Nothing in sub-section (1) contained shall affect a donation concluded before the commencement of this Act.'

Section 5 abolishes the common law principle whereby an unregistered donation exceeding £500 was invalid to the extent of the excess over £500 and provides that no executory contract of donation, i.e. a contract, not completed by delivery, in which a donor promises to donate, is valid unless embodied in a written document signed by the donor.

Section 16 deletes section 3 (2) (*a*) of the Prescription Act which prescribed a period of ninety days for the recovery of the excess in value over £500 of a donation which has not been registered or notarially executed.

[34] *Estate Phillips* v. *C.I.R.*, 1942 A.D. 35; 12 S.A.T.C. 17.
[35] Act No. 18 of 1943.

Having regard to section 5 and section 16 of the General Law Amendment Act, it is submitted that with effect from 22nd June, 1956, a donation takes effect for donations tax purposes on the date of delivery in the case of a verbal donation where the subject-matter donated is delivered by the donor to the donee, and where there has been no delivery, i.e. in the case of an executory contract, on the date when the donor signs a document embodying the terms of the contract. This applies whether or not the donation exceeds £500 in value. Thus if the donor and donee sign a deed of donation simultaneously, the donation takes effect on the date of signature even though delivery is to be made at a later date. A verbal contract of donation is invalid unless the subject-matter has been delivered or the terms thereof have been embodied in a written document signed by the donor. In such cases the donation takes effect on the date of delivery or on the date the donor signed the document.

Notwithstanding the general rule that a donation takes effect on the date of signature of a written deed of donation even though delivery is to be made at a later date, it is provided in section 54 *quat*(1) (*d*) that no donations tax is payable in respect of the value of any property disposed of under a donation in terms of which the donee will not obtain any benefit thereunder until the death of the donor, for example, the case of a donor who agrees to donate an asset, delivery of which is only to be made to the donee on the death of the donor.

It should also be pointed out that even though a donation has taken effect, no donations tax is payable if the donation is cancelled within six months from the date upon which it took effect — section 54 *quat*(1) (*e*). Thus, as long as not more than six months has elapsed from the date upon which a donation took effect, the donor and the donee may agree to the cancellation whether or not it involves redelivery of the property from the donee to the donor. Serious repercussions may, however, arise if, after a period of six months has elapsed from the date the donation took effect, the donor and the donee agree to a cancellation of the donation. Not only is donations tax payable on the original donation but it would seem on a strict interpretation that the consent of the donee to a cancellation without any consideration also amounts to a taxable donation.

III. Annuities

§ 243. Definition of 'annuity'

In terms of section 7 (*a*), any amount received or accrued by way of annuity must be included in the gross income provided that it is from a source within the Union (see § 20).[35a]

[35a] In terms of double taxation agreements negotiated with certain other countries (United Kingdom, United States of America, Sweden and the Federation of Rhodesia and Nyasaland), residents of such countries are exempt from Union tax on purchased annuities derived from Union sources as long as such annuities are taxable in their country of residence.

There is no definition of the word 'annuity' in the Act. An annuity may arise in a variety of forms, e.g.:

(i) there is the case of an ordinary annuity purchased from an insurance company;

(ii) an annuity may be granted by way of gift or legacy and without being purchased;

(iii) an annuity may be granted as consideration for the sale of a business or some asset or for the surrender of a right.

In *Foley* v. *Fletcher*,[36] it was held that —

> 'an annuity means where an income is purchased with a sum of money and the capital has gone and ceased to exist, the principal having been converted into an annuity'.

Whereas this definition meets the case of the ordinary type of annuity purchased from an insurance company, it does not cover all cases since an annuity may also be granted by way of donation or inheritance without being purchased, in which event the conversion of capital into an annuity does not arise.

The main characteristics of an annuity have been stated to be as follows in a case decided by the Special Court:[37]

(1) It is an annual payment (this would probably not be defeated if it were divided into instalments).

(2) It is repetitive — payable from year to year for, at any rate, some period.

(3) It is chargeable against some person.

There is no authoritative decision as to whether the annual payment must be a fixed sum of money or whether it could be of an uncertain amount in order that it may constitute an annuity. For example, a man may sell his business in return for an annual payment which is not fixed but is determined with reference to the annual profits earned in the business.

In a later case, the Special Court dealt with a case where under certain contingencies the annual payments were subject to variation in amount and held that they constituted annuities. The Court referred to the above characteristics of an annuity and held as follows:[38]

> 'It would appear from the definition given in the case referred to above, that in order that the payment of an annual sum shall be regarded as an annuity, the amount should be a fixed sum. For instance, Stroud gives the following quotation from a case: "An annuity is a yearly payment of a certaine summe of money granted to another in fee, for life, or yeares, charging the person grantor onely." And Wharton's *Law Lexicon* (14th ed.) states: "An annuity is a fixed sum payable annually either in perpetuity or for any less period." Byrne's *Law Dictionary*: " This — a yearly payment of a certain sum of money granted to another in fee, or for life, or for a term of years. . . ." The *Shorter Oxford Dictionary* states: " . . . The grant of an annual

[36] (1858), 28 L.J. Ex. 100, per Watson, B.
[37] I.T.C. No. 761, 19 S.A.T.C. 103.
[38] I.T.C. No. 768, 19 S.A.T.C. 211, per de Wet, J. (President).

sum for a term of years . . .", and in another meaning "an investment of money entitling the investor to receive a series of equal annual payments . . .". Again, I am not certain that the amount need necessarily be a *fixed* annual amount. I cannot see why a person cannot grant an annuity to somebody else although the exact amount of the annuity is uncertain, so long as it is definitely some amount which can, when it is due and payable, be ascertained.'

In *Modderfontein B Gold Mining Co., Ltd.* v. *C.I.R.*,[39] a gold-mining company was entitled to a share of the bewaarplaats moneys received by the Government in respect of the company's bewaarplaats which was leased by the Government to other parties. These moneys were payable annually and varied according to the annual profits derived from the respective leases. The Court held that the annual payments constituted income.

Innes, C.J., held:

'I do not suggest that these yearly payments constituted an annuity in the sense in which that word is used in the section referred to.'

§ 244. ANNUITY *v.* CAPITAL INSTALMENTS

If the annual payment is nothing more than an instalment due in respect of a transaction of a capital nature, it cannot be regarded as an annuity.[40] One must look at every case and see what the annual payment is for. If the annual payments represent the liquidation by instalments of a definite ascertainable price payable for the sale of capital assets, they are not annuities and fall outside the scope of section 7(*a*).

'A man may sell his property for a sum which is to be paid in instalments, and when you see that that is the case, that is not income or any part of it. . . . A man may sell his property for what is an annuity, that is to say, he causes the principal to disappear and an annuity to take its place. If you can see that that is what it is, then the Income Tax Act taxes it.'[41]

§ 245. ANNUITIES IN TERMS OF A WILL OR TRUST

Annual amounts payable in terms of a will out of the residue of an estate constitute an annuity whether payable for a specified term of years or for the lifetime of the recipient.[42] It is immaterial whether the annuity is payable out of the income or the capital assets of the estate.[43] Even though the annuity is paid in whole or in part out of exempt income it is taxable by reason of proviso (iii) to section 10(1). Annuities payable in terms of a will or trust are fully considered in § 68.

[39] 1923 A.D. 34.
[40] I.T.C. No. 115, 4 S.A.T.C. 66; I.T.C. No. 463, 11 S.A.T.C. 196; I.T.C. No. 254, 7 S.A.T.C. 56.
[41] *Jones* v. *I.R.C.*, [1920] 1 K.B. 711; 7 T.C. 310, per Rowlatt, J.
[42] I.T.C. No. 584, 14 S.A.T.C. 116; I.T.C. No. 761, 19 S.A.T.C. 103; I.T.C. No. 554, 13 S.A.T.C. 211.
[43] I.T.C. No. 70, 3 S.A.T.C. 58; I.T.C. No. 339, 8 S.A.T.C. 360.

§ 246. Voluntary payments

Voluntary payments, even though made regularly, cannot be regarded as annuities. Thus, a pension paid to a widow of a deceased employee terminable at the will of the employer cannot be regarded as an annuity and is not taxable. On the other hand, a life-pension payable to such widow where the employer has bound himself to pay such pension for life would constitute an annuity. Voluntary payments towards the maintenance of relations in poor circumstances are not annuities even though such payments are made regularly. On the other hand, a contractual obligation to make regular monthly or annual maintenance payments for life or for a fixed period of time would, it is submitted, constitute an annuity and be subject to tax.

§ 247. Purchased annuities

It does not matter that the amount received or accrued by way of annuity is in truth a receipt or an accrual of a capital nature. As long as the payment is received by way of annuity, it falls under the definition of 'gross income' and is taxable even though it be of a capital nature. No allowance is made in the Act for the capital laid out on the purchase of the annuity whether for the life of the annuitant or for a fixed number of years. An annuity is not to be resolved into capital and income so that the capital part of each payment is to be excluded from gross income.[44]

Where the owner of a business disposed of it in consideration of the payment to him by the purchaser of the sum of £50 per month for life, it was held that the amounts received represented an annuity and were taxable.[45] Had the business been sold for a lump sum, the whole amount would be a receipt of a capital nature and not taxable. This is a pitfall which taxpayers should carefully watch since whereas the annuity is taxable in the hands of the recipient in terms of section 7(*a*), it is not an admissible deduction from the income of the person responsible for payment. As the annuity is the consideration for the acquisition of a capital asset it is expenditure of a capital nature.

The Committee of Enquiry into the Income Tax Act[46] recommended that —

(*a*) in the case of a purchased annuity for life the full amount of each annual payment received should be included, as at present, in the taxable income of the recipient; and

(*b*) in the case of a purchased annuity for a fixed period only such proportion of each annual payment received as does not represent the purchase price paid, should be included in the taxable income of the recipient.

The Income Tax Commission[47] considered that no distinction should, for tax purposes, be drawn between life annuities and

[44] *C.I.R.* v. *Milstein*, 1942 T.P.D. 57; 11 S.A.T.C. 279.
[45] I.T.C. No. 713, 17 S.A.T.C. 337.
[46] *First Report*, p. 13, para. 16.
[47] *First & Final Report*, p. 5, para. 6.

annuities for a fixed period. In both cases it considered that the full amount of each annual payment should be taxed as at present.

The exemption of that portion of the annuity which represents a return of the purchase price is equitable. Precedent for not taxing such portion is to be found in section 8 (*a*) of the Income Tax Act of the Federation of Rhodesia and Nyasaland, section 11 (1) (*k*) of the Income Tax Act of Canada and in section 26 A.A. of the Australian Act. In these laws no distinction is drawn between the case of a purchased annuity for life and a purchased annuity for a fixed period. It is difficult to justify the differentiation drawn by the Committee of Enquiry which, in the case of a purchased annuity for life, considered that any attempt to calculate the capital content of any payment received by the annuitant could at best only be an estimate based on an assumed expectation of life of the annuitant. With respect, this is not an insuperable difficulty. In the Federation of Rhodesia and Nyasaland, the Commissioner uses the following formula for determining the interest content of an annuity:

$$I = \frac{(P \times N) - A}{N}$$

Where I = the interest content

P = the annual payment or annuity

N = the number of years payments expected (this may be a definite period or, in the case of a life annuity, it will be obtained from British Life Offices Mortality of Annuitants Tables)

A = the purchase price of the annuity.

Thus, if X purchases at a cost of £6,000 a life annuity of £600 per annum and if X's expectation of life is 15 years, then the interest content of the annuity to be included in X's gross income would be calculated as follows:

$$I = \frac{£(600 \times 15) - £6{,}000}{15}$$

$$= £200.$$

£400 of the annuity would therefore be regarded as a return of the purchase price.

Once the normal expectation of life has been exceeded and the full purchase price of the annuity has been recouped, the Commissioner will tax the full amount of the annuity.

Where a person sells his business for an annuity, the amount of the annuity is also resolved into income and capital in accordance with the above formula. In such a case the value of the assets transferred is regarded as the purchase price of the annuity.

In the United Kingdom it would appear to be the practice to exempt from tax in the case of purchased annuities for fixed periods, that part of the annuity representing the return of the purchase price. It should also be mentioned that in terms of section 27 of the Finance Act, 1956, of the United Kingdom, purchased life annuities are to be divided for tax purposes into capital and income elements. The part of each periodical annual payment representing the capital content is exempt from tax. In New Zealand, however, life annuities are wholly taxable whereas in the case of purchased annuities for fixed periods that part of the annuity representing the return of the purchase price is not assessable.

IV. Trading Stock

§ 248. Introduction

Up to and including the 1955 tax year, the Income Tax Act, save in respect of persons carrying on farming operations, contained no provisions regarding trading stock, although, in terms of para. 2 of the Regulations under the Income Tax Act, the return of income required to be rendered by a taxpayer must be accompanied *inter alia* by his trading account. It is implicit in the reasoning of Centlivres, C.J., in *Sub-Nigel, Ltd.* v. *C.I.R.*[48] that, prior to the 1956 tax year, there was no warrant for bringing into account in the determination of taxable income a trader's opening and closing stock.

The practice of the Commissioner was to insist upon trading stock being taken into account in the determination of taxable income. This was done by regarding the value of stock on hand at the end of the year as income and the value of the stock on hand at the beginning of the year as an expenditure. In this way, the taxpayer was only allowed to deduct the cost of goods purchased in the year in which it was sold. This practice was in conflict with the provisions of the Act for the whole scheme of the Act shows that as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular tax year can be deducted (*Sub-Nigel, Ltd.* v. *C.I.R.*[48]).

Since the Act contained no provisions regarding trading stock, the answer to the question of what valuation could be placed on the stock had to be sought from the practice of the Commissioner who generally permitted taxpayers to value their trading stock on the basis of cost or market value whichever was the lower. It must follow, therefore, that if market value was less than cost, anticipated losses were taken into account in determining the taxable income which, it is submitted, was in direct conflict with the Act (see § 138).

In *C.I.R.* v. *Jacobson*,[49] the Court approved of the principle of valuing stock-in-trade on hand at the end of a tax year at the lower of cost or market value. This conclusion, however, was based on the Court's view that 'income' was equivalent to 'profits and gains' which, with respect, is not correct. In *C.I.R.* v. *Niko*,[50] the Court *a quo* was of the opinion that a taxpayer's stock-in-trade on hand at the end of a year must represent the cost price. It was, however, not necessary for the Appellate Division to decide the point. In a Special

48 1948 (4) S.A. 580 (A.D.); 15 S.A.T.C. 381.
49 1923 C.P.D. 221.
50 1940 A.D. 416; 11 S.A.T.C. 124.

Court case, it was held that a motor-dealer had to bring in his stock of used cars on hand at the end of the tax year at their trade-in value, i.e. their cost, in the absence of any evidence of a fall in such value.[51]

§ 249. Present statutory provisions

With effect from the 1956 tax year, the legislator has attempted to resolve the matter by the insertion into the Act of provisions in regard to trading stock.

Section 11(5)(*a*) provides that the value of any trading stock on hand and unsold at the end of a year of assessment, which must be taken into account in the determination of the taxable income of the taxpayer, must be the cost price of such trading stock less such an amount as the Commissioner may consider reasonable as representing the diminution in value of such stock by reason of damage, deterioration, change in fashion, decrease in the market value or any other reason satisfactory to the Commissioner. It is, however, expressly provided that trading stock which consists of shares held by a company in any other company must be included at cost price irrespective of the market value. Thus, whereas in the case of individual stock-jobbers they are permitted to return for income tax purposes the value of shares on hand at the end of any tax year on the basis of cost or market value whichever is the lower, this concession is not extended to sharedealing companies which must bring in their securities on hand at the end of the tax year on the basis of cost price. It is extremely difficult to justify the present method of treatment whereby ordinary trading stock can be valued at the lower of cost or market value whereas shares in the hands of a sharedealing company must be valued at cost. Once it is accepted that the shares constitute the floating capital of the sharedealer the proceeds whereof will be included in the gross income of the taxpayer, there should be no difference in principle as to the basis of valuation at the end of a tax year. This position has now been accepted by the legislator as regards individual stockjobbers but the exclusion of sharedealing companies from the operation of the concession is not understandable and in effect amounts to an unfair discrimination against these taxpayers.

The value of any trading stock on hand and unsold at the beginning of a tax year, which must be taken into account in the determination of taxable income, must be the value of that trading stock at the end of the previous tax year brought into account in the determination of the taxable income for that tax year — section 11(5)(*b*)(i). If such trading stock did not form part of the taxpayer's stock at the end of the previous year of assessment, the value of such stock must be the cost price thereof — section 11(5)(*b*)(ii). Thus, if a taxpayer originally acquired an asset for the purpose of investment, and during a subsequent year changes his intention and converts his capital asset into trading stock, the value of the stock on hand at the beginning of such year in relation to that asset must

[51] I.T.C. No. 667, 16 S.A.T.C. 133.

be its cost price irrespective of its market value at the date of conversion of the asset from fixed capital into floating capital.

The cost price at which trading stock must be valued is the cost incurred by the taxpayer, whether in the current or any previous year of assessment, in acquiring such trading stock plus any further cost incurred in getting the trading stock into its existing condition or location — section 11 (5) (*c*).

As regards the determination of the cost price of trading stock on the 'last in — first out' (or LIFO) basis in terms of which the last item of any class of trading stock purchased is deemed to be the first item of that class of trading stock sold or used in production, section 11 (5) (*e*) permits a taxpayer, at his option, to adopt this basis of valuation provided that he maintains records in respect of his trading stock to the satisfaction of the Commissioner. It is, however, provided that once a taxpayer has elected to adopt the LIFO method of determining the cost of stock on hand, he is not permitted to depart therefrom in the future except with the consent of the Commissioner and subject to such conditions as he may impose. A taxpayer who elects to adopt the LIFO basis must give the Commissioner written notice thereof when he renders his return of income for the first year of assessment in respect of which he adopts this basis. The LIFO method of stock valuation has the merit of counteracting the effects of inflation upon the replacement cost of trading stock since it means that the trader's closing stock will usually be valued at the original cost price of the basic quantity of stock that must be carried in order to ensure the continuance of the business operations. In this manner the profit as determined for tax purposes will not be inflated by the unrealized profit existing in the difference in the initial cost price of such stock and its current replacement value which would otherwise be the result if the closing stock was valued at its replacement cost. Under this method, also, manufacturers are permitted to charge the cost of production with materials at the current cost price of the last items of any class of stock purchased even though they may carry stocks of the same class which were initially acquired at a cost price less than the current replacement cost.

If any trading stock has been acquired by a person for no consideration, e.g. in the case of an asset received by way of donation or inheritance, or for a consideration which is not measurable in terms of money, such person must be deemed to have acquired the trading stock at a cost equal to the price which, in the opinion of the Commissioner, was the current market price of such trading stock on the date on which it was acquired — section 11 (5) (*d*). It must follow from this provision that if trading stock is acquired by way of inheritance and at the date of inheritance the market value is, say, £5,000, on a subsequent realization thereof for, say, £7,500, an amount of £2,500 is included in taxable income. If the amount realized is £3,000, the taxpayer is entitled to claim a loss of £2,000. It must be borne in mind, however, that the proceeds derived from the sale of a donated or an inherited asset can only form part of the gross income if an actual trade is being carried on as distinct from a mere realization of the donated or inherited asset.[52] It is expressly provided that where bonus shares awarded by a company to a shareholder on or after 1st July, 1957, constitute trading stock in the hands of such shareholder, he will not be allowed to deduct the market value of such shares from the proceeds thereof in the event of a sale. For the purposes of section 11 (5) (*d*), such bonus shares shall have no value. The effect of this provision is that if a stock-jobber receives bonus shares which fall within the definition of 'dividend', not only will the nominal value of such shares form part of his gross income but on their disposal the full proceeds will also form part of his gross income.

The various discretionary powers reserved to the Commissioner in connection with the question of trading stock are not subject to objection and appeal. Thus, as long as the Commissioner has applied his mind to the matter and has acted *bona fide*, his decision cannot be reviewed by the courts.

§ 250. Definition of 'trading stock'

'Trading stock' is defined in section 1 and includes —

> 'anything produced, manufactured, purchased or in any other manner acquired by the taxpayer for purposes of manufacture, sale or exchange by him or on his behalf, or the proceeds from the disposal of which forms, or will form, part of his gross income'.

The definition of trading stock in section 1 is a wide one and includes both corporeal and incorporeal property. Land and stocks and shares are clearly included and so are book debts acquired for the purpose of resale at a profit. It would seem that partly manufactured goods (work in progress) fall within the definition but it is submitted that services partly rendered are not included. Thus, professional men are not required to bring in as closing stock at the end of a tax year the value of services partly rendered. It is submitted that the same applies to building contractors who erect buildings on land belonging to clients. It would seem that in their case it is not necessary to include in taxable income the value of the work done at the end of the tax year, although the Commissioner is not likely to raise any objections should they desire to do so. In the writer's view it was not wise of the Treasury to exclude from the definition of 'trading stock' the value of services partly rendered, particularly in the case of contractors who not only render services but also use materials in the completion of the contracts assigned to them. In view of the fact that the cost of the work done ranks as an allowable deduction from income and the value of services partly rendered does not constitute trading stock, it must follow that the taxpayer can create assessed losses in this manner and thereby regulate tax liability to the detriment of the *fiscus*. For example, a good illus-

[52] *C.I.R.* v. *Strathmore Exploration & Management, Ltd.*, 1956 (1) S.A. 591 (A.D.); 20 S.A.T.C. 375. See also I.T.C. No. 458, 11 S.A.T.C. 178.

tration is the case of a building contractor who commences building operations, say, on 1st April of the tax year. Although in practice the Commissioner allows the expenditure incurred during the period 1st April to 30th June to be carried forward and to be deducted from the contract price accruing in the next tax year, this practice is in conflict with the general deduction formula since the expenditure incurred for the three months in question is properly deductible even though no income has been derived. Thus, if say £10,000 expenditure has been incurred during the period of three months, the taxpayer is entitled to create an assessed loss. Of course, the correct accountancy approach would be to balance the loss by showing work in progress at the end of the tax year to the extent of the £10,000. When a builder undertakes to erect a property on land belonging to another it is submitted that he has not 'produced, manufactured, purchased or in any other manner acquired anything' and that the expenditure incurred in respect of work in progress on hand at the end of the tax year does not, therefore, constitute 'trading stock' within the meaning of the definition.

§ 251. Criticisms of the present provisions

How must the opening and closing stocks be taken into account?

Section 11 (5) provides that in determining the taxable income of a taxpayer the value of the trading stock on hand at the beginning and at the end of the tax year must be taken into account. The section provides no clue as to how this is to be done. Section 7 requires that before any amount can form part of the gross income there must be a receipt or an accrual, whereas section 11 (2) (*a*) allows only the deduction of expenditure incurred during the year of assessment in the production of the income. The value of trading stock on hand at the end of a tax year is neither a receipt nor an accrual and, therefore, cannot form part of the gross income. On the other hand, the value of trading stock on hand at the beginning of a tax year is not deductible in terms of section 11 (2) (*a*) since the expenditure was incurred in a previous tax year. The question may, therefore, be asked: How, in determining the taxable income, must the value of the opening and closing stocks be taken into account? In the writer's view, it would seem that the only possible basis — if it cannot be done by way of regarding the value of the opening stock as an allowable deduction in terms of section 11 (2) (*a*) and the value of the closing stock as a receipt or accrual of gross income in terms of section 7 — is by way of an adjustment to the taxable income. To the taxable income as determined, there should be added the value of the closing stock, whereas there should be deducted the value of the opening stock or, to put it in another way, the difference between the values of closing and opening stock should either be added to the taxable income or deducted from the taxable income according to whether the value of the closing stock is greater or less than the value of the opening stock.

It is to be regretted that the Legislature did not deal with the question of trading stock on a proper basis particularly when both the Committee of Enquiry into the Income Tax Act and the Commission of Inquiry into the Federation Income Tax Act made some very useful recommendations in regard to this matter.

The Committee of Enquiry[53] recommended that the opening and closing stocks should not be taken into account at all but that the expenditure on the trading stock should be deemed to be incurred in the year in which the stock is sold. In other words, what it recommended was that there should be allowed each year the cost of the goods sold irrespective of when the expenditure was incurred and that this should be determined by adding the value of the stock on hand at the end of the previous year to the cost of purchases of stock during the current tax year and deducting from this sum the value of the stock on hand at the end of the current year of assessment. This is a method well known to the business and accountancy world and fits in well with the basic principles of our tax law. One wonders, therefore, why the legislator did not accept this recommendation instead of adopting the obscure method now incorporated in the Act. The Committee's recommendations, which were accepted by the Income Tax Commission,[54] were as follows:

'(*a*) From the sum of the value of the stock in trade on hand and unsold at the closing date of the accounts submitted by the taxpayer in support of his return for the preceding year of assessment and the price which he contracted to pay for stock-in-trade acquired during the current year of assessment, there shall be deducted the value of all stock-in-trade on hand and unsold as at the closing date of the accounts submitted by the taxpayer in support of his return for the current year of assessment;

(*b*) for the purpose of determining the value of stock-in-trade on hand and unsold as at the closing date of the accounts such stock-in-trade shall be listed and each item thereof shall be valued at the price in money or the value of any other consideration given by the taxpayer on the acquisition of that item of stock-in-trade. The sum of the values of all items shall be the value of the stock-in-trade on hand and unsold at the closing date of the accounts: Provided that the value of the stock-in-trade as so determined may be reduced by such sum as the Commissioner may think just and reasonable as representing the amount by which the value of such stock-in-trade has been diminished by reason of damage, deterioration, change in fashion, decrease in the market value or such other reasons satisfactory to the Commissioner;

(*c*) in the event of a person engaged in trade acquiring stock-in-trade in any manner other than by purchase the value of the stock-in-trade so acquired shall be such value as the Commissioner may determine having regard to the value for which the stock-in-trade could have been acquired by purchase as at the date of acquisition by the taxpayer;

[53] *First Report*, p. 29, para. 36.
[54] *First & Final Report*, p. 11, para. 41.

(*d*) in the event of a person engaged in trade disposing in any year of assessment of stock-in-trade in any manner other than by sale, there shall be deducted from the value of stock-in-trade as at the closing date of the accounts submitted in support of his return for the immediately preceding year of assessment or from the price which he contracted to pay for stock-in-trade acquired during the current year of assessment as the case may be, the value included therein in respect of the stock-in-trade so disposed of;

(*e*) in the case of the disposal of stock-in-trade, where the purchaser and seller are not at arm's length and the sale is otherwise than in the ordinary course of the trade for which it was required, for a consideration which is, in the opinion of the Commissioner, less than the fair market value of the stock-in-trade as at the date of disposal, the Commissioner shall determine, subject to the right of objection and appeal, the value of the stock-in-trade so disposed of and that the value shall be included in the income of the taxpayer: Provided that any value so determined shall be deemed to be the value for which that stock-in-trade was acquired by the person to whom the ownership in the stock-in-trade was transferred.'

The Commission of Inquiry in the Federation dealt with the matter in a way that is even more logical and fits in better with the basic structure of the Act than the Committee's recommendation. It recommended as follows:[55]

'(1) If a taxpayer carries on any trade then the value, ascertained in terms of section . . ., of all trading stock on hand at the beginning of the year of assessment and of all trading stock on hand at the end of that year shall be taken into account for the purpose of determining the taxable income or the assessed loss of the taxpayer.

(2) If the value of all trading stock on hand at the end of the year of assessment exceeds the value of all trading stock on hand at the beginning of that year then the gross income of the taxpayer shall include the amount of the excess.

(3) If the value of all trading stock on hand at the beginning of the year of assessment exceeds the value of all trading stock on hand at the end of that year then the amount of that excess shall be an allowable deduction.'

Valuation of trading stock

The Act deals with the valuation of trading stock in a most unsatisfactory manner. It limits the basis of valuation to actual cost price, or, at the taxpayer's option, to the basis of 'last in — first out'. Yet, in practice, a number of methods are used. The determination of actual cost often proves difficult particularly where identical stock is purchased at various times and at different prices during the tax year. The only practical way to value the stock on hand at the end of the year in such circumstances is to adopt the average cost system under which the book cost price of the opening stock is averaged with the cost of goods acquired during the year after deducting the goods consumed at the average price in force at the date of consumption. The average cost system is employed often in practice where

[55] *Report of the Commission of Inquiry*, p. 28, para. 167.

actual cost is impossible to determine. Yet the Act does not allow the taxpayer to adopt this basis. Neither does it permit him to adopt the basis of ' first in — first out '. The effect of the application of the FIFO basis of stock valuation is that the first item of any class of trading stock purchased is deemed to be the first item of that class of trading stock sold or used in production. Other methods used in practice which the Act does not permit are those where the cost price is arrived at by an estimate, e.g. the standard cost method by which a predetermined cost per unit is taken, and the method of estimating cost by pricing the stock on hand at the current selling prices and deducting an amount equal to the normal profit margin. Some firms also value their stocks on hand at the current realizable value less a deduction for the estimated costs of selling.

There are probably many firms which for good reasons employ one or other of the methods described above other than the method of actual cost and LIFO and there appears to be no valid reason why they should not be entitled to adopt one or other of these different methods. Yet they are doing so in conflict with the provisions of the Income Tax Act. Every business has its own peculiar problems and it is, therefore, not correct for the Income Tax Act to permit one or other method to the exclusion of many others. This anomaly should be rectified. The Act should not debar taxpayers from determining the cost price of their stocks upon accepted business and accounting principles.

A further unsatisfactory feature of the stock provisions in section 11 (5) is that the final determination as to the extent to which the market value of trading stock has fallen below the cost price thereof rests with the Commissioner. Although it may be impossible to arrive at a suitable definition of ' market value ' in relation to the valuation of trading stock, there is no valid reason why the Commissioner should have the final say. A trader should have the right in cases of dispute to request that the court be asked to fix a fair and reasonable market value. The United Kingdom Income Tax Act contains no provisions relating to the valuation of trading stock. Accepted business and accounting principles are followed. The Australian and the New Zealand Acts, on the other hand, do contain provisions relating to the valuation of trading stock. For example, section 98 of the New Zealand Act provides that the value of trading stock shall be at the option of the taxpayer, its cost price, its market selling value, or the price at which it can be replaced. If provisions regarding the valuation of trading stock are incorporated into the Act, they should not disturb recognized accountancy and business methods of valuing stock-in-trade; neither should their effect be such that in cases of dispute a taxpayer is debarred from challenging the Commissioner's determination and from requesting the court to decide the matter.

Although the established practice of stock valuation is to value stock at the lower of cost or market value in respect of each individual item of trading stock, it is by no means clear from section

11 (5) whether this procedure or whether the 'global' method of valuation applies. In terms of the global method the aggregate of the total stock at cost is compared with the aggregate market value of all items, the lower of the two aggregates being regarded as the value of stock for tax purposes. In the United Kingdom where the Income Tax Act is silent on the question of valuation of trading stock, the Court has held[56] that a trader is entitled to value his stock item by item at cost or market value whichever was the lower.

§ 252. Disposals of trading stock not in the ordinary course of trade

A serious weakness of the present provisions relating to trading stock is that they do not deal with the following matters:

(i) Goods taken from stock for domestic or other private purposes;

(ii) goods donated otherwise than in the ordinary course of trade;

(iii) goods destroyed by fire or lost through theft or burglary;

(iv) goods disposed of at prices below market value.

Section 11 (5) provides that what must be taken into account in the determination of the taxable income is the value of the opening and the closing stock. It must follow, therefore, that if any stock is not held at the end of the year, the value thereof is not taken into account in the determination of taxable income no matter how such stock has been disposed of during the year save to the extent to which it is sold for some value which must be included in the gross income. Thus, if stock has been disposed of for no value, e.g. if destroyed by fire, or lost through theft or burglary or consumed by the taxpayer or donated otherwise than in the ordinary course of trade, it would seem that there is no provision in the Act whereby the taxpayer can be subjected to tax on the value of the trading stock so disposed of. It is doubtful, however, whether this could have been the intention of the Legislature. It is certainly not the practice of the Commissioner.

§ 253. Goods privately consumed

A taxpayer is, under the present practice, subject to tax on the cost of goods taken from stock for domestic or other private purposes. He is required to advise the Commissioner of the cost price of goods taken from stock for domestic or private purposes and the amount thereof is included in his taxable income, whether the cost has been claimed as a deduction in the current year or in a previous year of assessment. Where, however, the trader has credited his income with the cost of the goods taken for personal use, no further adjustment is necessary. It would appear that the Commissioner bases his practice on the provisions of section 12 (*a*) and (*b*) which provide that no deduction can be made in respect of the cost incurred in the main-

[56] *I.R.C.* v. *Cock, Russell & Co., Ltd.*, [1949] 2 All E.R. 889; 29 T.C. 387.

tenance of the taxpayer or his family or in respect of domestic or private expenses. He may also possibly rely on section 11 (2) (*a*) which only permits the deduction of expenditure incurred in the production of income or on section 12 (*g*) which prohibits the deduction of any moneys which are not wholly or exclusively laid out or expended for the purposes of trade. The argument, therefore, appears to be that when a taxpayer withdraws stock for private use, the cost thereof is a prohibited deduction and must, therefore, be added back in the assessment. The argument would be unanswerable if the taxpayer purchased the goods for the very purpose of private consumption by him or his family. Ordinarily, however, goods are purchased by a trader for the purpose of resale at a profit. No specific item is bought for private consumption. When, therefore, the trader withdraws stock for private consumption from the items originally purchased for the purpose of resale, can it be said that the cost originally laid out was incurred in respect of the maintenance of the taxpayer or his family or in respect of domestic or private expenses or was not incurred in the production of income or not wholly or exclusively laid out for the purposes of trade? The position is further complicated where the goods were purchased in one tax year, the cost being properly deductible under section 11 (2) (*a*) and not prohibited under section 12 (*a*), (*b*) and (*g*), and withdrawn from stock in a later tax year. In the writer's view, there would appear to be no provision in the Act for adding back in the year in which the goods are withdrawn from stock the cost incurred thereon in the earlier year. Moreover, the assessment in the previous year cannot be reopened since when the expenditure was incurred in that year it was properly allowable notwithstanding that the stock was withdrawn for private consumption in a subsequent year. Enough has been said to show that there is a fundamental weakness in the present provisions regarding trading stock. It is only proper that no deduction should be made in respect of goods taken from stock for domestic or other private purposes. It should be provided in the Act that if goods be taken from stock for domestic purposes then an amount equal to the value at which the goods were last brought into the taxpayer's accounts should either be included in the gross income or deducted from the opening stock. In this respect see para. (*d*) of the recommendations of the Committee of Enquiry (§ 251).

§ 254. Trading stock donated

If trading stock is donated otherwise than in the ordinary course of trade, an amount equivalent to the cost price of the goods donated and originally allowed as a deduction, is, in terms of the present practice, included in the taxable income. The remarks made above in relation to the Commissioner's treatment of stock taken for domestic or other private purposes apply equally to his practice in regard to goods donated. To give effect to his practice, the law should provide that an amount equal to the value at which the goods were last brought into his accounts should be included in the gross income or deducted from the opening stock. As regards the donee, the Act provides at present (section 11 (5) (*d*)) that if any trading stock has been acquired by any person for no consideration such person must be deemed to have acquired such stock at a cost equal to the current market price on the date of acquisition. It is wrong that whereas the donor is taxed on the cost price of the donated stock, the donee can claim the market price of the stock as an allowable deduction. It is, therefore, recommended that if the amount to be included in the income of the donor is to be the cost price of the goods donated, then the donee should be deemed to have purchased the goods for the amount which is included in the income of the donor. In this respect, see paras. (*c*) and (*d*) of the recommendations of the Committee of Enquiry into the Income Tax Act (§ 251).

On further study of the problem, the writer has come to the conclusion that in order to avoid a serious avoidance device it is not sufficient to tax the donor of trading stock on the cost price thereof and to allow the same amount as a deduction to the donee. As will be shown, in the interests of the *fiscus* it is desirable that the donor be taxed on the current market price of the donated stock and that the donee should be allowed as a deduction from his income whatever is taxed in the hands of the donor. Farmers are taxed on the market value of livestock or produce donated (see § 203) and there is no valid reason why this should not apply to the ordinary trader.

Under the present practice, and in terms of section 11 (5) (*d*), the donor is taxed on the cost price of the donated trading stock and the donee is allowed as a deduction the fair market price. There is nothing to prevent a taxpayer holding immovable property or shares, which constitute trading stock, from donating these assets to a company in which he is the sole beneficial shareholder. Since the donee, i.e. the company, can claim as a deduction, in terms of section 11 (5) (*d*), the market price of the asset received by way of donation, it must follow that on a resale there is nothing to tax in the hands of the company. Thus, the donor has disposed of his trading stock in such a way that the profit derived is not taxable at all. For example, Mr. A owns some land originally costing £4,000 and which was acquired on speculation account. The fair market price is £20,000. Mr. A is aware that on a sale of the land he has to pay tax on a profit of £16,000, perhaps some £10,000 working on the basis that he is subject to a maximum rate of 12*s.* 6*d.* in the £. He, therefore, donates the land to a newly formed company in which he or his family is the sole beneficial shareholder. The company then proceeds to sell the land for £20,000. Even if the Commissioner regards the land in the hands of the company as trading stock, he must allow, in terms of section 11 (5) (*d*), the market price, i.e. £20,000 as a deduction against the income. Thus, the company is not taxable on anything and Mr. A would have avoided tax on an income of £16,000, i.e. some £10,000. It is true that this device would cost Mr. A donations tax on a taxable donation of £20,000, i.e. some £1,870 as well as transfer duty, say, 4 per cent on £20,000, i.e. £800, but even taking this into consideration the saving still amounts to about £7,300. It is also true that the value of the donation would form part of the dutiable estate of Mr. A for estate duty purposes, but against the estate duty payable there can be set off the donations tax as well as the transfer duty payable in respect of the donation of the property to the company.

Unless the donor is taxed on the market value of the asset donated, there can be much loss of tax revenue to the *fiscus*. The donation can be made to members of his family or to a trust in which the beneficiaries are members of his family. Ordinarily, should the donee dispose of the donated property, the proceeds are not taxable being derived from the realization of a capital asset. But even if the proceeds did constitute taxable income, the donee would be entitled to deduct the current market value at the date of acquisition in terms of section 11 (5) (*d*). Owners of assets bought on speculation account can, therefore, arrange matters in such a way that the profit on a resale is not taxable in their hands. It is considered, therefore, that where the asset donated constitutes trading stock in the donor's hands, the amount to be taxed should be the market value at the date of the donation. As regards the donee, where the amount received or accrued upon the disposal of the donated property constitutes gross income, he should be allowed to deduct the value of the property at the time of the acquisition in accordance with the present provisions of section 11 (5) (*d*). Precedent for the writer's recommendations is to be found in section 36 of the Australian Act and section 102 of the New Zealand Act, which have no doubt been introduced to prevent a method of tax avoidance open to taxpayers by reason of the gap which may exist between the market value and the cost price of an asset.

If income tax is payable on the difference between the market value and the cost price of trading stock donated, donations tax should also not be payable on this amount but should be based on the cost price of the stock donated (cf. section 54 *quat* (1) (*k*)), otherwise both donations tax and income tax will be payable on the same amount.

§ 255. Trading stock lost by fire, theft or burglary

The provisions of section 11 (5) do not deal with the question of stock which is destroyed by fire, or lost through theft or burglary. If the taxable income is determined by taking into account a trader's opening and closing stocks, then it must follow that as goods lost or destroyed by theft or fire are not on hand at the end of the tax year, the taxpayer obtains a deduction in respect of such goods. It is only fair and equitable that a trader should be allowed to deduct such a loss in determining his profits. Of course, if any amounts are recovered under insurance policies in respect of such loss, they are included in gross income. In practice, the Commissioner deals with this problem differently, probably because of certain court decisions which were based on an Act which at the time contained no provisions regarding trading stock. The Special Court has held that a loss of stock-in-trade by fire is not deductible.[57] Where, however, uninsured stock-in-trade was lost by shipwreck, the Court held that the loss was deductible from income.[58] These decisions appear to be in conflict with each other. In practice, the Commissioner permits a deduction in respect of a loss by fire of uninsured stock-in-trade.[59] The Commissioner does not, however, permit a deduction of a loss suffered by reason of theft of stock-in-trade[60] unless, having regard to the nature of the business conducted, such losses must be regarded as an inevitable concomitant of the trade carried on, e.g. the loss is allowed in the case of bazaars where this type of loss occurs frequently. The present practice as regards losses in respect of goods lost by fire and theft is, therefore, inconsistent.

Where the Commissioner does allow a loss in respect of stock lost by fire or theft, he will only allow it to the extent to which it exceeds the amount recoverable under any insurance contract or indemnity since, in terms of section 12 (*c*), no deduction can be made in respect of any losses which would otherwise be allowable to the extent to which it is recoverable under any contract of insurance or guarantee.

Losses due to fixed assets such as plant, machinery, vehicles, etc., being destroyed by fire or being stolen, clearly do not rank for deduction as they are of a capital nature and not deductible in terms of section 11 (2) (*a*). Losses due to theft or embezzlement of cash or other cash shortages are also not allowable.[61] In *Lockie Bros., Ltd.* v. *C.I.R.*[62] the Court refused to allow a deduction to an English company in respect of a loss of £12,625 which was embezzled by its South African manager. During the course of judgment Mason, J., said:

> ' . . . The usual meaning which I think an ordinary person would attach to these words[62a] is that deductions are to be allowed for any losses or outgoings actually incurred in the course of and by reason of the ordinary operations undertaken for the purpose of conducting the business, not being losses or outgoings of a capital nature. . . . There could be no doubt that the loss due to this embezzlement was incurred during the course of the company's business operations. Was it due to those operations? . . . But there is a distinction between negligent handling of goods and embezzlement; the handling of the goods is a necessary incident of the business and negligence in that respect did not alter the nature of the transactions; but embezzlement is quite a different thing; it is not an operation undertaken for the purpose of the business.'

Thus, whereas losses due to embezzlement are not allowable, losses of trading stock occasioned by negligent handling on the part of employees are deductible in terms of the *Lockie Bros.* case.

[57] I.T.C. No. 207, 6 S.A.T.C. 54; I.T.C. No. 263, 7 S.A.T.C. 143.
[58] I.T.C. No. 303, 8 S.A.T.C. 72.
[59] The Commissioner apparently follows the principle established in I.T.C. No. 303.
[60] I.T.C. No. 686, 16 S.A.T.C. 490.
[61] I.T.C. No. 289, 7 S.A.T.C. 331; see also I.T.C. No. 733, 18 S.A.T.C. 111; I.T.C. No. 686, 16 S.A.T.C. 490; I.T.C. No. 815, 20 S.A.T.C. 487.
[62] 1922 T.P.D. 42.
[62a] 'in the production of income'.

The Committee of Enquiry into the Income Tax Act recommended that losses arising from theft or embezzlement during the course of trading operations, should be allowed as a deduction in the case of a trader, provided the Commissioner is satisfied concerning the *bona fides* of the claims.[63] The Income Tax Commission rejected this recommendation. It considered that losses from theft or embezzlement are purely capital losses and their allowance would be open to serious abuse and also impossible to 'control'. The Commission felt, however, that losses due to petty thieving, which are a concomitant risk of the trade, should be allowable but no further concession should be made.[64] It is interesting to record that the Commission of Inquiry into the Federation Income Tax Act considered that the disallowance of losses by embezzlement is inequitable. It recommended that if a loss sustained through the embezzlement, theft or larceny by any person employed in the business of the taxpayer, other than a director, if the taxpayer be a company, of money included in the taxpayer's income is discovered, then that loss should be deductible in the year of assessment in which the loss is discovered.[65] Section 71 of the Australian Act specifically provides that losses by embezzlement are deductible to the extent set out in the section.

§ 256. Disposals of trading stock at prices below market value

It has already been stated that between the beginning and end of the tax year, such trading stock as may have been consumed, destroyed, stolen or donated will not form part of the trading stock on hand at the end of the year and that it may not be legally possible for the Commissioner to increase the taxpayer's income by the cost of the stock so disposed of. Such stocks as are disposed of in the ordinary course of trade will give rise to receipts which form part of the gross income. But the present provisions relating to trading stock do not deal with the case of trading stock not sold in the ordinary course of trade and which is disposed of for a consideration less than the fair market price to a purchaser with whom the seller is not at arm's length. For example, a trader may sell an article costing £100, which he originally claimed as a deduction from income, for £50 to a relation or friend. If he sold such article in the ordinary course of trade, he could obtain the current market price of, say, £150. The attitude of the Department would probably be that since the cost price of £100 was originally allowed as a deduction, there must be included in the taxable income an amount of £50 in addition to the £50 received for the sale of the article. The writer is extremely doubtful whether this is correct law. In the writer's view the matter should be dealt with in exactly the same way as a donation of trading stock (see § 254). In the example cited, the trader should be taxable

[63] *First Report*, p. 36, para. 78.
[64] *First & Final Report*, p. 11, para. 45.
[65] *Report of the Commission of Inquiry*, p. 24, para. 152.

on the fair market price of the trading stock, i.e. £150, whereas the buyer should be deemed to have paid £150 for it. In this respect, see para. (*e*) of the recommendations of the Committee of Enquiry into the Income Tax Act (§ 251), which could usefully be adopted by the Legislature. Since the purpose of such provisions is designed to prevent tax avoidance, they should not extend to *bona fide* commercial transactions at arm's length. If a transaction has been at arm's length, the Commissioner should not have the power to amend the price.

Donations tax should not be payable on the difference between the fair market price and the consideration payable for the trading stock disposed of to the extent to which the excess is included in taxable income in accordance with the above recommendations (cf. section 54 *quat*(1)(*k*)), otherwise both donations tax and income tax will be payable on the same amount.

V. Benefits in Kind

§ 257. General principles

Gross income is defined in section 7 as the total amount, whether in cash or otherwise, received by or accrued to the taxpayer. The courts have given a very wide meaning to the words 'cash or otherwise'. They include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value. If a receipt or an accrual has not got an ascertainable money value, it cannot form part of the taxpayer's gross income.[66] 'The tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not money's worth or cannot be turned into money, it is not to be regarded as income.'[67] Unless money's worth as well as cash is included in the gross income, much revenue would be lost to the *fiscus*. Thus, if a person who has rendered services receives his remuneration in the form of shares instead of cash, the value of those shares at the date of accrual of the remuneration will form part of his gross income (see § 176).[68] If a primary producer were to sell his products in the United States for dollars, the equivalent Union currency at the date of accrual will form part of his gross income. In all cases, therefore, the receipt or accrual of an amount of income other than money must be valued and such value included in the gross income.

Notwithstanding the general rule that tax is payable only on receipts or accruals having a money value, there are instances in the Act whereby the tax is payable on amounts which do not constitute money's worth or cannot be turned into money. For example, section 7(*e*) includes in the gross income 'the annual value of any quarters or board or residence or of any other benefit or advantage granted in respect of employment' (see § 179). Section 7(*d*)*bis* taxes in the hands of the landlord the value of leasehold improvements effected

[66] *C.I.R.* v. *Butcher Bros. (Pty.), Ltd.*, 1945 A.D. 301; 13 S.A.T.C. 21.
[67] Per Wessels, C.J., in *C.I.R.* v. *Delfos*, 1933 A.D. 242; 6 S.A.T.C. 92.
[68] *Ochberg* v. *C.I.R.*, 1931 A.D. 215; 5 S.A.T.C. 93.

by a lessee in terms of a lease (see § 155) and its effect may be to subject the landlord to tax on a right which has no money value. Para. 10 of the Third Schedule subjects a farmer to tax on the market price of any livestock or produce donated by him notwithstanding that nothing has been received by him or has accrued to him in connection with the disposal of such livestock or produce (see § 203). Apart from these special instances, a benefit to be taxable must be money's worth or capable of being turned into money. On these principles, the benefit derived by a borrower from an interest-free loan is not taxable unless it is granted in respect of employment in which event the annual value is taxable in terms of section 7(*e*). The benefit derived from the free use of a house or other asset, e.g. jewellery, or a car, received by way of gift or inheritance, does not attract tax as it does not constitute something which can be turned into money and, therefore, does not fall within the definition of 'gross income'.

§ 258. Income in the form of shares

It may happen that a person sells property or renders services to a company but is, in terms of the agreement, obliged to utilize the purchase price or the remuneration to acquire an equivalent amount of shares in the company. The question that arises is whether the purchase price or remuneration agreed upon constitutes the income for tax purposes or whether the amount to be included in gross income is the value of the shares acquired. The answer, it is submitted, depends upon whether in terms of the agreement the intention was to make payment in shares, in which event the shares must be valued and included in gross income.

In *Lace Proprietary Mines, Ltd.* v. *C.I.R.*,[71] a company disposed of certain mineral rights to another company. The consideration was expressed to be the sum of £250.000 to be paid and satisfied by the allotment of 1,000,000 fully paid-up shares of the nominal value of 5*s.* in the purchasing company. The Special Court found that the value of the shares acquired was at least 12*s.* per share, which was the value fixed by the Commissioner. The Appellate Division held that the reference in the agreement to the sum of £250.000 and to the nominal value of the shares (5*s.*) could not override the true intention of the parties, which was that the true consideration was 1,000,000 shares in the purchasing company. Per Stratford, C.J.: 'No cash consideration could be demanded from the purchaser, who was entitled and obliged to deliver these shares in fulfilment of its obligation to pay for the assets bought. Thus, the consideration must be valued and such valuation cannot be affected by the reference to £250,000 or to the nominal value of the shares.' It is interesting to compare this case with *C.I.R.* v. *Lydenburg Platinum, Ltd.*,[72] in which the Court found that the purchase and sale of the shares was not a term in the contract of sale of the properties but that they constituted two separate agreements, one an agreement for the sale of

[71] 1938 A.D. 267; 9 S.A.T.C. 349. See also I.T.C. No. 337, 8 S.A.T.C. 354.
[72] 1929 A.D. 137; 4 S.A.T.C. 8.

properties for an agreed consideration and the other an agreement of sale of shares for a sum of money.

In *C.I.R.* v. *Hersov*[73] two directors waived their right to a permanent directorship as consideration for which the company agreed to pay a sum of £6,250 on the date on which the agreement became binding. The two directors, in the same agreement, bound themselves to make application to the company for the allotment and issue to them of 25,000 ordinary shares of 5*s.* each in the company and they undertook to pay the purchase price of £6,250 on the day on which the agreement became binding. The shares so acquired were worth £28,750 at the date of acquisition. The Court was of the opinion that the true consideration for the waiver of the permanent directorship was the right to subscribe for the shares at par as it was clear that it was not intended that any money should pass between the directors and the company. Thus had the consideration been taxable[74] it would have been measured by the value of the shares and not with reference to £6,250.

In a case which came before the Special Court,[75] the consideration for the sale of certain properties was stated to be the payment in cash of £150,000 '. . . subject to the obligation of the company simultaneously with such payment to subscribe for at par and to pay for in cash 300,000 shares of the nominal value of 10*s.* each in the new company '. The Court, relying upon the *Lydenburg Platinum* case,[76] considered that under the terms of the contract the consideration received by the seller of the properties was the cash fixed by the agreement, namely £150,000, the further conditions as to the purchase of shares being a supplementary agreement which did not affect the nature of the consideration actually passing.[77] This case was decided some time before the *Lace Proprietary* case. It is submitted, with respect, that the decision is not correct as the true intention was that the consideration should be the 300,000 shares which should have been valued for tax purposes.

Where, however, it is clear from the agreement that the seller is entitled to demand a cash consideration and there is no obligation on him to use the purchase price to acquire shares, this consideration must be included in the gross income even if the seller of his own accord uses the purchase price to acquire shares in the purchaser company.[78]

§ 259. Rental value of owner-occupied property

In terms of the present law the rental value of a residence owned and occupied by a taxpayer is not taxable since the benefit so derived does not constitute a receipt or an accrual within the meaning

[73] 1952 (1) S.A. 485 (A.D.); 18 S.A.T.C. 20.
[74] The Court considered the amount received to be a receipt of a capital nature and not taxable. This decision is no longer applicable in view of the provisions of sec. 7(*b*)*bis* (see § 177).
[75] I.T.C. No. 391, 9 S.A.T.C. 477.
[76] *Supra*, note 72.
[77] Similar decisions are to be found in I.T.C. No. 430, 10 S.A.T.C. 424, and I.T.C. No. 476, 11 S.A.T.C. 324.
[78] I.T.C. No. 347, 9 S.A.T.C. 55.

of the definition of 'gross income'. In the United Kingdom, the taxation system in force in that country provides for the levying of tax on the rental value of property which remains in the owner's occupation. The owner-occupier of business premises is charged on the net annual value of the premises but he is permitted to deduct from his profits the rent he might be supposed to pay to himself for the use of his own property. Tax is not only imposed upon the enjoyment of property by an owner-occupier but is also levied on an occupying tenant who holds property at a rental less than the annual value. The taxation of these benefits is justified by the principle that taxation should be adjusted to the relative capacity to pay of different taxpayers. It is said that an owner-occupier with a given income who pays no rent has a larger taxable capacity than a tenant with the same income out of which a liability for rent must be met. Thus, if two persons earning £1,000 per annum each inherit a sum of £5,000 one of whom buys a house to live in and the other invests his capital at 6 per cent per annum but hires a house identical to the one purchased by the other at an annual rental of £300, the person who bought the house will have a taxable income of £1,000 whereas the other who invested his capital and hired a house will have a taxable income of £1,300. The illustration shows that although the capacity to pay of the taxpayers is identical, the one pays more tax than the other. The case against the taxation of the rental value enjoyed by an owner-occupier is usually based on the grounds that the system involves the taxation of notional income and that it is inequitable to tax the beneficial enjoyment of an owner-occupied property when the enjoyment derived from the ownership of other forms of property, e.g. motor-cars and jewellery, goes untaxed. The second argument is unanswerable except on practical grounds that the task of valuing and revaluing all forms of movable property in order to assess their annual value is impossible of performance. Yet it is illogical that a man who spends a retirement gratuity on a private residence should be taxed on the rental value thereof whereas the man who uses his gratuity to buy a motor-car, a yacht or jewellery for his wife is free of tax on the benefit derived from the enjoyment of these forms of property.

In South Africa, therefore, a taxpayer in order to avoid tax on investment income is entitled to use his surplus funds on the acquisition of property in respect of which he can derive the beneficial enjoyment without the necessity of having to pay tax on the annual value of such property.

VI. Deceased and Insolvent Estates

§ 260. Deceased estates

General principles

Death terminates the taxable existence of a taxpayer, but any income received by or accrued to the deceased up to the date of his death is not relieved from tax which is a debt due by his estate.

In terms of section 69(*e*), the executor or administrator of the estate of a deceased person is the *representative taxpayer* in respect of the income of such person who dies during the year of assessment, or who dies after the close of any tax year, but before rendering a return of his income for such year.

The executor must make the return of income to the date of death, admit the resulting claim for tax against the assets of the estate and generally represent the estate in all matters relating to taxation.

Where a wife dies, her income to the date of her death is included in her husband's income for the year. No taxes are payable by her estate and there is no need for her executor to make a return of income to the date of death. The position would, however, be different if she or her husband had applied for the issue of separate returns in terms of section 58(1). In such a case, the wife would be a taxable *persona* and her executor would be required to complete a return of income to the date of her death.

Until such time as the administration of an estate has been completed and the residue has been ascertained, any income arising from the residue of an estate is taxable in the hands of the executor as representative taxpayer of the estate.[79] Heirs are accordingly relieved from tax on income derived from the residue until the administration of the estate has been completed and the residue ascertained, and when such income is eventually paid over to them it partakes of the nature of capital. '. . . Until the claims against the testator's estate for debts, legacies, testamentary expenses, etc., have been satisfied, the residue does not come into actual existence. It is a non-existent thing until that event has occurred. The probability that there will be a residue is not enough. It must be actually ascertained. And if this be so, then it cannot be held that until the residue has been ascertained any residuary legatee is entitled thereto. . . .[80]

It is submitted that the residue is only ascertained when the executor's account has lain for inspection without objection.[81]

In practice, the Commissioner has accepted the above principle and has ruled that the executor and not the beneficiaries must be taxed in respect of the income accruing to the estate during the period from the date of death to the date of confirmation of the executor's account. The ultimate distribution of such income among the heirs or beneficiaries would constitute a capital accrual in their hands.

A further question that arises is: Who should be assessed to tax on income derived from bequeathed legacies in respect of the period from the date of death to the time that the property bequeathed is delivered to the legatee? For example, if a deceased died on 13th July,

[79] I.T.C. No. 816, 20 S.A.T.C. 496; see also I.T.C. No. 69, 2 S.A.T.C. 264, and I.T.C. No. 279, 7 S.A.T.C. 249.

[80] *Barnardo's Homes* v. *The Commissioners*, [1921] 2 A.C. 1; 7 T.C. 666 (per Lord Atkinson); see also *Corbett* v. *I.R.C.*, [1938] 1 K.B. 567; 21 T.C. 449.

[81] *Estate Smith* v. *Estate Follett*, 1942 A.D. 364; *C.I.R.* v. *Estate C. P. Crewe & another*, 1943 A.D. 656; 12 S.A.T.C. 344; I.T.C. No. 816, 20 S.A.T.C. 496.

1956, and bequeathed a rent-producing property to a legatee but the estate is only wound up on 28th June, 1957, when transfer of the asset is made to the legatee, the question arises whether the net rentals for the period 13th July, 1956, to 28th June, 1957, accruing to the estate are taxable in the hands of the legatee or in the hands of the estate. It may be suggested that the correct procedure in such a case is to tax the legatee but it is submitted that such income is taxable in the hands of the estate since, until the executor's liquidation account has lain for inspection, the legatee is not entitled to claim his bequest and until that date he is therefore not entitled to claim the income derived therefrom.[82] The Commissioner has accepted this principle in practice.

In law there is nothing to prevent an executor distributing any of the assets of a deceased estate to an heir or legatee before the confirmation of the executor's account although he may run a risk of rendering himself liable to creditors or other heirs if he has transferred more to the beneficiary than he is entitled to. The question then arises: As regards the income accruing to the heir or legatee in respect of the asset transferred to him, is it taxable in the hands of the estate or in the hands of the heir or legatee? In practice, the Commissioner insists that all income derived in respect of the deceased's assets be taxable in the hands of the estate until the confirmation of the liquidation and distribution account even in cases where the executor has transferred assets to the heirs or beneficiaries. It is submitted that this practice is not correct law since once an executor has handed over or transferred or permitted the use of an asset to an heir or legatee in such a way that that heir or legatee has an enforceable right to claim the income in respect thereof, the income is taxable in the hands of the legatee even though the estate has not yet been wound up. From the income tax point of view there has clearly been no accrual to the estate so that there is nothing to tax in the hands of the estate: Thus, if soon after the date of death, a residuary heir, with the consent of the executors, takes possession of a business for his own account in such circumstances that the profits vest in him and do not belong to the executors, it is submitted that the profits are taxable in the hands of the heir from the time that he takes over the business.

It may be mentioned that where the executor decides to let a farm or other asset to an heir or beneficiary prior to the liquidation or winding-up of an estate, the Department accepts that the rental is taxable in the hands of the estate and that the net income derived from the asset is taxable in the hands of the heir or beneficiary.

Another problem that arises relates to joint or community estates. It may be suggested that until the confirmation of the liquidation and distribution account of the joint estate, the whole of the income accruing on the joint assets is taxable in the hands of the estate and not merely the one-half relating to the interest of the deceased. Having regard to the principle in law that in the case of a

[82] I.T.C. No. 816, 20 S.A.T.C. 496.

marriage in community of property the assets are owned jointly in equal shares by the spouses so that each spouse is the legal owner of one-half of the assets,[83] it is submitted that upon the death of one of the spouses, the survivor remains vested with the ownership of one-half of the estate so that any income accruing in respect thereof is taxable in the hands of the survivor and not in the hands of the estate of the deceased spouse notwithstanding the fact that under our system of administration of estates, the executor of the estate of the deceased spouse deals with the assets of the joint estate.

Method of assessment

Where an assessment is made upon the executor as representative taxpayer of the estate, normal tax is assessed at the rates and according to the primary rebate applicable to an *unmarried person*. As long as the taxable income does not exceed £250 for the year of assessment or a proportionate amount thereof if the period of assessment is less than twelve months, liability to normal tax does not arise. Super tax is assessed at the ordinary rates applicable to individuals subject to the primary rebate of £285. If the income subject to super tax does not exceed £2,300 for the year of assessment or a proportionate amount thereof if the period of assessment is less than twelve months, liability to super tax does not arise. In the year in which the estate comes into existence as a taxable *persona* or ceases its existence as a taxable entity, the period of assessment is less than twelve months and any rebate is proportionately reduced. It is provided that the estate of a deceased person is not liable for the savings levy in respect of any income accruing to it but this exemption is not extended to any trust created under the will of a deceased person. If the estate is resident in any one of the provinces for at least ninety days during the tax year and is liable to normal or super tax, it is also liable to provincial income tax but not to personal tax which is confined only to individuals.

In the determination of the income subject to the tax in the hands of the executor, deductions are allowed in respect of expenditure incurred in the production of the income, including administration charges, e.g. commission payable to the executor, premium on fidelity bond, etc. Executor's fees which relate to the liquidation of the assets of the deceased are clearly not deductible in terms of section 11 (2) (*a*). Expenditure which has reference to the capital assets of the estate is not deductible.[84]

Consequences of the present law

The principle that income accruing to executors from the date of death until the winding-up or liquidation of an estate is taxable in the hands of the estate and not in the hands of the heirs or beneficiaries, invites avoidance by heirs in the higher income groups

[83] *Union Government* v. *Leask's Executors*, 1918 A.D. 447; *Rosenberg* v. *Dry's Executors*, 1911 A.D. 679; *Estate Sayle* v. *C.I.R.*, 1945 A.D. 388; 13 S.A.T.C. 170.

[84] I.T.C. No. 387, 9 S.A.T.C. 463.

who may be tempted to postpone or prolong liquidation so that the income is taxable in the hands of the estate whose rate of tax may be very much lower than their individual rate of tax. Where there are a number of residuary heirs so that a division of the estate income among them would result in a lower rate of tax than that payable by the estate on the whole income, they may be tempted to arrange with the executors that they hire the estate assets so that the net income (after paying the rent to the estate) is taxable in their hands. A lease arrangement will in fact result in the creation of an additional taxable entity, viz. the estate, thereby resulting in a further saving of tax. For example, assume that the deceased left a business earning £6,000 per annum to two residuary heirs in equal shares. If nothing is done in the matter, the estate will be taxable on £6,000 per annum until the liquidation of the estate. On the other hand, if the executors let the business to the two heirs for a rental of £2,000 per annum, the net effect will be that the income will be divided among three different taxpayers. The tax saving will be substantial indeed.

It is interesting to record that in terms of Part XIX of the Income Tax Act, 1952, of the United Kingdom, income arising during the period in which the estate of a deceased person is being administered is deemed to be the income of the residuary legatee or heir absolutely entitled to receive the capital of the residue of the estate. Prior to the introduction of this measure, the income of the estate during the period of winding-up was taxable in the hands of the estate with the result that although it was liable to income tax it escaped surtax. When the residuary heir eventually received the income accumulated during the winding-up period it reached him as capital and the income thus escaped surtax. Apparently the Revenue experienced cases where the period of administration was deliberately prolonged so that the estate could accumulate as much income as possible which could be conveyed surtax free to the beneficiaries. Thus, it became necessary to counter the avoidance device by inserting special provisions which broadly had the effect of deeming the estate income to be the income of the beneficiary. Bearing in mind that an estate will not be liable to super tax until an income subject to super tax of £2,300 has been reached, beneficiaries in the Union may be tempted to postpone or prolong the liquidation of an estate so as to secure tax saving. The Union legislator should bear in mind the experience of the United Kingdom and the manner in which it has attempted to solve the problem.

§ 261. Insolvent estates

Upon the voluntary or compulsory sequestration of the estate of a person during a year of assessment, such person is assessed to tax in respect of all income accruing from the beginning of that year until the date of insolvency. From the date of insolvency, the debtor is regarded as a new taxable *persona* and if he receives any income in his own right, he is assessable to tax on such income. It follows, therefore, that in the year in which insolvency takes place, two assessments are raised on the insolvent, one covering the period from the beginning of the tax year to the date of insolvency, and the other covering the period from the date of insolvency until the end of that tax year. As the two periods of assessment are each less than twelve months, the rebates applicable to the insolvent are proportionately reduced. The procedure described is followed by the Commissioner in practice although there appears to be no clear authority for it in the Act. On the Departmental interpretation, it would seem to follow that if the insolvent is rehabilitated in the same year in which his estate is sequestrated, three assessments must be raised on the insolvent, one assessment covering the period from the beginning of the tax year to the date of insolvency, a second covering the period from the date of insolvency to the date of rehabilitation, and a third assessment in respect of the period from the date of rehabilitation until the end of the tax year. It is doubtful whether this is correct law. The law should clearly state that in the event of sequestration, a separate assessment shall be raised on the taxpayer in respect of the period from the beginning of the tax year until the date of sequestration.

Where a trustee of the insolvent estate carries on an insolvent's business for the benefit of the creditors, the income derived from such business is the income of the estate and is assessed to tax in the hands of the estate. The trustee is, in terms of section 69 (*c*), the representative taxpayer for the estate. He must make returns on behalf of the estate, is responsible for payment of the tax and generally represents the estate in all matters relating to taxation. The estate, as represented by the trustee, is regarded as an *unmarried person* for tax purposes and pays tax and is entitled to any rebate at the rate applicable to such persons. As long as the taxable income does not exceed £250 for the year of assessment or a proportionate part thereof if the period of assessment is less than twelve months, liability to normal tax does not arise. The estate is also subject to super tax if the income subject to super tax exceeds £2,300 or a proportionate part of £2,300 if the period of assessment is less than twelve months. In the year in which insolvency takes place, the estate's period of assessment is less than twelve months and any rebate is subject to proportionate reduction. Liability for the payment of any amount owing in respect of the savings levy falls away upon the insolvency of the taxpayer and the insolvent estate is likewise not liable for the savings levy in respect of any income accruing to it. If the estate is resident in any one of the provinces for at least ninety days during the tax year and is liable to normal and super tax, it is also liable to provincial income tax but not to personal tax which is confined only to individuals.

It is expressly provided in section 11 (3) (*a*) (i) that a person whose estate has been voluntarily or compulsorily sequestrated is not entitled to carry forward any assessed loss incurred prior to insolvency. Even if such person is subsequently rehabilitated he cannot enjoy the benefit of that assessed loss. The trustee of the estate is not entitled to carry forward an assessed loss incurred by the insolvent prior to sequestration.

Any tax payable by the insolvent on income earned prior to the date of insolvency, even if it has become payable only after such date, is a debt due to the Government by the estate, and the trustee, as representative taxpayer, must admit the claim and accord it the preference to which it is entitled in terms of the Insolvency Act. Section 101 of the Insolvency Act, No. 24 of 1936 (introduced by section 87 of the Income Tax Act), confers a preference on 'any tax on the income of the insolvent levied under any Act of Parliament relating to income tax or to any other tax upon income or profit . . .'. The preference does not therefore extend to the personal tax and the provincial income tax which are not levied under an Act of Parliament but under an Ordinance by the respective Provincial Administrations. Thus, in respect of these taxes, the Commissioner enjoys a concurrent claim only. The Commissioner's preferent claim ranks after salary or wages owing to the former employees of the insolvent but before general mortgage bonds. In the case of an insolvent partnership, the Commissioner has a preferential claim upon the assets of the partnership in respect of any tax due by a partner as is attributable to his interest in the partnership.

In regard to a voluntary assignment of a debtor's estate to a receiver or other person, there is no change in the legal status of the assignor, and even though his business or other assets are transferred to a receiver for the benefit of creditors, the income derived therefrom continues to accrue to him and he is the person who is to be taxed in respect of such income. Where, however, such a person makes an arrangement with his creditors for releasing him wholly or partially from his debts, any assessed loss incurred by him must, in terms of section 11(3) (*a*) (ii), be reduced by the value of the compromise benefit (see § 165).

VII. WHERE ACCOUNTING AND ASSESSMENT YEAR DIFFER

§ 262. STATUTORY PROVISIONS AND THEIR APPLICATION

The law

Section 55(13) provides that the return of income to be made in respect of any year of assessment must be a full and true return for the whole period of twelve months ending upon the last day of the year of assessment under charge.

Year of assessment is defined in section 1 and read with section 5(1) means the period of twelve months which runs from 1st July of one year to 30th June of the next succeeding year. It follows, therefore, that every taxpayer is required to render a return of his income made up to 30th June of each year.

In the case of a trader, his return must be accompanied by all such balance sheets, trading accounts and profit and loss accounts referred to in para. 2 of the Regulations under the Income Tax Act and these accounts are required to be made up to 30th June of each year.

In certain cases it is inconvenient or impracticable for taxpayers to draw up their annual accounts to 30th June and where the accounting year ends upon a date other than 30th June, the accounts to such other date may be accepted by the Commissioner as representing the income to 30th June. This procedure is authorized by the proviso to section 55 (13) which states:

> 'Provided that where it is established to the satisfaction of the Commissioner that the income of a person cannot be conveniently returned for that period, the Commissioner may accept returns made up to a date agreed to by him, which returns shall be deemed for all purposes of this Act to be returns for the periods covered by the years of assessment under charge, and the taxpayer shall not, without the consent of the Commissioner, be entitled to make a return in respect of any subsequent year of assessment to a date other than the date so agreed to.'

It should be noted that where the accounting year is different from the assessment year, the effect of such a difference relates only to the determination of the taxpayer's income subject to tax, i.e. the taxable income or income subject to super tax. For all other purposes of the Act, the operative date is always the statutory date, 30th June. All other matters including the determination of income tax rebates, rates of tax, etc., must be governed by the statutory assessment year.[85] The purpose of section 55 (13) is merely to enable the taxpayer to use the information attributable to his accounting period for the purpose of making his return for the normal fiscal year.

'Grossing up' and 'grossing down' adjustments

As a change in the accounting date from 30th June to some other date often results in the initial substituted period covering a period of less than twelve months, the Commissioner, in practice, makes such adjustment to the amount of the income disclosed by the taxpayer's return for the substituted period as will ensure that the taxpayer is taxed on an amount which could reasonably be taken to represent the amount on which he would otherwise have been taxed on a return for the year ending 30th June, or for such shorter period falling within that year during which he may have traded. This means, in effect, that the taxpayer is required to accept in the first year a reasonable estimate of his income for the relative year of assessment ending on 30th June. Thereafter, the income disclosed by his accounts for each substituted period of twelve months is accepted as a return of income for the year of assessment under charge usually to be followed in the year in which he ceases to carry on business by an adjustment on similar lines to that made in the first year. This procedure, although it ensures that the taxpayer is subject to tax only in respect of the actual period of trading, does not ensure that the actual income earned over the trading period is subject to

[85] *In re the Income of X* (decided by the High Court of Southern Rhodesia in 1924), 1 S.A.T.C. 82; *Fowler Tarspraying Company, Ltd.* v. *C.I.R.*, 1938 T.P.D. 164; 8 S.A.T.C. 190; *Pyott Ltd.* v. *C.I.R.*, 1925 A.D. 298; 1 S.A.T.C. 61; I.T.C. No. 309, 8 S.A.T.C. 147; *Roberts* v. *C.I.R.*, 1924 S.R. 33.

tax. For example, if the adjustment included in the initial period is greater than the adjustment excluded in the final period, the taxpayer is prejudiced since it must follow that he has been subject to tax on more income than what he has actually earned. Conversely, if the initial adjustment is less than the final adjustment, the *fiscus* is prejudiced since the taxpayer has paid tax on an amount which is less than the actual income earned during the entire period of trading. In this latter case, where the *fiscus* is likely to be severely prejudiced, the Commissioner will probably not make any 'grossing down' adjustment but is likely to subject to tax the full income earned in the final period, and allow as a deduction therefrom the adjustment included in income in the initial period. In this manner the taxpayer is subject to tax on the actual income earned over the entire period of trading. The Special Court has sanctioned this procedure.[86] See example in § 264.

In practice, the adjustment invariably takes the form of a simple 'grossing up' or 'grossing down', as the case may be, of the income disclosed by the taxpayer's return for the initial and final substituted periods, viz.

$$\text{Taxable Income} = \frac{\text{Period of Trading during year of assessment}}{\text{Period covered by substituted accounts}} \times \text{Income disclosed by substituted accounts}$$

No hard and fast rule can be laid down to serve as a basis for estimating income. Each case will have to be treated on its merits, and a solution will have to be found which takes into account all the facts and circumstances and does not result in either the taxpayer or the *fiscus* suffering an undue disadvantage. For example, if the trade carried on is of a 'seasonal' nature, the above formula might be modified by the Commissioner to allow an apportionment of the income disclosed by the substituted accounts on a turnover basis.

Where a loss is incurred in the initial substituted period covering a period of less than twelve months, it is not the practice of the Commissioner to 'gross up' such a loss. In such a case the procedure will probably be to wait for the next return covering twelve months in order to arrive at a fair estimate of the taxable income or assessed loss for the tax year in which the initial substituted period fell.

The position set out above applies to all those cases where a taxpayer has been permitted to make a return to a date ending prior to 30th June of the relevant tax year, e.g. the case of a taxpayer who draws up his accounts to 31st December or 31st March in respect of the tax year ending the following 30th June.

It may happen that a taxpayer has been permitted to make up his return to a date subsequent to or in advance of 30th June. In such cases it must follow that the initial adjustment is one of 'grossing down' since the initial return will cover a period greater than the actual period of trading during the tax year. On the cessation of business during any subsequent tax year, the taxpayer is subject to

[86] I.T.C. No. 806, 20 S.A.T.C. 334.

tax in respect of income earned from the beginning of that tax year to the date of cessation notwithstanding that any portion of such income may have been included in the return and taxed in respect of the preceding tax year.[87] See § 263 for an illustration dealing with this principle.

It is important to remember that when the Commissioner makes the initial or final adjustments in respect of the tax years in which a full twelve months' return has not been rendered, he is merely estimating the income of the taxpayer for the tax years in question in terms of section 64(1).[88] Thus, if only a six months' return is submitted in respect of a tax year during which there was twelve months' trading, he must estimate the income for an additional six months. On the other hand, if a six months' return is submitted in respect of a tax year during which there was only three months' trading, the Commissioner is entitled to estimate the income for three months and subject this to tax. Whatever adjustments he makes, he is, however, not permitted to include in the taxable income in respect of any tax year income earned in respect of a period which is greater than twelve months.[89] This point is well brought out in the case where a taxpayer, who has always rendered his return to 30th June, is granted permission to make up his return to 30th September, for example, the taxpayer who has made up his return for the 1958 tax year to 30th June, 1958, and receives permission to render returns to 30th September. Thus, the first substituted period will cover a period of fifteen months, 1st July, 1958, to 30th September, 1959, but the Commissioner is not entitled to tax the result of fifteen months' trading in respect of the 1959 tax year. The income shown by the return will have to be 'grossed down' so that only twelve months' income is taxed.

§ 263. Illustration where accounts made up to date in advance of 30th June

M commenced trading on 1st February, 1954, and was permitted by the Commissioner in terms of the proviso to section 55(13) to make up his return of income to 31st October following 30th June of each tax year.

M ceased trading on 31st March, 1958. He derived the following net income from trading:

Period	1. 2.54 to 31.10.54	£9,000
	1.11.54 to 31.10.55	£18,000
	1.11.55 to 31.10.56	£25,000

[87] *Stewarts and Lloyds of South Africa Ltd.* v. *C.O.T.*, 1955 (1) S.A. 151 (A.D.); 19 S.A.T.C. 331; see also I.T.C. No. 809, 20 S.A.T.C. 347.

[88] Sec. 64(1): 'In every case in which any person makes default in furnishing any return or information or if the Commissioner is not satisfied with the return or information furnished by such person, the Commissioner may estimate either in whole or in part the taxable income or the income subject to super tax in relation to which the return or information is required.'

[89] *Stewarts and Lloyds of South Africa Ltd.* v. *C.O.T.* (*supra*); I.T.C. No. 306, 8 S.A.T.C. 90.

1.11.56 to 31.10.57 .. .. .. £36,000
1.11.57 to 31. 3.58 .. .. .. £20,000

Calculate M's assessments for the relevant tax years assuming that the profits accrue equally from day to day in respect of each accounting period.

SOLUTION:

1954 *Tax Year*

The return for this year covers the period 1.2.54 to 31.10.54, i.e. nine months. Only five months' trading took place during the tax year (1.2.54 to 30.6.54).

∴ Taxable Income $\frac{5}{9}$ of £9,000 = £5,000

NOTE.—The balance of the profits earned, viz. £4,000, is not subject to tax at all.

1955 *Tax Year*

In respect of this tax year, the Commissioner has accepted a return for the period 1.11.54 to 31.10.55.

∴ Taxable Income £18,000

1956 *Tax Year*

In respect of this tax year, the Commissioner has accepted a return for the period 1.11.55 to 31.10.56.

∴ Taxable Income £25,000

1957 *Tax Year*

In respect of this tax year, the Commissioner has accepted a return for the period 1.11.56 to 31.10.57.

∴ Taxable Income £36,000

1958 *Tax Year*

The taxpayer's last accounts cover a period of five months (1.11.57 to 31.3.58). But as the taxpayer traded and earned an income for the period 1.7.57 to 31.3.58, i.e. for nine months of the 1958 tax year, in terms of the *Stewarts & Lloyds* case[87] the Commissioner, in addition to taxing the five months' profit as disclosed by the accounts ending 31.3.58, is entitled to tax the results of the trading for the four months ending 31.10.1957 notwithstanding that these profits have been subject to tax in the previous tax year.

∴ Taxable Income

Period 1. 7.57 to 31.10.57 ($\frac{4}{12}$ of £36,000) ..	£12,000
Period 1.11.57 to 31.3.58 (as per accounts) ..	20,000
	£32,000

NOTE.—In this example, the taxpayer has prejudiced himself by the adoption of a substituted return. The actual income earned during the period of trading amounts to £108,000 whereas an aggregate amount of £116,000 has been subject to tax. This is due to the fact that the 'grossing down' adjustment in the initial year, viz. £4,000, is less than the 'grossing up' adjustment in the final year, viz. £12,000.

§ 264. ILLUSTRATION WHERE ACCOUNTS MADE UP TO DATE PRIOR TO 30TH JUNE

A. Brown commenced business on 1st April, 1954, and with the consent of the Commissioner rendered his first accounts, drawn up for the period ending 31st December, 1954, with his return for the year of assessment ending 30th June, 1955. Thereafter accounts were drawn up to 31st December each year and these are accepted as a return for the year of assessment ending 30th June following.

A. Brown ceased trading on 31st August, 1957.

The taxable income determined from the accounts during the period of trading was as follows:

1.4.54 to 31.12.54	£15,000
1.1.55 to 31.12.55	£24,000
1.1.56 to 31.12.56	£36,000
1.1.57 to 31.8.57	£8,000

Calculate A. Brown's taxable income for the relevant tax years assuming the profits accrue equally from day to day in respect of each accounting period.

SOLUTION:

1954 Tax Year

The taxpayer earned income for three months during this year (1.4.54 to 30.6.54).

$\therefore$ Taxable Income £5,000 ($\frac{3}{9}$ × £15,000)

1955 Tax Year

The taxpayer earned income for twelve months during this year (1.7.54 to 30.6.55) but only nine months' accounts are available (1.4.54 to 31.12.54).

$\therefore$ Taxable Income £20,000 (£15,000 × $\frac{12}{9}$)

1956 Tax Year

In terms of the proviso to section 55 (13), the accounts covering the period 1.1.55 to 31.12.55 must be accepted as a return for this tax year.

$\therefore$ Taxable Income £24,000

1957 *Tax Year*

In terms of the proviso to section 55 (13), the accounts covering the period 1.1.56 to 31.12.56 must be accepted as a return for this tax year.

∴ Taxable Income £36,000

1958 *Tax Year*

The taxpayer earned income for only two months during this year (1.7.57 to 31.8.57) but eight months' accounts are available (1.1.57 to 31.8.57).

∴ Taxable Income £2,000 ($\frac{2}{8} \times$ £8,000)

In this case the taxpayer has been prejudiced by the adoption of a substituted return in that whereas the actual profit earned over the period of trading is £83,000, he has been assessed on £87,000. Whereas the adjustment in the initial years involved an addition to taxable income amounting to £10,000, the adjustment in the final year involved an exclusion of only £6,000 from the taxable income.

If the accounts for the final period of trading show a profit of, say, £24,000 instead of £8,000 and a 'grossing down' adjustment would therefore involve an exclusion from the taxable income of £18,000, the Commissioner, in order to ensure that the revenue is not prejudiced, will probably refrain from making such an adjustment but is likely to include in the assessment for the 1958 tax year the full profit earned for the final period of trading, viz. £24,000, and deduct therefrom the adjustment included in the taxable income in the initial years, viz. £10,000. In this way, the Commissioner ensures that the taxpayer is subject to tax on the actual income earned during the period of trading. The Special Court has sanctioned this procedure.[91]

§ 265. Criticisms of the present provisions

Anomalies and hardships

Although the provisions of section 55 (13) were introduced for the convenience of the taxpayer, it does not seem right that the taxpayer should pay for this convenience by being mulcted in more taxes in cases where the 'grossing up' adjustment in the initial year is greater than the 'grossing down' adjustment in the final year, or where the 'grossing down' adjustment in the initial year is less than the 'grossing up' adjustment in the final year. In all equity, the two adjustments should be equal although this will seldom, if ever, occur in practice. It may be suggested that the fairest basis of adjustment would be, in the final year of assessment, to total the taxpayer's income since the year in which the substituted period started and to subject to tax the difference between this total and the aggregate of the taxable income upon which he has been assessed.

[91] I.T.C. No. 806, 20 S.A.T.C. 334.

Although this basis of adjustment would be a very useful safeguard to both the taxpayer and the *fiscus* it cannot always be applied in practice since if the interval between the original and the final adjustment is a lengthy period, the details of actual earnings and taxable income over the many years may not be available to either the taxpayer or the Department. Furthermore, the suggested basis of adjustment cannot assist a taxpayer who has been assessed on a total taxable income in excess of the actual income earned. For example, take a case in terms of which in the original year of change, the Commissioner grossed up the six months' income of a company by an amount of some £25,000 on which full taxes were paid. Thereafter tax was paid for a number of years on the income actually earned. For the last two years the company has been making losses and has gone into liquidation. Thus:

Year 1 (original year): 6 months' accounts showed a net profit of £25,000.
Year 2: 12 months' accounts showed a net profit of £40,000.
Year 3: 12 months' accounts showed a net profit of £33,000.
Year 4: 12 months' accounts showed a net loss of £15,000.
Year 5 (year of liquidation): 10 months' accounts showed a net loss of £10,000.

In the first year the Receiver grossed up the profits and taxed the company on £50,000 in accordance with the well-established practice. The company has paid tax during the first thirty months of its trading on an amount of £123,000 (£50,000 in Year 1, £40,000 in Year 2 and £33,000 in Year 3), whereas in actual fact during this period of trading aggregate profits amounted to only £98,000. It is now clear that the company should never have paid tax on the original grossed-up amount of £25,000. The unfortunate aspect is that the original assessment is now final and binding against the taxpayer who has suffered tremendous hardship by the system employed by the Commissioner and is now unable to receive a refund of the tax overpaid. Even if the Commissioner were to be sympathetic and allow the £25,000 as a deduction to the company in the year of liquidation, i.e. Year 5, which will give it a total assessed loss of £50,000 — a procedure for which there is no statutory authority—of what real use is it to a company in liquidation?

Recommendations of the Committee of Enquiry

If ever there is an aspect of the law that needs urgent reform, it is the question of substituted returns. The Committee of Enquiry into the Income Tax Act made some very valuable recommendations in regard to substituted returns. It recommended as follows:[92]

(1) That all taxpayers be required to make returns of their incomes from all sources to the 30th June, save in the cases referred to under (2) and (3) below;
(2) that, where it is established to the satisfaction of the Commissioner that the income of a person from a particular business can more conveniently

[92] *Second and Final Report*, p. 3, para. 18.

be returned to a date other than 30th June, and that revenue will not be materially prejudiced by the acceptance of accounts drawn to such other date, the Commissioner shall accept returns made up to a date other than 30th June agreed to by him;

(3) that, subject to the approval of the Commissioner, taxpayers who at present make returns of their incomes from business operations to 30th June be permitted, if they so desire, to make such returns, in respect of such business operations only, for financial years with a closing date other than 30th June annually;

(4) that the system at present operating under the proviso to section 55 (13) of the 1941 Act be discontinued in respect of the taxpayers referred to under (2) and (3) above, and that in such cases no adjustments be made in the assessments for either the trading period during which the financial year-end date selected by the taxpayer first becomes effective or the final trading period;

(5) that income which is reflected by accounts for a completed financial year ending upon a date other than 30th June within the period of twelve months from 1st December of one year to 30th November of the next, or by accounts for part of a financial year which, if completed, would end upon a date within that period, be taxed at the rates applicable to and as though it formed income of the year of assessment ended upon 30th June falling within that period;

(6) that in cases in which the taxpayer dies during the course of the year of assessment the concessional deductions to be allowed should be calculated with reference to the period the taxpayer was alive during any year of assessment in respect of which an assessment is made upon him, and not with reference to the period he was alive during any financial year of the business the accounts of which are drawn to a date other than 30th June;

(7) that in respect of the trading period during which the financial year-end date selected by the taxpayer first becomes effective and the final trading period the Commissioner be authorized to refuse to accept any accounts which cover a period which is in excess of fifteen months, and that in respect of all other trading periods it be stipulated that, unless the Commissioner otherwise agrees, the accounts to be drawn should cover a full period of twelve months ending upon the selected date annually;

(8) that where, in the initial year, an adjustment has been made on a basis of estimate, to the income of a taxpayer who at present renders returns of income to a date other than 30th June under the proviso to section 55 (13) of the 1941 Act, a corresponding adjustment be made, in the year of assessment in respect of which the recommendations contained in this Chapter, if accepted, first became operative, as far as is practicable on such a basis as will ensure that the aggregate of the taxable income assessed to tax in the various tax years during which the business has been carried on is equal to the aggregate of the taxable income for the entire period of trading based upon the trading results reflected by the accounts of the business, and that the Commissioner for Inland Revenue be given statutory authority for the making of such an adjustment.

The Committee's proposed system, apart from meeting the difficulties of taxpayers who cannot conveniently make a return of their income to 30th June, has the valuable advantage that the need for adjustments in the initial and the final years will be eliminated. Moreover, the difficulties of the accountancy profession in preparing balance sheets and accounts for the majority of their clients to the same date each year will be eased with a consequent reduction in the number of applications for extension of time for the rendition of returns. The Committee's recommendations also do away with an unsatisfactory feature of the present system which permits of the rendering of the taxpayer's entire return of income to a date other than 30th June. All that is really necessary is to permit a substituted return for the results of trading in respect of a particular business and not in respect of all income. For example, investment income should always be returned to 30th June. It is a matter for regret that the Income Tax Commission rejected the Committee's recommendations on the ground that they will lead to considerable administrative difficulties. The Commission recommended that the present system should continue to operate.[93]

VIII. Taxation of Isolated Profit-making Schemes

§ 266. Introduction

By the definition of 'gross income' in section 7 of the Act, receipts or accruals of a capital nature are, with certain exceptions, not subject to tax.

There is no definition in the Act of receipts and accruals 'of a capital nature'. No doubt the legislator has realized that it is not possible to define the qualities which render a receipt or an accrual either capital or income as the case may be. From the large mass of judicial decisions on the question whether a receipt or an accrual is of a capital or an income nature, it becomes obvious that the phrase 'of a capital nature' is not a precise term and that there is no single infallible test for settling the question as to whether a particular receipt or accrual is income or capital. The problem has given rise to much difficulty.

In ordinary cases the determination of whether a receipt or an accrual is of an income or a capital nature creates no problem. Thus, amounts received for allowing the use of an asset to some other person, e.g. interest, rents, royalties, all partake of the nature of income and fall within the definition of 'gross income'. 'It is true that there is no definite test that can always be applied in order to determine whether a gain or profit is income or not, but it may safely be asserted that the revenue or profit which is derived from a thing without its changing owners is rather to be considered as income than as capital.'[94] Amounts received for services rendered clearly partake of the nature of income. On the other hand, fortuitous accessions to capital such as lump-sum legacies and gifts, and isolated lottery, betting or sweepstake wins are of a capital nature and fall

[93] *First and Final Report*, p. 25, paras. 1-8.
[94] *C.O.T.* v. *Booysen's Estate Ltd.*, 1918 A.D. 576, per Innes, C.J.

outside the definition of gross income. The proceeds derived from the sale of ordinary investments or from the sale of assets by a person who does not trade in such assets, e.g. a taxpayer's private house, paintings and jewellery are of a capital nature. On the other hand, if the taxpayer makes it his business to buy and sell houses, paintings and jewellery, the proceeds derived from the sale of such assets would be of an income nature.

§ 267. The test of intention

One of the most important tests laid down by the courts, where the receipt or accrual consists of the realized proceeds of an asset which has been disposed of, is the intention with which the asset was acquired. If in the carrying out of a scheme for profit-making an asset is acquired for the purpose of resale at a profit, the proceeds derived from the sale of such asset constitute revenue derived from capital productively employed to earn such revenue and are of an income nature.[95] On the other hand, if an asset is acquired to produce an income in the form of, say, rent or dividends and not for the purpose of resale at a profit, the proceeds derived from a subsequent disposal of such asset are of a capital nature. It is clear that the application of this test involves a consideration of all the circumstances surrounding the acquisition of and the method of dealing with the particular asset. The test applies whether the property is movable or immovable, corporeal or incorporeal. Thus, if a person buys a book debt for the purpose of resale at a profit, the profit is on income account and is taxable.

A taxpayer is not precluded from changing his intention in regard to the use to which a particular asset may be put. Various decisions of the courts take account of the possibility that a change of intention on the part of a taxpayer may affect the result of the inquiry as to whether the receipt or accrual is of a capital nature or not.[95a] An original intention to use an asset as an investment may be changed to one to use it in the carrying out of a scheme of profit-making. Conversely, an original intention to acquire an asset for the purpose of resale at a profit may be changed into one to hold it as an investment.

§ 268. Isolated transactions

In terms of well-established departmental practice fortified by numerous decisions of the Special Court, it is not an essential requirement that a taxpayer must be carrying on a trade or business in a particular type of asset in order that the proceeds derived from the sale of such an asset can be regarded as income. The frequency of a

[95] See for example *Overseas Trust Corporation, Ltd.* v. *C.I.R.*, 1926 A.D. 444; 2 S.A.T.C. 71; *Bailey* v. *C.I.R.*, 1933 A.D. 204; 6 S.A.T.C. 69; *Lace Proprietary Mines, Ltd.* v. *C.I.R.*, 1938 A.D. 267; 9 S.A.T.C. 349; *Rhodesia Metals, Ltd.* v. *C.O.T.*, 1938 A.D. 282; 9 S.A.T.C. 363; 1940 A.D. 432; 11 S.A.T.C. 244; *Marshall Industrials Ltd.* v. *C.I.R.*, 1951 (3) S.A. 581 (A.D.); 17 S.A.T.C. 378.

[95a] *C.I.R.* v. *Lydenburg Platinum, Ltd.*, 1929 A.D. 137; 4 S.A.T.C. 8; *C.I.R.* v. *Richmond Estates (Pty.), Ltd.*, 1956 (1) S.A. 601 (A.D.); 20 S.A.T.C. 355; *New Mines, Ltd.* v. *C.I.R.*, 1938 A.D. 455; 10 S.A.T.C. 9.

particular transaction may provide a guide in determining whether a transaction is one on capital or revenue account. Yet an isolated transaction not in the ordinary course of the taxpayer's business is not necessarily free from tax. The real test depends upon the intention or motive behind the transaction and whether there is a scheme of profit-making involved.[96] Should a person buy a farm with the intention of reselling it at a profit, any such profit made would be taxable even though such person does not ordinarily carry on a business of buying and selling farms. If a person acquires shares or land for the purpose of resale at a profit, any profits so made are taxable even though he does not carry on any business of trafficking or dealing in shares or land and even though the transaction may be an isolated one. In regard to isolated Stock Exchange transactions, see § 281.

'. . . so far as the question of isolated transactions is concerned, this has been settled by numerous decisions in the Supreme Court and this Court, that if a profit arises out of trading it is taxable notwithstanding the fact that the transaction is an isolated one.'[97]

A single salvage transaction was held to be taxable because the motive was profit-making.[98]

Where a taxpayer, who was the manager of an auctioneering business and as such received a salary and a commission, entered into an agreement with the owner of certain livestock under which the taxpayer and an associate in the venture guaranteed a certain fixed sum to the owner of the livestock in consideration of any surplus over the agreed sum being shared by the taxpayer and his associate, the Court held that the amount accruing to the taxpayer from the venture was not of a capital nature even though the transaction was of an isolated nature.[99]

A speculation in futures was held to be taxable even though of an isolated character.[1]

Options to purchase property acquired with a view to profitable disposal have been held to give rise to income on the sale thereof,[2] though isolated ventures outside the scope of the taxpayer's business.

A profit on the sale of shares in a land company where the taxpayer was neither a dealer in shares nor a speculator in land was held to be taxable even though this was the first transaction of its kind.[3]

A speculative profit resulting from a purchase and sale of gold bullion was held to be taxable even though the transaction was an isolated one.[4]

[96] *Chennels* v. *C.O.T.*, 1936 S.R. 100; 8 S.A.T.C. 181; see also I.T.C. No. 194, 5 S.A.T.C. 373.
[97] I.T.C. No. 382, 9 S.A.T.C. 439, per Dr. Manfred Nathan (President).
[98] *Stephan* v. *C.I.R.*, 1919 W.L.D. 1.
[99] I.T.C. No. 378, 9 S.A.T.C. 336.
[1] I.T.C. No. 43, 2 S.A.T.C. 115.
[2] I.T.C. No. 118, 4 S.A.T.C. 71; I.T.C. No. 120, 4 S.A.T.C. 112; I.T.C. No. 640, 15 S.A.T.C. 229.
[3] I.T.C. No. 598, 14 S.A.T.C. 267.
[4] I.T.C. No. 509, 12 S.A.T.C. 239.

§ 269. Recommendations

The question as to whether the acquisition of an asset for the purpose of sale at a profit does not render the profit income unless the taxpayer is a trader, has not yet been solved by the superior courts. In *C.O.T.* v. *Levy*,[5] the counsel for the taxpayer contended that even where the taxpayer acquires property of some kind for the purpose of resale at a profit, any profit made is not income unless the taxpayer is a trader in that kind of property. For this proposition, counsel relied upon the cases of *Jones* v. *Leeming*[6] and *C.I.R.* v. *Stott.*[7] Schreiner, J.A., who heard the appeal, considered that the argument advanced by counsel raised a very interesting and important issue. Unfortunately, however, the Court did not find it necessary to decide whether the taxpayer's submission was well founded because the appeal by the Commissioner could be disposed of on other grounds.

The question of the taxation of isolated transactions was not dealt with by the Committee of Enquiry into the Income Tax Act but the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland was of the opinion[8] that specific legislative provision should be inserted into the Act to cover the case of an amount received or accrued upon the realization of property not in the course of nor as part of any business carried on by the taxpayer. In the words of the Commission:

> 'The need for such a provision is emphasized by decisions such as *Jones* v. *Leeming*, [1930] A.C. 415 and *C.O.T.* v. *Levy*, 1952 (2) S.A. 413 (A.D.). We consider that if property has been acquired for the purpose of profit-making by way of sale then the proceeds of realization should be regarded as " gross income " and not as a capital receipt or accrual, even though the acquisition and realization be an isolated transaction, cf. *Edwards* v. *Bairstow*, [1955] 3 W.L.R. 410. If a profit-making undertaking or scheme is carried on or carried out the amount received or accrued thereunder is regarded as " gross income " and not as a capital receipt or accrual, even though the undertaking or scheme be an isolated venture. We recommend that section 8 be amended by adding to the specific items included in the definition of "gross income" the amount received or accrued upon such a realization and also for the sake of completeness, the amount received or accrued under such an undertaking or scheme. Precedents are to be found in section 26(*a*) of the Income Tax and Social Services Contribution Assessment Act, 1936-54, of Australia, and in section 88(*c*) of the Land and Income Tax Act, 1954, of New Zealand.'

The Commission's recommendation is worthy of serious consideration for although there are many decisions of the Special Court confirming the taxation of profits derived from isolated transactions, there has so far been no pronouncement from the superior courts on this important issue. As the Commission pointed out, profits from isolated transactions should be taxable. If not, taxpayers would be

[5] 1952 (2) S.A. 413 (A.D.); 18 S.A.T.C. 127.
[6] 1930 A.C. 415.
[7] 1928 A.D. 252; 3 S.A.T.C. 253.
[8] *Report of the Commission of Inquiry*, p. 4, para. 21.

presented with opportunities for avoidance of tax in respect of profits derived from isolated transactions outside the scope of their ordinary business, notwithstanding that they may have been undertaken in pursuance of a profit-making scheme and, therefore, represent income.

IX. Effect of Memorandum and Articles of Association

§ 270. Effect of the court decisions

The memorandum of association may be material in deciding whether a profit is income or capital and thus taxable or not. Apart from this, the form of the company's memorandum is not important.

One of the most important tests laid down by the courts, where the receipt or accrual consists of the realized proceeds of an asset which has been disposed of, is the intention with which the asset was acquired. If in the carrying out of a scheme for profit-making an asset is acquired for the purpose of resale at a profit, the proceeds derived from the sale of such asset constitute revenue derived from capital productively employed to earn such revenue and are of an income nature.[9] On the other hand, if an asset is acquired to produce an income in the form of, say, rent or dividends and not for the purpose of resale at a profit, the proceeds derived from a subsequent disposal of such asset are of a capital nature. It is clear that the application of this test involves a consideration of all the circumstances surrounding the acquisition of and the method of dealing with the particular asset.

Since a company is an artificial person its intention must be taken to be the intentions of its directors acting as such. In the case of a so-called one-man company where one person is the sole beneficial shareholder and controls the company one must regard the mind of the company as being the mind of its sole beneficial shareholder.[10]

A company's intentions must not be confused with its objects clause. If a company has power in its memorandum to undertake a transaction, that does not mean that any profit accruing from such a transaction is subject to tax. The test of intention must be applied. Thus, if by its memorandum a manufacturing company is given power to buy and sell land, it does not follow that a profit on the sale of land is taxable. If it is part of the business of the company to buy and sell land, such profit would be taxable. If the land was originally purchased to hold as a capital asset, its subsequent sale would be a transaction on capital account.[11]

[9] See for example *Overseas Trust Corporation, Ltd.* v. *C.I.R.*, 1926 A.D. 444; 2 S.A.T.C. 71; *Bailey* v. *C.I.R.*, 1933 A.D. 204; 6 S.A.T.C. 69; *Lace Proprietary Mines, Ltd.* v. *C.I.R.*, 1938 A.D. 267; 9 S.A.T.C. 349; *Rhodesia Metals, Ltd.* v. *C.O.T.*, 1938 A.D. 282; 9 S.A.T.C. 363; 1940 A.D. 432; 11 S.A.T.C. 244; *Marshall Industrials, Ltd.* v. *C.I.R.*, 1951 (3) S.A. 581 (A.D.); 17 S.A.T.C. 378.

[10] *C.I.R.* v. *Richmond Estates (Pty.), Ltd.*, 1956 (1) S.A. 601 (A.D.); 20 S.A.T.C. 355; *Yates Investments (Pty.), Ltd.* v. *C.I.R.*, 1956 (1) S.A. 612 (A.D.); 20 S.A.T.C. 368.

[11] I.T.C. No. 668, 16 S.A.T.C. 135; see also I.T.C. No. 87, 3 S.A.T.C. 149.

Where a company carries on business or a profit-making scheme not permitted by its memorandum, the profits accruing are taxable even though the operations carried on are *ultra vires* the objects of the company.[11a]

A company's objects clause is usually drawn up in wide terms since it cannot act beyond the limits laid down in its memorandum:

> 'Every trading company, every company that invests in land in order to mine it, must take to itself the right of selling its land in case of need. In the case of an individual his own will determines what he will do with his property, but in the case of a company the promoters must secure for that company wide powers and extensive objects so as to avoid future difficulties. . . . Suppose that a company is *bona fide* formed for the purpose of mining claims and that it never had any intention to speculate in claims, and owing to adverse circumstances it could not begin mining, can we say that its real and primary object was land speculation merely because one of its objects was to sell its land? . . . You must determine its primary intention from what in the ordinary course it appears to have set out to do, and if you find that it never did speculate in land you cannot say that because it eventually sold its land at an enhanced value, therefore the gain it made was income and not capital.'[12]

If it is not clear from a company's course of dealing what its true intentions are, it is submitted that its objects clause as set out in its memorandum may properly be taken into account together with other evidence in determining whether a transaction is on revenue or capital account.[13]

> 'Where evidence exists *aliunde* in support of the theory that a company is carrying on a certain line of business, then the possession of the powers to do so in its objects clauses may be a material ingredient in support of an affirmative conclusion.'[14]

It has been held that if the primary object of a company can be ascertained from its memorandum, an inference can be drawn that prima facie its subsequent activities are in the fulfilment of that object.

> 'It is, of course, true that the memorandum is not conclusive, for its objects clause sets out what the company may do, not what the company will necessarily do. But it must carry weight in the inquiry particularly when the objects are set out in such a way that it can be gathered what is its primary object and business, and what are its merely ancillary objects. For in the light of the objects clause it may be possible to interpret a transaction or separate transactions and ascertain whether such transactions are more probably than not steps in a scheme of profit-making, rather than a mere change of investment.'[15]

[11a] I.T.C. No. 194, 5 S.A.T.C. 373.

[12] *C.O.T.* v. *Booysen's Estate, Ltd.*, 1918 A.D. 576, per Wessels, J., in the court *a quo*.

[13] See I.T.C. No. 677, 16 S.A.T.C. 245; see also *C.I.R.* v. *Strathmore Exploration & Management, Ltd.*, 1956 (1) S.A. 591 (A.D.); 20 S.A.T.C. 375, and I.T.C. No. 31, 2 S.A.T.C. 52.

[14] I.T.C. No. 596, 14 S.A.T.C. 261, per C. J. Ingram (President).

[15] *Reliance Land & Investment Co. (Pty.), Ltd.* v. *C.I.R.*, 1946 W.L.D. 171; 14 S.A.T.C. 47, per Murray, J. See also I.T.C. No. 612, 14 S.A.T.C. 385.

The authorities, therefore, show that the objects of a company as contained in its memorandum of association are not necessarily decisive on the question whether a receipt or an accrual is income or capital. Although the objects and powers of a company are important factors in the determination of that question, the actual operations or activities of the company must also be taken into account and may be decisive on the question. Both the company's objects and actual operations must, therefore, properly be taken into account. 'In the case of a company the Court had primarily to look at its objects laid down in its constitution, and next at its actual operations.'[16]

In more than one case the court has emphasized that the test whether a company was carrying out a scheme for profit-making is not quite the same as the test in the case of an individual. A company may carry out an isolated transaction as a profit-making scheme whereas it may not be so in the case of an individual so that 'continuity' (as it has been called) is a necessary element in the carrying on of a business in the case of an individual but not of a company.[17]

A company's objects clause may be an important factor in determining whether a company is an investment-dealing or holding company, i.e. whether it holds its investments as stock-in-trade or as fixed capital assets. This was so in the case of the *L.H.C. Corporation of S.A. (Pty.), Ltd.* v. *C.I.R.*,[19] where Schreiner, J.A., held as follows:

> 'By far the most important material that the special court had before it was the company's memorandum of association. As appears from the extracts quoted above the objects of the company were predominantly financial; it was essentially what is called an investment or financial company. There are, no doubt, investment companies the memorandum of which is such that their investments do not constitute their stock-in-trade. Such holding companies are referred to in Simon's *Income Tax* (Vol. 2, secs. 176, 209-10). But in the present case the company was clearly not a holding company but an investment-dealing company such as dealt with in sec. 211 of the same work. It is true that, apart from para. (*f*), which deals with the shares of similar companies in which the company may have become interested, there is not in the objects clause any one paragraph that states as an object the buying and selling of shares, but that this was a principal object appears clearly from the memorandum. The company has the power to buy shares and the power to sell any of its property and to change its investments; and there are no restrictions upon the way in which it may deal with the profits derived from such transactions. It is an investment company in the sense used by the present Chief Justice in the Court below in *Overseas Trust Corporation, Ltd.* v. *Commissioner for Inland Revenue*, 1926 A.D. 444 at 446,[20] that is, a company whose

[16] *C.I.R.* v. *Lydenburg Platinum, Ltd.*, 1929 A.D. 137; 4 S.A.T.C. 8, per Stratford, J.A.

[17] See *Platt* v. *C.I.R.*, 1922 A.D. 42; *Stott's* case (note 7); the *Lydenburg Platinum* case (*supra*); *Yates Investments* case (note 10), and the *Strathmore* case (note 13).

[19] 1950 (4) S.A. 640 (A.D.); 17 S.A.T.C. 125.

[20] 2 S.A.T.C. 71.

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16 *C.I.R.* v. *Lydenburg Platinum, Ltd.*, 1929 A.D. 137; 4 S.A.T.C. 8, per Stratford, J.A.
17 See *Platt* v. *C.I.R.*, 1922 A.D. 42; *Stott's* case (note 7); the *Lydenburg Platinum* case (*supra*); *Yates Investments* case (note 10), and the *Strathmore* case (note 13).
19 1950 (4) S.A. 640 (A.D.); 17 S.A.T.C. 125.
20 2 S.A.T.C. 71.

business it is "to deal in shares at a profit". That may not be the whole of its business but it is at least a principal part of it.

Counsel for the company pointed out that its first object begins with the words, "To acquire and hold for purposes of investment", and there is no doubt that for various reasons it would, like any investor, whether speculative or not, hold shares for longer or shorter periods. But the company is not restricted to holding shares for dividends. "Investment" is often used to include investment for appreciation and the business operations contemplated in the memorandum clearly included the gaining of profit by selling shares at higher prices than were paid for them. It was one of the "appointed means of the company's gains" (see *The Scottish Investment Trust* case, 31 S.L.R. 219 at 221). Apart from the case of companies restricted to holding for dividends, which is not this case, investment or finance companies, when they buy shares, make their profits either by selling or holding, which are "merely alternative methods of dealing with the shares for the purpose of making a profit out of them" (per Solomon, J.A., in the *Overseas Trust Corporation* case (*supra* at 457).'

§ 271. Conclusions

The *L.H.C. Corporation* case clearly shows that in certain cases the company's memorandum may be the most important factor if not the decisive material for determining whether a profit is income or capital. Circumstances may arise whereby it is necessary for a company which had acquired an asset, e.g. land or shares, for investment purposes to dispose of it. The sale may take place soon after the acquisition thus possibly indicating to the Revenue that a profit-making scheme was contemplated rather than an investment. The period of holding may be so short that it may not be easy for the company to discharge the onus falling upon it in terms of section 78 of the Act of showing that the profit is one of a capital nature and, therefore, not taxable. How often has the writer not experienced in cases of this nature that when one turns to the memorandum the dominant object of the company gives it the power to deal or traffic in investments thereby making it virtually impossible for the company to discharge the onus! Where a company acquires assets for investment purposes the memorandum should be such that the investments do not constitute stock-in-trade but fixed capital assets. The company should not have the power to deal or traffic in investments and there should be restrictions upon the way it may deal with any profit derived from the sale of the investments, e.g. the memorandum should provide that such a capital profit must not be distributable by way of dividends (see the remarks of Schreiner, J.A., in the *L.H.C. Corporation* case, *supra*). If this is done, possibly a lot may turn on the form of the company's memorandum in considering the taxability of a profit made on the sale of an asset where the actual operations or activities of the company have not been carried on for a sufficiently long period as to be decisive on the question. At any rate, the company is better equipped to discharge the onus falling on it in terms of section 78. Although the wise course must be to see that the objects are wide enough to cover all the activities it is desired that the company should undertake, if the object is to hold certain assets not for resale but for investment the dominant object should state this intention and not disclose an intention to deal or traffic in such assets as part of a profit-making business.

From the tax point of view, nothing or very little is likely to turn on the form of the company's articles of association. In the United Kingdom, where residence has been adopted as a basis of liability for tax and where there are numerous provisions relating to 'controlled' companies, the Articles may well be of importance in determining the residence of a company or whether it is 'controlled' for the purpose laid down in the taxing Act.

X. Controlled Enterprises Not Dealing at Arm's Length

§ 272. Union and foreign enterprises not dealing at arm's length

A device for the avoidance of tax is where a taxpayer is able to manipulate the affairs of his business in and outside the Union through the creation of separate taxable enterprises in the foreign country with which he is not dealing at arm's length in such a way that profits which are in truth derived from the Union enterprise are diverted to the foreign enterprise so that they accrue from a source outside the Union. In this way, the Union resident is able to shift taxable profits between Union and non-Union enterprises and thus seek the benefit of a lower rate of tax in the foreign country. Effective provisions to counter this type of tax avoidance already exist under the various agreements entered into between the Union and the United Kingdom, the United States of America, Canada, Sweden and the Federation of Rhodesia and Nyasaland. The provisions are usually along the following lines:

'Where —

(*a*) an enterprise of one of the Contracting Governments participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting Government; or

(*b*) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the Contracting Governments and an enterprise of the other Contracting Government; and

(*c*) in either case, conditions are made or imposed between the two enterprises, in their commercial or financial relations, which differ from those which would be made between independent enterprises;

any profits which would but for those conditions have accrued to one of the enterprises but by reason of those conditions have not so accrued may be included in the profits of that enterprise and taxed accordingly.'

There is no reason why these provisions should not be of general application no matter in what country the non-resident enterprise is situated. In this respect, section 19 *bis* already provides the Commissioner with power to amend the price at which any commodity is purchased or sold between controlled enterprises but only for the purpose of giving effect to any double taxation relief agreement with a foreign country. The section reads as follows:

> 'For the purpose of giving effect to any agreement entered into under section *ninety-four*, the Commissioner may, if —
>
> (*a*) any person carrying on business in the Union has purchased any commodity for importation into the Union or has sold any commodity for export from the Union; and
>
> (*b*) such person participates directly or indirectly in the management, control or capital of the business of the buyer or seller of such commodity, as the case may be; or
>
> (*c*) any other person participates directly or indirectly in the management, control or capital of the business both of such first-mentioned person and of such buyer or seller, as the case may be,
>
> determine the taxable income of such first-mentioned person as if such commodity had been purchased or sold, as the case may be, at a price determined in accordance with the provisions of the agreement.'

In the writer's view this provision should be of general application and not only for the purpose of giving effect to the terms of any double taxation agreement.

The Committee of Enquiry into the Income Tax Act referred to a type of contractual arrangement for tax avoidance for which it felt the Act should contain specific provisions, namely an arrangement under which a taxpayer is able to manipulate the affairs of his business through its branches or through persons with whom he is not at arm's length in such a manner that profits which in reality accrue from a Union source are made to appear to have accrued from sources outside the Union. It recommended[21] that the Act be amended so as to provide that, where —

(1) an enterprise participates directly or indirectly in the management, control or capital of another enterprise and one of such enterprises carries on business in the Union and the other outside the Union (the term 'enterprise' for purposes of this section including a company, partnership, trading venture or branch of a business); or

(2) the same persons participate directly or indirectly in the management, control or capital of an enterprise carrying on business in the Union and an enterprise carrying on business outside the Union; and

(3) in either case conditions are imposed between the different enterprises in their commercial or financial relations which differ from those which could reasonably be expected to be made between independent enterprises; and

(4) the conditions so imposed have had the effect of reducing the income subject to Union taxation of any person;

the income of that person and of any other person whose liability for taxation may be affected by such conditions, shall be adjusted for taxation purposes to such amounts as, in the opinion of the Commissioner, they would have

[21] *Second & Final Report*, p. 31, para. 17.

been had such conditions not been imposed and the conditions had obtained which would reasonably be expected to have obtained between persons acting independently and at arm's length. Any decision of the Commissioner in the exercise of his discretion under this section shall be subject to objection and appeal.

Both section 19 *bis* and the Committee's recommendation could be usefully adopted by the Legislature except that since they are designed to prevent tax avoidance, they should only be capable of being invoked by the Commissioner in cases where the dominant purpose of the arrangement is tax avoidance. It should not be applied to *bona fide* commercial transactions unconnected with tax avoidance.

§ 273. UNION ENTERPRISES NOT DEALING AT ARM'S LENGTH

In the writer's view special provisions are also necessary to provide an effective counter to tax avoidance brought about by the process of shifting taxable profits by arranged transactions of purchase and sale as, for example, between one Union company earning large profits and its Union subsidiary company which has an assessed loss or between a Union company and a resident individual. Purchases and sales of commodities may take place at arranged prices so that taxable profits can accrue to one enterprise rather than to another at the expense of the *fiscus*. Section 29(1) of the Income Tax Act of the Federation of Rhodesia and Nyasaland can usefully be adopted to counter the avoidance of tax of this nature between one Union enterprise and another. The section reads as follows:

> 'Where any person carrying on a trade in the Federation purchases any property, whether movable or immovable, from any other person at a price in excess of the fair market price, or where he sells any poperty whether movable or immovable to any other person at a price less than the fair market price, the Commissioner may, for the purpose of determining the taxable income of such first-mentioned person, determine the fair market price at which such purchase or sale shall be taken into his accounts.'

This provision is clearly designed to prevent tax avoidance and the Court will only invoke the section if tax avoidance is present. The section cannot be applied to *bona fide* commercial transactions unconnected with tax avoidance.[22]

Another useful precedent for the effective countering of this type of avoidance device is to be found in section 17(1) and (2) of the Canadian Income Tax Act which reads as follows:

17(1). 'Where a taxpayer carrying on business in Canada has purchased anything from a person with whom he was not dealing at arm's length at a price in excess of the fair market value, the fair market value thereof shall for the purpose of computing the taxpayer's income from the business, be deemed to have been paid or to be payable therefor.

17(2). Where a taxpayer carrying on business in Canada has sold anything to a person with whom he was not dealing at arm's length at a price

[22] *Elite Wholesale (Rhodesia) (Private) Ltd.* v. *C.O.T.*, 1955 (1) S.A. 350 (S.R.); 20 S.A.T.C. 33.

less than the fair market value, the fair market value thereof shall, for the purpose of computing the taxpayer's income from the business, be deemed to have been received or to be receivable therefor.'

The recommendations made by the Committee of Enquiry into the Income Tax Act (*supra*) in regard to Union and foreign enterprises not dealing at arm's length can also be usefully adopted to meet the case of enterprises in the Union not dealing at arm's length. In fact, the Income Tax Commission[23] accepted the Committee's recommendations but considered that it should not be limited to transactions between an enterprise in the Union and an enterprise outside the Union. It should be extended to cover cases where both enterprises are in the Union.

The adoption of provisions such as those set out above will serve as a strong deterrent to Union taxpayers from shifting taxable profits from one source to another.

XI. TRAFFICKING IN ASSESSED LOSSES OF COMPANIES

§ 274. STATUTORY PROVISIONS

Section 90(1)(*b*) has been introduced to prevent a specific scheme of tax avoidance, namely the trafficking in assessed losses of companies. It is provided that —

> 'whenever the Commissioner is satisfied that any agreement or any change in the shareholding in any company, as a direct or indirect result of which income has been received by or has accrued . . . to any company during any year of assessment, has . . . been entered into or effected by any person solely or mainly for the purpose of utilizing any balance of assessed loss incurred by the company, in order to avoid liability on the part of any person for the payment of any tax, duty or levy on income, or to reduce the amount thereof, the set-off of any such balance against any such income may be disallowed.'

The decision of the Commissioner is subject to objection and appeal but whenever it is proved that tax avoidance would result from any such agreement or change in shareholding, the onus of rebutting the presumption that such agreement or change in shareholding was entered into or effected for the purpose of avoiding tax, is upon the taxpayer — section 90(2).

But for the provisions of section 90(1)(*b*), the provisions relating to the deduction of assessed losses of previous years (see section 11(3)) enable a taxpayer to avoid tax by the purchase of a company with a large assessed loss and thereafter transferring a lucrative business or his income-producing assets to the company. The intention behind section 90(1)(*b*) is, therefore, clear, namely that where income is diverted or caused to accrue to a company as a direct or indirect result of any agreement or any change in the shareholding in any company which has been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed

[23] *First & Final Report*, p. 35, para. 65.

loss of the company in order to avoid or reduce taxation, the set-off of the assessed loss against the income must be disallowed. Assuming that the section gives effect to this intention, the following examples attempt to illustrate its likely application in practice:

(1) A is the sole beneficial shareholder of B (Pty.), Ltd. carrying on a business undertaking. The operations were unsuccessful and an assessed loss was incurred. The company now acquires from some independent person a business or other income-producing asset and derives an income from the new venture. The company, it is suggested, is entitled to set off the assessed loss against the income. Section 90(1)(*b*) is not operative. Although there is an agreement as a direct or indirect result of which income accrues to the company, that agreement was not entered into solely or mainly for the purpose of utilizing the company's assessed loss, but for the purpose of earning profits from the new venture.

(2) A carries on a successful business undertaking. For the express purpose of avoiding liability for the payment of tax, he acquires the total share capital in B (Pty.) Ltd. with an assessed loss. Thereafter he sells his existing business to the company which derives an income therefrom. It is suggested that section 90(1)(*b*) is operative. There is an agreement and a change in the shareholding of the company as a result of which income has accrued to the company. The agreement has been entered into and the change in the shareholding effected by A solely for the purpose of utilizing the balance of assessed loss in order to avoid his liability for the payment of tax. The position would not be altered even if A did not transfer the existing business to the company, but simply diverted a portion of the income-producing operations of his own business to B (Pty.) Ltd. The position would, however, be different if B (Pty.) Ltd. conducted trading operations similar to A and if A effected the change in the shareholding for the purpose of developing the business of the company in view of his special knowledge relating to that type of business. If A developed the business of the company in a profitable manner so that income accrued to the company, it is suggested that the provisions of section 90(1)(*b*) would not be operative.

§ 275. Recommendations

So far section 90(1)(*b*) has not received judicial interpretation but there is no doubt that the language of the section is obscure and although the purpose behind the section is clear it is extremely doubtful in view of the principle established in *C.I.R.* v. *King*[24] whether

[24] 1947 (2) S.A. 196 (A.D.); 14 S.A.T.C. 184.

the language used gives effect to the purpose. The correct interpretation may very well be that the section cannot be applied in cases where the company's assessed loss is used as a set-off against income which is in reality the income of the company (*C.I.R.* v. *King*).[24] If this is so, the purpose of the legislator would not have been achieved since taxpayers would be free to alienate income-producing assets to companies with large assessed losses and in this manner avoid the provisions of section 90(1)(*b*).

In Australia and New Zealand there exist specific provisions to deal with the trafficking in assessed losses of companies. Assessed losses of previous years are not deductible if there has been a substantial change in the beneficial ownership of the shares in the company.

The Committee of Enquiry into the Income Tax Act did not criticize section 90(1)(*b*) in any respect and considered that it should be re-enacted in its present form.[25] The Income Tax Commission accepted this recommendation.[26] However, the Commission of Inquiry into the Income Tax Act of the Federation of Rhodesia and Nyasaland expressed the view that the language of section 90(1)(*b*) was 'obscure in the extreme'.[27]

The fact that over all these years there is no reported case on section 90(1)(*b*) may mean that the section is acting as an effective deterrent against the trafficking in assessed losses of companies. On the other hand, it may be evidence that the Department is not applying the section strictly or that taxpayers are in one way or another overcoming the effect of the section. Section 90(1)(*b*) should be amended so as to give proper effect to the intention behind it. Very recently, the Federation of Rhodesia and Nyasaland introduced a measure to prevent the trafficking in assessed losses of companies.[28] It took the form of an amendment to the provisions relating to the deduction of assessed losses (section 13(3)) which is probably a better way of dealing with the problem than the Union method of combining a special provision with the general anti-avoidance provision of section 90(1)(*a*). The Federation provision reads as follows:

> 'If during any year of assessment there is a change in the shareholding of a company with an assessed loss or in the shareholding of any company which directly or indirectly controls any company with an assessed loss and the Commissioner is satisfied that such change has been effected solely or mainly in pursuance of or in connection with any scheme for taking advantage of such assessed loss, no assessed loss incurred prior to that change shall be deductible. . . .
>
> For the purposes of this proviso a company shall be deemed to be controlled by another company if the majority of the voting rights attaching to all classes of its shares are held directly or indirectly by such other company.'

[25] *Second & Final Report*, p. 32, para. 27.
[26] *First & Final Report*, p. 36, para. 67.
[27] *Report of the Commission of Inquiry*, p. 73, para. 364.
[28] Proviso (iv) to sec. 13(3) introduced in 1958.

The decision of the Commissioner is subject to objection and appeal but it is expressly provided that the burden of proof that the change in the shareholding was not effected in pursuance of or in connection with any scheme to take advantage of the assessed loss of the company, shall be upon the company claiming the assessed loss as a deduction.

XII. Foreign Exchange Transactions

§ 276. Exchange profits

Income received or accruing in a foreign currency must be brought to account at its equivalent Union currency at the date of receipt or accrual of the foreign currency. If the equivalent Union currency is remitted by the oversea debtor then the amount received in South African currency is included in the gross income. Thus, if a Union exporter sold goods in the United States on 13th January for $10,000 when the rate of exchange is $2·85 to the £ but the dollars are remitted to the Union by the debtor on 13th March when the rate of exchange is $2·8, the amount to be ultimately included in gross income is the amount actually received and based on the rate of exchange of $2·8. If, instead of the debtor remitting the equivalent Union currency, he makes payment of the dollars into the creditor's banking account kept in the United States and thereafter as a result of a favourable rate of exchange a profit is made on a subsequent conversion of the dollars into pounds, such profit is one of a capital nature.[29] Thus, profits derived owing to fluctuations of exchange when transferring to the Union in the ordinary course of business the proceeds of goods sold in oversea countries would be taxable. Conversely, losses would be allowed.[30]

It has been held that inasmuch as a debt due to a bank on overdraft is of the nature of a loan and therefore a capital liability, any profit made by exchange in discharging a bank overdraft in London was also of a capital nature, but on the other hand a profit made in the discharge of bills given in the course of trading for goods purchased was properly taxable.[31] It has also been held that profits derived from forward purchases of foreign currency in order to safeguard the business against losses are not of a capital nature.[32]

A difficulty arises in cases where the Union exporter has already paid tax on the basis of an accrual of foreign currency converted into the equivalent Union currency at the date of accrual of the foreign currency. If in a later tax year, the oversea debtor remits the equivalent Union currency and the amount so received by the taxpayer is less than the amount on which he has been subjected to tax in the previous tax year when the foreign currency accrued to him, it would seem that there is no machinery in the Income Tax Act

[29] I.T.C. No. 9, 1 S.A.T.C. 58.
[30] I.T.C. No. 114, 4 S.A.T.C. 64.
[31] I.T.C. No. 308, 8 S.A.T.C. 99.
[32] I.T.C. No. 340, 8 S.A.T.C. 362.

whereby the earlier assessment can be reopened so that the taxpayer can receive a refund of the amount of tax overpaid. The assessment was based on the then existing equivalent Union currency of the foreign currency which had accrued to the taxpayer. Moreover, the taxpayer, it is submitted, is not entitled to claim the difference between the accrual and the receipt as an allowable deduction in the year of receipt as no expenditure or loss has actually been incurred in terms of section 11 (2) (*a*). All that has happened is that, as things have turned out, the accrued amount was stated at too high a figure having regard to the amount received. In practice, no doubt, the accountant will effect the adjustment in the year of receipt so that the 'loss' will be written off in that year. The writer has not experienced any case where the Revenue has refused to allow such a loss even though it may not be properly deductible in terms of the Income Tax Act.

In *S.A. Marine Corporation, Ltd.* v. *C.I.R.*,[33] an exchange profit made by a Union shipowning company which carried on business operations both in the Union and through an agent in the United States of America which operations necessitated the constant transmission of moneys to and from America — the conversion of pounds into dollars and of dollars into pounds — was held to be of an income nature and taxable as such.

In this case the taxpayer habitually transmitted dollar sums to its agents in America and as regards the earnings derived from its American trading operations there was at all material times in existence the additional necessity of complying with the Union's Exchange Control Regulations whereunder dollar balances in excess of $100,000 held on the taxpayer's behalf by its agents in America had to be sold to the Union Treasury for Union pounds.

Per Ogilvie Thompson, J.:

> 'Though neither trading in dollars nor, on the facts, designedly operating to make profits consequent upon the devaluation of the pound, appellant was at all material times not merely entitled, but actually obliged, to convert into South African pounds its dollar balances in excess of the figure of $100,000. Indeed, having regard to the Exchange Regulations, the transmission to the Union of such dollar balances was virtually of the essence of appellant's American trading operations. . . . The transmission of moneys to and from America — the conversion of pounds into dollars and of dollars into pounds — is not merely part of appellant's trading structure but is an integral part of appellant's business operations in carrying out a scheme of profit-making: in my judgment such transmissions of money to and from America constitute transactions on revenue account, and exchange profits or losses (as also bank charges) attendant upon such transmissions have a revenue character.'

In *C.I.R.* v. *Brown Bros., Ltd.*,[34] a Union company, in order to swell the working capital of its subsidiary company in America, left

[33] 1955 (1) S.A. 654 (C); 20 S.A.T.C. 15.
[34] 1955 (2) S.A. 165 (T); 20 S.A.T.C. 55.

with this latter company in America certain amounts due to it as a share of commission earned by the subsidiary. The Court held that when this money eventually came to be refunded to the Union company it was paid not as a share of commission earned but as the repayment of a loan so that any exchange increment realized was of a capital nature and not taxable as such.

It is interesting to compare *Brown Bros.'* case with a Special Court case[35] which dealt with somewhat similar facts except that in this latter case the debt for services rendered was not converted into a loan. This case concerned an agent in the Union who during the 1949 tax year was entitled to certain commission in respect of orders booked for American manufacturers. The commission was credited (in dollars) to the taxpayer's account. The amounts so credited were remitted during the 1950 tax year and owing to a favourable rate of exchange, the agent in South Africa derived a profit on the exchange representing the difference between the amount actually received in the 1950 tax year and the amount credited to the agent in the 1949 tax year. The Court held that until the debt was paid, it represented a claim for services rendered and as such it was impressed with an income or revenue nature. If before its value had altered it had been invested on a loan to the principals (as in the *Brown Bros.* case) its character would have been altered and it would have ceased to be income and would have become capital. The Court considered that the enhancement in value was of a revenue nature.

The position may, therefore, be generally stated that exchange profits are taxable if, having regard to the nature of the taxpayer's business and the nature of the exchange transactions which form part of that business, it is directly or sufficiently closely bound up with the income-earning operations.

On the other hand, profits derived from exchange transactions undertaken as part of a scheme of profit-making are clearly taxable in accordance with the general rules.[36]

§ 277. Exchange losses

Expenditure incurred in a foreign currency must be brought to account at its equivalent Union currency at the date the expenditure is incurred, or, if by agreement the price must be converted at a rate of exchange ruling on a certain date, at such stipulated date.[37] When payment takes place and the Union merchant is required to lay out South African currency in order to acquire the foreign currency, he is not entitled to deduct the amount so laid out except to the extent to which it exceeds the amount brought to account as a deduction at the date when the original conversion took place. Thus, if a Union importer bought goods in the United States on 15th May, 1958, for $10,000 when the rate of exchange was $2·85 to the £, he can claim

[35] I.T.C. No. 808, 20 S.A.T.C. 343.
[36] I.T.C. No. 313, 8 S.A.T.C. 157. See, however, I.T.C. No. 314, 8 S.A.T.C. 162.
[37] See I.T.C. No. 300, 8 S.A.T.C. 63.

as a deduction in the 1958 tax year an amount represented by $\frac{\$10,000}{2 \cdot 85} = £3,508$. If the $10,000 is remitted in the 1959 tax year and the importer spends £3,800 South African money to make the remittance, although expenditure totalling £3,800 has been laid out in the 1959 tax year, only £292 is deductible since £3,508 was claimed as a deduction in the 1958 tax year. It is submitted that in the same way as there is a necessary implication in the Act that an amount of income should not be subjected twice to the same tax, so there is a necessary implication that an expenditure cannot be deducted twice in the determination of taxable income. If in the 1959 tax year it costs only £3,200 to purchase $10,000, although the Commissioner insists, in practice, that the difference of £308 be taxed, it is doubtful whether it is taxable in terms of the strict letter of the law. If the correct position is that £3,508 was properly deductible in the 1958 tax year, it is difficult to see how the £308 can be taxable in the 1959 tax year. It has not been received nor has it accrued in that year and it does not appear to be taxable as a recovery or recoupment as envisaged by section 11(4)(*a*) (see § 166).

It is submitted that the principles governing the taxation of profits derived from foreign exchange transactions apply *mutatis mutandis* to losses incurred in connection with exchange transactions. Thus, exchange losses are deductible if, having regard to the nature of the taxpayer's business and the nature of the exchange transactions which form part of that business, they are sufficiently closely bound up with the income-earning operations.

XIII. Capital Profits and Tax Avoidance

§ 278. Introduction

It is beyond the scope of this thesis to discuss the general case for and the arguments against the taxation of capital profits.

The Committee of Enquiry into the Income Tax Act[38] was of the view that the scope of the income tax should not be extended to capital gains generally but the tax should continue to be imposed on any profit resulting from the disposal of assets only where, on the application of the established tests, such profit is not of a capital nature. The Income Tax Commission agreed with this recommendation.[39] An unsatisfactory feature of the present system, however, is that individuals are not required to include details of capital profits in the annual return of income to be rendered by them. The return of income calls only for income receipts and accruals. The effect of permitting the taxpayer to exclude from his return what he considers to be capital profits means that the Commissioner is prevented from examining the nature of the profit and possibly challenging the taxpayer's view of the matter. It is in the taxpayer's interests that

[38] *First Report*, p. 15, para. 35.
[39] *First & Final Report*, p. 5, para. 7.

he should include in his return details of all profits which he considers to be of a capital nature since if he does not do so and subsequently the profit comes to the notice of the Commissioner, who may be of the view that the profit is income, he may be involved not only in the payment of tax on the profit but also in the imposition of penalties in respect of income omitted from a return. For this reason, the recommendation made by the Committee of Enquiry[40] that the taxpayer's return of income should require disclosure of all amounts, in excess of some specified reasonable sum, which the taxpayer has excluded from his gross income, as being of a capital nature, should be welcomed. Unfortunately, the Income Tax Commission rejected this recommendation on the grounds that it was unnecessary since the present Act authorized the Commissioner to call for full details of all amounts, whether of a capital nature or not, received by or accrued to the taxpayer.[41] With respect, the Commission's reasons are not convincing. The extra administrative burden would be considerable if the Commissioner were to call for details of capital profits from every taxpayer. It would be far less cumbersome to call for the information in the annual return of income.

Whatever arguments there may be in favour of the taxation of capital profits, the full significance of the omission of capital gains from the ambit of the Income Tax Act only becomes clear on an appreciation of the extent to which a taxpayer can by manipulation cause the equivalent of his income to be received by himself as a benefit in a non-taxable form, i.e. as a capital accrual. The Income Tax Act offers opportunities for a taxpayer so to arrange his affairs that his rewards take the form of tax-free capital gains rather than taxable income. In many of these cases, it would be impossible to frame anti-avoidance provisions. It is proposed to consider some of these cases in the ensuing paragraphs.

§ 279. Goodwill

Taxation of proceeds

Any amount received in respect of the sale of the goodwill of a business is a receipt of a capital nature and not taxable provided that the seller originally purchased the business in order to derive an income from the carrying on thereof and not for the purpose of resale at a profit. The same remarks apply to the proceeds derived from the sale of trade marks, trade licences and other rights to trade. As long as the goodwill is a fixed amount it partakes of the nature of capital, irrespective of whether it is payable in one sum or in periodical instalments.

Where, however, the consideration for the sale of goodwill takes the form of an annuity, the annual payment is taxable in terms of section 7(*a*) (see § 247).

[40] *First Report*, p. 13, para. 10.
[41] *First & Final Report*, p. 5, para. 5.

A share premium received by a company upon the issue of its shares at a price exceeding the par or nominal value thereof is a receipt of a capital nature and is not taxable.

Where it is clear from the terms of an agreement that a payment is not received for the sale of goodwill out-and-out but merely for the right of use thereof for a certain period on the expiration of which the goodwill is to revert to the owner, then such payment is in the nature of income.[41a]

It may be that the sale price of goodwill is not a fixed amount but is measured by the income or net profit derived by the purchaser from the particular business or asset sold. Thus, X may sell his business to Y, the consideration for the goodwill being 50 per cent of the annual net profits of the business for the five years immediately following the sale of the business. It is submitted that by virtue of such an arrangement the annual payments received by X are in the nature of income. In *Deary* v. *Deputy Commissioner of Inland Revenue*[42] the taxpayer agreed to sell his business to three partners and entered into an agreement with them whereby the partners were to pass a bond in favour of him for the value of the stock, furniture, etc., which bond was to be reduced by yearly payments of a specified amount, which amount might be reduced or increased by him at his discretion. So long as there was any sum of money due under the bond the partners were to pay the taxpayer one-quarter of the net profits of the business for and in consideration of his goodwill. The Court held that the annual payments so received were of an income nature.[43]

In *Jones* v. *I.R.C.*[44] it was stated as follows:

> ' A man may sell his property nakedly for a share of the profits of a business, and if he does that, I think the share of the profits of the business would be undoubtedly the price paid for his property, but still that would be the share of the profits of the business and would bear the character of income in his hands, because that is the nature of it. . . . I therefore think that what one has to do is to look and see what the sum payable really is. . . . Here, when we look at it, I do not think that there is any difficulty in seeing what was intended. The property was sold for a certain sum, and in addition the vendor took an annual sum which was dependent, in effect, on the volume of business done; that is to say, he took something which rose and fell with the chances of the business. I think, when a man does that, he does take an income — that is what it is. It is in the nature of income. . . .'

Where the consideration for the sale of the goodwill of a business is expressed to be a lump sum plus an annual payment representing a share of the net profits, the lump sum is a capital receipt whereas, it is submitted, the annual payments are income.

41a I.T.C. No. 66, 2 S.A.T.C. 259.

42 1920 C.P.D. 541.

43 See also the remarks of Innes, C.J., in *Modderfontein B Gold Mining Co., Ltd.* v. *C.I.R.*, 1923 A.D. 34.

44 [1920] 1 K.B. 711; 7 T.C. 310, per Rowlatt, J.

From the above principles it can thus be deduced that where a taxpayer sells the goodwill for a lump sum it is a capital profit whereas if it is sold for a share of the future profits of the business or in return for an annuity, it is taxable. In practice, goodwill is often determined on the basis of a number of years' purchase of the past average annual net profits. This yardstick for determining the goodwill, i.e. on the basis of past profits, has no bearing on its taxability although it means much for the seller of the business who now receives a lump-sum payment equivalent to a number of years' profit free of tax. For example, if the goodwill is expressed to be five years purchase of the past average annual net profits which are, say, £5,000, making a total tax-free payment of £25,000 this, in effect, is equivalent to a payment subject to tax of £50,000 (assuming the taxpayer has other income and is subject to an average marginal tax rate of 10s. in the £). In other words, if on an annual profit of £5,000, the marginal tax payable is £2,500, it must follow that it would take the taxpayer ten years to accumulate a total sum of £25,000. In addition, the taxpayer is entitled to the benefit of the investment of the purchase price of the goodwill, i.e. the £25,000. Tax-free goodwill payments, therefore, bestow considerable advantages on a taxpayer who may welcome a cash payment free of tax rather than work hard and assume heavy risks and responsibilities in order to obtain the equivalent in, say, six, eight or ten years' time.

Deduction of payments

Any amount paid for the acquisition of the goodwill of a business is expenditure of a capital nature and is not deductible provided, of course, that the business is purchased in order to derive an income therefrom and not for the purpose of resale at a profit. In this latter case the cost of acquisition is properly deductible from the proceeds derived from a resale of the goodwill. The fact that the purchase price is payable in monthly or annual instalments does not affect the position that what is laid out is for the acquisition of a capital asset and is, therefore, of a capital nature.

Where, however, it is clear from the terms of the agreement that annual payments are not made for the out-and-out purchase of the goodwill but merely for the right of use thereof for a certain period on the expiration of which the goodwill is to revert to the owner, then such payments are in the nature of rent and are properly deductible from income.[46]

It may be that the purchase price of goodwill is not a fixed amount but is measured by the income or net profit derived by the purchaser from the particular business or professional practice acquired. Thus, X may purchase a business from Y, the consideration for the goodwill being periodical payments equivalent to 33⅓ per cent of the annual net profits of the business for the ten years immediately following the sale of the business. It is submitted that such an arrangement does not entitle X to deduct the annual payments so

[46] I.T.C. No. 444, 11 S.A.T.C. 81.

made to Y. The true position, it is submitted, is that since the annual payments represent the consideration for the acquisition of a capital asset they partake of the nature of capital expenditure. It has been stated above that in the circumstances described Y would be subject to tax on the annual payments being in the nature of income in his hands. It does not necessarily follow, however, that X is thereby entitled to a deduction in respect thereof. X's tax position can only be determined with reference to the provisions of section 11(2) (*a*) and has no bearing on the method of taxation applicable to Y.

Great care must, therefore, be exercised in ensuring that the purchase price of goodwill is a fixed amount since, if it is measured by periodical payments out of the income or net profit of the business, or, if it takes the form of an annuity, it is taxable in the hands of the recipient but not allowed as a deduction to the payer. This, in effect, means that the same amount is being taxed twice, but as the taxation is in the hands of two different taxpayers, relief from double taxation cannot be obtained (see § 53).

§ 280. Interest

Interest derived from a loan or investment of money or in respect of the outstanding purchase price of goods or some other asset sold, is taxable being consideration received for the use of money or for the provision of credit.

A loan may be made subject to a condition that a fixed larger amount be repaid at a future date in which event the increased sum represents consideration received for the credit given and partakes of the nature of income.[47] In a case where there was no arrangement for the repayment of a loan at a premium, the money having originally been advanced free of interest, and the advance was repaid some years later with an additional amount, it was held that the premium was taxable.[48] In another case, a taxpayer lent money to a company for the purpose of acquiring landed property in consideration for a one-half share of any profits accruing on the resale of the property. The Court held that the consideration accrued to the taxpayer as the result of capital productively employed and was income.[49]

Where loans or debentures are issued at a discount or are repayable at a premium in addition to the periodical interest, in deciding whether the discount or the premium is in the nature of interest all the circumstances must be taken into account. In *Lomax* v. *Peter Dixon & Son, Ltd.*,[49a] Lord Greene, M.R., held as follows:

> ' (1) Where a loan is made at or above such a reasonable commercial rate of interest as is applicable to a reasonably sound security, there is no presumption that a "discount" at which the loan is made or a premium at which it is payable is in the nature of interest. (2) The

[47] I.T.C. No. 244, 6 S.A.T.C. 372.
[48] I.T.C. No. 416, 10 S.A.T.C. 261; see, however, I.T.C. No. 368, 9 S.A.T.C. 211.
[49] I.T.C. No. 165, 5 S.A.T.C. 82.
[49a] [1943] K.B. 671; 25 T.C. 353.

true nature of the "discount" or the premium, as the case may be, is to be ascertained from all the circumstances of the case and, apart from any matter of law which may bear upon the question (such as the interpretation of the contract), will fall to be determined as a matter of fact by the Commissioners. (3) In deciding the true nature of the "discount" or premium, in so far as it is not conclusively determined by the contract, the following matters together with any other relevant circumstances are important to be considered, viz. the term of the loan, the rate of interest expressly stipulated for, the nature of the capital risk, the extent to which, if at all, the parties expressly took or may reasonably be supposed to have taken the capital risk into account in fixing the terms of the contract.'

In practice, the benefit of a premium or discount in respect of loans or debentures is not usually taxed in the hands of ordinary investors who, apart from this benefit, are entitled to a reasonable commercial rate of interest. Dealers in securities are, however, subject to tax on such benefits.

§ 281. Share transactions

It must be emphasized that profits in respect of share transactions do not become taxable only when the frequency and volume of the number of transactions are so great as to constitute the carrying on of a business. Profits resulting from share transactions may be of a revenue nature if the shares were acquired for the purpose of resale at a profit.[50] There is no reason why transactions on the Stock Exchange should be governed by different rules. However, in practice, the Commissioner does not tax isolated transactions by individuals on the Stock Exchange, although where a person regularly or systematically indulges in share transactions the profits are taxable. On the other hand, if shares are acquired not for the purpose of dealing therein but as an income-bearing asset to hold for investment, any subsequent profit realized is on capital account.[51]

In the case of sharedealing companies, i.e. companies whose business it is to buy and sell shares, the Court has held that when they buy shares they make their profits either by selling or holding, which are merely alternative methods of dealing with the shares for the purpose of making a profit out of them.[52] It was not the law that if an investment-dealing company bought shares for a purpose that would probably involve the retention of the shares for even a considerable period the shares are for that reason to be regarded as fixed capital, the enhanced value of which is a capital accrual.[53] There may

[50] *Deceased Estate* v. *C.O.T.*, 1949 (4) S.A. 491 (S.R.); 16 S.A.T.C. 305; *Marshall Industrials, Ltd.* v. *C.I.R.*, 1951 (3) S.A. 581 (A.D.); 17 S.A.T.C. 378; I.T.C. No. 447, 11 S.A.T.C. 92; I.T.C. No. 438, 10 S.A.T.C. 461; I.T.C. No. 598, 14 S.A.T.C. 267; I.T.C. No. 646, 15 S.A.T.C. 346; I.T.C. No. 448, 11 S.A.T.C. 95; I.T.C. No. 31, 2 S.A.T.C. 52.

[51] *C.O.T.* v. *Levy*, 1952 (2) S.A. 413 (A.D.); 18 S.A.T.C. 127. See also *C.I.R.* v. *A. R. Ellis (Pty.), Ltd.* (not reported in S.A. Law Reports), 13 S.A.T.C. 66; I.T.C. No. 683, 16 S.A.T.C. 362; I.T.C. No. 448, 11 S.A.T.C. 95.

[52] *Overseas Trust Corporation, Ltd.* v. *C.I.R.*, 1926 A.D. 444; 2 S.A.T.C. 71.

[53] *L.H.C. Corporation of S.A. (Pty.), Ltd.* v. *C.I.R.*, 1950 (4) S.A. 640 (A.D.); 17 S.A.T.C. 125.

be exceptional cases to this rule, e.g. if it acquired the shares in a company owning a building, in order to use the building as its offices, a profit derived on realization would not attract tax.

On the other hand, an investment-holding company whose memorandum is such that it has not got the power to deal or traffic in shares but is restricted to holding shares for dividends and it is restricted in the way in which it may deal with any profits derived from the sale of any of its investments, is not taxable on profits arising from the sale of any of its investments. Its investments do not constitute its stock-in-trade but represent fixed capital assets. See § 270.

The Commissioner's practice of not taxing isolated transactions by individuals on the Stock Exchange has created a device of tax avoidance with consequential loss of revenue to the Treasury. Although it is not possible to say what proportion of the shares bought on the Stock Exchange are acquired with the object of making a profit on resale as distinct from those purchased for the purpose of earning dividends, it is evident that a substantial proportion of shares are regularly bought with speculation the dominant motive. It is generally accepted by the tax-paying public that the Department does not seek to tax profits derived from Stock Exchange transactions unless a business is carried on. Accordingly, substantial profits resulting from share transactions are not disclosed in the taxpayers' returns and are, therefore, not subject to review by the assessing officers. If they were disclosed, owing to the volume of Stock Exchange transactions, assessing officers would be burdened with a considerable amount of additional work, as taxpayers may have engaged in a number of share transactions some of which were acquired for speculation and others for investment. Thus, a taxpayer may be found to be taxable in respect of the results of some transactions but not in respect of others depending upon the circumstances of each case. It may also be found that in the aggregate more losses on share transactions would have to be allowed as a deduction to taxpayers than the amount of profits taxed in the hands of taxpayers. This may perhaps account for the reason why the Department is reluctant to tax the results of isolated transactions on the Stock Exchange. The Committee of Enquiry into the Income Tax Act[54] referred to the position in the United Kingdom where the difficulties which arise in the Union are not encountered because profits arising from the realization of share investments are only taxable if the taxpayer carries on a trade or business of dealing in shares. It saw no reason why the question should not be dealt with in the same way in South Africa in order to remove the uncertainty which at present surrounds the taxation of profits or losses on share transactions. It is presumed that the test recommended by the Committee would be restricted to share transactions only, for if it were extended to all transactions it would mean that profits in respect of

[54] *First Report*, p. 16, para. 39.

isolated transactions would not be taxable with a resultant loss of revenue to the *fiscus*. See also § 269.

Transactions in the form of shares are often undertaken in order to avoid a taxable profit being made in the hands of the company in which the shares are held. For example, whereas a company may be subject to tax on a profit derived from the sale of a certain asset, e.g. land or shares, it does not necessarily follow that the shareholders in such company will be subject to tax if, instead of letting the company sell the asset at a profit, they sell their shares at a price which takes into account the profit which the company would otherwise have made if it had disposed of the asset. Where the company disposes of the asset, not only is there a problem of possible liability to tax on the profit, but since the profit legally belongs to the company, the shareholders can only obtain the benefit of that profit by a declaration of a dividend which will involve them in a liability for super tax. A transaction in the form of shares may, therefore, cause an amount, which would be taxable in the hands of the company on the sale of its assets, to be received in a non-taxable capital form. This would not be advantageous to the purchasing shareholder who has paid for this expected profit in the purchase price of the shares and who would indirectly have to bear any tax payable by the company when the profit is eventually realized on the disposal of the assets.

Sharedealing companies may be able to avoid the payment of tax on profits derived from share transactions by declaring dividends out of the undistributed profits of controlled companies whose shares they intend selling thereby receiving a reduced price for the sale of the shares. For example, a sharedealing company intends to sell shares in a company whose net assets amount to £100,000 made up of £40,000 share capital and £60,000 undistributed profits. If it paid £50,000 for the shares, it must follow that if the shares are sold for £100,000 a taxable profit of £50,000 will arise. If, prior to the sale, it arranges for the declaration of a dividend of £60,000 out of the undistributed profits and sells the shares for £40,000, it will be able to deduct from its income a loss of £10,000 (the original price of £50,000 *less* £40,000). It is true that although the dividend of £60,000 will not attract any normal or super tax in the hands of the company, it will form part of the distributable income for undistributed profits tax purposes. This procedure may, therefore, create a problem in regard to undistributed profits tax unless the company is one that is exempt from the tax.

§ 282. MINING RIGHTS

The exact nature of mining rights and of so-called leases and tributes of mining rights and claims has been considered in various cases and the decisions are unanimous in laying down that there is a great academic difficulty in finding an appropriate juristic niche for such rights. It is clear that when the owner of a farm or land who acquired it for the purpose of carrying on farming or mining operations disposes out and out of the mineral rights for a lump sum, the amount received partakes of the nature of capital and is not taxable. Where an owner of land permits another to exercise the right to extract, remove and dispose of the minerals in the land for a defined period and not for all time, the question arises whether the consideration received is income or capital. It is submitted that a right to extract and remove minerals is a disposal of portion of the realty, i.e. the land, so that any lump-sum consideration received partakes of the nature of capital.[55] Where, however, the consideration takes the form of periodical rentals, it is submitted that it constitutes income.[56] The writer understands that in practice the Commissioner regards as capital an amount received as consideration for a mining lease where such consideration is in the form of a lump sum. On the other hand, where the consideration is by way of periodical royalty or rental payments, it is regarded as income.

The above cases should be distinguished from the case where a person is not the owner of mineral-bearing land but merely possesses a right to mine or extract minerals on land belonging to others. If instead of exercising this right himself, he permits another to do so, i.e. he leases his right to mine, it is submitted that the essence of the transactions is one of use of a right and is in the nature of a lease, so that whatever is received for the use of such right, whether in the form of a lump sum or periodical rental or royalty payments, is on income account.

It is clear, of course, that when mining rights are acquired for the purpose of resale at a profit, the proceeds derived on a resale partake of the nature of income.[57] Conversely, a sale of mining rights which were originally acquired in order to carry on mining operations is in the nature of a capital transaction.[58]

It must follow from the above principles that if the owner of a property originally acquired as a capital asset, e.g. as a farming property, wishes to avoid tax on the proceeds derived from the mining rights, he should dispose of such rights out and out for a lump sum or, alternatively, he should grant the right to remove the minerals for a fixed period of time in return for a lump-sum consideration. It is submitted that in both cases what he receives is a capital sum and is not taxable as such. If he grants the right to remove the minerals in return for a periodical rental, it is submitted that he is taxable in respect thereof. It, therefore, lies within the power of the taxpayer to decide whether the proceeds derived from mining rights attaching to a capital asset, should be taxable or not.

[55] See I.T.C. No. 429, 10 S.A.T.C. 355; *Sherwood Starr Gold Mining Co., Ltd.* v. *C.O.T.*, 1943 S.R. 23.

[56] *Modderfontein B Gold Mining Co., Ltd.* v. *C.I.R.*, 1923 A.D. 34; I.T.C. No. 652, 15 S.A.T.C. 373.

[57] I.T.C. No. 476, 11 S.A.T.C. 324; I.T.C. No. 336, 8 S.A.T.C. 344; I.T.C. No. 796, 20 S.A.T.C. 209.

[58] *C.O.T.* v. *Booysen's Estate, Ltd.*, 1918 A.D. 576; *C.O.T.* v. *South Deeps, Ltd.*, 1918 A.D. 605; I.T.C. No. 87, 3 S.A.T.C. 149; I.T.C. No. 405, 10 S.A.T.C. 133.

§ 283. Sale of shares in lieu of dividends

A method of obtaining the equivalent of the profits of a company without attracting any liability to super tax is for the shareholder to sell his shares rather than declare a dividend. If a shareholder sells his shares the price he receives will be a capital receipt not subject to tax as long as it is not his business to deal or traffic in shares. Since the price he receives takes into account the undistributed profits of the company, it must follow that the company's profits have been received in a tax-free form. If the purchaser insists that the seller declares all the undistributed profits by way of dividend to himself thereby subjecting him to a heavy super tax liability, it may be possible to do so within the framework of the income tax law without attracting any liability to super tax (see § 28). It must also be mentioned that certain companies are entitled to capitalize their undistributed profits and reserves by the issue of bonus shares which are free of tax in the hands of the shareholders (see § 44).

§ 284. Loans in lieu of dividends

In the case of private companies, it is not an uncommon feature to find that instead of declaring dividends to shareholders they make loans to their shareholders either with or without interest. In this manner shareholders can enjoy the profits earned by their companies without attracting any liability to tax. The matter is dealt with fully in § 34.

§ 285. Sale of the 'fructus' of property acquired by gift or inheritance

A lump-sum payment or an asset received by way of gift, donation or inheritance is in the nature of capital and not taxable. Liability for donations tax may, however, arise on the value of any donation made.

If a donation or inheritance takes the form of an annuity, it is taxable in the hands of the recipient in terms of section 7(*a*) (see § 243).

The proceeds derived from the disposal of an asset received by way of gift or inheritance are of a capital nature[59] unless the asset is sold in pursuance of a profit-making scheme or as part of a business carried on.[60]

If the donated or inherited asset is not sold the proceeds derived from the disposal of the *fructus* of the asset form part of the gross income of the donee or heir even though such income was due wholly

[59] I.T.C. No. 458, 11 S.A.T.C. 178; I.T.C. No. 129, 4 S.A.T.C. 129.

[60] *C.I.R.* v. *Strathmore Exploration & Management, Ltd.*, 1956 (1) S.A. 591 (A.D.); 20 S.A.T.C. 375.

to the efforts of the donor or the deceased. In *Crowe* v. *C.I.R.*,[61] Wessels, J.A., held:

> 'The *fructus* had always been regarded as equivalent to rent or revenue in our law. The *fructus* of houses was rent, of an apple orchard was apples, of a sugar plantation was sugar-cane, and the *fructus* of land with a wattle plantation grown for sale was the wattles when severed from the land.'

Thus, if a person were to donate a matured wattle plantation to another, the proceeds derived from the sale of the *fructus*, i.e. the timber, form part of the gross income of the donee. Similarly, an heir who inherits a farm with a fully grown grape crop hanging on the vines, is subject to tax on the proceeds derived from the sale of the *fructus*, i.e. the grapes, and a legatee who comes into possession of sheep carrying a full growth of wool is taxable on the proceeds derived from the sale of the wool.[62] In all these cases it is not competent for the recipient to claim that the proceeds derived from the sale of the *fructus* represents a disposal of a portion of the capital asset acquired. The true position seems to be that when the timber is felled, the grapes picked and the wool clipped, the proceeds of such *fructus* constitute receipts of a revenue nature and are taxable.

An heir, legatee or donee may, therefore, find himself in a very unfavourable position from the income tax point of view should he receive by way of gift or inheritance a farm with a matured crop or plantation standing thereon. The proceeds derived from the disposal of the *fructus* would be taxable in his hands without any deduction in respect of the value of the standing crop or timber at the date of donation or inheritance.[63] If it is not his intention to carry on farming, he has a remedy since if the donated or inherited asset is sold as it stands, i.e. without removing the *fructus*, the proceeds are derived from the disposal of a capital asset and are not taxable. Instead of being taxable on an income, i.e. the *fructus*, the taxpayer has arranged for it to be received in a tax-free capital gain.

It is only equitable that an heir, legatee or donee should be entitled to deduct from the proceeds derived from the sale of the *fructus* the value thereof at the time of inheritance or donation. Precedent for such a provision is to be found in section 13 (2) (*l*) of the Income Tax Act of the Federation of Rhodesia and Nyasaland although this section is restricted to standing timber only.

It must be emphasized, however, that standing timber sold in the circumstances described can only be taxable if the timber in question can be regarded as the *fructus* of the land. Where the timber consists of pine trees, for example, which do not reproduce themselves when cut down, but die, it cannot be regarded as *fructus* with the result that the disposal of the standing timber is a realization

61 1930 A.D. 122; 4 S.A.T.C. 133.
62 I.T.C. No. 782, 19 S.A.T.C. 410.
63 This follows the principle established in *C.I.R.* v. *George Forest Timber Co., Ltd.*, 1924 A.D. 516; 1 S.A.T.C. 20, and *Baikie* v. *C.I.R.*, 1931 A.D. 496; 5 S.A.T.C. 193.

on capital account. These trees must be clearly distinguished from trees which when cut down grow again from the roots and which fall within the category of *sylva caedua* and must, therefore, be regarded as the *fructus* of the land.[63a]

Where the heir, legatee or donee of a farm with a standing plantation thereon carries on farming, then irrespective of whether or not the trees fall within the category of *sylva caedua*, the proceeds derived from the sale of the timber constitute gross income in terms of para. 19(1) of the Third Schedule. Para. 20(1)(*b*) permits a deduction only in respect of the cost of acquisition of any plantation purchased by a farmer. No deduction is permitted in respect of the value of the standing plantation at the date of inheritance or donation. See § 215.

§ 286. Deposits on containers

It has been held that where commodities and the containers in which they are packed, e.g.. casks, drums, bottles, etc., are sold subject to the payment of a deposit fee in respect of the container in addition to the price of the goods and there is no obligation on the part of the customer to return the container and the deposits are not received in trust by the supplier for its customers but become its absolute property, then the deposit fees must be regarded as gross income of the supplier notwithstanding the fact that there is an undertaking by the supplier to refund the deposit if the container is returned.[64]

It seems clear from the decisions of the court, however, that deposit fees cannot be included in 'gross income' —

(*a*) if the deposits are received by the supplier in trust for his customers, i.e. the supplier has not the right to retain these deposits as his absolute property and be free to mix them with his own money or to use them for any purpose he might deem fit but is under an obligation to keep the deposits in trust, i.e. in a separate banking account controlled by trustees; or

(*b*) if in terms of the contract between the parties a definite obligation is imposed on or undertaken by the customer to return the container and the deposit is a security given to secure performance of such an obligation. In such circumstances it is submitted that the containers would be in the nature of fixed capital assets in the hands of the supplier, so that any deposit received in respect thereof partakes of the nature of a capital receipt.

In this respect it lies within the power of the taxpayer to treat his containers as capital assets so that deposit fees are not taxable.

[63a] I.T.C. No. 596, 14 S.A.T.C. 261.

[64] *Brookes Lemos, Ltd.* v. *C.I.R.*, 1947 (2) S.A. 976 (A.D.); 14 S.A.T.C. 295; *Greases (S.A.), Ltd.* v. *C.I.R.*, 1951 (3) S.A. 518 (A.D.); 17 S.A.T.C. 358; *Pyott Ltd.* v. *C.I.R.*, 1945 A.D. 128; 13 S.A.T.C. 121.

§ 287. SECURITIES SOLD CUM RIGHTS

In the case of securities, e.g. shares, debentures, government stocks, sold with dividend or interest rights, i.e. the purchaser is entitled to receive the forthcoming dividend or interest, the question arises: In whose hands is the income taxable? If the income has already accrued to the seller prior to the sale, it is taxable in his hands. The mere fact that the purchaser will receive it is irrelevant. If the income only accrues after the sale when the buyer is the owner of the security, it is taxable in the buyer's hands. There can be no question of apportioning to the seller the income relating to the period up to the date of sale and to the buyer the income in respect of the period after the date of the sale. The whole income is taxable in the hands of either the seller or buyer whoever is entitled thereto. Thus, if on 1st June, 1958, A sold to B certain Government Stock in respect of which interest is payable on 30th June and 31st December each year, the six months' interest due on 30th June, 1958, is wholly taxable in the hands of B. The interest only accrued on 30th June, 1958, when B was entitled to receive it. The mere fact that A held the stock for five out of the six months is irrelevant. The true position is that on 1st June, 1958, there was no accrual of any portion of the interest. Thus, from the income tax point of view an apportionment of the interest between A and B is not permissible. Even if the proceeds received by A included an amount for the right to the five months' interest, such amount is not taxable in his hands, since the full amount realized is capital in his hands unless he is a dealer in securities.

If, on 10th June, 1958, C sold shares to D in respect of which a dividend was declared on 15th May, 1958, payable to shareholders registered on 1st June, 1958, and payment was to be made on 25th June, 1958, it is submitted that the dividend is taxable in the hands of C. The date of accrual of the dividend is 1st June, 1958, at which date C was the beneficial shareholder (see § 236). Thus, even if the shares were sold *cum* dividend, i.e. it was part of the contract that D was to receive the dividend, C is the party who is subject to tax in respect thereof. He merely disposed of the dividend after it had accrued to him.

When, therefore, securities are purchased and sold *cum* dividend or *cum* interest, the dividend or interest must be included in the gross income of the party to whom it accrues in terms of the Income Tax Act. As shown above, this is not necessarily the party who is entitled to the benefit of the dividend in terms of the contract of purchase and sale of the shares.

Thus, by selling his securities *cum* dividend a taxpayer can cause the equivalent of his income to be received by himself as a benefit in a non-taxable form, i.e. as a capital profit. A disadvantage of selling the securities in this manner is that the taxpayer may deprive himself of a lucrative income-bearing asset which he may not wish to dispose of. Where the securities are quoted on a stock exchange the taxpayer could sell them *cum* dividend, thereby causing the equivalent of the dividend to be received in the form of a capital profit. Thereafter, he could re-purchase the same securities *ex* dividend. It is doubtful whether this procedure will be advantageous at all since a sale and a re-purchase of the securities will involve the double payment of brokerage and marketable securities tax which may extinguish the benefit derived from the avoidance of super tax on the dividend. This may perhaps account for the reason why these 'bond-washing' expedients are not carried out on any large scale in South Africa where the maximum rate of super tax, being some 8*s*. 6*d*. in the £, is not high enough to encourage the adoption of this device. In the United Kingdom, this form of avoidance was met by section 203 of the Income Tax Act, 1952, which provides that where the owner of any securities agrees to sell or transfer them and by the same or any collateral agreement agrees to buy them back, then if the result of the transaction is that any interest payable on the securities is receivable by some person other than by the owner, such interest shall be deemed to be the income of the owner.

§ 288. Betting, gambling and racing activities

The case of *Morrison* v. *C.I.R.*[65] is authority for the taxing of gains made from betting and gambling on the part of any person who systematically carries on these activities. The Court considered that once it is conceded that the bookmaker must be taxed on his gains it becomes difficult to exclude the systematic punter and concluded that no rule exists that a bookmaker's activities constituted the carrying on of a trade or business while those of a punter do not. The question has to be decided on the facts of each case. In practice, the Commissioner taxes the results of betting transactions where systematically carried on. Amounts derived by racehorse owners and trainers are subject to tax where the betting is made a regular practice.[66] In one case, the Special Court held that because a person made his livelihood from betting and gambling, he was liable to tax thereon.[67] In another case, a book-keeper conducted betting transactions on such a scale that the Special Court concluded that it had become the taxpayer's intention to make his occupation as a punter on the racecourse so that his betting winnings were taxable.[68] In practice, bookmakers and others who are subject to tax on the proceeds of regular betting, are taxable on lottery or sweepstake wins. Losses are accordingly allowable.

It must be accepted that from time to time there is a substantial amount of betting and gambling winnings accruing to individuals from bets on horse racing, winnings from cards and games and other speculations. Although a fair portion of such gambling is pursued as a form of amusement, excitement or entertainment, there can be little doubt that a substantial portion of the various forms of betting and gambling are pursued as a scheme to make profit and should,

[65] 1950 (2) S.A. 449 (A.D.); 16 S.A.T.C. 377.
[66] See I.T.C. No. 712, 17 S.A.T.C. 335.
[67] I.T.C. No. 556, 13 S.A.T.C. 294.
[68] I.T.C. No. 765, 19 S.A.T.C. 198.

therefore, strictly speaking be taxed under an Income Tax Act which embraces all receipts and accruals other than those of a capital nature, irrespective of whether they flow from a trade or not. Notwithstanding the law, it is not the policy of the Department to tax betting and gambling winnings except in the case of bookmakers and those persons who systematically and regularly pursue betting and gambling activities. As a result of this policy, it is probable that substantial sums of betting and gambling wins are not disclosed in the income tax returns of taxpayers. On the other hand, it must not be overlooked that if betting and gambling winnings are to be generally taxed, their losses must be allowed. Bearing in mind that professional bookmakers more often than not do make a living out of their calling, it is not unreasonable to suggest that the losses suffered by the community must be substantial and this no doubt accounts for the reason why the Department is so reluctant to tax betting and gambling winnings more generally. Another practical consideration is that if profits are to be taxed and losses allowed there must be the means of obtaining the necessary information so that there can be a proper ascertainment by assessing officers of gain and deficits. This will be exceedingly difficult in practice as the majority of people who indulge in gambling are not likely to keep any accurate record of their activities due to the often unusual circumstances in which many of these operations or transactions take place. All in all, the Department is probably wise by refraining from taxing the results of betting and gambling except where regularly practised even though there may be taxpayers obtaining the benefit of tax-free gains which should be subject to tax at possibly high marginal rates.

Racing stakes won by racehorse owners are, in practice, taxable if the activities carried on can be regarded as the carrying on of a trade or business. This is difficult to justify for the Act does not lay down that the carrying on of a trade or business is a requisite for the taxation of income. The result of the present practice has meant that certain racehorse owners with a small number of horses fall outside the taxation net, not because it is established that there is no profit-making scheme in the conduct of the business, but simply on account of the fact that the operations involve the racing of only a few horses. It is only correct that if a horse is professionally trained and run for the purpose of winning a stake, the operation falls within the taxation net irrespective of the number of horses owned by the taxpayer. In one case, the Special Court refused to accept a taxpayer's contention that his receipts from stakes for racing horses did not constitute income because he did not carry on racing as a business but as a hobby.[69]

§ 289. Damages and compensation

General principles

An amount received by way of damages or compensation for the loss, surrender or sterilization of a fixed capital asset or a tax-

[69] I.T.C. No. 641, 15 S.A.T.C. 233. See also I.T.C. No. 712, 17 S.A.T.C. 335.

payer's income-producing machine is a receipt of a capital nature.[70] On the other hand, where the damages or compensation are paid to compensate a taxpayer for loss of profits which he otherwise might have earned and are not in respect of the deprivation of any portion of his capital assets, they are of an income nature. A useful test which may be applied is whether the damages or compensation have been paid to fill a hole in the profits of a taxpayer or whether to fill a hole in his fixed capital assets.[71] In the former case the damages will generally be regarded as income whereas in the latter case the damages will partake of the nature of capital. Thus, compensation received by a cane-grower for the destruction of sugar-cane and loss of future crops on leasing its canefield to a Government body in order to avoid expropriation, was held to be of a capital nature since, having regard to the true nature of a canefield in the economy of a cane-grower, the amounts paid in respect of the destruction of the sugar-cane constituted compensation for the loss of portion of the taxpayer's income-producing machine.[72]

Examples of compensatory payments and their taxability

Payments received in respect of a restraint of trade, e.g. where a person undertakes not to exercise a trade, profession or occupation, etc., in a specified area for a defined period of time in return for some compensation, are in the nature of capital since they represent compensation received for the surrender or sterilization of a capital asset. Thus it has been held that a consideration received by a garage proprietor from an oil company for undertaking to become a one-brand petrol station, i.e. to sell only the products of the oil company, is a capital receipt. The Court considered that a garage proprietor's right to deal in such brands of products as he desired constituted part of his machinery for producing income, i.e. it formed part of his capital assets.[73] On the same principle, payments received by a taxpayer from a competitor for agreeing to close down a branch of his business were held to be of a capital nature.[74]

An amount received by an agent for the cancellation of an agency agreement has been held to be of an income nature, being compensation for loss of profits.[75]

Compensation paid by a lessee of premises for the cancellation of a lease was held to be of an income nature in the hands of the landlord.[76] On the other hand, a payment made by a lessor to a lessee for a surrender of the latter's rights in the lease was held to be of a capital nature in the hands of the lessee.[77]

An amount received by way of damages is income if the transaction out of which the claim for damages arose is one which, had it

[70] *Glenboig Union Fireclay Co., Ltd.* v. *I.R.C.*, 1921 S.C. 400; 12 T.C. 427.
[71] *Burmah Steamship Co., Ltd.* v. *I.R.C.*, 1931 S.C. 156; 16 T.C. 67.
[72] *C.I.R.* v. *Illovo Sugar Estates, Ltd.*, 1951 (1) S.A. 306 (N); 17 S.A.T.C. 387.
[73] I.T.C. No. 772, 19 S.A.T.C. 301.
[74] I.T.C. No. 254, 7 S.A.T.C. 56.
[75] *Verrinder Ltd.* v. *C.I.R.*, 1949 (2) S.A. 147 (T); 16 S.A.T.C. 48; I.T.C. No. 333, 8 S.A.T.C. 333; I.T.C. No. 527, 12 S.A.T.C. 430.
[76] I.T.C. No. 312, 8 S.A.T.C. 154.
[77] I.T.C. No. 175, 5 S.A.T.C. 180.

been completed, would have resulted in an income and not in a capital gain or loss.[78] Thus, damages received by a trader or manufacturer from a supplier for agreeing to the cancellation of a contract of purchase of goods to be supplied are of an income nature.[79] On the other hand, damages received by a taxpayer for agreeing to the cancellation of a contract of sale of his private residence or other capital asset partake of the nature of capital.

Damages received for personal injury or for libel or some similar cause of action are of a capital nature.

Compensation received from an insurance company by a trader for the destruction of trading stock due to fire or shipwreck at sea is of an income nature.[80] Amounts received in respect of the destruction of plant or other capital assets are, however, of a capital nature, but compensation received from an insurer in respect of a loss of profits insurance policy is of an income nature.[81]

Conclusions

The dividing line for the taxation or non-taxation of damages and compensation is sometimes drawn very finely indeed, and no hard and fast rule can be deduced as to whether compensation received is taxable or not. There will have to be taken into account, the nature of the taxpayer's business, the nature of the compensation received, the purpose of the compensation and generally the circumstances surrounding its payment. This approach is implicit in the reasoning of Lord Clyde in *Burmah Steamship Co.* v. *I.R.C.*[82] — a case in which a steamship company received compensation from certain ship repairers who failed to make timeous delivery of one of the company's vessels sent to it for an overhaul.

> 'Now in the present case, the injury inflicted on the appellant by the repairer's failure to make timeous delivery of the vessel is obviously not an injury to the appellant's capital assets. Time sounds in money, no doubt, but the loss to the appellant by the late delivery was in the form of the loss of trading opportunities, not in the form of the loss of fixed capital. The appellant got full value for his half of £60,543; his only complaint was that he got it late, and could not begin trading with the vessel as soon as he was entitled to expect.
>
> It is true that the measure by which the amount of damages or compensation is ascertainable is no criterion of the capital or revenue character of the sum recovered for the purpose of adjusting an Income Tax account of profits and gains (*Glenboig Union Fireclay Coy.* v. *Inland Revenue*,[83] 1921 S.C. 400; 1922 S.C. (H.L.) 112). But, as the case just referred to shows, it is very relevant to enquire whether the thing in respect of which the taxpayer has recovered damages or compensation is deprivation of one of the capital assets of his trading enterprise or — short of that — a mere restriction of his trading opportunities. In the *Glenboig* case, the trader was irretrievably deprived of the fireclay leasehold (or a material part thereof) which was one of

78 I.T.C. No. 723, 17 S.A.T.C. 496.
79 I.T.C. No. 3, 1 S.A.T.C. 50.
80 I.T.C. No. 3, 1 S.A.T.C. 50.
81 I.T.C. No. 594, 14 S.A.T.C. 249; I.T.C. No. 597, 14 S.A.T.C. 264.
82 1931 S.C. 156; 16 T.C. 67.
83 12 T.C. 427.

the most important and essential of his capital assets, and the fact that the compensation paid him was measured by the profit capable of being made out of it — wasting asset as it was — was held to be ineffectual to countervail the fact that the injury done to him was in respect of a capital asset. Suppose the Glenboig Company had not been subject to statutory interference under the Railway Acts, but that someone — say the owner of the surface — had wrongfully interdicted them from working a particular part of their field. The damages recoverable in that case on the withdrawal of the interdict would, I think, be profit, because the damage done by the interdict was to the trade in fireclay goods during the subsistence of the interdict, and not to the clayfield as a capital asset, which remained neither more nor less valuable than before the interdict was laid on. In the present case there can be no doubt that, when the appellant entered into the contract with the repairers, the consequences of a failure by the latter to deliver punctually, which were in the contemplation of both parties at the time, were that the appellant would be deprived of the opportunity of putting the vessel to immediate profitable use in his business. It was in respect of this deprivation that the damages were recovered. The contemplated " hole " in the appellant's profits was unfortunately made, and in my opinion the damages recovered must go, as a matter of sound commercial accounting, to fill that " hole ", and therefore constitute a proper item of profit in the appellant's profit and loss account.'

In certain cases, the taxation of compensation may be avoided by changing the agreement in such a way that the compensation constitutes a consideration for the grant of a restrictive covenant. For example, whereas compensation received by an agent for the cancellation of an agency agreement is taxable, compensation received by him for agreeing not to exercise his occupation with respect to certain commodities in a defined area would be of a capital nature and not taxable. To take another example, the benefit received by a garage proprietor from an oil company in respect of a reduction in the price of petrol and oil because of an undertaking to become a one-brand petrol station is, it is submitted, taxable since the garage proprietor can now only claim the deduction of the reduced amount payable for his petrol and oil. On the other hand, had he merely received a cash payment not connected with petrol and oil purchases, the compensation so received would be of a capital nature and this would be the case even if the payment is liquidated in periodical instalments.[84] Where the consideration for a ' tie ' agreement consists of a contribution of, say, £2,000 towards certain repairs to premises owned by the dealer and undertaken by him, if the dealer incurs the expenditure on the repairs it is deductible in terms of section 11 (2) (*c*), but the contribution made by the oil company must, in terms of section 11 (4) (*a*), be regarded as a taxable recoupment. On the other hand, if the dealer merely received a cash sum of £2,000 in consideration of the ' tie ', this would not be taxable. It will be seen, therefore, that in these cases a taxpayer may cause the equivalent of what would otherwise be a taxable benefit to be received in a non-taxable form, i.e. as a capital accrual.

[84] I.T.C. No. 772, 19 S.A.T.C. 301.

XIV. Profits Prior to Incorporation

§ 290. General Principles

What happens to income after it has been received by or accrued to a taxpayer is of no consequence to the tax gatherer. From the income tax point of view, once profits have accrued to and vest in a taxpayer, they cannot be sold or transferred to another person so that such person is now subject to tax in respect thereof.[85] The question of disposal of profits frequently arises in the case of a sale of a business during a tax year where the vendor sells to the purchaser the benefit of all the profits earned from the previous financial year-end. For example, the owner of a business whose financial year ends on 31st March might sell the business on 29th December following including the right to the profits as from the previous 1st April. It is clear, however, that the income earned from 1st April to 29th December has vested in the vendor, and he is liable to tax thereon. The sale of the income to the purchaser cannot alter the vendor's liability for tax. Similarly, where a company is formed on 25th October, and on 28th November purchases a business with the benefit of all profits as from the previous 1st July, the vendor will be assessable on the profits earned from 1st July to 28th November.[86]

On the same principle it must follow that profits earned prior to the incorporation of a company but enjoyed by it in terms of a pre-incorporation contract, are not taxable in the hands of the company. They are taxable in the hands of the vendor. Conversely, losses incurred prior to incorporation are allowable for tax purposes to the vendors of the business and not to the company. This principle applies even though the vendors have sold their business to the company under a contract entered into prior to the incorporation of the company.

§ 291. Effect of the provisions of the companies act

Section 71 of the Companies Act (Act 46 of 1926) provides that an agent or trustee can validly enter into a contract on behalf of a company not yet incorporated provided that the contract is in writing and the memorandum contains as one of the objects of the company the adoption or ratification of or the acquisition of rights and obligations in respect of such contract. Upon incorporation, such contract may be adopted and enforced by the company as if it had been duly incorporated at the time when the contract was made. For example, Mr. X professing to act as trustee for a company to be formed (X (Pty.) Ltd.) purchases a business from Mr. Y in terms of a pre-incorporation contract dated 30th September, 1958. The company is entitled to the benefit of all profits as from 1st July,

[85] *Hiddingh* v. *C.I.R.*, 1941 A.D. 111; 11 S.A.T.C. 205; see also I.T.C. No. 350, 9 S.A.T.C. 69.
[86] I.T.C. No. 209, 6 S.A.T.C. 57.

1958. The company is incorporated on 1st November, 1958, but in terms of its memorandum only ratifies the contract on 1st December, 1958. It is submitted that the profits derived from Mr. Y's business during the period 1st July, 1958, to 1st December, 1958, are taxable in the hands of Mr. Y and not in the hands of X (Pty.) Ltd.

The effect of a pre-incorporation contract under section 71 of the Companies Act is that should the company fail to adopt or ratify the contract after incorporation, it cannot be enforced against the company. In effect, the contract gives the company an option of adopting it within a reasonable time after incorporation but the company is under no obligation to do so.[87] It must follow, therefore, that until a company adopts a pre-incorporation contract for the purchase and sale of a business, the profits derived from such business are taxable in the hands of the vendors and any losses incurred must be allowable to them. It is, therefore, not the date of incorporation which determines the date from which the company is taxable on the profits but it is the date when the company adopts or ratifies the contract which is the determining factor. Attention must also be drawn to section 84(3) of the Companies Act which provides that any contract made by a company before the date on which it is entitled to commence business shall be provisional only and shall not be binding on the company until that date. In terms of section 84(1), a public company may not commence business unless it has complied with certain requirements and the Registrar has certified that it is entitled to commence business. A private company, on the other hand, may commence business immediately on incorporation (section 84(6)). Thus, in the case of a public company, the earliest date on which it can ratify a pre-incorporation contract is the date on which it is entitled to commence business. Accordingly, in terms of the principles discussed above, the profits earned up to the date of the commencement of business are taxable in the hands of the vendor assuming that the contract is ratified on such date. If the contract is ratified at a later date the profits earned up to the date of ratification are taxable in the hands of the vendor.

On the other hand, since a private company may commence business immediately on incorporation, should it ratify the contract on the date of incorporation, the profits earned up to the date of incorporation are taxable in the hands of the vendors. If the contract is ratified at a later date, the profits earned up to the date of ratification are then taxable in the vendor's hands.

XV. Taxation of Payments Received in Advance

§ 292. Introduction

A serious criticism of the current taxation legislation in force in the Union is the disparity that exists between the determination of profits based on sound accountancy and business principles and what

[87] *Peake Lode Gold Mining Co., Ltd.* v. *Union Government*, 1932 T.P.D. 48.

the Income Tax Act regards as the income subject to tax, i.e. the *taxable income*. From the trend of the various decisions of the courts in recent years it seems that whereas the definition of *gross income* is being accorded a very wide interpretation to include just about every type of receipt or accrual from Union sources other than capital receipts or accruals, the general deduction formula contained in section 11 (2) (*a*) and section 12 (*g*) has been interpreted by the courts in a way which bears little resemblance to the accountant's or business man's concept of deductible business expenses. The disparity between the accountant's idea of taxable profits and what the tax legislator calls the taxable income is invariably to the detriment of the taxpayer.

In terms of the South African Income Tax Act an assessment is made by taking under the name of 'gross income' all amounts whether in cash or otherwise received by or accrued to a person excluding receipts or accruals of a capital nature from any source within the Union or deemed to be within the Union. In addition certain receipts or accruals of a capital nature are specifically required to be included in the gross income. From the 'gross income' deductions are to be made in respect of receipts or accruals that are expressly stated to be exempt from tax and so one arrives at what is referred to as the 'income'. From the 'income' only such deductions in respect of expenditure incurred must be made as the statute permits in order to arrive at the *taxable income*.

The definition of 'gross income' is exceedingly wide. Neither the word *profit* nor the word *income* is specifically mentioned in it; it includes every single receipt or accrual of a taxpayer excluding only capital receipts or accruals. It does not appear to be a requirement of the definition that the receipt or accrual must in effect form part of the computation of the annual profits of the trade which are earned or ascertained in the tax year in question. As long as there is an amount that has been received or accrued it falls into the gross income of the year, whether earned or not in that year, unless, of course, it is of a capital nature. The trend of certain decisions of the Special Court appears to move in this direction as shown by the following cases:

§ 293. Case law

One case,[88] decided in 1949, concerned a company which carried on the business of poultry-farming, hatching and supplying day-old chicks to its customers in terms of a contract embodied in a printed form in which the following conditions, *inter alia*, appeared:

1. Payment was to be made in advance before any order was executed.
2. No guarantee was given as to the date of delivery, or as to the condition of goods on arrival at destination, and the seller would not be liable if delivery was made late, or for failure to deliver, or if the goods did not arrive in good order and condition. Full refund was to be made for non-delivery or part-delivery.
3. The order was not subject to cancellation.

[88] I.T.C. No. 675, 16 S.A.T.C. 238.

The accounting procedure adopted by the company on receipt of a deposit was to credit the individual customer concerned in its books. Amounts received in respect of chicks were, therefore, not credited to sales until the chicks were dispatched when the personal account of the customer was debited with the full amount of the order as against the amount already credited to him. The balance sheets of the company as at 30th June of the years in question disclosed as liabilities the deposits received against poultry to be supplied. The Commissioner included these amounts in the taxable income of the company for the years in question. Objection and appeal were lodged by the company on the grounds that no income accrued to it in respect of the amounts concerned until the orders were supplied and the chicks were delivered.

The Special Court held that although the deposits were in the first place credited to the customers concerned and not to *sales* till delivery took place, they were merged in the general funds of the company. They were not credited to a separate trust fund. The company could utilize them in its business as it pleased. There was no evidence that the customers regarded the payments made by them as paid to the company to be held by it in trust in case the company did not exercise its option. On these facts the customers were merely concurrent creditors of the company. Accordingly, the Special Court found that the amount of the deposits were properly included in the gross income of the company for the years in which the deposits were received. The learned President held that ' there can be little doubt that, viewing the matter from the aspect of a correct computation of the profits made by the taxpayer, the conclusion arrived at must be regarded as repugnant to correct accounting principles but the answer is that an Income Tax Act has laid down what is to be taxed even if in so doing it may be said to disregard those principles '.

In a later case,[89] decided by the Cape Income Tax Special Court, an appellant carried on the business of an undertaker and also conducted a funeral insurance business. In addition he conducted what was known as a Prepaid Funerals Scheme. Under the Prepaid Funerals Scheme contracts were entered into with persons who were over the age limit for acceptance in the funeral insurance fund under which the appellant agreed, in consideration of a monthly contribution of 2*s*. 6*d*., to provide on the death of the contributor a funeral to the value of £10. It was a condition of the contract that should the amount of £10 not be fully paid at the time the funeral was required, the balance due became payable before the funeral would be provided. It was also provided that in the event of failure to pay any monthly contribution within 90 days, the obligation to provide the funeral would fall away and any previous payments made would be forfeited.

During the year of assessment under review, instalments to an amount of £225 were received by the appellant from contributors under the scheme, funerals to a cost of £100 were provided and

[89] I.T.C. No. 707, 17 S.A.T.C. 224.

refunds to an amount of £20 were made by the appellant to contributors.

The difference between the gross amount so received by the appellant and the cost of the funerals provided together with the amounts refunded, viz. £105, was included by the Commissioner for Inland Revenue in his determination of the taxable income of the appellant for the year of assessment.

Objection was lodged against the inclusion of the sum of £105 in question in the appellant's taxable income, it being contended that the payments received in respect of the prepaid funerals were only taxable in the hands of the appellant when in fact the service was provided. The Special Court held that the amounts received by the appellant constituted receipts of a business venture consisting of the receiving of payments in advance for a funeral to be supplied at a later date, and as such constituted a revenue and not a capital accrual.

Herbstein, J., in giving the decision of the Court, stated:

> 'As we view this matter the position is a very simple one. The appellant was engaged on a business venture. He carried on that business in a number of different ways. The one we are concerned with consisted, simply stated, in receiving payments in advance for a funeral to be supplied at a later date. Section 7 of the Act provides that gross income means " the total amount whether in cash or otherwise received by or accrued to or in favour of any person, excluding such receipts or accruals of a capital nature as are not receipts or accruals referred to in paragraphs (*a*) to (*h*) hereunder, in any year or period assessable under this Chapter from any source within the Union or deemed to be within the Union".
>
> 'It is clear that the amount of £225 was the total amount (less commissions) of advance payments and that they constituted actual cash received by the appellant. This amount was received in connection with an ordinary business activity. . . . We have no doubt that it was not a capital accrual at all. It constituted an ordinary revenue income of this business and the manner in which it was dealt with, as detailed by appellant in his evidence, strengthens this view. This money went into his ordinary business accounts; it was not put into a trust fund, but it was used by him in the ordinary course of his business. Portion of it may have been invested. If that were so then the interest on those investments accrued to him. If it was not so invested then it was used to finance the running of the business. It is correct that there always existed in respect of the money so collected for these prepaid funerals a contingent liability in respect of the funerals which had to be provided, but the accounts which the appellant has submitted show that the cost of funerals provided in any particular year were set off against the particular collections of that year. If the cost of the funerals was an ordinary expense of the business and not a loss of capital then it is impossible to hold that the income was not ordinary revenue. . . . The evidence is clear that at no stage were the "advance payments" placed in any special account. Appellant at all material times dealt with the moneys received under those particular contracts as his own moneys. In the circumstances it is impossible to hold that he has discharged the onus of proving that such moneys were receipts of a capital nature.'

A further interesting case,[89a] decided by the Natal Income Tax Special Court, concerned a company which 'carried on the business of technical consultants and advisers in connection with the erection, construction, maintenance and operation of machinery and plant of all kinds'.

During the year of assessment under review the appellant company received a payment of £12,500, satisfied by the issue of 12,500 fully paid-up shares of a nominal value of £1 each in a company to which the appellant company had rendered technical services in consideration of:

(*a*) services rendered during the year of assessment in supervising the erection of a factory and the installation of plant therein for the company by which the payment was made; and

(*b*) an undertaking by the appellant company to continue to render services of a technical and advisory nature for a further period, amounting in all and inclusive of the period of erection of the factory, to ten years.

The appellant company included in its profit and loss account for the year of assessment a sum of £1,014, being a proportion of the total amount of £12,500, represented by shares, received by it.

The Commissioner for Inland Revenue in his determination of the taxable income of the appellant company included the whole of the amount of £12,500. Objection was lodged against the Commissioner's assessment and on appeal to the Special Court it was held that as the sum of £12,500 was not of a capital nature and was received by the appellant company during the year of assessment, it was properly included in the taxable income of appellant company for that year.

§ 294. Conclusions

In spite of these decided cases, the writer has experienced that taxpayers are in many instances only assessed to tax on advance payments or deposits as and when they arise as income. Thus in the case of rentals received in advance by a property owner, it is usual for the taxpayer to include in his tax returns only such portion of the receipts as can properly be regarded as income for the year. Similarly, advance payments or deposits received in respect of goods to be delivered or services to be rendered in a later year are usually returned in the years in which the orders are executed or the services performed. This procedure accords with well-established accountancy practice although it may not be correct law.

Advance payments received in the circumstances described above must be distinguished from cases where the payment is in truth in the nature of a loan as between the parties and not an advance payment

[89a] I.T.C. No. 702, 17 S.A.T.C. 206.

in terms of a contract of sale or service. For example, an employer may advance money to an employee payment to be made by a set-off of the monthly salary due to the employee. The amount received is in the nature of a loan and is on capital account. Similarly, advances made to a commission agent against commission still to be earned are capital receipts in his hands. Payments received in advance by farmers and others from a co-operative society or an agent in respect of goods delivered for sale on behalf of the supplier, are in the nature of loans and constitute capital receipts in the hands of the suppliers even though such amounts are to be liquidated by the proceeds derived from the sale of the goods.

Unfortunately the problem of the taxation of payments received in advance has not yet been tested in the higher law courts. The problem was raised as far back as 1926 by Watermeyer, J. (as he then was), in the *Lategan* case.[90] When commenting on the definition of *gross income*, which had been introduced for the first time in Act 41 of 1917, he said:

> 'It would be noticed that the definition of "gross income" did not seem to limit receipts of money in the year of assessment to such receipts as were the reward of work done or capital employed in the year of assessment. So far as receipts were concerned the time of the receipt seemed to be looked to rather than the time when the work was done which earned the receipt, whereas so far as earnings which were due but had not been received were concerned, the time when the work was done was looked to and not the time of receipt.
>
> 'This seemed to be an attempt to combine in the definition two fundamentally different conceptions of income, because the same sum of money might accrue in one year and be received in another, and it could never have been intended that income tax should be paid twice over. Again, an amount might both accrue and be received in one year, but it might be in respect of work done in another year.
>
> 'Thus a man might let his house and receive payment in advance for, say, two years. Was this whole amount income for the year when the rent was received? If the definition were read as if some such words as "in respect of work done or capital employed in the year of assessment" appeared after the word "person" these difficulties would disappear.'

So far the Special Court has not read into the definition of gross income words such as those quoted by the learned Judge, namely 'in respect of work done or capital employed in the year of assessment'. Accountants and the business community should view this aspect of the taxing law with alarm even though the Commissioner is not applying the rule rigidly. It is hard to believe that in a modern taxing system such as ours there should be provisions like these which so violently transgress sound accountancy and business principles. These provisions would not be found in the English taxing laws where the tax is determined on profits or gains as established by proper accountancy methods or in the Australian Income Tax Act which taxes only receipts which are truly and properly income for the tax

[90] *Lategan* v. *C.I.R.*, 1926 C.P.D. 203; 2 S.A.T.C. 16.

year under review. It is a matter for regret that the Committee of Enquiry into the Income Tax Act paid no attention to this important matter. They did consider the question of the deduction from income of a provision for deferred expenditure and made certain recommendations (see § 141).

A satisfactory solution to the problem, it is submitted, would be an amendment to the definition of *gross income* on the lines indicated by Watermeyer, J., in the *Lategan* case, the effect of which would be that it is only amounts which are truly and properly income for the tax year in question that should be included in the gross income. Some such provision, it is felt, would be a considerable improvement to the Income Tax Act and would remove the present disparity that exists between the sound accountancy and business concept of what constitutes taxable profits and the taxable income as laid down in the Income Tax Act.

It is a general principle in the computation of the annual taxable profits of a trade or business, under most modern taxing systems, that only those elements of profit or gain which are earned or ascertained in the year to which the inquiry refers enter into the computation. It is obviously desirable that the amount on which income tax is chargeable in respect of income from trade should accord as closely as possible with the amount of the profits of such trade determined in accordance with accepted principles of accountancy practice.

XVI. Copyrights, Patent Rights and Trade Marks

§ 295. Taxation of proceeds

Any amount received by a novelist or author in connection with his business of writing books is of an income nature whether his reward is in the form of royalties or a lump-sum payment for an out-and-out sale of the copyright. The proceeds derived from the use or sale of a copyright are the product of the wits, labour and intellect of the author and constitute income.

In *Millin* v. *C.I.R.*[91] the Court pointed out that a novelist's copyright in his novel was not capital but income. 'In the case of the *Commissioner of Taxes* v. *Booysen's Estates* [1918 A.D. 576] it was pointed out that income was sometimes the product of capital invested, and sometimes was earned by the labour or the wits of the recipient. Mrs. Millin's business of writing novels was based, not upon capital, but upon her wits and labour. By the exercise of these she produced, let it be supposed, a novel a year and sold the copyright outright, say for £1,000. Could there be any doubt that that amount, less any expenses to which she might have been put, would represent the income of her business for the year, and it could not make any difference in principle that instead of receiving a lump sum for the copyright, she was remunerated by royalties spread over a

[91] 1928 A.D. 207; 3 S.A.T.C. 170.

term of years. In the latter case the profits from her business would accrue to her, not in one sum but in driblets, and the tax would be spread over a number of years. But in principle there was no distinction between the two cases, and his Lordship was unable to concur in the contention that the copyright was capital and that it was the employment of this capital which had produced the income.' It is submitted that this principle applies *mutatis mutandis* to an inventor who receives payments for the use or sale of his patent rights.

In terms of section 10(1)(*r*), any amounts received by an author for the use or sale of his copyright are exempt from tax if such amounts have been charged with tax in another country (see § 113). For a discussion on the source of royalties, see § 18.

An isolated sale of a copyright or patent rights by a person who does not carry on the business of a novelist or inventor is, it is submitted, taxable, if the proceeds can be regarded as the product of the wits, labour and intellect of the author or inventor.

Amounts received for the sale of copyrights or patent rights by a person who originally acquired such rights for the purpose of investment are of a capital nature. On the other hand, if such rights were acquired for the purpose of dealing therein at a profit, the proceeds would be on income account and taxable.

A taxpayer may sell patent rights held for investment purposes not for a lump sum but for a consideration measured by the annual income or net profit derived from the use of the patent or depending upon the number of articles produced or sold. It is submitted that by virtue of such an arrangement, the periodical payments cannot be regarded as receipts of a capital nature but partake of the nature of income. Where the consideration is expressed to be a lump sum plus such a periodical payment, the lump sum is a capital receipt whereas the periodical payments are income (cf. the receipt of goodwill in similar circumstances (§ 279)).[92]

The Committee of Enquiry into the Income Tax Act[93] considered a submission received that where an author sells his copyright outright, the proceeds should be regarded as being of a capital nature and not taxable. The Committee was unable to accept this argument as it felt that whether an author's rights are disposed of by means of an outright sale for a lump-sum payment or by means of an assignment of or grant of an interest in a copyright in return for a royalty, the amount received represents the remuneration for his work or labour and is thus of an income character.

§ 296. Deduction of payments

The cost of taking out a patent is capital expenditure unless incurred by a dealer in patent rights. Similarly, a trader's or manufacturer's costs of registering a trade mark or trade name constitute capital expenditure.

92 *Deary* v. *Deputy C.I.R.*, 1920 C.P.D. 541; *Modderfontein B Gold Mining Co., Ltd.* v. *C.I.R.*, 1923 A.D. 34; *Jones* v. *I.R.C.*, [1920] 1 K.B. 711; 7 T.C. 310.

93 *First Report*, p. 24, para. 25.

Fees paid for the renewal of a patent are deductible.

The cost incurred for the out-and-out acquisition of a patent or a trade mark is capital expenditure unless acquired for the purpose of speculation. It matters not, it is submitted, that the purchase price is paid by annual instalments,[94] whether fixed or variable or depending upon the magnitude of the profits earned from the use of the asset (cf. payment of goodwill in similar circumstances (§ 279)).

A premium paid for the use of a patent or trade mark as distinct from a payment made for its total acquisition, is deductible in annual instalments over the period of use in terms of section 11(2)(*e*) (see § 154).[95]

Annual royalty payments for the use of a patent or trade mark are clearly deductible, whether paid in fixed amounts or in variable amounts, e.g. depending upon the number of articles sold.

XVII. Averaging of Incomes

§ 297. The problem of fluctuating incomes

Although for the great majority of taxpayers, their incomes are even and regular, for certain taxpayers their income is irregular and fluctuating. In any tax system, which is based on a progressive rate of tax, the taxpayer whose income varies from year to year is likely to pay more tax over a given number of years than a taxpayer earning in the aggregate the same amount of income but who receives it by regular accruals over the same period. In the Union, where a steeply graded progressive rate of tax is in force, considerable hardship and inequity can arise in some cases. For example, take the case of A whose income varies from year to year and B whose income is regular over a given period of years (both taxpayers being married Cape residents).

Tax Year	*Taxable Income* A	*Taxable Income* B
I	£1,000	£2,000
II	NIL	2,000
III	4,000	2,000
IV	1,000	2,000
V	2,000	2,000
VI	4,000	2,000

A, whose income varies from year to year, pays over the six years an aggregate tax bill of some £1,959 on the total income of £12,000, whereas B, whose income is regular, pays £1,023 also on a total income of £12,000 (calculations based on 1958 rates of tax).

At present there are some spreading provisions in the Union Act which are not of general application but apply only to special cases. They arise in the following forms:

[94] I.T.C. No. 353, 9 S.A.T.C. 82.
[95] I.T.C. No. 613, 14 S.A.T.C. 389.

(i) In the circumstances laid down in section 7(*b*), amounts derived by employees upon and because of the termination of their services, by way of bonus, gratuity or compensation, are deemed to accrue in three successive equal annual instalments.

(ii) To prevent a taxpayer's rates of tax being unduly inflated owing to the inclusion in his income in any year of assessment of a lump-sum payment from a pension or provident fund, it is provided that in calculating the rates of normal tax and super tax for such year, there must be deducted from his taxable income and income subject to super tax the lump sum so included (proviso (v) to section 7(*b*)*ter*).

(iii) Para. 20(3) of the Third Schedule makes provision for the prevention of an undue increase in the rate of normal and super tax payable by a farmer in respect of any year of assessment because of abnormal accruals of income arising from the disposal of plantation or forest produce during that year of assessment. For the purpose only of calculating the rates of normal and super tax, there must be deducted from the taxable income and income subject to super tax of such farmer the amount by which the taxable income derived by him in that year from the disposal of plantation and forest produce exceeds the annual average taxable income derived by him from that source over the three years of assessment immediately preceding the said year of assessment.

(iv) Para. 22 of the Third Schedule makes provision for the prevention of an undue increase in the rate of normal and super tax payable by a farmer in respect of any year of assessment because of abnormal accruals of income arising from the disposal of sugar-cane damaged by fire. A farmer whose sugar-cane fields have been damaged by fire can claim that for the purpose only of calculating the rates of normal and super tax payable in respect of the year of assessment, there must be deducted from his taxable income and income subject to super tax so much of that taxable income as is proved to the Commissioner's satisfaction to have been derived from the disposal of sugar-cane as a result of fire in his canefields and which but for such fire would not have been derived by him.

(v) Para. 18(1) of the Third Schedule provides a measure of relief for farmers who are compelled in any year of assessment to sell livestock on account of drought or stock disease by allowing such farmers to deduct from the proceeds of the sale of such livestock the cost of replacing the livestock so sold even though the re-stocking may take place in a subsequent year.

There are particular classes of taxpayers who suffer under a progressive system of taxation and it is, therefore, wrong, in principle, to single out a particular group and to grant them relief on fluctuating incomes. Authors, artists, inventors, boxers, miners, stockbrokers, farmers and barristers are some examples of taxpayers who under a system of graduated tax suffer serious unfairness because their incomes are erratic and irregular. If the aim is to spread the burden of taxation fairly among taxpayers, then equity demands that the case of these classes of taxpayers calls for some relief.

§ 298. Recommendations

The Committee of Enquiry into the Income Tax Act[96] gave very careful consideration to the problem of taxation relief on fluctuating incomes and pointed out that if a system of relief is adopted it should be of universal application within the limits laid down. With respect, this is a sound approach, because the tax problem connected with fluctuating incomes could affect any taxpayer although not with the same force as the particular classes referred to above. The Committee recommended as follows:

> 'Upon application by the taxpayer and provided his income subject to super tax has fluctuated beyond such margins as may be prescribed, the relief should be determined on the following basis:
>
> (1) That portion of the actual income subject to super tax as is equal to the average of the income subject to super tax of the current year and the incomes subject to super tax of three immediately preceding years should be subjected to tax at the rate applicable to the actual income subject to super tax.
>
> (2) The excess of the current income subject to super tax over such average should be subjected to tax at the rates applicable to such average.'

The Committee was of the opinion that the relief should be extended only to super tax and should not be given to every taxpayer whose income is subject to fluctuation but should be confined only to cases where the fluctuation exceeds a certain prescribed margin. To qualify for the relief, therefore, a taxpayer should in the particular year be in receipt of an income which exceeds the average of his total income for that year and the last three preceding tax years by both a prescribed minimum percentage and a prescribed minimum amount. The Committee felt that in this way the number of applications for relief will be considerably restricted and that the additional administrative burden arising from the adoption of such relief measures will be reduced.

To illustrate its proposals, the Committee gave the following example.

Year	(1)	(2)	(3)	(4)
Amount subject to super tax	£2,000	£2,000	£2,000	£10,000

Assuming that total income has fluctuated sufficiently in year (4) to qualify for the application of relief measures in respect of that year, the extent of the relief would be calculated as follows:

[96] *First Report*, p. 46, para. 27 et seq.

Year (4) —

Average income subject to super tax of the current year (year (4)) and the three immediately preceding years (years (1), (2) and (3)), is thus:

$$\frac{£2{,}000 + £2{,}000 + £2{,}000 + £10{,}000}{4} = £4{,}000$$

Super tax liability would thus be computed as follows:

£4,000 (average) at rates applicable to £10,000 (actual)

£6,000 (excess) at rates applicable to £4,000 (average)

One can have little quarrel with the Committee's recommendations although there appears to be scant logic in adopting the method of applying the actual rate to the average income and the average rate to the balance. It may, therefore, be suggested that the system in force in Australia is more logical. In this country, primary producers are assessed in accordance with averaging provisions (Division 16 of the Income Tax Act), the effect of which is that the rate applicable to the current year's income is determined by the amount of the average of the taxable income of the current year and the four preceding tax years. The actual income for the current tax year is then taxed at the rate applicable to the average. But even this method reflects a certain weakness because the taxpayer who earns his income in a regular manner and does not receive relief may be at a disadvantage as compared with the taxpayer who receives relief in that the latter while paying tax at the average rate on his later income pays at rates smaller than the average on the earlier incomes. Whichever method is adopted, anomalies are bound to arise unless the assessments for the last three or four years are reopened and the taxes reassessed as if the income had accrued evenly in those years. This, no doubt, is the ideal method but is not practical of administration since the reopening of a number of previous years of assessments would place an impossible burden on the administrative machinery. In this respect, it is interesting to refer to the recommendations of the Royal Commission on the Taxation of Profits and Income[97] in regard to the introduction of a relief for fluctuating incomes, viz.:

(1) Any taxpayer who can show that his total income for any year was not more than 50 per cent of his total income for the previous year shall be entitled to have his total income for each of those two years assessed as if the aggregate income of the two years had accrued evenly throughout the period.

(2) The total tax bill for the two years would be adjusted accordingly, any tax found to have been overpaid in respect of the first year being applied as a credit against the tax of the second year or, if necessary, repaid.

[97] Cmd. 9474, p. 65, issued by Her Majesty's Stationery Office, London.

(3) If a year in which the income falls by 50 per cent or more is followed by a year in which the total income is itself not more than 50 per cent of the income of the year that precedes it, the taxpayer shall have a right to claim an adjustment on similar lines to cover the average income of the three years concerned. And so on for every successive year in which a drop of 50 per cent or more occurs.

The Commission recommended that relief should be available in the assessment of income tax and in computing income tax reliefs and allowances as well as in the assessment of surtax.

In a tax system based on a progressive or graduated rate of tax the argument that relief should be given to extreme cases of fluctuating income is unanswerable. Whatever method is adopted, some equity would be achieved not only as between the different classes of taxpayers but also as between the taxpayer and the *fiscus*. Moreover, the wider economic implication should not be overlooked. It is not the purpose of this treatise to discuss the dangers of excessive rates of taxation. It must be pointed out, however, that one of the great dangers arising from excessive tax rates is the detrimental effect on incentive particularly in a young and developing country. If the people's incentive is diminished, they will lose their initiative. The system of relief measures recommended by the Committee of Enquiry will, therefore, provide a greater incentive to production. It is a matter of extreme regret that the Income Tax Commission rejected the recommendations of the Committee as it considered that if the marginal rate of tax is fixed at 12*s*. 6*d*. per £ no further concession for fluctuation of income is warranted.[98] One of the terms of reference of the Committee of Enquiry was to investigate the working of the Income Tax Act and to make any recommendations for amendment of the law which may appear to be desirable in order to achieve a fair and equitable distribution of the burden of taxation and the removal of anomalies and hardships in the incidence of the taxes imposed. The recommendations of the Committee in regard to relief measures for fluctuating incomes would have this result but the Commission's rejection of them is to perpetuate an anomaly and a hardship.

XVIII. Discretionary Powers of the Commissioner

§ 299. General principles

There are many instances in the Income Tax Act where an issue depends upon the opinion of the Commissioner, for example, section 11 (2) (*d*) where the amount of wear and tear depends on what the Commissioner considers just and reasonable (see § 149), section 11 (2) (*g*) and (*h*) where the amount of bad or doubtful debts must be proved to the satisfaction of the Commissioner (see §§ 152 and

[98] *First & Final Report*, p. 15, para. 61.

153), section 11(2)(*b*) where the deduction in respect of expenditure incurred outside the Union is to be so much as the Commissioner may allow (see § 132), section 11(5)(*a*) where the amount of the reserve to provide for a fall in the market value of the trading stock of the taxpayer depends on what the Commissioner considers just and reasonable (see § 249), section 9(8) where the Commissioner can regard as income amounts paid to an employee as entertainment or travelling allowances which he is satisfied were not so expended by the taxpayer (see § 180), and para. 16 of the Third Schedule where the value to be placed upon produce held by a farmer at the end of the tax year is to be such fair and reasonable value as the Commissioner may fix (see § 200).

It is trite law that where a matter is left to the discretion of an official, his decision, even if erroneous, cannot be interfered with, provided that he has applied his mind to the point and has exercised his discretion *bona fide* and his decision was not in conflict with statutory provisions or the decisions of competent courts of law.[99] Thus, in the case of a decision given by the Commissioner under a section which requires him to exercise an administrative discretion, no appeal lies to the Special Court.

Where, however, it is provided in the Act that the Commissioner's decision shall be subject to objection and appeal (see section 11(2)(*i*)*bis*(iv), section 11(4)(*c*)(ii), section 20(7), section 40, section 54, section 54*dec*(6), section 64(2), section 65(2)(*b*), and section 90(2)), an aggrieved taxpayer can ask the Special Court to review it. In such a case, the Court has full power to rehear the whole matter and substitute its own decision for that of the Commissioner even though he has applied his mind *bona fide* to the matters in issue. No right of appeal lies to the Supreme Court against the findings of the Special Court in such a matter, unless it acted contrary to the law.[1]

§ 300. Recommendations

One of the cardinal principles of fiscal law enunciated by Adam Smith in his *Wealth of Nations* is that a tax ought to be certain and not arbitrary. 'The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality . . . is not near so great an evil as a very small degree of uncertainty.' Every instance in the Income Tax Act where liability to tax is made to depend upon the final decision of an officer is a violation of this fundamental principle.

It must be readily conceded that in the interests of both the *fiscus* and the tax-paying public, it is not practicable to eliminate

[99] *Shidiack* v. *Union Government*, 1912 A.D. 642; *C.I.R.* v. *City Deep, Ltd.*, 1924 A.D. 298; 1 S.A.T.C. 18. See also *Britten & others* v. *Pope*, 1916 A.D. 150, where Innes, C.J., states that there are limits to the exercise of an administrative discretion, 'it must be used in good faith, and after fair inquiry, not arbitrarily or capriciously, but bearing in mind the interests both of the public and of the applicant, and within the limits of the Statute'.

[1] *Rand Ropes (Pty.), Ltd.* v. *C.I.R.*, 1944 A.D. 142; 13 S.A.T.C. 1.

from the Income Tax Act all the discretionary powers vested in the Commissioner and to lay down rigid rules of assessment to provide for all cases, even though it has the undesirable effect, in many instances, of rendering the taxpayer's liability to tax uncertain. The Committee of Enquiry into the Income Tax Act recommended[2] that discretionary powers should be vested in the Commissioner only in relation to —

(1) matters of routine administration and tax collection not affecting the extent of the taxpayer's liability to taxation; and

(2) matters in respect of which rigid rules of assessment are incapable of being drawn without unduly endangering the proper and legitimate claims of the *fiscus*, or giving rise to anomalies and hardships.

Where, however, it is found necessary or expedient to entrust the Commissioner with discretionary powers, which directly affect the taxpayer's liability for tax, justice and equity demands that his decision be subject to review by the courts. In such cases it is manifestly unjust that the Commissioner should have the final say. When it comes to the routine administration of the Income Tax Act, one cannot validly object to the various discretions vested in the Commissioner even though his decision may not be subject to appeal to the court. These discretionary powers are usually designed to facilitate administration in purely routine matters, e.g. the rendering of returns, the issue of assessments, and do not affect the liability for tax.

The writer is at a loss to understand why the Commissioner should have the final say in such matters as, for example —

(*a*) the current market price of livestock or produce donated by a farmer and which is included in his income in terms of para. 10 of the Third Schedule;

(*b*) the value to be placed upon produce held by a farmer at the end of a tax year (see para. 16 of the Third Schedule);

(*c*) the amount by which the value of trading stock on hand at the end of a tax year has been diminished by reason of damage, deterioration, change in fashion, decrease in the market value (see section 11(5)(*a*));

(*d*) the determination of whether any debt due to the taxpayer is bad (see section 11(2)(*g*)).

Both the Committee of Enquiry into the Income Tax Act[3] and the Income Tax Commission[4] agreed that no appeal should lie against the decisions of the Commissioner in the exercise of his discretionary powers in routine administrative matters and matters of tax collection not affecting the amount of the tax payable by the taxpayer or the amount of his assessed loss. However, in all cases where the

[2] *Second and Final Report*, p. 10, para. 17. These principles were accepted by the Income Tax Commission (*First & Final Report*, p. 28, para. 24).
[3] *Second & Final Report*, p. 11, paras. 19 and 20.
[4] *First & Final Report*, p. 28, paras. 25 and 26.

decision of the Commissioner in the exercise of a discretionary power affects the amount of tax payable by the taxpayer or the amount of his assessed loss, the taxpayer should, except in certain special cases, be entitled to object and appeal to the Special Court against such decision.

There is probably no other country in the Commonwealth whose taxing law is so studded with discretionary powers, which are not subject to appeal, as is the case in South Africa. In one subsection alone, namely section 11(5), five instances of non-appealable discretionary powers are to be found. The Third Schedule to the Income Tax Act affecting farmers contains as many as fifteen instances of non-appealable discretionary powers affecting tax liability.

As the discretionary powers of the Commissioner directly affect the rights and liberties of the taxpayer, serious attention should be given to this matter particularly in view of the recommendations made by the Committee of Enquiry and the Income Tax Commission.

XIX. Personal Tax Anomalies

§ 301. Dividends

In terms of the four provincial Ordinances, whereas all other income subject to the personal tax is restricted to income derived from Union sources, dividend income is taxed irrespective of its source. The relative provisions are as follows:

Transvaal: Definition of 'income', section 1, Ordinance No. 10 of 1928, as amended.

> '"Income" . . . shall mean an amount determined by the Commissioner upon the principles and according to the methods prescribed for the calculation of taxable income under the Income Tax Act . . . and shall include the amount of any dividends received by or accrued to any person and his wife during the year of assessment.'

Cape: Section 6, Ordinance No. 31 of 1932, as amended.

> '. . . the amount of the income of any person shall be the sum of an amount determined by the Commissioner or any revenue officer on the principles and according to the methods prescribed for the calculation of Union normal taxable income under the Income Tax Act . . . and any dividends received or accrued to such person during the year of assessment. . . .'

Natal: Definition of 'taxable income', section 2, Ordinance No. 17 of 1928, as amended, read with section 3(2)(*d*).

> '"Taxable income" shall be an amount determined by the Commissioner upon the principles and according to the methods laid down in the Income Tax Act for the determination of taxable income. . . . The taxable income of any person shall be increased by the amount of any dividends received by or accrued to such person or deemed to have been received by or accrued to such person during the year of assessment. . . .'

Orange Free State: Definition of 'taxable income', section 1, Ordinance No. 4 of 1928, as amended, read with section 3 (1) (*c*).

'"Taxable income" shall be the amount determined by the Commissioner upon the principles and according to the methods laid down in the Income Tax Act for the determination of taxable income. . . . For the purpose of determining the tax on persons the taxable income of any person shall be increased by the amount of any dividends received by or accrued to such person . . . during the year of assessment. . . .'

It will be observed that only dividends received by or accrued to the taxpayer for the particular year of assessment can be included in the income subject to personal tax. It is submitted, therefore, that where in one tax year an assessed loss for normal tax purposes is utilized as a set-off against dividend income in the super tax assessment in terms of section 28 (*b*), the amount of the set-off which must, in terms of section 27 (*c*), be included in the next year's income subject to super tax, is not subject to the personal tax, as it does not constitute dividends received or accrued in that year.

On a strict interpretation it would also seem that for personal tax purposes the gross amount of the dividend must be included and that no provisions exist in the various Ordinances for the deduction of expenses incurred in the production of such dividends. For super tax purposes any expenditure or losses, other than expenditure or losses of a capital nature, incurred in the production of any dividends may be deducted from the gross amount of the dividend received or accrued (section 28 (*a*)).

§ 302. Assessed losses

A further difficulty arises in the case of a taxpayer who incurs an assessed loss for normal tax purposes and who receives dividends from companies during the same year of assessment. It is not clear at all from the definitions quoted above whether the assessed loss is to be deducted from the dividends received, or whether the definitions envisage only the case where the taxable income does not result in an assessed loss so that an assessed loss has to be ignored in the determination of the income subject to personal tax. The first approach can produce anomalous results as the following example shows:

Tax Year I		Tax Year II	
Trading loss	£400	Trading loss	£100
Dividends	£1,000	Dividends	£600

Tax Year III

Trading income ..	£1,000
Dividends ..	£500

(*a*) *Where assessed loss is to be deducted from dividends received*

Tax Year I

Normal tax:

Assessed loss	£400
Loss forward to Year II	£400

Personal tax:

Dividends	£1,000
Less Assessed loss	400
Subject to personal tax	£600

TAX YEAR II

Normal tax:

Loss forward from Year I	£400
Trading loss, Year II	100
Loss forward to Year III	£500

Personal tax:

Dividends	£600
Less Assessed loss	500
Subject to personal tax	£100

TAX YEAR III

Normal tax:

Trading income, Year III	£1,000
Less loss forward from Year II	500
Taxable income	£500

Personal tax:

Taxable income	£500
Dividends	500
Subject to personal tax	£1,000

On this basis it follows that whereas the true income for the three tax years amounts to £2,600 the income subject to personal tax is merely £1,700.

(*b*) *Where assessed loss is to be ignored*

TAX YEAR I

Income subject to personal tax	£1,000

TAX YEAR II

Income subject to personal tax	£600

TAX YEAR III

Taxable income	£500
Dividends	500
Income subject to personal tax	£1,000

With this method the aggregate income subject to personal tax, viz. £2,600, is equal to the true income and is more commendable than the first method. In the first two tax years, however, the taxpayer is called upon to pay personal tax on £1,000 and £600 respectively whereas his true income is merely £600 and £500 respectively. The position, however, rights itself in the third year.

A more practical approach might take this form:

TAX YEAR I

Normal tax:

Assessed loss	£400
Loss forward to Year II	£400

Personal tax:

Dividends	£1,000
Less Assessed loss	400
Subject to personal tax	£600

TAX YEAR II

Normal tax:

Loss forward from Year I	£400
Trading loss, Year II	100
Loss forward to Year III	£500

Personal tax:

Dividends	£600
Less Assessed loss for Year II	100
Subject to personal tax	£500

TAX YEAR III

Normal tax:

Trading income, Year III	£1,000
Loss forward from Year II	500
Taxable income	£500

Personal tax:

Taxable income (excluding loss brought forward)	£1,000
Dividends	500
Subject to personal tax	£1,500

Although this approach is the most realistic, it is clearly not in accordance with the definitions quoted above and they would have to be redrafted to allow such an interpretation.

The Provincial Councils should give serious consideration to an amendment whereby the income subject to the personal tax should be defined as the income subject to super tax determined by the Commissioner upon the principles and according to the methods prescribed for the calculation of income subject to super tax under the Income Tax Act, provided that for the purpose of determining the amount subject to the personal tax the proviso to section 28 (*b*) should not apply. This last-mentioned proviso authorizes the set-off of an assessed loss for normal tax purposes againt the income subject to super tax up to an amount sufficient to relieve the taxpayer from liability to super tax. In its stead there should be a proviso limiting the set-off of an assessed loss to an amount sufficient to relieve the taxpayer from liability to personal tax.

Not only would such an amendment overcome the difficulty of assessed losses but it would also ensure that for personal tax purposes expenditure incurred in the production of dividends will rank as a deduction.

With such a definition, the example above should be worked out as follows:

TAX YEAR I

Normal tax:	
Assessed loss	£400
Loss forward to Year II	£400
Income subject to super tax:	
Dividends	£1,000
Less Assessed loss	400
	£600
∴ *Income subject to personal tax*	£600

TAX YEAR II

Normal tax:	
Loss forward from Year I	£400
Trading loss, Year II	100
Loss forward to Year III	£500
Income subject to super tax:	
Dividends	£600
Plus Assessed loss set off in Year I	400
	£1,000
Less Assessed loss	500
	£500
∴ *Income subject to personal tax*	£500

TAX YEAR III

Normal tax:

Trading income, Year III	£1,000
Less Loss forward from Year II	500
Taxable income	£500

Income subject to super tax:

Taxable income	£500
Dividends	500
Assessed loss set off in Year II	500
	£1,500

∴ *Income subject to personal tax* £1,500

CHAPTER THIRTEEN

THE PROBLEM OF TAX AVOIDANCE

§ 303. Tax avoidance and the national interests

It is not only by illegal evasion that much revenue is lost to the *fiscus*. Every man, so the *dictum* runs, is entitled to arrange his affairs within the framework of the law so as to attract upon himself the least amount of tax. This course may also result in a substantial loss of revenue to the Treasury as the writer has endeavoured to show in this treatise.

It is a fundamental principle of taxation that the burden of income tax should be spread as fairly and equitably as possible among all the taxpayers. In this respect one must keep well in mind that important maxim of Adam Smith in his famous work *Wealth of Nations*:

> 'The subjects of every state ought to contribute towards the support of the Government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation, is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists, what is called the equality or inequality of taxation. . . .'

If the tax laws are such that certain taxpayers are free to arrange their affairs and reduce their fiscal obligations, they secure an unfair advantage over other taxpayers who are not in a position to take advantage of the 'loophole'. Widespread tax avoidance may mean that the loss of revenue suffered by the State must be made up by an increase in the rate of tax or that the taxpaying public may be deprived of a reduction in the rate of tax. The rich tax avoider, like the illegal tax evader, shifts his burden on to the shoulders of others and frequently poorer taxpayers.

Not only the Treasury, but also all taxpayers, should take a very serious view of a tax system which readily lends itself to large-scale tax avoidance and tax reduction since, apart from the substantial loss of revenue to the *fiscus*, there is the important consideration of the injustice and inequality falling upon those taxpayers who may be unwilling or unable to profit by the particular avoidance device. There is no doubt that a system of taxation, the effect of which is that a taxpayer pays more or less tax than his fellow-countryman according to his knowledge of loopholes in the law or the skill of his adviser or the dictates of his conscience, is bad and requires reform. It is also often forcefully argued that the prevalence of tax avoidance leads to increased tax evasion since if one taxpayer is aware that his neighbour is not paying tax because of legal means which he either does not understand or from which he cannot profit, he may be tempted to adopt illegal means to obtain the benefits of reduced taxation accruing to his neighbour. Another oft-mentioned criticism of tax avoidance is the loss to national wealth from the enormous amount of time and ingenuity spent by taxpayers and their advisers on seeking loopholes in the law and working out schemes to avoid the tax. Discovering a loophole is one thing but working out a scheme for taking advantage of the loophole might involve the employment of a number of persons, and when the scheme is challenged by the Department and perhaps tested in the courts, the loss to the national wealth from all these unproductive efforts might be considerable. It may, therefore, have to be conceded that in the national interests tax avoidance is undesirable.

§ 304. Tax avoidance consciousness and the public attitude

Tax avoidance consciousness is increasing among the taxpaying public in South Africa and today there are few wealthy persons who would refuse to take advantage of known loopholes in the law for patriotic reasons or feeling of social obligation. It is also certain that there are a large number of taxpayers who are not aware of the various loopholes which would permit them to reduce their tax. This lack of knowledge among potential tax avoiders is probably saving the Treasury substantial sums of money. Nevertheless, the knowledge of loopholes in the law spreads and unless important changes in the law are going to be made, the *fiscus* is bound to suffer.

Save for most exceptional reasons, tax legislation is not made retrospective and this is perhaps another reason why the taxpayer is willing to pursue the avoidance device. He may secure the benefit for a few years before the loophole is closed.

The Committee of Enquiry into the Income Tax Act has held[1] that their investigation of the Union's income tax system has satisfied them that while the great majority of taxpayers do not seek to avoid tax but fully accept their financial responsibilities towards the state, there existed a minority of taxpayers who continually seek to escape tax either by the employment of fraudulent devices or by other legal means. Whereas this may be true in regard to fraudulent devices, the writer cannot agree that only a minority of taxpayers are interested in adopting legal devices for the purpose of avoiding tax. The courts have sanctioned tax avoidance and have held that every person is entitled to order his affairs for the purpose of avoiding or reducing his liability for the payment of tax ('. . . if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be'[2]). This is a sufficient comfort for the taxpayer to take advantage of known loopholes.

[1] *Second and Final Report*, p. 28, para. 1.
[2] Per Lord Cairns in *Partington* v. *Attorney-General*, 21 L.T. 370.

The Income Tax Act recognizes no sentiment or equity. On these grounds, tax avoidance is often justified. It is generally felt that if a particular lawful course involves the payment of less tax than the adoption of some other method, the choice of the former course raises no moral issue since the law permits it — the same law which recognizes no sentiment or equity. How often have not the Judges expressed sympathy for taxpayers owing to the harsh operation of the income tax law and yet confirmed the assessments raised upon them on the grounds that 'if a person sought to be taxed comes within the letter of the law, he must be taxed however great the hardship may appear to the judicial mind to be'?[2]

Whatever the public attitude may be towards tax avoidance, that is whether or not it is immoral or anti-social, or opposed to the national interests, the Treasury is not without remedy; it can press for a change in the law which will close the gap, and, where the tax avoidance that is being practised is contrary to public policy or is not in the national interests, the Treasury will be failing in its duty if effective measures are not taken to plug the holes.

§ 305. Anti-avoidance measures and a simplified code

It has long been recognized that simplification in a taxing statute is an unattainable ideal. The experience of most countries has been that taxation is a cat-and-mouse game in which the mouse is usually one jump ahead of the cat.[3] Many taxpayers do order their affairs within the framework of the law so as to attract the least amount of tax and the State is constantly changing its legislation to plug the holes created by situations which it had not contemplated. The long and constant struggle between the tax-gatherer and the taxpayer has inevitably resulted in intricate and complex taxation laws which fall far short of that important canon propounded by Adam Smith,[4] namely:

> 'The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. . . .'

The Income Tax Acts of countries such as the United Kingdom, Canada and Australia bear testimony to the fact that if tax avoidance on a large scale is to be avoided, the tax structure must of necessity become more complicated. If the Union Treasury wishes to reduce tax avoidance to a minimum, it can only do so at the expense of a more complex Income Tax Act. Involved and intricate amendments for the purpose of closing holes in the law ought to be welcomed if they mean that widespread avoidance with its resultant loss of revenue

[3] 'For years a battle of manoeuvre has been waged between the Legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow-subjects. In that battle the Legislature has often been worsted by the skill, determination and resourcefulness of its opponents . . .' (per Lord Green, M.R., in relation to the United Kingdom Income Tax Act, in *Lord Howard de Walden* v. *I.R.C.*, [1942] 1 K.B. 389; 25 T.C. 121.

[4] In his *Wealth of Nations.*

to the *fiscus* and inequity among taxpayers, is to be prevented. The risk of creating an involved or complex Income Tax Act should never be made an excuse for the carrying out of a policy of active legislative control of tax avoidance. This does not mean, however, that the legislator should not be ever-mindful of that important canon of taxation that the law ought to be clear and plain and that the tax ought to be certain and not arbitrary. If, to safeguard the *fiscus* against tax avoidance, it is deemed necessary to confer the Commissioner with discretionary powers in the administration of anti-avoidance measures in the law which affect the taxpayer's liability to tax, any decision of the Commissioner should be subject to review by the courts at the instance of the taxpayer (see § 300).

§ 306. Legislative control of avoidance

The present Income Tax Act of the Union is full of provisions which invite avoidance. As the writer has attempted to show in this thesis, there are far too many obvious avoidance devices and loopholes available to the taxpayer. Some of these devices are due to the adoption of the source test (see Chapter Two) or arise because of lower tax rates in neighbouring countries, e.g. South West Africa and the Federation of Rhodesia and Nyasaland, but many of the loopholes are due to faulty and inadequate legislation. Whatever may be the reason for the existence of these devices and loopholes, the methods of tax avoidance and reduction are becoming more widely understood and may indeed become a substantial business in the near future unless effective steps are taken by the Treasury to close the gaps. Unfortunately, there is no way of discovering the extent of the tax revenue lost because of the methods of tax avoidance but there is good reason to believe that it is substantial.

In view of the extremely limited scope accorded to section 90 by the Appellate Division in *King's* case,[5] the Treasury can no longer rely on the section as an effective anti-avoidance provision. As has been shown in this treatise, most of the present avoidance schemes and devices cannot be stopped by section 90 since the avoider arranges for the income-producing asset to belong to another so that the income is in reality the income of the new owner. (*King's* case laid down that the section applies only if the income is in reality the income of the taxpayer — see § 8.) The new owner may be a child or some other relation of the taxpayer or it may be a company in which the taxpayer or his family may be the beneficial shareholders.

Tax avoidance and reduction is a problem common to every taxation system and the greater the rate of tax the more its presence is likely to be felt. An examination of the taxing systems of the United Kingdom and other Commonwealth countries reveals that different methods have been adopted by the different countries to try to solve the problem of tax avoidance. For example, the United Kingdom has tried to solve it by the enactment of numerous specific

[5] *C.I.R.* v. *King*, 1947 (2) S.A. 196 (A.D.); 14 S.A.T.C. 184.

provisions to counter known tax avoidance devices. Australia and Canada have enacted general provisions which aim to nullify the effect of transactions which have as their purpose the avoidance of tax on income which is in reality that of the taxpayer but in addition have also enacted a number of specific provisions to counter particular devices and to deal with particular situations. South Africa has followed the course adopted by Australia and Canada, i.e. the enactment of a general provision as well as specific provisions, although when a comparison of the different tax laws is made it will be observed that the Union lags far behind as regards special provisions to counter tax avoidance. The countries, which have adopted a general provision to counter tax avoidance, have learnt that an anti-avoidance section which is cast in the widest and most general possible language does not work in practice. The United Kingdom has wisely refrained from the adoption of such a general provision.

The United Kingdom and Canada, particularly, have detailed sets of rules to counter particular devices of avoidance. Their tax laws are studded with anti-avoidance provisions which no doubt have a strong deterrent effect on taxpayers. In the writer's view, this is the only effective way to handle the problem of tax avoidance. The finding of ways and means by the taxpayer and his advisers to avoid or reduce tax is a continuous process but the Treasury must be equipped to meet those situations with effective anti-avoidance provisions.

As regards the Union, it is clearly necessary to add to the present legislation new provisions specifically designed to effectively counter known devices and loopholes. In some respects, the net of the Revenue is all-embracing, in other respects, however, the net is full of holes. For example, the Legislature has left no stone unturned in its endeavour to tax just about every amount accruing from employment and services. In this respect, the definition of 'gross income' in section 7 contains five all-embracing provisions. This degree of care and attention has not, for example, been given to the taxation of profits earned through the medium of companies in respect of which effective anti-avoidance measures to close up some gaping loopholes are urgently required. Detailed legislative control of the numerous avoidance devices and loopholes is imperative even at the expense of burdening the administrative machine. In regard to many of the present loopholes, the law can be altered without serious administrative difficulty. The value of an effective anti-avoidance provision as a strong deterrent to the carrying out of an avoidance or reduction scheme, must not be overlooked.

It has been learnt from experience that however ramified and comprehensive taxation legislation may be, there may still be ways and means by which the heavy incidence of tax can be avoided. This, however, is no excuse for not closing the gaps created by obvious loopholes in the law which are both undesirable and contrary to public policy. A wise Treasury should always be alert and on the look-out for obvious loopholes and it should never hesitate to plug a hole effectively. It should at all times be equipped and ready to deal with new situations arising from the discovery of new loopholes and avoidance devices, and it should not hesitate to press for effective deterrents which will put a stop to practices which are considered to be against the public interest. Only in this way will it be acting in the best interests of the State and the taxpaying public in general.

Experience in other countries has clearly shown that the framers of Income Tax Acts are not so lacking in ingenuity as to be unable to deal with devices and schemes to reduce or avoid liability to tax. For example, in the United Kingdom the Treasury has successfully overcome 'bond-washing' transactions in securities whereby the owner of securities makes an arrangement to sell or transfer securities just before the interest becomes payable and to re-acquire them after the interest has been paid (section 203 of the Income Tax Act, 1952). To take another example, prior to 1938, the effect of the law in the United Kingdom was that income earned by the executors during the winding-up of a deceased estate was taxable in the hands of the estate and not in the hands of the beneficiaries. As cases were found to occur where the period of administration was prolonged in order to collect income which could be conveyed free of surtax to a beneficiary, the Legislature countered the device by special provisions so as to ensure that the income earned during the winding-up is taxable in the hands of the beneficiaries (Part XIX of the Income Tax Act, 1952). These examples indicate that a Treasury can successfully surmount known schemes or devices to avoid or reduce tax.

As the writer has tried to indicate in this work, in the solution to many of our problems of tax avoidance, much can be learned from the methods adopted in the United Kingdom and other Commonwealth countries.

§ 307. ANTI-AVOIDANCE MEASURES AND ADMINISTRATIVE DIFFICULTIES

In certain instances the income tax law cannot be altered without serious administrative difficulty and there is no doubt that changes in tax legislation are greatly influenced by the capacity of the administrative machine to assume the extra burden. For many years now the Department has suffered an acute shortage of staff and, no doubt, it will be reluctant to support any change in the law which is likely to present a substantial administrative problem. In those cases where tax avoidance devices are practised on a widespread scale or where loopholes can be closed without serious administrative difficulty, the loss of revenue to the *fiscus* and the maintenance of equity as between the different taxpayers should never be sacrificed for administrative expediency. Effective anti-avoidance legislation does not necessarily mean serious administrative difficulty. In many instances, the strong deterrent effect of a special provision in the Act will keep administration to a minimum.

As the Committee of Enquiry into the Income Tax Act[6] pointed out, the successful administration of the Income Tax Act is largely dependent upon the efficiency of the staff appointed to carry out the provisions and if the best results are to be achieved, it is essential that members of the staff possess a high degree of technical skill and knowledge. At present there would appear to be a great shortage of properly trained officers the result of which is that the Income Tax Act cannot be administered very effectively. With an adequate supply of well-trained staff the Department will not only be in a position to collect the taxes promptly and efficiently but it will also be able to administer much more effectively any anti-avoidance provisions required to close the present loopholes in the law. Lest both the *fiscus* and the tax-paying public suffer, it is imperative that the Department should be accorded the highest degree of priority in the allocation of properly trained and efficient staff. Bearing in mind that during the 1957/58 financial year, income tax collections totalled some 146 million pounds out of an aggregate amount of all inland revenues totalling about 196 million and out of the country's total revenues of about 306 million,[7] one cannot stress too greatly this vitally important aspect of effective administration.

[6] *Second & Final Report*, chapter 15, p. 39.

[7] House of Assembly Debates (Hansard), 14th July to 18th July, 1958 (No. 2), p. 415.

Customs		£38,462,815
Excise		40,681,345
Posts, Telegraphs & Telephones		30,651,810
Inland Revenue:		195,832,628
Normal and super tax	£139,442,277	
Non-resident shareholders' tax	5,851,995	
Undistributed profits tax	236,228	
Donations tax	31,395	
Personal and savings fund levy	601	
	£145,562,496	
Other Inland Revenues	50,270,132	
	£195,832,628	
Total Revenue		£305,628,598

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NOTE.—The figures refer to paragraph numbers and NOT to page numbers.