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LLM (COMMERCIAL LAW)

DISSERTATION ON TAX LAW (CML 6036W):

**THE CLASSIFICATION, FOR PURPOSES OF
THE CALCULATION OF TAXABLE INCOME, OF
LAND AND ASSETS INCIDENTAL TO LAND,
THAT ARE USED AS TRADING STOCK**

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I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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1. INTRODUCTION

In calculating the taxable income of a taxpayer, items of income and expenditure are classified as being either capital or revenue in nature, and are treated differently according to such classification.

Over the years, a debate has emerged regarding the classification of items of income that are either part of the ground or accede to it, but which are treated by the taxpayer as trading stock. The debate extends to the classification of items of expenditure laid out in the production of income and for the purposes of trade, but which relate to land or things adhered to land. Items forming the subject matter of the discussion include sand, stone, coal, trees and other plants to be used not for the sale or use of their fruit, but for sale or use themselves.

The debate stems from the basic principle that land is a capital asset and the argument, based on the law of things, that land includes things adhered to it by way of accession. The problem is that items of trading stock are treated as revenue assets, and concerns have been expressed around the classification of assets as revenue while, in the law of things, they are considered an inseparable part of a capital asset.

In this work it will be shown that there is no compelling reason to depart from the ordinary test which is trite in our tax law. The test applied in the determination of the classification of an asset for tax purposes is the intention of the taxpayer with regard to the income or expenditure, taking into account the nature of his business and the manner in which he deals with the asset. It will be shown that parts of land (for example coal or sand) or items attached to it (for example trees) that are used by the taxpayer as trading stock, can (and indeed should) be labelled as revenue for income tax purposes, notwithstanding the fact that they are considered in law to be an inseparable part of a capital asset.

In order to standardise the practical application of the law and to fill in the gaps which presently exist, I would propose that the current legislation be amended in certain respects, which I outline below.

2. CURRENT POSITION OF SOUTH AFRICAN LAW

2.1. Capital / Revenue Classification

Gross income, being the point of departure from which taxable income is calculated, excludes 'receipts or accruals of a capital nature'.¹ Furthermore, expenditure and losses 'not of a capital nature' are deductible from a taxpayer's income in the calculation of taxable income.² It is critical therefore, that income and expenditure be classified as being of a capital nature or not (in which case they are revenue in nature) for the purpose of the said calculation.

Nowhere in the Act is the meaning of the word 'capital' defined. As such, in the determination of taxable income our courts have gone to great lengths to distinguish capital assets or expenditure from revenue assets or expenditure. What follows is a brief discussion on the reported cases dealing with this distinction in relation to items that form part of land or are adhered to land.

Commissioner for Inland Revenue v George Forest Timber Co Ltd³

In this case the taxpayer, a timber merchant, purchased forested land and felled and worked the trees in its sawmill for sale as logs. The court considered first whether the proceeds of the sale of the logs from the forest were receipts of a capital or revenue nature, and second whether a proportional cost of the forest

¹ Definition of 'gross income' in Section 1 of the Income Tax Act, 58 of 1962 (hereafter referred to as "the Act").

² Section 11 of the Act.

³ 1924 AD 516

bought by the taxpayer was deductible from the proceeds as being of a revenue nature.

On the first question, the court found that the proceeds of the sale of the logs were part of the company's revenue as received in the course of its business⁴. On the second question, however, it found that a proportion of the cost was not deductible from the proceeds. As the basis for the latter finding, Innes CJ held that: '[the trees] formed part of the realty to which they acceded, and they passed with it.'⁵

In summary then, proceeds from the sale of trees by a plantation farmer are revenue in nature because they are intended to be sold in the course of his business. Their cost is, however, not deductible as they are one with the capital asset to which they are attached.

Crowe v Commissioner for Inland Revenue⁶

Here, the taxpayer, a wattle farmer, presold a wattle plantation in order to raise finance for the purchase of the land on which the plantation stood. Following the same route as the court in *George Forest Timber*, the court considered first whether the amount received on the presale of the plantation was a receipt of a capital nature and if not, whether the cost of the plantation was deductible from such receipt.

The court found that the proceeds merely represented the realisation of a capital asset and were not made in the course of the taxpayer's business. In this case the court emphasised that the taxpayer sold the plantation without planting and cultivating it, but merely in order to raise the purchase price for the rest of the

⁴ At 525

⁵ At 526

land on which he would *then* commence farming. As such, his conduct which was of importance was his speculation on the plantation, and not his farming of it in the course of his business.

Thus, a farmer who speculates on the sale of trees (as distinguished from farming them in the course of his business) realises part of his capital asset and the proceeds of the speculation are capital in nature.

Baikie v Commissioner for Inland Revenue⁷

In this case, the taxpayer, a wattle farmer, sought to deduct a proportional cost of his plantation from his income on the basis that it was expenditure actually incurred in the production of his income and not of a capital nature.

The court dealt only with the second question faced by the courts in *George Forest Timber* and *Crowe* (because the CIR had already treated the Appellant's income from the plantation as revenue). Applying *George Forest Timber*, it held that since the plantation was accessory to the land, its cost was not capable of being separated from that of the land for the purposes of claiming a deduction from gross income. In that case the court confirmed the summarisation of the court *a quo* of the finding of *George Forest Timber* as:

'...;

(2) "... when land has been acquired with trees and other accessories thereon for the purpose of obtaining an income from the trees and accessories, the acquisition of the trees cannot be divorced from the acquisition of the land."⁸

The principle to be extracted follows *George Forest Timber*, being that the cost of a plantation is not a deductible expense as the trees are inseparable from the capital asset to which they are attached.

⁶ 1930 AD 122

⁷ 1931 AD 496

⁸ At 499

Matla Coal Ltd v Commissioner for Inland Revenue⁹

Here, the court considered the question of whether the proceeds from the sale of coal rights by the taxpayer were of a capital nature.

On the evidence, it was held that the taxpayer was not in the business of selling coal rights for profit. It was a coal mining company for its own right, and mining rights were not its stock in trade.

Thus, where a coal mining company speculates in coal rights (as distinguished from mining coal in the course of its business), the proceeds are capital.

The court, however, went further and stated *obiter* that: '*...coal itself can only be regarded as stock-in-trade and become the subject matter of a sale in the course of a business once it is separated from the land of which it forms part, i.e. is mined.*'¹⁰ Notwithstanding its *obiter* status, this statement has fuelled the debate which is discussed in detail below.

Bourke's Estate v Commissioner for Inland Revenue¹¹

In this case, the court dealt with the classification of an amount received by the taxpayer as compensation for the loss of a pine plantation destroyed by fire.

In his discussion regarding the nature of fixed [capital] (capital) as opposed to floating capital (revenue), Hoexter JA held that:

'[t]he labelling of capital in either category at a given time and in a particular situation does not import any ingrained character, incapable of fluctuation, to the capital involved. The immutability of the nature of

⁹ 1987 (1) SA 108 (A)

¹⁰ At 128G

¹¹ 1991 (1) SA 661 (A)

capital is neatly put by Swinfen Eady J in the *Ammonia* case supra at 287¹² in the following words:

“It must not, however, be assumed that the division into which capital thus falls is permanent. The language is merely used to describe the purpose to which it is for the time being appropriated”.

Second, what must be steadily borne in mind is that the assignment of capital to the one or the other category

“... depends in no way upon what may be the nature of the asset in fact or in law. Land may in certain circumstances be circulating capital. A chattel or a chose in action may be fixed capital. The determining factor must be the nature of the trade in which the asset is employed. The land upon which a manufacturer carries on his business is part of his fixed capital. The land on which a dealer in real estate carries on his business is part of his circulating capital”.¹³

Having regard to the facts of the case, he continued as follows:

‘The argument for the appellants focuses in the main on the legal nature of the asset for which compensation was paid (the pine trees standing on the property and, prior to felling, adhering thereto). Now it is trite that the planting of land and the taking root thereon provides an example of industrial accession. The trees are incorporated into the soil which nurtures them. But here the enquiry relates not to the legal status, in the law of things, of the crop on the property, but exclusively to the nature of the business carried on ... in relation to such pine trees. [The appellants] farmed with the pine trees in order to derive income therefrom.’¹⁴

The court found that the fact that the trees adhered to the land and would only produce income once felled was irrelevant, and that the pine trees constituted floating capital as much before as after felling. It held therefore that the compensation in respect of the unfelled trees was not of a capital nature.¹⁵

In summary,

¹² *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 CH 266 (CA) 286

¹³ At 672H

¹⁴ At 673C

¹⁵ The court went on to distinguish the facts of *Bourke's Estate* from those present in *George Forest Timber, Crowe and Baikie*. The distinctions are, with respect, somewhat lacking in particularity. As will be discussed later, however, the relevant principle in these cases is, since the advent of the provisions of Schedule 1 to the Act, no longer of application so the merits of such distinction are now academic.

1. The capital/revenue classification of a thing does not change the ingrained character of that thing, and merely describes the purpose for which it is for the time being appropriated; and
2. Compensation from the destruction of trees from which the farmer intended to earn an income, is revenue; and
3. This is the case even though the trees were destroyed *while still being attached to the ground*.

Commissioner, South African Revenue Service v Van Blerk¹⁶

Here, the court considered whether proceeds from the sale by the taxpayer of rights to mine sand on the farm which he otherwise used for purposes of farming, was capital or revenue.

The court, ignoring the distinction between the sale of sand and the sale of a right to remove sand, found that the question is not whether the sand is *corpus* or *fructus* of the land, but what the taxpayer's intention was with regard to such sale within the context of the nature of his business.

The court held that the land was used for a dual purpose, being trading in sand and farming, and that the proceeds were therefore revenue. Relying on *Bourke's Estate*, the court formulated the test thus:

¹⁶ 2002 SA 1016 (C)

‘The proceeds of the sand are not to be determined by whether the fruits or corpus has been sold, but rather by means of an examination of the nature of the transactions and the intentions with which they were undertaken by the taxpayer.’¹⁷

and

“The enquiry relates not to the legal classification of the thing sold, that is whether it is part of the corpus or constitutes a sale of fructus, but exclusively to the nature of the business carried on by [the taxpayer] in relation to such sand.’¹⁸

Thus, the intention of a farmer with regard to the sale of sand, within the context of the nature of his business, is paramount in deciding whether the proceeds of the sale are capital or revenue. Where he intends to sell sand in the course of his business of trading sand, the proceeds are revenue.

Samril Investments (Pty) Ltd v Commissioner, SARS¹⁹

Here, the taxpayer earned income from the sale of sand on its farm. It had previously earned an income through rental for grazing and for the sale of farm produce.

The court was faced with the question of whether payment for the right to mine sand was of a capital or revenue nature, its primary question being whether the receipt constituted a gain made pursuant to a scheme of profit-making. It applied the dictum of Smalberger JA in *CIR v Pick ‘n Pay Employees Share Purchase Trust*,²⁰ to the extent that a revenue receipt or accrual was ‘not

¹⁷ At 1020 C

¹⁸ At 1021 F

¹⁹ 2003 (1) SA 658 SCA

²⁰ 1992 (4) SA 39 (A)

fortuitous but designedly sought and worked for.²¹ On this basis the court found the proceeds of the sale of sand to be of a revenue nature.

Thus, proceeds from the sale of sand earned pursuant to a scheme of profit-making, are revenue.

In summary, the law as pronounced by the Appellate Division of the Supreme Court (or the Supreme Court of Appeals as it is called today) is as follows:

1. Income in the form of the proceeds of an asset, are classified with reference to the nature of the transactions and the intention of the taxpayer in undertaking them within the context of his business. By way of example:
 - 1.1. Proceeds from the sale of logs by a timber merchant are revenue in nature;²²
 - 1.2. Proceeds of the sale of trees by a farmer speculating but not farming them constitutes the realisation of a capital asset;²³
 - 1.3. Proceeds received by a coal mining company for the sale of coal rights (as opposed to coal itself) are not revenue in nature;²⁴
 - 1.4. Compensation for the loss of unfelled trees to be used for sale once felled is revenue in nature;²⁵ and

²¹ At 57 E

²² *George Forest Timber case supra*

²³ *Crowe case supra*

²⁴ *Matla Coal case supra*

²⁵ *Bourke's Estate case supra*

- 1.5. Proceeds from the sale of sand by a farmer, that are earned as part of a scheme of profit-making, are revenue in nature,²⁶ and
2. Trees in a plantation that are to be sold once felled are revenue in nature *even while adhered to the land*,²⁷ but
3. Since trees form part of the land (capital) to which they adhere, their cost is not a deductible expense.²⁸ Today, this aspect is of academic value only, which is discussed in more detail below.

2.2. Criticism of authorities

It is argued that, since trees form part of the land to which they adhere, they cannot be considered to be trading stock in the hands of a plantation farmer.²⁹ In support, reliance is made on the finding in *George Forest Timber* that the cost of trees is not a deductible expense because trees form part of the land. Further reliance is made on the *obiter dictum* of Corbett JA in *Matla Coal* that '*coal can only be regarded as trading stock ... once it is separated from the land of which it forms part*'.

The idea that trees form part of land stems from the law of things in terms of which a thing that accedes to land is considered one with the land for purposes of determining ownership.

This criticism, as well as the pronouncements on which it is based, calls for an examination of the relevant legal principles contained in the law of things and an analysis of their applicability in tax law.

²⁶ *Samril Investments case supra*

²⁷ *George Forest Timber case supra*

²⁸ *George Forest Timber and Baikie cases supra*

²⁹ TS Emslie SC in Emslie, Davis, Hutton & Olivier *Income Tax Cases and Materials* 3ed (2001) 787

2.3. Law of Things

The South African law of things stems from Roman law and Roman-Dutch law. The Roman law maxim *omne quod implantatur solo cedit* was expanded on by Roman-Dutch writers. Voet defined the word 'accession' as '**a method of acquiring ownership** by which a thing becomes another's because it accedes to a more principle thing of that other'³⁰ (my emphasis). He goes further to say:

'Things planted and sown go with the ground on the analogy of things built on other things, provided that the things so planted have struck roots. This is because it is fair that a plant should **belong to him** from whose ground it is fed through the roots'³¹ (my emphasis).

Van Leeuwen stated that:

'1. Accession *per consequentiam rei* is where two substances, being united together, the more valuable carries with it the less valuable, or inferior, by reason of the form-giving commixion.

2. Accordingly whatever is inseparably built or sown on another's land, is held to **belong to** the owner of the soil: ...'³² (my emphasis).

Huber stated that:

'17. ..., [T]rees which are planted on another's ground **become the property** of the owner of the ground, not, however, before they have struck roots into the ground; both because they become an accession to the ground, and because the tree, drawing its food from another's ground, gradually derives its whole body from the nourishment in the ground, out of which it is fed. ...

20. **Such is the law that we use in regard to the ownership, ...**³³ (my emphasis).

³⁰ Voet *Commentary on the Pandects* XL 6.1.1.14

³¹ Voet *Commentary on the Pandects* XL 6.1.1.15

³² Van Leeuwen, *Commentaries on Roman-Dutch Law* 1.5.1

In South African law, accession, and more specifically planting and sowing, is dealt with as an original mode of acquisition of ownership and *only* dealt with in such context:

‘Accession takes place when two corporeal things or parts of things (usually a principal and an accessory thing) are combined either through human activities or natural processes in such a way that the one thing or part of a thing loses its physical or economic dependence and becomes a component of another thing. The thing which remains essentially independent is called the principal thing, while the thing which is merged or combined in such a way that it loses its independence, is called the accessory thing. The **owner** of the principal thing **becomes the owner** of the new thing by operation of law without him necessarily being aware of the accession’³⁴ (my emphasis).

‘Plantatio et satio is the process through which growing things accede to the land and **become the property** of the landowner’³⁵ (my emphasis).

‘Planting and sowing is the process whereby growing moveable things are attached to the land and **become the property** of the landowner. Everything growing on the soil becomes part of the land as soon as it takes root and gets nourishment from the soil’³⁶ (my emphasis).

‘According to Voet “[t]hings planted and sown go with the ground ... provided that the things so planted have struck roots”. In other words, if a person has planted his seeds or saplings of young trees and the like, on another’s land, their **ownership** is vested in the owner of that land as soon as they have taken root, although the person who has planted them may have a claim for compensation against the owner’³⁷ (my emphasis).

‘Ingevolge die Romeinsregtelike reël *omne quod implantatur solo cedit* wat die Romeins-Hollandse in Suid-Afrikaanse reg oorgeneem is, vorm alles wat in die grond geplant of gesaai is, deel van die grond. Sodra saad wat in die grond gesaai is, ontkiem en sodra plante wat in die grond

³³ Huber *The Jurisprudence of my Time* 1.2.17, 20

³⁴ AJ van der Walt and GJ Pienaar, *Introduction to the Law of Property* 4 Ed (2002) 118

³⁵ DL Carey Miller *The Acquisition and Protection of Ownership* (1986) 20

³⁶ AJ van der Walt and GJ Pienaar, *Introduction to the Law of Property* 4 Ed (2002) 120

³⁷ D G Kleyn, A Boraime and W du Plessis, *The Law of Property* 3 Ed (1992) 205

geplant is, wortels skiet, vorm hulle 'n eenheid met die grond en **behoort** hulle aan die eienaar van die grond'³⁸ (my emphasis).

So, for purposes of the determination of **ownership**, it is settled in our law that things planted on land and drawing nourishment from land are considered the property of the landowner.

It is now important to decipher the purpose of the law of things so that it is not given an application for which it is inappropriate.

'The law of things operates in three spheres. First, it strives to harmonize various competing ownership rights especially between neighbouring landowners. Harmony is achieved by applying the rules of neighbour law; thus no one is allowed to exercise his rights of ownership in such an unreasonable way that he derives no benefit from them whilst his neighbour suffers unproportionate prejudice because of his activities. Secondly, the law of things endeavours to harmonize the rights of an owner with regard to his property vis-à-vis the rights of holders of limited real rights, possessors and detentors. This is done by restricting the number and the content of limited real rights and by giving preference to owners vis-à-vis possessors and detentors, subject to the institutions of prescription and estoppel. Thirdly, the law of things controls the exchange of things and real rights. It controls the transfer of things or real rights from one person to another and settles conflicting claims between, for instance, the former owner and a subsequent bona fide purchaser.'³⁹

Accordingly, the law of things fulfils an essential function. It determines rights of **ownership** and makes for easier regulation of relations between persons in respect of property. Whether it is appropriate for purposes of the classification and labelling of assets for tax purposes is an entirely separate issue, which will be explored later.

³⁸ CG van der Merwe, *Sakereg* 2 Ed (1989) 245

³⁹ CG van der Merwe and MJ de Waal *The Law of Things and Servitudes* (1993) para 3

2.4. Trading Stock

If an asset is dealt with as revenue, it is understood to be an item of trading stock. In the same way, items of trading stock are classified as revenue assets. The classification of an asset as trading stock also has tax consequences because trading stock has to be accounted for at the beginning and end of each tax year. Thus it becomes important to understand the concept of trading stock in attempting to provide a practical solution to the debate around assets forming part of or adhered to land.

Trading stock is defined in the Act as:

- '(a) anything –
 - (i) produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by him or on his behalf; or
 - (ii) The proceeds from the disposal of which forms or will form part of his gross income, ...; or
- (b) any consumable stores and spare parts acquired by him to be used or consumed in the course of his trade, ...;'

Section 11(a) of the Act allows for the deduction of expenditure and losses actually incurred in the production of income, provided that they are not of a capital nature, from a taxpayer's taxable income. Thus expenditure incurred in the purchase of trading stock is deductible from gross income.

Section 22 of the Act, entitled 'Amounts to be taken into account in respect of values of trading stock', provides as follows:

'22(1) The amount which shall, in the determination of taxable income derived by any person during any year of assessment from carrying on any trade (other than farming), be taken into account in respect of the value of any trading stock held and not disposed of by him at the end of such year of assessment [referred to in practice as 'closing stock'], shall be –

(a) In the case of trading stock other than trading stock contemplated in paragraph (e), the cost price to such person of such trading stock, less such amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock, ..., has been diminished by reason of damage, deterioration, change in fashion, decrease in the market value or for any other reason satisfactory to the Commissioner; and ...

22(2) The amounts which shall, in the determination of taxable income derived by any person during any year of assessment from carrying on any trade (other than farming) be taken into account in respect of the value of any trading stock held and not disposed of by him at the beginning of any year of assessment [referred to in practice as 'opening stock'], shall –

(a) If such trading stock formed part of the trading stock of such person at the end of the immediately preceding year of assessment be the amount which was, in the determination of the taxable income of such person for such preceding year of assessment, taken into account in respect of the value of such trading stock at the end of such preceding year of assessment; or

(b) If such trading stock did not form part of the trading stock of such person at the end of the immediately preceding year of assessment, be the cost price to such person of such trading stock.'

'22(4) If any trading stock has been acquired by any person for no consideration or for a consideration which is not measureable in terms of money, such person shall, for the purposes of subsection (3) be deemed to have acquired such trading stock at a cost equal to the current market price of such trading stock on the date on which it was acquired by such person. ...'

The words 'taken into account' are not spelled out in the Act (in comparison to the words 'included in income' found in Schedule 1 which deals with farming). The problem is that closing stock is not a 'receipt or accrual' and can thus not be included in income in terms of Section 1, and opening stock cannot be deducted in terms of Section 11(a) because it was incurred in a previous year. It is argued that the figures are 'taken into account' by way of an adjustment to taxable income⁴⁰ by adding the value of his trading stock at the fiscal year end to his income for that year and deducting the value of his opening stock from such figure at the beginning of the fiscal year.

This adjustment is presumably envisaged to ensure that the Receiver is able to assess and tax the taxpayer on the total value of his business, including the stock that he holds at year end and intends to sell in the following years. If he is not made to do so, a taxpayer can use all his profits to purchase stock just before the year end and in so doing, deflate his profit figures for tax purposes. It thus becomes important to classify assets adhered to land or forming part of land as trading stock or not, so that such adjustments can be made accordingly.

Paragraph 12(2)(c) of the eighth schedule to the Act (which deals with capital gains tax) provides that where assets are held by a taxpayer otherwise than as trading stock and are then commenced to be held by him as trading stock, they are deemed to have been disposed of by him at that point for a sum equal to their market value (which is treated as an accrual) and immediately reacquired at an expenditure equal to the market value (which is treated as having actually been incurred for the purposes of paragraph 20(1)(a)). Thus, where an asset is not included in a taxpayer's closing stock because it was regarded by him as a capital asset, a deemed cost equal to its market value is taken into account as an opening stock figure *at the date on which he forms the intention to use it as trading stock* (in terms of section 22(3)(a)(ii)).

⁴⁰

A De Koker *Silke on South African Income Tax* vol 2 memorial ed (1995) 8-290-1

In *Richards Bay Iron & Titanium (Pty) Ltd and Another v CIR*,⁴¹ the court held that the first part of the definition of trading stock (as it then was and which is substantially the same as the present part (a)(i)) includes articles not saleable or contemplated for sale in their then state.

In *Ernst Bester Trust v CSARS*,⁴² the court held that income from sand removed from a farm constitutes revenue as it was 'made in the operation of an ongoing scheme of profit-making' as the result of a 'contractual relationship designed for that purpose'.⁴³ The court then considered whether the taxpayer was entitled to an opening stock deduction in respect of the sand. The court held that, since Section 22 of the Act provides for 'stock held and not disposed of', it has no bearing on stock that is acquired and wholly disposed of in the same year.⁴⁴ Since it was the taxpayers case that the sand only constituted trading stock once separated from the land and since it was common cause that it was disposed of immediately once separated (or at least within the same year), the court found that the taxpayer was not entitled to an opening stock deduction in terms of section 22.⁴⁵

In *ITC12463*, the tax court considered the status of stockpiles of phosphate-bearing ore. It was common cause that the phosphate-bearing ore had not been acquired for purposes of sale⁴⁶ or exchange so the court had to decide the narrow question of whether it had been acquired 'for the purpose of manufacture' so as to be included within the definition of trading stock.⁴⁷ The court drew a distinction between manufacturing and mining and held that, where minerals are extracted without a different product emerging (as with phosphate-bearing ore), the process constituted mining. As a result, the stockpiles of

41 1996 (1)SA 311 (A)

42 2008 (5) SA 279 (SCA)

43 At 284G

44 At 288A

45 At 288D

46 It is interesting that the parties considered it common cause that the ore had not been acquired for the purposes of sale in light of the finding made in the *Richards Bay case supra*.

47 At paragraph 19

phosphate-bearing ore were not acquired 'for the purpose of manufacture' and therefore not trading stock within the first part of the definition.⁴⁸ The court held further that, since it was not amenable to being disposed of for value (was not in a realisable state), the stockpile did not fall into the second part of the definition either.⁴⁹

As is evident, the classification of items forming part of land or adhered to land as trading stock is not only complex, but also has far reaching consequences.

3. HYPOTHESIS

3.1. **Main hypothesis**

My view is that the use of the law of things, and more specifically the rule that items attached to land are one with the land, as shown above for purposes of the determination of ownership, is an inappropriate mechanism for use in the determination of the capital or revenue nature of assets and their labelling and treatment as such. Tax law does not use ownership as a basis of any characterisation. It looks at the intention of the taxpayer with regard to such asset and within the context of his business in the determination of its classification. The argument that, because trees are considered one with the land for purposes of ownership, they must, irrespective of the intention of the taxpayer (who is in any event usually the undisputed owner of both), be labelled as capital assets, is thus unnecessary and artificial.

In the law of taxation, the intention or purpose of the taxpayer is of paramount importance with regard to the classification of income and expenditure, as well as of trading stock.⁵⁰ The intention test is a subjective one and is decided taking

⁴⁸ At paragraph 29

⁴⁹ At Paragraph 31

⁵⁰ There are some cases in which the word 'intention' is distinguished from the word 'purpose'. A full analysis of these cases can be found in A De Koker *Silke on South*

into account all the circumstances surrounding the acquisition of, and the method of dealing with, the asset.⁵¹

In *CIR v Stott*,⁵² the court held that, in the determination of the nature of income, the *intention* of the taxpayer on the date of acquisition of the asset was of importance. It explained that unless he showed that, when sold, the asset was sold as part of a scheme of profit making (so there had been a change of intention since its purchase), the initial intention of the taxpayer was conclusive.

⁵³

In *Natal Estates Ltd v SIR*,⁵⁴ the court faced a situation where a taxpayer had purchased land for use as farming and then embarked on a scheme of subdividing it and selling it to make a profit. The court held that his conduct of embarking on such a scheme in which he used the land as stock-in-trade showed that the taxpayer had changed his *intention* and thus 'crossed the Rubicon'. The court held that, as at the date of his change of intention, his land constituted a revenue asset.

Similarly, with regards to the enquiry as to the nature of income, it is clear that the courts in the cases cited in part 2.1 relied on the intention of the taxpayer in making their determination.

The intention of the taxpayer is also of paramount importance in determining the nature of expenditure. In *CIR v Genn & Co (Pty) Ltd*,⁵⁵ it was held that in determining whether a taxpayer's expenditure has been incurred in the production of income, the closeness of the connection between his expenditure

African Income Tax vol 2 memorial ed (1995) 3-7 & 8. The distinction does not, however, impact on the scope of this work.

⁵¹ ITC 1510 (1989) 54 SATC 30 36

⁵² 1928 AD 252

⁵³ At 264

⁵⁴ 1975 (4) SA 177 A at 203

⁵⁵ 1955 (3) SA 293 A

and his income earning operations must be assessed with regard to, firstly the *purpose* of the expenditure, and secondly its effect.⁵⁶

In *New Estate Areas Ltd v CIR*,⁵⁷ the court held that in determining whether expenditure is of a capital or revenue nature, the true nature of the transaction must be examined, the *purpose* of the expenditure being an important factor.⁵⁸ In short, the court set out the test as follows: expenditure incurred for the purpose of establishing, improving or adding to the equipment of the income-producing structure is capital and expenditure incurred as part of the cost of performing income-producing operations is revenue.⁵⁹

Of further importance when discussing the nature of expenditure, is Section 23(g) of the Act which provides that expenditure or losses are deductible to the extent to which they are laid out for the *purpose* of trade.⁶⁰

The classification of trading stock is also determined by the taxpayer's intention. Part (a)(i) of the definition of 'trading stock' found in Section 1 of the Act refers to things produced '... for the *purposes* of manufacture, sale or exchange'.

Part (a)(ii) which provides that things, 'the proceeds from the disposal of which forms or will form part of the taxpayer's gross income,...' are trading stock, has been interpreted by the court in *De Beer's Holdings (Pty) Ltd v CIR*,⁶¹ to mean that the taxpayer must *intend* to sell or dispose of the assets when he acquired

⁵⁶ At 299G

⁵⁷ 1946 AD 610

⁵⁸ At 627

⁵⁹ At 627

⁶⁰ On this point, the judgments in *George Forest Timber, Crowe and Baikie* differ, as they pronounce the cost of trees not to be deductible from income despite them being laid out for the purpose of trade. As is explained in footnote 15, these cases are, however, no longer authorities on the point.

⁶¹ 1986 (1) SA 8(A)

them. In other words, that part (a)(ii) denotes futurity and not a hypothetical state of affairs.⁶²

Part (b) provides for consumable stores `... *to be used* ...' in the course of his trade. This too refers to the taxpayers intention. Clearly, the intention of the taxpayer in respect of items to be defined either as trading stock or not, is paramount.

Such classification based on intention does not interfere with the law of things. The rules of ownership stand when the question of ownership of a thing arises, and the revenue/capital *label* of that thing for tax purposes does not change its ownership. Conversely, the law of ownership should not interfere with the inquiry in tax law as to the nature of the thing for taxation purposes.

There is absolutely no problem in law in attaching to a tree a 'revenue' label, whilst it is rooted to ground bearing a 'capital' label. Nor is there a problem in attaching to coal or sand that is yet to be mined 'revenue' for tax purposes. The fact that in terms of our law they are considered only one 'res' or 'thing', is neither here nor there. The classification does not change the inherent nature of the thing, it merely attaches a signpost to that thing for the purpose of taxation. As mentioned above, the court clearly set out in *Bourke's Estate* that the language is merely used to describe *the purpose to which it is for the time being appropriated*.

In my view therefore, the findings of the courts in *George Forest Timber* and *Baikie* are, with respect, incorrect.

Practically, however, there are difficulties in applying the rules relating to trading stock to items adhered to or forming part of land. Firstly, there is a debate as to

⁶² At 33

the point in time at which such items become classified as revenue. Secondly, there can be difficulties in quantifying the trading stock to which a value has to be assigned for tax purposes while the stock is still attached to or inside the land. These issues will now be dealt with in turn.

3.2. Timing of classification

The question as to the point in time at which something affixed to land becomes labelled 'revenue' for tax purposes is a complicated one. Some argue that the label can only be assigned at the point at which the thing is separated from the land. This argument seems also to be based on the finding in *George Forest Timber* that the trees are one with the land, and the *obiter dictum* of ... in *Matla Coal* that '...coal itself can only be regarded as stock-in-trade and become the subject matter of a sale in the course of a business once it is separated from the land of which it forms part, i.e. is mined.'⁶³

With respect, I submit that it is more in-line with the principles of tax law to attach the labelling of a thing as revenue to the point in time at which the intention is formed by the taxpayer to deal with it as stock-in-trade. There is no compelling reason why a physical act is necessary to mark the occasion. The use of separation as the defining moment is unnecessarily academic and artificial. It suggests that a millimetre of space between land and a grain of sand is physically necessary for the signposting of the sand as revenue for tax purposes.

The view is also contrary to the finding in *Bourke's Estate* that the compensation paid for the unfelled trees was revenue, which implies that the trees were classified as revenue even while rooted to the ground.

⁶³

At 128G

My view is in line with the provisions of paragraph 12(2)(c) of Schedule 8 to the Act which provides for the accounting adjustments to be made where a taxpayer changes his intention with regards to a capital asset and begins to regard it as trading stock. This provision seems to take as the point of departure that the classification of a capital asset that the taxpayer later intends to use as trading stock should change at the time his intention changes.

Also, the use of separation as the defining moment can have unsatisfactory results. Consider a taxpayer who buys a farm on which to retire and that the farm has on it a well established plantation of which he is not very knowledgeable and intends to leave as is. Upon discovering the price that he could fetch should he sell the trees, he embarks on doing just that. He agrees with the timber merchant that the latter will fell the trees and obtain ownership of them on felling. On the reasoning that the trees remain capital until separation, the income earned by the retiree is capital in nature even though he intended to, and in fact did, sell the trees in terms of a scheme of profit-making using the trees as his stock-in-trade. On the reasoning that the trees become revenue from the moment at which he forms the intention to sell them for a profit, the income earned would be revenue.

Schedule 1 to the Act, which regulates *inter alia* plantation farmers, is consistent with an approach of attaching the classification to intention because it provides that proceeds from the sale of plantations, whether sold together with the land or not, constitute revenue.⁶⁴ It also allows for a deduction of the cost of acquisition of the plantation⁶⁵ as well as expenditure incurred by a plantation farmer for the establishment and maintenance of his plantations.⁶⁶ These provisions render the finding in *George Forest Timber* inapplicable to plantation farmers.⁶⁷

⁶⁴ Paragraph 14(1)

⁶⁵ Paragraph 15(1)(b)

⁶⁶ Paragraph 15(1)(a)

⁶⁷ A De Koker *Silke on South African Income Tax* vol 2 memorial ed (1995) 15-94

One view held is that, by enacting the provisions of Schedule 1 to the Act, the legislator acknowledged and tried to overcome the consequences of the actual legal position, being that the trees are capital while attached to the soil. I disagree and submit that the provisions merely clarify and elucidate the legal position, which is that the trees are revenue if they are intended by the taxpayer to be used as stock-in-trade.

3.3. Quantification of trading stock adhered to land

In the abstract, it seems difficult to imagine a process whereby sand to be sold by a farmer is quantified for purposes of recording the value of trading stock. In reality, and as long as the taxpayer's intention as to the sand he wishes to sell is kept in mind, this should not pose a problem. When a taxpayer forms the intention to begin using a capital asset for sale as his stock-in-trade, he has an idea of the scope of the asset that he intends selling. He would need to have such an idea since he would have to do a feasibility assessment, if even a rudimentary one, of the process of extraction/removal and transaction of sale. He would need to apply his mind to what exactly he wished to sell, how much of it there is available to extract/ remove, how much of it he would sell, the process whereby it would be extracted/removed from the land, the cost of extracting/removing it and the amount that he would receive for it. Only after having done so, could he decide whether it would be a financially worthwhile venture.

Having followed such a process, a taxpayer should have a reasonably good idea of the quantity of sand or other substance that he wished to use as trading stock. He should record the value of the total amount of sand or other substance that he wishes to sell in future. He should not use only the value of trading stock that he intends to sell that year but the whole amount that he intends to sell in future (as he would do with any other form of trading stock).

In *De Beer's Holdings (Pty) Ltd v CIR*⁶⁸ the court interpreted part (a)(ii) of the definition of trading stock as connoting futurity and not a hypothetical state of affairs. The court held that part (a)(ii) classifies as trading stock articles intended to be disposed of in the future (as opposed to articles, if disposed of, which would constitute gross income)⁶⁹. The taxpayer must therefore intend to dispose of the items in future for them to be classified as trading stock.

4. **PRACTICAL APPLICATION**

In summary of the authorities, the taxpayer's intention, within the context of the nature of his business, in respect of assets that form part of or are adhered to land determines their nature for tax purposes. Bearing this in mind and applying the hypotheses put forward above, taxpayers who intend to use part of their land or plants adhered to their land as trading stock should deduct the cost of acquisition of the things and must account for such stock as revenue as of the moment they form the intention to deal with it as trading stock in terms of a scheme of profit-making.

Because of the provisions of Schedule 1 to the Act relating to farming, as well as recent judgements relating to mining, it is necessary to discuss the practical application of the law and my thesis in each area separately.

4.1. **Farming operations**

As mentioned briefly above, Schedule 1 to the Act, entitled 'Computation of taxable income derived from pastoral or other farming operations', sets out certain provisions in respect of plants adhered to land but used as trading stock. The provisions affect farmers who grow crops for sale as commodities as well as plantation farmers, both of whom grow the plants for the purpose of sale of the plants themselves (and not use of their fruit or use as feed to livestock).

⁶⁸ 1986 (1) SA 8 (A)
⁶⁹ At 32H

4.1.1. Plantation farming

Paragraph 14 of Schedule 1 provides that amounts received by or accrued to farmers in respect of the disposal of plantations, whether disposed together with the land or separately, are deemed not to be of a capital nature and to form part of the farmer's gross income.⁷⁰ The paragraph further provides a mechanism by means of which the proceeds of the sale of a plantation together with the land on which it is growing can be valued for this purpose.⁷¹

Since income from the disposal of plantations, whether disposed of together with or separately from the land, is deemed a receipt of a revenue nature and forming part of a farmer's gross income, it is, in terms of part (a)(ii) of the definition of 'trading stock', regarded as trading stock.

It is not, however, accounted for in terms of Section 22 of the Act because that section applies only to trades 'other than farming'. It must, therefore, be accounted for in terms of paragraph 3 of Schedule 1. In terms of that paragraph, farmers must account for 'livestock and produce' held and not disposed of at the beginning and end of each tax year.⁷² 'Produce' is not defined in the Act but is thought to refer to 'crops that have ... reached the stage of being converted into produce having a saleable or marketable value' and includes only growing crops that have been gathered and are ready for sale.⁷³

I disagree with this argument and submit that, in line with *Bourke's Estate* and the reasoning set out above, trees should be dealt with as trading stock as soon as the taxpayer forms the intention to use them as trading stock and that separation from the land is not necessary for their classification as such. As such, they should be accounted for as 'produce' from the point at which the farmer intends to sell them in terms of a scheme of profit-making.

⁷⁰ Paragraph 14(1)

⁷¹ Paragraph 14(2)

⁷² Paragraph 3(1)

⁷³ A De Koker *Silke on South African Income Tax* vol 2 memorial ed (1995) 15-11

4.1.2. Crop farming

Schedule 1 does not provide for the classification of proceeds of the sale of crops whether sold together with the land or otherwise. It seems assumed that the proceeds of crops that are sold once removed from the land are revenue. Following from this, the arguments above and the provisions of paragraphs 14 and 15 relating to plantation farmers, I submit that proceeds from the sale of crops sold together with the land on which they stand should be accounted for as revenue and the cost of establishment, maintenance or purchase of the crops should be a deductible expense and that the Act should be amended to cater for this.

In terms of the Schedule, crop farmers must account for produce held and not disposed of at the beginning and end of each tax year.⁷⁴ As mentioned above, crops should be dealt with as trading stock as soon as they are considered as trading stock by the farmer and separation from the land is not necessary for their classification as such. They are planted and nurtured with a view to making a profit from their sale and should therefore be treated as revenue.

4.2. Mining

The proceeds of mining activities are revenue in nature and should form part of gross income. The coal, sand or other mineable substance should be classified as revenue from the time that the taxpayer forms the intention to deal with it as trading stock. As such, the Act should be amended to provide for the deduction of the proportionate share of the price of the land from the taxpayer's income for the year in which he purchases the land on which the deposits are situated.

The taxpayers who carry out mining activities should account for their trading stock in the ordinary way. Mined substances that are capable of 'sale or

⁷⁴ Paragraph 3(1)

exchange' upon being separated from the land, for example sand, are considered to fall within the definition of trading stock.

Other substances like phosphate-bearing ore, which has to undergo a process whereby the phosphates are won from the soil, only becomes trading stock upon being so won. In order to standardise the treatment of mined substances, the Act should be amended by inserting the word 'mining' between the words 'manufacture,..' and 'sale or exchange...'. Then, all substances won from the soil, whether capable of sale as such or not would be treated in the same way.

5. **CONCLUSION**

Items of income and expenditure that form part of land or are adhered to land but used or intended to be used by the taxpayer as trading stock are revenue in nature and should be so labelled as of the time the taxpayer forms such intention. For purposes of taking into account the values of trading stock at the beginning and end of each fiscal year, the values should be determined with reference to the taxpayer's intention with regards to the quantity of the stock.

In order to standardise the practical application of the law, certain amendments to the Act are necessary. These amendments should cover the following aspects:

1. Items intended to be used as trading stock should be so considered and accounted for as such as of the time at which such intention is formed;
2. Amounts received by or accrued to farmers in respect of the disposal of crops, whether disposed together with the land or separately, should be deemed not to be of a capital nature and to form part of the farmer's gross income;

3. A mechanism by means of which the proceeds of the sale of a crop together with the land on which it is growing can be valued should be provided for;
4. Expenditure incurred by a farmer for the establishment and maintenance, as well as acquisition, of crops should be allowed as a deduction from income;
5. The definition of trading stock should include the word 'mining' between the words 'manufacture,..' and 'sale or exchange...';
6. Amounts received by or accrued to taxpayers engaged in mining in respect of the disposal of mines should be deemed not to be of a capital nature and to form part of the taxpayer's gross income;
7. A mechanism by means of which the proceeds of the sale of a mine together with the land in which it is located can be valued should be provided for; and
8. Expenditure incurred by a taxpayer engaged in mining for the establishment and maintenance, as well as acquisition, of mines should be allowed as a deduction from income.

These amendments would clarify the legal position for taxpayers in the affected fields and ensure that our tax law is not burdened by rules that are neither appropriate nor necessary for its practical efficiency.

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