

Purpose and Effect:

‘The Role of a Taxpayer’s Intention in Tax Legislation’

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I INTRODUCTION

This paper examines the role of a taxpayer's intention in the way certain transactions will be taxed. The paper will examine the weight accorded to a taxpayer's stated intention in different situations (i.e. in what situations/ transactions will a taxpayer's intention have comparatively little weight when compared to the objective facts of the case?)

The paper first ascertains the meaning of intention/purpose/motive in terms of the Income Tax Act, 58 of 1962 as amended, (hereafter referred to as "the Act"). The question is whether these words are synonymous or have separate and discrete meanings.

The paper then looks at the typical areas of difficulty associated with a taxpayer's intention. Share disposals are one example discussed, as it is often difficult to determine whether these disposals are of a capital or revenue nature.

The weight accorded to a taxpayer's intention in schemes involving tax avoidance is also discussed. Case law surrounding section 20A and section 80A-S80L of the Act are reviewed to ascertain how a taxpayer's intention is dealt with in these sections.

II INTENTION/MOTIVE/PURPOSE

The intention of a taxpayer is a common theme that permeates a number of issues surrounding tax law. It is often referred to as the taxpayer's ipse dixit and provides varying degrees of importance in determining how a particular scheme or transaction will be taxed.¹

A taxpayer's intention is invariably of a subjective nature and is influenced by a number of factors that may be unique to a particular case. The taxpayer themselves may be uncertain as to their intention when entering into a particular transaction. It is impractical to think that a taxpayer, however genuine and honest they may be, will portray their intention in a completely neutral and unbiased way.

The interplay between a taxpayer's ipse dixit and the objective set of facts provided to the court is a complex issue. It is further confused through the use of different words to describe a taxpayer's intention. Words such as intention, object or purpose are often used synonymously to describe the taxpayer's ipse dixit. Botha JA clarified the meaning of intention somewhat in the case of *SIR v The Trust Bank of Africa Ltd.*² The judge stated,

'In an enquiry as to the intention with which a transaction was entered into for the

¹ *Malan v KBI*, 1983 (3) SA 1 (A).

² *SIR v Trust Bank of Africa Ltd* 1975 (2) SA 652 (A).

purpose of the law relating to income tax, a court of law is not concerned with that kind of subjective state of mind required for the purposes of criminal law, but rather with the purpose for which the transaction was entered into.’

Botha JA is suggesting that intention from the perspective of criminal law is different to intention from the perspective of tax law. This is an interesting departure and is examined in detail in an article published in the Chicago Law Review.³

From the perspective of criminal law intent, motive, purpose and have distinct meanings. These distinctions are often of vital importance in handing down a judgment for criminal cases. The question is whether it is necessary to distinguish between these terms in the context of tax law. To clarify these terms for the purposes of criminal law, the author uses a classic example. A defendant aimed a pistol at a person he wished to shoot. He pulled the trigger. The bullet hit a bystander who was directly in the line of fire. The marked man was unharmed.

The defendant’s purpose in this case would be what he aimed to get out of the act of pointing and firing the gun. In this case it would be to shoot the marked man with the bullet. His intent would depend on the physical facts of the case. If the bystander, whom the defendant hit was not directly in the line of fire of his intended target, it may be said that he did not intend to harm the victim. This would change if the bystander was in fact directly in front of the target man. It could then be said that the defendant intended to harm the victim (bystander.)

The motive of the defendant would be his reasoning behind the act. Why did the defendant want to hit the marked man? The motive is of critical importance in deciding the outcome of a criminal case. It may mean the difference between self-defence and murder. If the marked man was about to shoot the defendant, the defendant’s motive would be one of self-defence. If the marked man was sleeping with the defendant’s wife, the defendant’s motive would be one of revenge.

In the case of criminal proceedings the acceptability of the motive plays a decisive role in the judgment. Self-defence being a more acceptable motive than revenge. The question now is whether it is critical to distinguish between these terms in the context of tax law.

In the case of CIR v Pick ‘n Pay Employee Share Purchase Trust, Smalberger JA said the following when dealing intention,

³ Walter J Blum ‘Motive, Intent and Purpose in Federal Income Taxation’ (1966-1967) 485 The University of Chicago Law Review 486 available at <http://heinonline.org> accessed 20 August 2013.

*'Contemplation is not to be confused with intention in the above sense. In a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.'*⁴

From this passage the judge seems to be inferring that tax law is not concerned with the side effects (whether accidental or not) which may arise from the act. In tax law we are concerned with the actual purpose underlying the act. In the above example, the defendant's actual purpose was to shoot the marked man. The fact that the defendant hit a bystander, would not be relevant from a tax law perspective. However if that side effect was not only contemplated, but inevitable the situation may be different. It seems unrealistic to take no notice of an inevitable side-effect of an act perpetrated by a taxpayer. This point is made by the judge in the case of *CIR v Pick 'n Pay Employee Share Purchase Trust* as discussed later in this paper. If the effect of a scheme is an inevitable generation of profit, it is likely to be considered a purpose of the scheme.

The passage above also seems to suggest that, 'purpose', 'object', 'aim' and 'intention' are in fact interchangeable. Interesting is that the theme amongst cases in New Zealand is to differentiate between the above terms.

In *Plimmer v CIR (1958) NZLR 147*⁵ it was held that

'A man's purpose is usually, and more naturally, understood as the object which he has in view or in mind, but in ordinary language purpose connotes something added to intention and the two words are not ordinarily regarded as synonymous.'

The distinction between motive/purpose and intention has been made in other areas of South African law. A good example is the case of *Hippo Quarries (Tvl) (Pty) Ltd v Eardley*⁶, where the court was asked to determine whether a contract to transfer a right was genuine. Judge Neinaber had this to say,

'Motive and purpose differ from intention. If the purpose of the parties is unlawful, immoral or against public policy, the transaction will be ineffectual even if the intention to cede is genuine. That is a principle of law. Conversely, if their intention to cede is not genuine, because the real purpose of the parties is something other than cession, their

⁴*CIR v Pick 'n Pay Employee Share Purchase Trust* 1987 (3) SA 453 (A).

⁵ PricewaterhouseCoopers 'Purpose, intention, object, motive' available at http://www.saica.co.za/integritax/2006/1421_Purpose_intention_object_and_motive.htm accessed on 20 August 2013.

⁶ *Hippo Quarries (Transvaal) (Pty) Ltd. v Eardley* (189/90) [1991] ZASCA 174.

ostensible transaction will likewise be ineffectual. That is because law disregards simulation. But where, as here, the purpose is legitimate and the intention is genuine, such intention, all things being equal, will be implemented.'

The above passage confirms the previous submissions that motive is the reason behind the act. It is the reason why the defendant fired the gun (revenge/self-defence etc.) The above passage also confirms that where the purpose/motive is unlawful or immoral the transaction itself will be invalid. As a result there can be no valid contract of sale between a supplier and dealer of drugs for instance, because their motives are illegal despite the fact that the contract they conclude may meet the requirements to be a valid contract of sale. The dealer and supplier may genuinely intend to enter into a valid contract of sale; however the fact that the goods transferred are of an illegal nature means the contract itself can never be valid.

It seems tax legislation may be different, as shown by CIR v Delagoa Bay Cigarette Ltd⁷ where it was held that the legality of a business was not relevant in determining tax liability. Judge Bristowe J had the following to say,

'I do not think it is material for the purpose of this case whether the business carried on by the company was legal or illegal. Excess profits duty, like income tax, is leviable on all incomes exceeding the specified minimum, and after making the prescribed calculations and deducting the exemptions, abatement and deductions enumerated in the statute. The source of the income is immaterial.'

This shows that tax legislation is not concerned with any illegal motives that may be present in a transaction or scheme. Tax legislation is merely concerned with whether the intention between the parties is genuine.

The idea is strengthened with the findings of MP Finance v CSARS⁸ where the court held that an illegal contract may have fiscal consequences. The case dealt with a pyramid scheme where the taxpayer argued it had not 'received' amounts from investors, because it still had a legal obligation to repay. However the taxpayer had never had any intention to retain investors' money until the repayment date. The taxpayer used the investor's money for its own benefit and as such the amounts received from investors was considered income despite the fact that the scheme was illegal. The legality of the scheme was of no relevance to the tax consequences.

In conclusion it seems that South African courts have not seen the differences

⁷ *Cir v Delagoa Bay Cigarette Co. Ltd* (1918 TPD 391).

⁸ *MP Finance v CSARS* 2007 (5) SA 521 (SCA).

between motive/purpose and intention as critical to the outcome of tax cases as such they have not clearly distinguished the terms.

As Botha JA stated in *The Trust Bank of Africa*⁹ case, tax courts are not concerned with a taxpayer's subjective state of mind. The court is concerned with the taxpayer's actual intention. This seems to suggest that motive, as distinguished in criminal law is not relevant for the purposes of tax law. However motive drives intention and in most cases may be difficult to clearly distinguish. For the remainder of this paper the words purpose/motive and intention are used interchangeably.

III THE ROLE OF INTENTION

ITC 1185¹⁰ provides a useful summation of the interplay between the taxpayer's intention and the facts and circumstances presented to the court. The judge explained that it is often difficult to ascertain the true intention of the taxpayer; however this does not preclude the court from giving a taxpayer's intention due importance in the decision. What is apparent is that the intention of a taxpayer cannot stand alone as an independent test. It must be considered with reference to the facts and circumstances presented before the court. Where a taxpayer's intention proves to be incongruous to the presented facts, their intention may be disregarded and the effect/outcome of the transaction may be taxed. The struggle between the concept of intention of a transaction and its effect will form the basis of this paper.

The case of *CIR v Pick 'n Pay Employee Share Purchase Trust*¹¹, shows this struggle between intention and effect clearly. The taxpayer was the Pick 'n Pay Employee Share Purchase Trust (the Trust), which was formed to benefit qualifying employees working for Pick 'n Pay. The trust acquired shares in various ways and sold them to qualifying employees at the market value at the time of acceptance of their application. Employees were allowed to pay for the shares 5 years after acquisition (but no later than 10 years after acquisition.)

If the employee's services were terminated within 5 years, or at any time due to dishonest or fraudulent conduct, the Trust was obliged to acquire the relevant shares for the amount of the employee debt.

In the 1982, 1983 and 1984 years of assessment the trust made profits. The

⁹ Supra note 2.

¹⁰ *ITC 1185*.

¹¹ Supra note 4.

commissioner taxed these profits on account that the sale of the shares was of a revenue nature.

Smalberger JA relied on a concept used in both the *Natal Estates Ltd v SIR* 1975¹² as well as *Elandsheuwel Farming (Edms) Bpk v SBI* 1978¹³ to decide the case. The concept was whether the taxpayer was engaged in a “scheme of profit making.” Smalberger JA concluded that a business should have a profit making purpose. The judge went on to say, *‘The application of this test involves a consideration of the objectives of the taxpayer (the Trust) and what its purpose, or if there was more than one, what its dominant purpose was.’*

The trust was created to serve as a way to allocate shares to qualifying employees. This was the stated intention for the creation of the trust. The trust was not created to buy shares and sell them at a profit. That being said, the trust did in fact make a profit for 3 consecutive years of assessment. In other words one of the effects of implementing the scheme was the generation of profit.

However, quite critically, the generation of profit was due to the scheme not performing at its full potential. The profit generated was due to the forfeiture provision specified in the scheme. The profit was generated through the repurchase of shares resulting from employees resigning or being fired for misconduct. The generation of profit also required a number of other variables (such as dates of resignation compared with dates of acquisition of the shares.) None of these variables could have been controlled by the Trust. The trust could not choose when to buy and sell shares. All these decisions were taken by the obligations laid out in the scheme. The profit is as a result an incidental by-product of the scheme.

Smalberger JA went on to say that the situation may have been different had the generation of profit been an inevitable effect of the scheme. The scheme made a loss in the 1985 year of assessment, which lends creditability to the fact that profits were not an inevitable effect of the scheme.

Another case, which dealt with the struggle between the purpose and effect of a transaction is the case of *Warner Lambert SA (Pty) Ltd v CSARS*.¹⁴ Conradie JA had the following to say on the matter, *‘It is quite easy to mistake the purpose of an act for its consequences.’* Later on in the judgement he also stated,

‘The consequences of an act often proclaim its purpose. After all, a person is

¹² *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A).

¹³ *Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (A).

¹⁴ *Warner Lambert SA (Pty) Ltd v CSARS* 2003 (5) SA 344 (SCA).

presumed to have intended the natural consequences of his acts. Nevertheless, a Court must look carefully at the evidence. If there is credible evidence about a taxpayer's purpose, it is not open to the court to turn what is in reality a consequence into a purpose and ascribe that to the taxpayer.'

In the Warner Lambert case, the deductibility of social responsibility expenditure was called into question. The taxpayer, which was a subsidiary of an American company, incurred certain expenditure in order to continue trading in South Africa. The expenditure related to a code called the Sullivan Code, which was introduced to govern the conduct of American companies in apartheid South Africa. The deductibility of this expenditure was questioned for a number of reasons. The question relevant to this paper was whether the expenditure was laid out for the purposes of trade.

The commissioner argued that the expenditure incurred served three purposes. The first purpose was saving the parent company from potential embarrassment and negative economic consequences, which may have followed had the subsidiary not paid the money. The second purpose was one of pure altruism and the third purpose was the protection of the taxpayer's income-earning structure.

The commissioner then went on to argue that expenditure incurred for the benefit of the group is not deductible, using the case of Solaglass Finance Company (Pty) Ltd v CIR¹⁵ to substantiate the argument. The benefit derived by the group is not deemed to be linked to the expenditure with a sufficient level of closeness. As a result, the first purpose was not a trade purpose, if the argument of the commissioner is accepted.

Furthermore the commissioner argued that expenditure laid out for the purposes of pure altruism is not a trade purpose. The commissioner used the case of Pick 'n Pay Wholesalers¹⁶ to substantiate this argument.

As a result only the last purpose (protection of income-earning structure) was said to be a trade purpose according to the commissioner. What is of interest is the case dealt with both the pre-1992 and post-1992 years of assessment. Up to and including the 1992 year of assessment s23 (g) of the Act disallowed expenditure unless it had been, '*wholly and exclusively laid out for the purposes of trade.*' From 1993 onwards, the definition was amended to allow expenditure incurred, '*to the extent*' it was incurred for the purposes of trade. Effectively from 1993 onwards, the expenditure may have been apportioned between trade and non-trade purposes.

¹⁵ *Solaglass Finance Co (Pty) Ltd v CIR* 1991 (2) SA 257 (A).

¹⁶ *CIR v Pick'n Pay Wholesalers (Pty) Ltd* 1987 (3) SA 453 (A).

However Conradie JA found this to be unnecessary in his judgement. The judge found that the altruism and group benefits were in fact effects of the social responsibility expenditure. The real underlying reason or purpose of the expenditure was to avoid the loss of the taxpayer's business in South Africa. In order to do avoid losing its business in South Africa, the taxpayer had to comply with the Sullivan Code. This required the taxpayer to incur this social responsibility expenditure. The natural consequences of this expenditure were of an altruistic nature as well as being of benefit to the group.

Conradie JA thus found that the expenditure was laid out '*wholly and exclusively*' for the purposes of trade. It is clear that Conradie JA is implementing a composite test with no overriding factor, which determines the nature of the transaction. In the above case the act of paying social responsibility expenditure was supported by a reasonable and commercial intention to save the South African business. The court cannot take the altruistic effect of this expenditure and proclaim it to be the purpose. The court cannot override a taxpayer's stated intention unless there is evidence which shows a different or secondary intention.

There might be a counter argument based on CIR v Pick 'n Pay Employee Share Purchase Trust¹⁷, where Smalberger JA stated that if profit generation was an inevitable effect of the scheme it may be seen as at least a secondary purpose for which it was created. If the altruism was an inevitable effect of the social responsibility expenditure it could be said that at the very least this was a secondary purpose of the taxpayer. As such the respondent's argument to apportion the expenditure in terms of section 23(g) may have merit.

A case where the test of the taxpayer's intention was seemingly applied incorrectly was that of CSARS v Founders Hill (Pty) Ltd.¹⁸ In this case the compound test of a taxpayer's intention was disregarded.

AECI owned an explosives factory with vacant land. The manufacturing process of explosives had changed so that the buffer around the factory did not have to be so extensive. As a result AECI decided to sell or develop the land. For this purpose they incorporated the taxpayer as a "realisation company." The land was sold to the taxpayer, which then subdivided, developed and disposed of it. Judge Lewis JA held that the taxpayer purchased the land from AECI with the express intention of selling it at a profit. As a result the taxpayer had embarked on the business of selling land. Consequently the taxpayer's profits were gains '*made by operation of the business in carrying out a scheme for profit-making,*' and they therefore of a revenue nature. The appeal was therefore upheld and the profits were taxed as

¹⁷ Supra note 4.

¹⁸ CSARS v Founders Hill (Pty) Ltd 2011 (5) SA 112 (SCA).

being of a revenue nature (The tax court having ruled that the taxpayer had in fact acted as a realisation company and that the proceeds of the land sales were of a capital nature.)

In a critical review of the Founder's Hill decision, Eddie Broomberg¹⁹ highlights various weaknesses in the judgement, one of which relates to the intention of the taxpayer. His review shows the over simplification of the test to determine whether a taxpayer is trading. According to the judgement, if a taxpayer acquires an asset for resale, the taxpayer is trading. However, this test neglects the taxpayer's intention. As Broomberg says, *'there cannot be a trade without an intention to trade.'* Broomberg uses the decision laid down by CIR v Pick 'n Pay Employee Share Purchase Trust²⁰. The scale of the Trust's buying and selling of shares in the above case, would suggest the Trust was involved in share dealing activities. However the purpose of the trust as stated earlier was to provide shares to qualifying employees. In the same way this taxpayer was solely incorporated as a vehicle to realise the land sold to it by AECl. Its purpose was to realise the assets on behalf of its shareholders, being the original owners of the asset and then distribute the proceeds to those shareholders (AECl). The taxpayer never acted beyond this mandate and thus could not be considered to be trading in its own right.

It seems that the intention of a realisation company is synonymous with that of its creator, being the sole shareholder. The mere interposition of a realisation company should not alter the nature of an asset, provided the realisation company does not trade in its own right. As is shown by the above case the test of a taxpayer's intention is complex and has been applied incorrectly in the past. It involves an enquiry into the true and underlying intention of the taxpayer. The realisation company was created to resell land at a profit. However this was not the underlying intention of the taxpayer. The taxpayer formed part of a larger scheme to dispose of excess land not needed by AECl, which is the underlying intention behind the scheme.

III(a) Share Disposals

Disposals of shares have typically been contentious from a tax perspective. Numerous cases have been argued in order to ascertain whether the disposal is of a capital or revenue nature. In other words whether the taxpayer is trading in shares and has entered into a profit making

¹⁹ Broomberg E 'NWK and Founders Hill' *The Taxpayer* 187-197.

²⁰ Supra note 4.

scheme. The issues arise, because of the homogenous nature of shares. Shares in most companies are perfectly interchangeable and easily traded. Investors/traders may also hold the same shares for vastly different reasons. Added to this, is the fact that shares have become very easily transferable in recent times.

Shares are not held for their aesthetic value, unlike paintings. As such the reason for holding shares is solely to earn a return on an investment. It is accepted that the disposal of shares passively invested will be of a capital nature. The difficulty arises when an investor begins to actively switch between shares to maximize his/her return. This is where the true intention of the taxpayer needs to be ascertained. In certain instances the intention of a taxpayer is disregarded completely in favour of the facts and circumstances presented to the court. This may be the case where the intention of a taxpayer is based on the incorrect interpretation or understanding of the law.²¹ An example of this would be the case of *Barnato Holdings Ltd v SIR*²². The case involved a company who genuinely believed they were holding shares as capital assets. However the taxpayer applied the incorrect test in order to determine the nature of the shares. The test the company applied was in fact far less stringent than the applicable test applied by the courts. As a result the distinction the company drew was of no relevance to the court when deciding the nature of the shares.

There are in fact numerous other cases dealing whether share disposals by companies were in fact capital or revenue in nature. An underlying theme is shared amongst the majority of these cases; namely the idea of a secondary purpose or intention. The idea of a secondary purpose or intention is tackled in Blum's Paper.²³ The paper asks a number of questions regarding the practicality of ascertaining a taxpayer's supposed '*primary*' and '*secondary*' purpose. In reality it is accepted that a taxpayer may enter into a transaction with more than one purpose in mind. However distinguishing between a secondary purpose and an incidental effect of a transaction does provide some difficulties. The relevant questions asked in the Blum's paper are: What constitutes a major/significant purpose and how do we distinguish this from a secondary purpose? In order for the purpose to be considered '*primary*' does it merely need to be more significant than any other purpose? Or does its importance have to outweigh all other purposes added together. As an example say I enter into a scheme to buy shares. I do this in order to save for my retirement. This is my stated intention. However, I also know a lot about shares and as a result I will switch investments

²¹ Clegg D *Income Tax in South Africa* (2013) ch 5.2.1 available at <http://beta.mylexisnexis.co.za.ezproxy.uct.ac.za/Index.aspx> accessed on 2 November 2013.

²² *Barnato Holdings Ltd v SIR* 1978 (2) SA 440 (A).

²³ Walter J Blum op cit note 3.

on a regular basis to obtain the highest return from my investment. It is accepted that one of my purposes is to save for my retirement. How do we determine whether the potential gains made are an incidental effect of the intended purpose (to save for retirement) or a secondary purpose? The tax consequences are quite different depending on whether the gains are deemed an incidental effect or a secondary purpose. If the gains are found to be an incidental effect of a scheme, they will be capital in nature as the primary purpose is long-term investment. However if the gains are seen as a secondary purpose, they will be revenue in nature. It is accepted that payments to a pension fund, would in no way constitute a profit making scheme. The taxpayer is not involved in where the money is invested. It is a passive earning of income. On the other end of the scale, if the taxpayer were to constantly watch their investment and switch in and out of stocks on a regular basis, it would be accepted as a profit making scheme. The taxpayer's stated intention is still, however to save for their retirement. *Nussbaum v CIR*²⁴ dealt with a similar situation as the example above. Howie JA held,

'By keeping a constant watch over his portfolio and "farming" it assiduously, the taxpayer had manifested a secondary purpose of dealing in shares for a profit, notwithstanding that his primary purpose had been to maximise dividend income.'

This shows that although a taxpayer's stated intention may be to save for retirement. The way this is done, may display a secondary trading purpose.

The case of *African Life Investment Corporation (Pty) Ltd v SIR*²⁵ shows this principle strongly. The taxpayer was a subsidiary of The African Life Assurance Society Ltd. The memorandum of incorporation (MOI) stated that the company was formed to operate as an investment company. The investments were not to constitute trading stock and the company was not authorised to deal in shares. The narrowly defined MOI makes the intention of the taxpayer clear. On the surface it appears the taxpayer would be holding the shares on capital account. However the investment policy devised by the taxpayer was to maximise the return of capital employed. In order to achieve this, the taxpayer needed to switch out of investments providing unacceptable dividend pay-outs and into investments providing better returns. The taxpayer made profits on sale of these shares, which the commissioner attempted to tax as trading income. The court agreed, stating that dividend yield and capital appreciation are inseparably linked. Steyn CJ held in the judgement that the taxpayer had a composite purpose or intention. The stated intention was to maximise the return on investment, however this inevitably lead to a profit as a result of switching shares.

²⁴ *CIR v Nussbaum* 1996 (4) SA 1156 (A).

²⁵ *African Life Investments Corporation (Pty) Ltd v SIR* 1969 (4) SA 259 (A).

The taxpayer countered that the effect was merely incidental and the dominant purpose was the receipt of dividends. The taxpayer was relying on an argument succinctly stated in the case of *CIR v Pick 'n Pay Employee Share Purchase Trust*.²⁶ Smalberger JA, said the following when dealing intention,

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

Smalberger JA is clearly showing the difference between the intention with which a taxpayer enters into a transaction and the potential effects of that transaction. The tax consequences are generally based on the underlying intention of the taxpayer.

However, Smalberger JA did qualify his judgement in the *Pick 'n Pay* case, by saying that the situation may be different where profits are an inevitable effect of a scheme. If profitable sales of shares are inevitable given the nature of the scheme, it would seem to suggest that this was intended by the taxpayer. As a result at least a part of the reason why the taxpayer entered into the scheme was to derive a profit. In the case of *African Life Investment Corporation (Pty) Ltd v SIR*²⁷, the court held that the profit making purpose was in fact a secondary purpose of the scheme (and not incidental.) As such the profits were deemed to be of a revenue nature and taxed accordingly.

Another case, which could not be distinguished from *African Life Investment Corporation (Pty) Ltd v SIR* (69), was that of *Barnato Holdings Ltd v SIR*²⁸. As stated by Trolip JA in the above case; the question of whether an investment shareholding company will be deemed to be carrying on a secondary business of dealing in shares for profit is a question of fact. It is a question of degree. The volume of trading and time taken to 'watch' over the investments will be relevant factors in deciding the nature of the disposals.

The introduction of section 9C in the Act (its predecessor being section 9B) deems the sale of certain shares held for longer than 3 years to be of a capital nature. Section 9C applies to shares, which meet the criteria of a qualifying share as defined in section 9C. A qualifying share being an equity share, which has been disposed of by a taxpayer, if the taxpayer immediately prior to such disposal had been the owner of that share for a continuous period of at least three years. The definition excludes certain shares, such as foreign listed

²⁶ Supra note 4.

²⁷ Supra note 25.

²⁸ Supra note 22.

companies. In this way the legislation disregards the intention of the taxpayer and taxes the outcome/effect of a transaction.

The taxpayer's investment policy (intention) may mean shares are held for longer than 3 years (incidental effect.) This incidental effect classifies the transaction as either capital or revenue in nature. SARS have indicated that section 9C was introduced to avoid the '*protracted legal disputes*' associated with the sale of shares.²⁹ In effect SARS is following the canons of taxation; namely efficiency and certainty.³⁰ However there may be certain instances where share traders would prefer the sale of shares to remain revenue in nature (i.e. if the tax consequences were favourable when compared with the application of section 9C.) The application of section 9C is not at the election of the taxpayer and as such the taxpayer would face the potentially adverse tax consequences without choice. More research needs to be done on this area. The question remains as to whether the legislation has promoted effective tax collection at the cost of neutrality.³¹

III(b) Tax Avoidance Situations

III(b)(i) Section 20A. Ring-fencing Assessed Losses of Certain Trades

There are other instances where an objective review of the facts outweighs the taxpayer's intention in deciding how a transaction should be taxed. This is particularly evident in the section of tax legislation dealing with tax avoidance. A taxpayer is less likely to give an objective statement regarding their intention if the transaction involves the possibility of tax avoidance. It would be naïve to think that the objectivity of a taxpayer's stated intention would not be influenced by the desire to avoid tax.

*CSARS v Smith*³² is another example of the struggle between the intention of the taxpayer and the effect of his actions as indicated by an objective assessment of the facts of the case. The taxpayer was a medical practitioner who engaged in farming, mostly in his spare time. He originally purchased a farm to angora goats and then converted to game farming. At the time of buying the farm he did foresee that the farm would be profitable in the future (giving a time period of roughly 8 to 10 years.) He eventually sold the farm due to

²⁹ SARS. 'Interpretation Note: No. 43 (Issue 4)' available at <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-43%20-%20Circumstances%20Disposal%20Shares%20Capital%20Nature%20Amounts.pdf> Accessed on 8 January 2014.

³⁰ T S Emslie & D M Davis *Income Tax Cases & Materials* 3 ed (2011) 1.

³¹ *Ibid.*

³² *CSARS v Smith* 2002 (6) SA 621 (SCA).

poor health. He subsequently bought another farm, once again with the intention of farming game. Both farms ran at substantial losses throughout the period of ownership. The taxpayer offset these losses against the taxable income from his medical practise. In 1996 the commissioner notified the taxpayer that he would not allow the losses incurred in 1992, 1993, 1994 and 1995 to be set off. The reason given by the commissioner was that there had been no reasonable prospect of making a profit.

The cases relied upon by both councils created two schools of thought. The idea relied upon by the commissioner was the idea laid down by Smalberger J in ITC 1319. Smalberger disagreed with a statement made in the 9th edition of *Silke on South African Income Tax* when he said,

*'In so far as the test propounded by Silke purports to be an entirely subjective one, I do not agree with it. It seems to me that before a person can be said to be carrying on farming operations there must be a genuine intention to farm, coupled with a reasonable prospect that an ultimate profit will be derived, thereby incorporating an objective element into the test. To hold otherwise would make it well-nigh impossible for the commissioner to determine whether or not to allow farming losses as a deduction from other income, for he must needs adopt an objective approach when doing so.'*³³

If there was any doubt that Smalberger had an independent profit criteria in mind, this doubt is put to rest in the following extract,

*'In all the circumstances the indications are that in 1976 and 1977 the appellant, despite his ipse dixit to the contrary, had no genuine intention of farming and was, at best, merely marking time until he could subdivide and dispose of the bulk of his property. It is, however, not necessary to come to any firm decision on this point as it appears in any event that at the relevant time...the appellant had no reasonable prospects of ultimately farming on a profitable basis...'*³⁴

The judgement of Smalberger J above makes it clear, that a reasonable prospect of profit should be an independent objective test applied separately to that of the the intention of a taxpayer. The above argument attempts to use the objective facts of the case to over-rule the intention of the taxpayer. The commissioner has '*objectively*' reviewed the taxpayer's case after the fact and concluded that there was never a reasonable prospect of profit. As a result the taxpayer may not offset the losses sustained from other taxable income. The commissioner is attempting to replace a forward looking subjective test of intention, with a

³³ Ibid.

³⁴ Ibid.

backward looking objective review of the outcome/ effects of the business venture. The commissioner, in 1996 effectively decided that he would not allow the set off for the years 1992, 1993, 1994, 1995, because there had been no reasonable prospect of making a profit. The commissioner is using the exact science of hindsight to determine the tax consequences of what is by its very nature a risky business in terms of commercial success.

Heher AJA touched on this point agreeing with the following extract of a tax case in New Zealand. The Court of Appeal of New Zealand had the following to say in *Grieve v CIR*

*'It is not suggested that it is the function of the income tax Acts, or of those who administer them, to dictate to the taxpayers in what business they shall (628) engage or how to run their business profitable or economically. The Act must operate upon the result of a taxpayer's activities as it finds them. If a taxpayer is in fact engaged in two businesses, one profitable and the other showing a loss, the commissioner is not entitled to say he must close down the unprofitable business and cut his losses even if it might be better in his own interests and although it certainly would be better in the interests of the commissioner if he did so (Toolhey's Ltd v COT for NWS (1922) 22 SR 432 at pp 440-1). If the appellant succeeds and makes a profit it will plainly be taxable, and it is difficult to see how his activities could at that moment of time be transmogrified from an indulgence in a somewhat unusual form of recreation into the carrying on of a business. I am satisfied that the appellant is seeking to establish himself at Winlton as a recognised breeder of high-class stud stock, and that while he is prepared to make losses to achieve this ambition he has a genuine belief that he will be able eventually to make the business pay. Indeed, unless he can do so, his experience will hardly be an encouragement to others to emulate his example.'*³⁵

The outcome of the case of *CSARS v Smith*³⁶ was that although profitability may be a contributing factor in assessing the reasonability of a taxpayer's intention, it may not stand alone as an independent test. It is not for the commissioner to judge the commercial viability of a business venture using a backward looking test with no reference to the taxpayer's intention at the time of entering into said business venture. The judge in an Australian case summarised the matter crisply, *'It is enough to travel hopefully even if one is never destined to arrive.'*³⁷

³⁵ Ibid.

³⁶ Ibid.

³⁷ Ibid.

That being said, CSARS v Smith³⁸ deals with a taxpayer who is effectively farming as a hobby. His income was derived from a successful medical practice. As a result it is not unreasonable to suggest that the taxpayer may have entered into the scheme partly to reduce his tax liability. Schemes where the avoidance of tax liability is a possibility generally render the stated intention of the taxpayer less reliable. As a result more emphasis is placed on an objective review of the facts.

The decision handed down in the Smith case above lead to the introduction of section 20A into legislation. The reason for the introduction is explained in Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003. The memorandum explains that not all activities are trades, even if the taxpayer labelled or even intended the activity to be so. The intention behind the introduction of section 20A is to ring-fence losses incurred in respect of “hobby” activities in order to stop these losses being set-off against the taxpayer’s other income. This ‘*other*’ income usually takes the form of professional fees or a salary. In the Smith case, the taxpayer was a doctor who earned professional fees. The memorandum goes on to say that a ‘*facts and circumstances*’ test will be used to ascertain whether the activity constitutes a ‘*hobby*’ activity. The intention of the taxpayer is thus accorded little (if not no weight), in favour of an objective review of the facts.³⁹ The commissioner uses the argument put forward by Smalberger J in ITC 1319 as cited above in this paper to defend this test. The judge argued that the absence of objectivity in the test would make it, ‘*well-nigh impossible for the commissioner to determine whether or not to allow farming losses as a deduction from other income.*’ For this practical reason, the intention of the taxpayer takes on very little weight in determining whether an activity is deemed to be a ‘*hobby*’ activity or a ‘*suspect trade.*’ Subsection (1) of section 20A explains the general rule, which ring-fences assessed losses from suspect trades as listed in subsection (2.) If a trade is deemed to be suspect trade, the loss arising from this trade may not be set-off against other income of the taxpayer. Subsection (2) explains that section 20A is only applicable where the taxpayer earns sufficient taxable income to be taxed at the highest marginal rate of tax. The taxable income must be taken before the set-off of the assessed loss in question.

There are two ways a trade can be deemed to be a suspect trade. Either it is explicitly listed in section 20(A)(2)(b) or the trade has incurred losses for at least 3 years in a 5 year period. Included in the list of suspect trades is farming (unless done on a full time basis.)

Section 20A(3) effectively provides an escape clause in certain circumstances. It

³⁸ Ibid.

³⁹ SARS ‘Explanatory Memorandum on The Revenue Laws Amendment Bill’ (2003) 60.

allows the taxpayer to prove that the trade is not a 'hobby' activity or suspect trade, despite the fact that it meets the criteria as set out in section 20A(2)(a) or section 20A(2)(b).

Section 20A(3) states that the provisions of subsection (1) do not apply in respect of an assessed loss incurred by a person during any year of assessment from carrying on any trade contemplated in subsection (2)(a) or (b), where that trade constitutes a business in respect of which there is a reasonable prospect of deriving taxable income, within a reasonable period. The legislation goes on to name the objective factors, which would decide whether commissioner believes the trade has a reasonable prospect of deriving taxable income.

The notion of a '*reasonable prospect of deriving taxable income*' has been added to the legislation in Section 20(A)(3). The legislation has favoured the argument stated by Smalberger J in ITC 1319 as shown in the use of the above term. The legislation now suggests that '*a reasonable prospect of deriving taxable income*' will stand as an independent criteria in determining whether a trade will be deemed to be a suspect trade. The legislation has favoured the test laid down by Smalberger J, which treated the taxpayer's intention and the ability of the activity to generate a profit as separate criteria. The original test required that both criteria be met in order for the activity to be deemed to be a bona fide trade. Section 20A takes this test one step further as it makes no mention of the taxpayer's intention, effectively disregarding it in the decision.

The reasons for this are quite clear. The possibility of a taxpayer disguising private consumption by labelling a hobby as a trade is high. It is naïve to think that the taxpayer's stated intention would be completely free from bias given the potential tax advantages at stake. As is stated in the explanatory memorandum, section 20A was introduced, '*as a means to uncover these artificially labelled trades.*'⁴⁰ Furthermore, section 20A only applies to natural person who earn sufficient taxable income to be taxed at the highest rate of tax, which currently stands at R638 601. Thus section 20A only applies to those taxpayers who have the means to disguise a hobby as a trade.

Nevertheless, the legislation effectively imposes a model of how a business should be run in order for it to have a '*reasonable prospect*' of taxable income. Effectively, the legislation is asking the question of whether a reasonable businessman would have structured his affairs and made the same decisions as the taxpayer in question. As a result, if a taxpayer fails to live up to these '*standards*' of business he will deemed to have no genuine business

⁴⁰ SARS op cit 40.

motive, despite what his actual intention may have been. This may be appropriate given the fact that section 20A only applies to high income earners. It assumes that because the taxpayer is at the highest marginal tax rate, he will have the knowledge to live up to these 'standards' of business as outlined in section 20A(3.)

Take the scenario of a taxpayer wishing to start a vineyard from scratch. Let us say it takes three years for the vines to grow to such an extent that they are able to produce wine. Add to this the fact that some wine needs to be aged before it may be sold. During this time the farm will incur expenditure and will undoubtedly end up in an assessed loss position.

Farming is a suspect trade (unless done on a full time basis section 20(A)(2)(b).) These losses will be automatically ring-fenced from the taxpayer's other taxable income (provided the taxpayer is at the highest marginal tax rate.) The only hope for the taxpayer is that the trade is deemed to be carried on with a '*reasonable prospect of deriving taxable income.*' Section 20A(3).

In this situation it seems the taxpayer will struggle to prove the 'standards' outlined in section 20A(3) in order to avoid the assessed loss being ring-fenced.

The first '*standard*' outlined in section 20A(3)(a) looks at the proportion of gross income derived from trade in that year of assessment in relation to the amount of allowable deductions incurred. The majority of farms are unlikely to turn any kind of income in their initial stages of development. A wine farm for instance would take a substantial period of time to begin producing wine. As a result it is likely, that most farms would fail this '*standard*' initially.

Some of the other factors listed are: the level of activities; the commercial manner and the business plans of the taxpayer. It looks to be a difficult task to prove that a loss making farm will be deemed to be carried on with a '*reasonable prospect of deriving taxable income.*' If we continue with our example of the wine farm, assume that the criteria under section 20A(3) were applied and it has been decided that the business has no '*reasonable prospect of deriving taxable income.*' The farm made losses for 5 years as the vines grew. As the yield improved, the farm made a taxable profit in year 6. It has subsequently made profits ever since. Is the continued profit from year 6 not evidence enough that there was a reasonable prospect of profit from year 1 to 5? If there was no reasonable prospect of profit does that make these profits fortuitous gains and therefore capital in nature? The last question is unlikely to hold any water as an argument, but it does show the unbalanced nature of this provision.

In the Smith case, the continued losses caused the commissioner to take notice and

ultimately deem that there was '*no reasonable prospect*' of making a profit. The commissioner did lose the case. However the introduction of section 20A, would most probably have changed the outcome. The use of the term, '*reasonable prospect of deriving taxable income*' in section 20A(3) shows the heavy reliance placed on the argument of Smalberger J in ITC 1319. It would be interesting to note whether continued profits after initial losses would be enough to indicate that in fact the business had a reasonable prospect of profit. If this is so, the balance of the assessed loss would not be ring-fenced under section 20A and would be allowed to be set-off against the taxpayer's other income. Section 20A(5) suggests that this would not be possible. Section 20A(5) states any balance of assessed loss, which has been ring-fenced in terms of section 20A may only be set off against income derived from carrying on that trade (i.e. the trade that created the assessed loss.) If we apply this to the wine farm example, say the commissioner deemed that there was no reasonable prospect of profit after the first 5 years of operation of the farm, due to the continued losses. The losses were ring-fenced as a result. The wine farm began to make a profit from year 6 and continued to do so into the future. The continued profit might signify that there was in fact a reasonable prospect of profit; however the balance of the assessed loss would not be allowed to be set-off against the taxpayer's other income. It would continue to reverse against the income of the wine farm. The legislation does allow for the nature of the activity in determining whether it is a suspect trade. Section 20A(3)(d) compares the number of years a trade has been making losses to the total number of years the taxpayer has been carrying on the particular trade. A higher proportion of loss making years may suggest a suspect trade. However the sub-section does make provision for the nature of the trade. The explanatory memorandum uses the example of an olive farm as an activity with a long start-up period.⁴¹

The question remains at what point in time will the trade be deemed to be as suspect trade? In the case of "hobby" farming it will be deemed to be a suspect trade immediately as it is listed. For other activities, the existence of continued losses may signify a suspect trade. The next question is when will the assessment of '*reasonable prospect of taxable income*' be made? Will it be made at the same time that the trade is deemed to be suspect? The legislation refers to a '*reasonable period*' which provides little guidance in this regard.

A likely interpretation is that the operation of the trade will be examined over a number of years, as in the Smith case. The taxpayer will have to prove there is a reasonable prospect of profit for the trade given the information present during the years under review.

⁴¹ SARS op cit 40.

The evidence given by the taxpayer will be evaluated with reference to the actual losses sustained during the time period under review. If the activity is then deemed not to meet the requirements of section 20(A)(3) the losses will be ring-fenced. Once ring-fenced, the losses cannot be reclassified, even if there are continued profits after the assessment. This seems to suggest the time period under examination is vitally important in coming to the correct decision as to whether there is a *'reasonable prospect of deriving taxable income.'* What is clear is that at no point are we concerned with what the taxpayer was attempting to achieve from this activity or trade. This piece of legislation is driven only by results or effects of a transaction. If the effect of your activity makes losses, it is up to you to prove that the activity was a bona fide trade. The evidence you need to present is not focused on your state of mind or intention, but on your actions i.e. how you went about this activity. The reasoning is best described using the saying, *'Actions speak louder than words.'*

III(b)(ii) Section 80A. Impermissible Tax Avoidance Arrangements

The anti-avoidance provisions outlined in section 80A to section 80L of the Act were introduced on 2 November 2006 and are applicable to any arrangement or entered into on or after that date. The previous version was contained in section 103(1) of the Act. Arrangements which could potentially fall into this section of the Act are always going to present a problem in terms of ascertaining a taxpayer's intention. The potential to avoid income tax creates a very real and tangible incentive to cloud stated intentions. It is unrealistic to assume evidence given by a taxpayer in these instances to be free from self-interest. As such it becomes imperative for the court to examine the taxpayer's stated intention in light of the facts of the case. This strong reliance on the objective facts of the case does create the potential to overrule the taxpayer's stated intention completely.

This issue was clearly dealt with in the case of *Secretary for Inland Revenue v Gallagher*⁴². The case dealt with the previous version of the anti-avoidance provision contained in section 103(1.) In this case the court rejected the commissioner's argument that an *'objective'* test should be applied over a *'subjective'* test in order to determine the purpose of the transaction, operation or scheme. The court rejected the idea that the word *'purpose'* as used in section 103(1) denotes an element of objectivity and in fact is synonymous with the word *'effect.'* The court found that that word *'purpose'* as used in section 103(1) of the act has the same subjective connotations as found elsewhere in the act, wherever such word is

⁴² *Secretary for Inland Revenue v Gallagher* (1978) 3 All SA 1 (A).

used. As this case dealt with the previous version (section 103) of the provision there is a question as to whether section 80A places the same reliance on the taxpayer's subjective intention as the previous version.

This issue was addressed in an article written in *The Taxpayer*⁴³. The author came to the conclusion that principles laid down in Gallagher are equally applicable to section 80A. The author uses the point that an avoidance arrangement as defined in section 80L is an arrangement which results in a tax benefit. Thus an effect of the transaction is the attainment of a tax benefit. However to be an impermissible tax avoidance arrangement (as defined in section 80A) its sole or main purpose must be to obtain a tax benefit. Thus the legislation is clearly distinguishing between the effect of a transaction and the purpose with which the taxpayer entered into the transaction. As such the author concludes that the intention of the taxpayer is still of relevance when deciding the tax consequences in section 80A. Once it has been proved that an avoidance arrangement is present the onus then falls on the taxpayer to prove that the tax benefit received was not the sole or main purpose of the scheme. This presumption of purpose is found in section 80(G)(1) and it places a strong burden of proof on the taxpayer. Section 80(G) of the Act states,

'An avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit unless and until the party obtaining a tax benefit proves that, reasonably considered in light of relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.'

This test has an element of objectivity. The court is required to consider the *'facts and circumstances'* surrounding the case together with the stated intention of the taxpayer. It seems it is not enough for the taxpayer to explain other viable reasons for entering into the transaction. The evidence given by the taxpayer must be consistent with an objective review of the *'facts and circumstances.'* It is up to the taxpayer to prove that they are not within the realm of section 80A once a tax benefit is present and the other requirements of section 80A are met. It is submitted that this is a difficult but not impossible task.

An interesting argument is provided Blum on intention and anti-avoidance. The author examines a piece of legislation in American tax legislation not dissimilar to South African Income Tax anti-avoidance legislation. The extract of the legislation is provided below:

'The fact that the earnings and profits of a corporation are permitted to accumulate

⁴³ Peter Dachs 'Anti Tax-Avoidance Provision – is the Purpose Test Subjective or Objective?' (2013) 62 *The Taxpayer* 183-185.

*beyond the reasonable needs of the business shall be determinative of the purpose to avoid income tax with respect to shareholders, unless the corporation by preponderance of the evidence shall prove to the contrary.*⁴⁴

This legislation has aspects, which are comparable to section 80(G)(1) Both pieces of legislation give a presumption of purpose. In the above case if the accumulation of profit exceeds the ‘*reasonable needs of the business*’ the purpose is deemed to be that of the avoidance of income tax. The taxpayer is then required to prove otherwise. Interestingly the author states that where the reasonable needs test goes against the taxpayer there is only a small chance of proving a dominant purpose other than the proscribed one. The author concludes later on that the subjective test has been reduced to the ‘*last hope*’ argument for the taxpayer. It is clear that American legislation has merely persuasive significance in South African courts. However the passage above does illustrate the strong burden of proof required in order to rebut the presumption of purpose outlined in section 80A.

A good example of where the underlying purpose of the transaction was the decisive factor in the decision is that of *CIR v Conhage*.⁴⁵ The taxpayer required finance and as such concluded a sale and leaseback of some of its manufacturing plant and equipment. The question was whether the scheme fell into the ambit of the previous anti-avoidance provision, section 103(1.) The argument considered by the court was whether the sole or main purpose of the scheme was to obtain a tax benefit. The court held that the true purpose of the scheme was to obtain finance. The choice of the sale and leaseback, because of its tax efficient nature was not enough to make it the main or sole purpose of the scheme. As such the scheme was not deemed impermissible tax avoidance. As concluded in the Taxpayer article, although the purpose test in section 80A remains subjective in nature, the courts will never accept the taxpayer’s stated intention without a comparison to the objective facts of the case.

IV CONCLUSION

In conclusion the intention of a taxpayer forms part of a compound test used by the courts to determine the true nature of a transaction. A taxpayer’s intention will very rarely be taken at face value without an examination of the facts of the case.

It seems the complexity of modern transactions has caused ever increasing legislation

⁴⁴ Blum, Walter J cit op note 3.

⁴⁵ *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd* 1999 (4) SA1149 (SCA).

around the effects of a transaction in an attempt to obtain consistency in the application of the legislation. Section 9C is an example of this as discussed earlier in the paper.

Section 80B to section 80E is another example of the legislation defining the effects or characteristics of a transaction which could fall into the ambit of its section. These paragraphs describe effects and characteristics of schemes or transactions, which are likely to be impermissible tax avoidance arrangements. These '*guidelines*' were not present in previous versions of anti-avoidance legislation. The question is whether the taxpayer's intention will remain relevant in the future despite the movement towards taxing the effects of a scheme or transaction.

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