

# **Was the Supreme Court of Appeal's judgment in CSARS v Founders Hill Correct?**

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## Chapter 1: Introduction

Tax is one of the largest expenses one finds in a set of a company's financial statements and as a result companies are always looking for ways to decrease this expense. To achieve this, companies arrange their matters in a perfectly legal manner by reducing their taxable income, or not having taxable income in the first place, thus they need to know what constitutes gross income and what does not. It is important to note that for a receipt or accrual to be included in a taxpayer's gross income, it must meet all the requirements of the 'gross income' definition.

Taking a look at the 'gross income' definition in section 1 of the Income Tax Act <sup>1</sup>('the Act') the definition is as follows:

“Gross income” in relation to any year or period of assessment means –

- (i) In the case of any resident, the total amount, in cash or otherwise, received or accrued to or in favour of such resident; or
- (ii) In the case of any person other than a resident, the total amount, in cash or otherwise, received or accrued to or in favour of such person from a source within the Republic

During such year or period of assessment, excluding receipts or accruals of a capital nature, but including.....

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<sup>1</sup>Income Tax Act 58 of 1962.

Although South African income tax is levied by application of the Act, it is accepted that in instances where the Act does not provide a clear definition, case law interpretations can be applied to define the Act terms. Not all the terms in the ‘gross income’ definition are defined, so it is essential to apply interpretations that have been established in case law to interpret the terms that are not defined. For purposes of this research, I will be looking at the last part of the ‘gross income’ definition that is, the exclusion of receipts of a capital nature.

The term ‘receipts and accruals of a capital nature’ is one of the terms that is not defined in the Act and as a result it is left to the courts to decide on its interpretation. This means that receipts and accruals fall into two categories, either revenue in nature or capital in nature. In *Pyott Ltd v CIR*<sup>2</sup>, the court held that each and every receipt and accrual is either revenue or capital in nature and to accept the claim that a particular receipt or accrual is neither revenue nor capital would result in a ‘half-way house’ of which Davis AJA (at 121) had no knowledge. While it has just been submitted that a single receipt or accrual cannot be non-revenue and non-capital simultaneously, that does not preclude the receipt or accrual from being apportioned between its capital and revenue elements, as was determined in *Tuck v CIR*<sup>3</sup>.

Before 1 October 2001, there were no tax consequences on receipts and accruals of a capital nature in South Africa. This resulted in taxpayers attempting to pass off all their receipts and accruals as being of a capital nature so as not to have any tax consequences. Tax on receipts and accruals of a capital nature known as Capital gains tax was introduced in South Africa on 1 October 2001, and although capital receipts and accruals are still excluded from ‘gross income’ they are subject to tax in terms of the Eighth Schedule to the Act and are included in taxable

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<sup>2</sup> *Pyott Ltd v CIR* 1945 AD 128, 13 SATC 121.

<sup>3</sup> *Tuck v CIR* 1988 (3) SA 819 (A), 50 SATC 98.

income in terms of section 26A of the Act at an appropriate inclusion rate. Capital gains tax is a relatively new concept in South Africa but there is substantial case law from the years preceding its introduction that can be applied to determine whether a receipt is of a capital or revenue nature.

It is important to realize that according to the provisions of s 102 of the Tax Administration Act, No. 28 of 2011<sup>4</sup>, the burden of proof about the nature of a receipt rests upon the taxpayer. When deciding whether a receipt is of a capital or revenue nature the court looks at both the subjective and objective factors specific to each case. The subjective factors look at the intention of the taxpayer while the objective factors do not look at the intention of the taxpayer.

The intention of the taxpayer is an important factor that courts look at when deciding the nature of a receipt. In *CIR v Stott*, the court held that ‘the primary intention with which property is acquired is conclusive as to the nature of the receipt arising from the realization of that property unless other factors intervene which show that it was sold in pursuance of a scheme of profit making.’<sup>5</sup> Where a taxpayer acquires an asset with the intention of selling it a profit, the receipt will be of a revenue nature. Conversely the receipt will be capital in nature where the asset was acquired by the taxpayer with the intention of producing income with the asset. The taxpayer’s intention is a subjective test which might be difficult to determine so the courts rely on what the taxpayer says<sup>6</sup>In *ITC 1185*, the court stated that

‘the ipse dixit of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the

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<sup>4</sup> Silke, Divaris & Stein, *Silke on South African Income Tax*, 9 ed ( Juta).

<sup>5</sup> *CIR v Stott* 1928 AD 252, 3 SATC at 254.

<sup>6</sup> *ITC 1185 (1972)* 35 SATC 122 (N) at 123/4 .

relevant facts and circumstances what the motive, purpose and intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transaction in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions<sup>7</sup>.

It is nevertheless likely that the taxpayer might acquire an asset with a capital intention and later change that intention and embark on a scheme of profit- making the proceeds revenue in nature. The courts will look at the taxpayer's intention at the time the taxpayer acquired the asset, during the period the taxpayer held the asset and when the taxpayer disposes of the asset. Where the taxpayer has more than one intention with regards to the asset, the court will look at the dominant intention *COT v Levy*<sup>7</sup>.

A taxpayer can change his intention with regard to an asset. The change in the intention of the taxpayer will result in a change in the nature of the asset, most of the times the change in intention will be from a capital intention to a revenue intention. This will also change the nature of the receipt from the disposal of the asset from a capital receipt to a revenue receipt. A taxpayer can also change his intention with regard to an asset from a revenue intention to a capital intention. This was argued in *CIR v Stott*<sup>8</sup>. The taxpayer owned properties that he had held for a period of over 20 years with a capital intention. One of the properties was originally purchased with the intention of building a residence on but it was substantially larger than the taxpayer needed. Since it was larger than required, the taxpayer subdivided it into a residential portion and a non-residential portion. The non-residential portion was subdivided into lots and

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<sup>7</sup> *COT v Levy* 1952 (2) SA 652 (A), 18 SATC 127.

<sup>8</sup> *CIR v Stott* 1928 AD 252, 3 SATC 253.

sold piecemeal. The taxpayer had also acquired a fruit farm which was subject to a long-term lease agreement. This lease agreement was cancelled after a breach on the part of the lessee and subsequently the property was re-let subject to the condition that the taxpayer might later subdivide and sell the farm, which he indeed did. The Commissioner argued that the taxpayer had, in respect of both pieces of land, changed his intention from a capital intention to a revenue intention. With particular reference to the subdivided property, the court declared that the mere fact that the property was subdivided did not instantly convert the nature of the proceeds to revenue. The court commented that the mere fact that the taxpayer had subdivided the land did not change the nature of the proceeds from a capital nature to a revenue nature; the taxpayer was merely realizing his asset to best advantage, there was no change in intention. The court established that the mere decision to sell does not show a change in intention, something more was needed to show a change in intention.

Nevertheless the sale of an asset does mean there is a change in intention with regards to the asset. In *John Bell & Co (Pty) Ltd v SIR*<sup>9</sup> the court once again ruled that a taxpayer is entitled to realize his asset to best advantage and that the proceeds from the asset will not certainly result in 'gross income' unless there is supporting evidence that shows that the asset is being held as trading stock instead of a capital asset. Something else that is more than the mere realization of an asset to best advantage is needed. In *CIR v Richmond Estates*<sup>10</sup> (Pty) Ltd, the court held that the mere fact that a taxpayer decides to dispose of a capital asset at a profit does not make the resulting profit subject to tax. It was also established that some of the properties disposed of by the taxpayer were originally acquired with a revenue intention but were afterward held as capital assets due to a change in intention by the taxpayer.

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<sup>9</sup> *John Bell & Co (Pty) Ltd v SIR* 1976 (4) SA 415 (A), 38 SATC 87.

<sup>10</sup> *CIR v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A), 20 SATC 390.



In addition in *Natal Estates Ltd v SIR*<sup>11</sup> the taxpayer held a large piece of land purchased with the intention of sugar cane farming. It was therefore clear that the intention of the taxpayer with respect to the land at the time of acquisition was of a capital nature. The court found that in the company's conduct, whilst subdividing the land, the planning that went into the project, the large-scale nature of the project, the time taken to complete the project as well as the marketing of the company meant that it was clear that the taxpayer had crossed the Rubicon and had entered into a scheme of profit-making. Therefore the land constituted trading stock and the receipts from the sale of the land were included in the gross income of the taxpayer. There is a limit to what a taxpayer may do in order to realize an asset to his or her best advantage.

As I have mentioned above, the court will look at both the subjective and objective factors of a case when determining the nature of the receipt. One of the objective factors includes: the length of time that the taxpayer held the asset for. An asset that has been held for a long period of time is more likely to be a capital asset than one held for a short period of time. The frequency with which the taxpayer transacts in similar transactions can also be a useful test. Where the taxpayer frequently buys and sells an asset, there is the assumption that such asset is held for a scheme of profit-making and will be seen by the Commissioner as a revenue asset. When dealing with a company the intention and objective of the directors captured in minutes to meetings can also be used by the courts.

This research will be focused on the tax effect of realizing capital assets by the use of a realization company and evaluating the nature of a receipt or accrual in the hands of a taxpayer.

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<sup>11</sup> *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.

This objective will be achieved by analyzing the judgment of the *Founders Hill* case and by looking at previously established cases. Articles from various authors will also be considered.

## Chapter 2

### Background and facts of the case<sup>12</sup>

AECI Ltd ('AECI') had surplus land that it held as a fixed capital asset. AECI no longer needed the land so the company decided to sell or develop the land. To achieve this the company decided to form a realization company, namely Founders Hill (Pty) Ltd ("Founders Hill") for the sole purpose of realizing the land to best advantage for AECI's shareholders.

Founders Hill had no employees of its own and its only shareholder was AECI. Its directors were the same as those of AECI. Founders Hill began realizing the land with the help of some of AECI's subsidiaries. The land was subdivided and developed so it could be disposed of. AECI believed that the proceeds from the sale would be of a capital nature as they were merely realizing their capital asset to best advantage.

At first the Commissioner for the South African Revenue Service ('the Commissioner') approved that the land was a capital asset but contended that AECI had 'crossed the Rubicon' and was now trading in land and as a result saw the proceeds of the sales as of a revenue nature.

The Commissioner relied on the decision in *Natal Estates Ltd v Secretary for Inland Revenue*<sup>13</sup> ('Natal Estates') case by arguing that the company had changed had changed its intention from capital to revenue. The Commissioner claimed that the company had embarked on a scheme of

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<sup>12</sup> *Founders Hill (Pty) Ltd, CSARS v*, 2011 (5) SA 112 (SCA), 73 SATC 183, 2011. The background and facts of the case are summarized in my own words.

<sup>13</sup> *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A), 37 SATC 193.

profit making. Founders Hill maintained its position that it had merely realized the land as a capital asset and it relied inter alia on *Berea West Estates (Pty) Ltd v SIR*<sup>14</sup> (Berea West).

When the matter was taken to the Tax Court the issue was whether Founders Hill realized the land as a capital asset or if it embarked on a scheme of profit making. The Tax Court found that Founders Hill did not embark on a scheme of profit making and as a result no tax was payable on the proceeds.

On appeal by the Commissioner to Supreme Court of Appeal, the Court gave the following reasons for coming to its conclusion:

Firstly the court questioned the formation of Founders Hill for the disposal of the land rather than AECI disposing of the land itself. AECI's response was that it was acting on legal advice. The court expressed that acting on legal advice is not reason enough to regard the land as a capital asset. The court established that when a realization company acquires assets from its shareholders, it acquires them as trading stock making the proceeds revenue in nature and taxable. Relying on the decisions in *Malone Trust v SIR*<sup>15</sup> ("Malone") and *Berea West Estate*<sup>16</sup>s *(Pty) Ltd v SIR* cases, the court established that in both cases there was a reason why a realization company was required in order to realize a capital asset. The court found that since Founders Hill only had one shareholder it could have disposed of the land itself. It was established that case law sets out special situations in which a realization company would be recognized, rather than a general rule. Where the original owner of the asset could, without the creation of a new subsidiary dispose of the asset itself, then it could not be the intention of the

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<sup>14</sup> *Berea West Estates (Pty) Ltd v SIR* 1976 (2) SA 614 (A), 38 SATC 43.

<sup>15</sup> *J M Malone Trust v SIR* 1977 (2) SA 819 (A), 39 SATC 83.

<sup>16</sup> *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue* 1976 (2) SA 614 (A), 38 SATC 43.

new subsidiary to dispose of the asset as a capital asset. Furthermore, if the only reason the asset was transferred to the new subsidiary is for it to be disposed of then there is no basis on which they can claim that they held it as a capital asset.

The Supreme Court pointed out that just because Founders Hill said that they acquired the land as a capital asset did not mean that it was in fact a capital asset for tax purposes.

The court accordingly upheld the appeal and overturned the order of the Tax Court. The Court did not however impose penalty interest on Founders Hill as it had mistakenly believed it was only realizing land and had disclosed all facts to SARS in its tax returns.

### **Chapter 3: Discussion of the case**

The judgment from the Founders Hill case has created a stir in the tax planning community. This is because many taxpayers assumed that the use of a realization company to dispose of capital assets resulted in the proceeds being capital in nature. Some people feel that the judgment has overturned longstanding principles established in law while others feel that it reinforced and clarified the longstanding principles.

#### **3.1 Arguments in support of the judgment**

The question of whether proceeds made by companies formed with the sole purpose of realizing an asset to best advantage are capital or revenue in nature has come before the courts on a number of occasions. The tax planning community is torn between with one part thinking that the decision of the court overturned long standing rules from past cases and the other part saying that the decision emphasized long standing principles.

When the Supreme Court of Appeal heard the case, it did not look at the arguments brought before it but instead looked at the intention of Founders Hill when it acquired the land. The court established that the reason behind the acquisition of the land would decide whether the land was acquired with a capital or revenue intention. Some of the members of the tax community agree with the court's view that when Founders Hill acquired the land, it acquired it with the intention of selling it thereby making the land trading stock and the proceeds from it taxable. The court held that the creation of a realization company would not make the land a capital asset when it was acquired by Founders Hill with the intention of selling it. The court used authority from the Malone and Berea West cases to reach this decision.

Judge Lewis<sup>17</sup>, in the Supreme Court of Appeal, pointed out that Founders Hill was created as a “realization company” on legal advice and that by acquiring the land from AECI and realizing same to best advantage it should not cross the Rubicon. The judgment contains an analysis of the tax treatment of realization entities and particularly the decision of the court in *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue*. In that case, the profit realized on the disposal of land by a company formed for the purpose of realizing land held by different family members was held to be capital in nature. Judge Lewis noted that an interposed realization company will be treated as holding assets acquired by it as capital assets from the seller in special circumstances as set out in *Berea West’s* case and not merely where the realization company acquires property for the avowed purpose of disposing of same at a profit.

When the court assessed the judgment from the *Berea West* case it found that there needed to be special reasons for the creation of a realization company. It established that only in special cases will the proceeds be of a capital nature. It was emphasized that the case of *Berea West* was a special case and its judgment did not create a general rule.

### **3.2 Arguments against the judgment**

In its judgment the court relies on the judgment of the Supreme Court of Canada reported as *Balstone Farms Limited v Minister of National Revenue*<sup>18</sup>. What happened in this case was that an old couple sold farm land that they held under a lease at a profit to a company. The company later sold the land. The minister assessed the proceeds as revenue. On appeal to the Supreme

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<sup>17</sup> *Founders Hill (Pty) Ltd, CSARS v, 2011 (5) SA 112 (SCA), 73 SATC 183*

<sup>18</sup> *Balstone Farms Limited v Minister of National Revenue [1968] SCR 205.*

Court the company argued that it was formed for the purpose of disposing of capital assets. The court established that the company was created with the sole purpose of purchasing the land and later disposing of it. The Supreme Court rejected Balstone's argument saying that Balstone was not a realization company and as a result ruled that the proceeds were of a revenue nature and as a result taxable. In Broomberg's<sup>19</sup> opinion the judge was wrong in thinking that the facts in the Founders Hill case were not different from those of the Balstone case. His view is that the two cases are different because in the Balstone case the sale was an out and out sale. The couple was not shareholders of the company and the realization was not for their benefit but for the benefit of Balstone's shareholders. He said that it is the essence of a realization company that it realizes the assets on behalf of its shareholders, who were the original owners of the asset, and that it distributes the net proceeds back to the original owners who had held the asset as fixed capital. It is important to recognize that Balstone was not a realization company as it did not do that. This was spelled out in the Balstone judgment when the learned judge after referring to the familiar leading realization company cases, said the following;

“ In none of these realization cases was there an out and out transfer by former owners for a cash consideration ... [ Balstone] was not “realizing” or selling these properties for the benefit of prior owners ”.<sup>20</sup>

He believes that if the original shareholders had held the shares in the company so that the properties would have been realized for their benefit then the Canadian Court would have treated the company as a realization company and would not have taxed the proceeds.

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<sup>19</sup> Eddie Broomberg “On NWK and Founders Hill” 2011 The Taxpayer Volume 60 No 10 and 11.

<sup>20</sup> (1968) SCR 205 at 212 – 213.



Founders Hill as a realization company acquired property from AECI for the very purpose of developing and selling it. The courts in the Republic and abroad held that realization companies are not taxable on the proceeds of the disposal of their assets. This means that even though the assets are acquired by the realization company with the intention to sell, the purpose is not to trade for profit but rather to realize the asset to best advantage on behalf of the shareholder and to account to shareholder for the net proceeds. The assets are therefore not acquired as trading stock and the proceeds of the realization are of a capital nature. The general rule always has been that a realization company acquires its assets as fixed capital. The court in the Founders Hill case got it wrong in ruling that the general rule is that a realization company acquires its assets as trading stock.

In its judgment the court held that the rule is simple: if a taxpayer acquires an asset with the intention to sell it then that person is trading. Broomberg is of the opinion that the court forgot that there cannot be trade without the intention to trade. He uses authority from the Pick 'n Pay<sup>21</sup> case where it was held that the fundamental principle that there cannot be trade without an intention to trade for profits not only applies to isolated transactions but equally to a continuous series of transactions which objectively viewed, might be perceived as amounting to the carrying on of a business. In the Pick 'n Pay case, a trust was formed to acquire Pick 'n Pay shares for the purpose of reselling them to employees of the Pick 'n Pay Group in terms of a conventional share incentive scheme. It would also repurchase shares from employees who quit the scheme. It was never the intention of the trust in purchasing shares that it would retain those shares. It was always the intention that the shares would be resold, at market value as soon as the circumstances allowed as such. It was more than likely that the trust would make profits on these

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<sup>21</sup>*Pick 'n Pay Employee Share Purchase Trust, CIR v, 1992 (4) SA 39 (A) 54 SATC, 1990.*

transactions since the market value of the Pick 'n Pay shares tended to increase over time. As it turned out profits were actually made. The Commissioner taxed these profits on the basis that the proceeds of the shares sold were not of a capital nature. Because of the scale on which the trust was continuously buying and selling shares, it could be said that, objectively viewed, the trust was conducting a business of dealing in shares.

The court held that the test for distinguishing between capital and revenue receipts or accruals from the sale of an asset is whether the taxpayer was engaged in a scheme of profit making. Where a business is carried on, receipts or accruals will only be of revenue in nature if the business was conducted with the purpose of making a profit. In the Pick 'n Pay case, the trust had not been carrying on a business of trading in shares. The purpose of the share purchase scheme was not to make profits, and the activities of the trust were therefore not part of a scheme of profit-making. Where no trade is conducted there cannot be floating capital. The trust did not trade in shares for profit, and the shares were therefore not floating capital in its hands. It mattered not that the shares were purchased with the intention of reselling them nor that the making of profits may have been contemplated, nor even that the trust was conducting a business. Because the purpose of the trust was to serve the Group's share incentive scheme, and it was not the purpose of the trust to trade for profit, the shares it bought and sold were not trading stock, and proceeds of the sales were therefore capital in nature as opposed to revenue in nature. Therefore the shares it bought and sold were not trading stock and the proceeds were capital in nature.

Broomberg<sup>22</sup> further argues that the court in *Founders Hill* seems to have ignored that the *ratio decidendi* in *Pick n Pay* was to the effect that it is not enough that a taxpayer acquires an asset intending to resell it to make the asset a floating capital. The purpose of the transaction must have been to trade for profit in other words the asset must have been resold as an operation of business in a scheme of profit making. The court ruled under the impression that the general rule is that a realization company acquires its assets as trading stock. However, the general rule always has been that a realization company acquires its assets as fixed capital.

Another case that the *Founders Hill* court relied on in its decision was the *Berea West*<sup>23</sup> case. The case dealt with land that was donated in 1922 by one K to a trust for his children and transferred to the trust after his death in 1927. Half of the land was given to his children under his will. Due to unforeseen circumstances and difficulties experienced, it was agreed among the interested parties that land should be transferred to a company and that the consideration should be satisfied by the issue to the beneficiaries as shareholders and debentures. An approval was obtained, prior to the transfer to the company, for the establishment of a township and subdivisional plans had also been approved. The company's general procedure was to develop one area and sell the plots and use the money to develop a further area. The company did not acquire any other land and carried out no development scheme other than that prescribed by the township conditions. The court held that the company was a realization company and not a company carrying on a business. The findings of the court that the company had deviated from its intention of acting as a realization company was, on evidence, not one which could reasonably be reached. Therefore the profit which was received by the company pursuant to the sale of land was regarded as being of a capital nature.

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<sup>22</sup> Broomberg *The Taxpayer* Volume 60 No 10 & 11.

<sup>23</sup> *Berea West Estate (Pty) Ltd v SIR 1976 (2) SA 614 (A), 38 SATC 43.*

Broomberg<sup>24</sup> determined that the issue raised in the Berea West case was whether or not the proceeds of the realization of assets by Berea West, which was formed as a realization company, were to be treated as of a capital nature. The court dealt with that issue in identifying several factors on which it based its findings that the proceeds of disposal were of capital nature. These include the objects of the company as stated in its Memorandum of Association, and the provision of the Sale and Purchase Agreement that when the whole property had been realized the company was to be wound up and the remaining available funds distributed among shareholders. Davis<sup>25</sup> specifies that it is critical to evaluate the conduct of the taxpayer where it is a realization company. On appeal, Founders Hill relied on the fact that its sole purpose was to sell the land which AECI had held for decades and its intention therefore was to realize capital assets to best advantage. The court concluded that there was no basis on which the property which had been transferred to the taxpayer was not its stock in trade. Dennis Davis is of the opinion that the judgment without any plausible justification, swept away significant precedent by way of a misunderstanding of the significant implications of critical tax cases, in particular Berea West<sup>26</sup> and Natal Estates. In Dennis Davis's view the courts in Berea West and Natal Estates were simply applying the basic principle, the golden rule that holds that if there is no trading profit there can be no trading stock. This is where the Founders Hill court got it wrong.

<sup>27</sup>Broomberg argued that the Founders Hill court was called upon to account for the fact that in a number of decisions in South Africa and abroad, the courts have held that the proceeds of the disposal of assets by a realization company are of a capital nature.<sup>28</sup> Broomberg further

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<sup>24</sup> Broomberg The Taxpayer Volume 60 No 10 & 11

<sup>25</sup> Broomberg The Taxpayer Volume 60 No 7 of July 2011 p123

<sup>26</sup> *Berea West Estate (Pty) Ltd v SIR 1976 (2) SA 614 (A), 38 SATC 43*

<sup>27</sup> Broomberg The Taxpayer Volume 60 No 10& 11 of October – November 2011.

<sup>28</sup> *Ibid.*

highlights a well-known case of *Realization company v COT*<sup>29</sup> which until the advent of the Berea West judgment served as the leading case on realization companies in the subcontinent. The realization company was a wholly owned subsidiary of a single company as in the case of Founders Hill, and the proceeds of the realization were held to be of a capital nature. JA Holmes expressly approved the principle applied in the judgment made by the *Realization company* court and drew a conclusion that it is apparent that a company can be formed to realize certain assets and to realize them without being liable to tax on any profit resulting from realization, provided that the company does not trade. This appears to be relevant as the principle applied in the court of the Realization Company case was expressly approved by Holmes JA in the *Berea West*<sup>30</sup> case. Moreover in the case of *ITC 1481*<sup>31</sup> which significantly was decided after the Berea West case, a realization company which had been formed to realize land belonging to a single owner, was held not liable for tax on the proceeds of the realization as they were of capital in nature.

Broomberg<sup>32</sup> also revealed that the counsel for AECl, the Commissioner and the court in the Founders Hill case were all correct in approaching the matter on the basis that Founders Hill had acquired the land as a fixed capital, and that the only issue was whether the company had crossed the Rubicon. In treating the proceeds of the disposal by the realization company as being of capital in nature, the court in Berea West was simply applying the basic principle, the golden rule that holds if there is no trading for profit there can be no trading stock.

In addition to the Berea West case the case of Natal Estates also contributes in giving a distinction between proceeds which are of capital in nature and those which are revenue in

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<sup>29</sup> *Realization Company v Commissioner of Taxes 1951 (1) SA 177(SR).*

<sup>30</sup> *Berea West Estate (Pty) Ltd v SIR 1976 (2) SA 614 (A), 38 SATC 43.*

<sup>31</sup> ITC 148152 SATC 285.

<sup>32</sup> Broomberg The Taxpayer Volume 60 No 10 & 11.

nature. In the case of Natal Estates the taxpayer owned vast tracks of land along the coast of north Durban. The taxpayer carried on business as a grower and miller of sugar cane and a manufacturer of sugar. The directors of the company were aware throughout the years of the possibility that the local authorities could expropriate the property for essential public development. Over the years the company's newly constituted board of directors consulted professionals in order for the project to be successful, these included engineers, architects and financial analysts. The project was successful and the taxpayer then sold the developed land piece by piece directly to the public. The Commissioner included the proceeds of these sales in the taxpayer's gross income and this is what made Natal Estates Ltd to appeal to court. Holmes JA held that the fact that all the land had originally been acquired with the intention of holding it as a capital asset was not decisive as to preclude a change of intention. The fact that a taxpayer was engaged in land development with professionals in place was of merely evidential value. The Special Court had been entitled, on all facts, to find that the taxpayer was not merely realizing its capital to best advantage but, having regard to the scale of its township development activities, was carrying on a business of selling land for profits using the land as trading stock. The court considered the fact that the taxpayer had gone over to the business of township development and held that the company changed its intention to sell the land at a profit. Therefore the proceeds of the sales formed part of company's gross income and were subject to normal tax.

Davis<sup>33</sup> further brings attention to the case of *Malone trust v Secretary of Inland Revenue*<sup>34</sup> where the executor of a deceased estate decided to establish a trust in which he transferred the property, he then made himself the trustee and disposed of the property. In that case the court

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<sup>33</sup>Broomberg The Taxpayer Volume 60 No 7 of July 2011 p123.

<sup>34</sup> *J M Malone Trust v SIR 1977 (2) SA 819 (A), 39 SATC 83.*

held that if the taxpayer had established a township himself, he would have done no more than realized the property to best advantage. It made no difference, therefore that the property had been sold by a trust. Trollip JA mentioned:

“ If a trust is formed for the purpose of facilitating the realization of property and the trust does no more than act as a the means whereby the interests of its beneficiaries may be properly realized in the property, surpluses made from sale of the property are not taxable as trading profits since such are capital receipts. The trust was purely a realization trust to which the principles explained in *Berea West* case are applicable”.

In Davis's<sup>35</sup> opinion, the Founders Hill court distinguished the judgments in both *Berea West* and *Malone Trust*<sup>36</sup> from the facts with which it was confronted, on the basis that in the earlier cases there was a 'real justification for formation of the company or a trust'. This is where the taxpayer in the Founders Hill case failed to explain why a realization company had been employed to dispose of the property. Davis points out that AECI as a trading company mentioned that it held land which was of a capital nature and wished to dispose of that land it was more convenient for the land to be disposed of by a realization company as had occurred in *Berea West* case. The court in Founders Hill case concluded that there was no basis on which the property which had been transferred to the taxpayer was not its trading stock therefore the proceeds on disposal of property were revenue in nature. This conclusion was not accurate, as mentioned above, as similar events took place in *Berea West* case. However Holmes JA carefully examined the manner in which the land has been disposed of by the realization company in the Founders Hill case. He mentioned that the fact that there had been no deviation from the initial intention of the

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<sup>35</sup> Broomberg The Taxpayer Volume 60 No 7 of July 2011 p124.

<sup>36</sup> *J M Malone Trust v SIR 1977 (2) SA 819 (A), 39 SATC 83.*

realization company, as divined from its activities, it had showed that the proceeds can never be revenue in nature.



## Chapter 4: My views

A realization company is not defined in the Act so the court looks to case law to attach a meaning to the word. I agree with Broomberg's<sup>37</sup> view with regards to the confusion made by the Supreme Court of Appeal. In my opinion a realization company should be responsible only for the realization of its owner's assets and its proceeds should be of a capital nature. I believe that if a realization company is created, the court should first assess whether the taxpayer focused on realizing the assets to best advantage or if the taxpayer crossed over and embarked on a scheme of profit making. If the court finds that the realization company did in fact only dispose of the assets to best advantage then the proceeds should be of a capital nature. But where a company did more than realize the assets, that is, it embarked on a scheme of profit making then its proceeds should be of a revenue nature. Founders Hill's intention was to only realize the land for the benefit of its original shareholders and AECI wanted to achieve the same results as that in the Berea West case.

Since trading is a requirement before profits can be taxed, I think the court should have assessed whether Founders Hill had started trading or not. According to the *Pick 'n Pay*<sup>38</sup> case for a company to trade there must have been an intention to trade. I believe that Founders Hill never had an intention to trade. A company might not have an intention to trade but according to the *Natal Estate* case the extent of a taxpayer's activities in developing its land will result in the taxpayer carrying on a business of selling land, now using the land that was originally purchased with capital intentions as its trading stock. I believe that this is the test that should have been applied to the Founders Hill case.

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<sup>37</sup>Broomberg *The Taxpayer* Volume 60 No 10 & 11.

<sup>38</sup>*Pick 'n Pay Employee Share Purchase Trust, CIR v, 1992 (4) SA 39 (A) 54 SATC, 1990.*

I will now look at the concept of a realization company. There is an important exception to the general rule that if a company acquires an asset with the express object of reselling it the proceeds are income. This is found in the concept of a ‘realization company’<sup>39</sup>. This concept has its origin in the Rhodesian case of *Realization Company v COT*<sup>40</sup> where the company concerned had been formed with the object of liquidating to best advantage assets that it took over from its holding company, which owned all the shares of the company. The court considered that what was envisaged by the concept of a ‘realization company’ in certain foreign cases was ‘a company the main object of which is the recovery of capital, not the making of profits’, and Judge Beadle concluded that;

‘where a company is formed for a legitimate purpose unrelated to tax avoidance with the express object of realizing assets acquired at its formation from its promoter – assets which the promoter himself could have realized in similar circumstances without attracting tax, and that company does nothing more than realize those assets, then any gains [proceeds] made on a simple realization of those assets would be regarded as accruals of a capital nature<sup>41</sup>.’

The number of cases that have dealt with realization companies established a general rule that proceeds from sales of a realization company are of a capital nature. The first time South African law saw a case that dealt with the concept of a realization company was with the Berea West case where the Supreme Court of Appeal found that the proceeds were of a capital nature. The court quoted the Balstone case in its reasoning saying that the Founders Hill case was the same as Balstone case, which I do not agree with. The interesting thing about the Founders Hill case is

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<sup>39</sup>Silke, Divaris & Stein, *Silke on South African Income Tax*, 9 ed (Juta).

<sup>40</sup>*Realization company v Cot* 1951 (1) SA 177 (SR) (1950 SR 182) . 17 SATC 139.

<sup>41</sup> *Ibid.*

that in both of their arguments the Commissioner and Founders Hill relied on mostly the same cases and yet their conclusions differ. This shows that the problem is in the interpretation of past judgments. The court was interested in the reason behind the acquisition of the land by Founders Hill. I believe that Founders Hill's intentions were the same as those of AECI and that the court should not have viewed Founders Hill as being separate from AECI. The court argued that Founders Hill acquired the land with the intention of selling it, which is true but Founders Hill and AECI were part of the same group of companies and was created to see to the realization of the land not in a scheme of profit-making but to best realize the land for its shareholders. On the court's analysis of the *Berea West*<sup>42</sup> case and the *Malone case*<sup>43</sup> it found that a real justification should exist for a company to create a realization company. In my opinion the realization company should be subject to the same tests that a normal company would be subject to when it sold a capital asset and the court should look at the realization company as if it was the holding company that held the property initially.

I hold this view because of what was decided in the *Solaglass* tax case<sup>44</sup>. In the *Solaglass* tax case taxpayer was a subsidiary company created with the goal of being a finance company within the group. The case dealt with whether the losses sustained by the taxpayer were of a revenue nature and therefore deductible under s11 (a) of the Act and whether the losses represented moneys wholly or exclusively laid out or expended for the purposes of trade. The taxpayers counsel argued that even though Solaglass was created with the intention of promoting the group's interests, when it started trading it served its own interests and not those of the group. The court disagreed with this view. In its judgment the court said that the reason Solaglass was

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<sup>42</sup> *Berea West Estate (Pty) Ltd v SIR 1976 (2) SA 614 (A), 38 SATC 43.*

<sup>43</sup> *J M Malone Trust v SIR 1977 (2) SA 819 (A), 39 SATC 83.*

<sup>44</sup> *Solaglass Finance Co Pty Ltd V CIR 1991 (2) SA 257, 53 SATC 1.*

created did not disappear when it started trading. The court decided that the controlling mind which brought Solaglass into operation also directed its ongoing activities working towards promoting the interests of Solaglass as well as those of the group. I believe that this was the case with Founders Hill; the controlling mind behind Founders Hill activities was AECI and the profits made from the sale of the land were not just for Founders Hill but were also for AECI. The activities conducted by Founders Hill were governed by the policies of AECI and I believe that for that reason the court should have viewed Founders Hill and AECI as one legal entity.

When you look at Founders Hill and AECI as one legal entity, the sale of the land from AECI should be disregarded as this is one legal entity so there will be no argument as to the nature of the land in Founders Hill's hands. The land will preserve its nature as a capital asset and the Supreme Court of Appeal's argument that the land was trading stock will not hold. The supreme court of appeal questioned the very creation of Founders Hill but if the two companies are seen as one legal entity that would not be an issue anymore. Looking at the companies as one legal entity would have forced the supreme court of appeal to focus on the activities carried on by Founders Hill in realizing the land. The supreme court of appeal would have to look at the issue that was brought to it on the first place which was whether Founders Hill had 'Crossed the Rubicon' in its efforts to realize the land.

The arguments brought forward by the tax community are mostly whether Founders Hill was a realization company or not. I believe that the court should have also focused on the extent of Founders Hill activities while trying to realize the asset

I am now going to look at the original argument that was brought to the Supreme Court of Appeal, which is whether Founders Hill had crossed the Rubicon and started trading in land. The Tax Court ruled that Founders Hill had not traded in land and that the land was a capital asset so the proceeds would not be subject to income tax.

I am going to apply the tests that courts use to determine whether proceeds are of a capital nature or not. Firstly I will look at the company's intention with regards to the land. Founders Hill was incorporated for the sole reason of realizing the land for its original shareholders that is AECI Ltd. Its sole shareholder was AECI Ltd and its directors were the same as those of AECI. This means that we can look at Founders Hill and AECI as one taxpayer. Since Founders Hill is a company its intentions will be the same as the intentions of its directors. AECI Ltd.'s intention was to realize to its best advantage the surplus land. This should be the same intention for Founders Hill as its directors are the same as those of AECI Ltd. So I will look at Founders Hill and AECI ltd as one taxpayer as Founders Hill was just used to carry out AECI's intentions.

When the land was acquired, it was acquired as a capital asset and AECI had no intentions of trading in it. As years went on, there were changes and as a result AECI no longer had use for the land and as a result decided to sell the land. I do not believe that this shows a change in intention with regards to holding the land. I say this because in the *Stott*<sup>45</sup> case the court ruled that the mere decision to sell an asset does not instantly convert the proceeds to revenue proceeds and that every taxpayer has a right to realize his assets to best advantage.

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<sup>45</sup> *Stott, CIR v, 1928 AD 252, 3 SATC 253.*

Furthermore in the *John Bell*<sup>46</sup> case, the court ruled that something more than the mere decision to sell was needed to make convert proceeds from a capital nature to a revenue nature. This principle was further emphasized in the *Natal Estates*<sup>47</sup> case where the court said that where a company had crossed the Rubicon and crossed over to the business of trading in land for a profit using its land as trading stock, its proceeds would be of a revenue nature. This was the main argument brought by the Commissioner to the Supreme Court of Appeal. Founders Hill subdivided the land and included professionals to develop the land. Expenditure was also incurred to ensure that each subdivided stand could be sold with services such as the supply of water, electricity and sewerage by the local authority. Heartland Properties (Pty) Ltd, another wholly owned subsidiary of AECI was introduced into the property selling activities as a marketing company. The question is whether all these activities amount to crossing the Rubicon.

Looking at some of the objective factors of this case, starting with the length of time the asset was held, AECI held the land for a number of years before they decided to sell it, this indicates a capital intention. This was the first time that AECI had sold land, so the company did not frequently transact in selling land.

In Founders Hill, the company was created for the purpose of realizing land formerly owned as a capital asset by its holding company, namely AECI Limited. I believe that when a company is referred to as a realization company and the company does no more than realize the asset owned by it, its proceeds should be of a capital nature. Therefore the court should have based its conclusion on the nature of the proceeds by assessing whether Founders Hill ‘crossed the Rubicon’ making the proceeds revenue in nature, rather than merely realizing the asset to

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<sup>46</sup> *John Bell & Co (Pty) Ltd v SIR* 1976 (4) SA 415 (A), 38 SATC 1976

<sup>47</sup> *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193

AECI's best advantage due to the activities Founders Hill did when realizing the asset. When the Tax Court looked at the case it held that Founders Hill did not cross the Rubicon and I agree with that judgment.

Therefore I do not think that the Supreme Court of Appeal was correct in its judgment.

## **Chapter 5: Impact of the court's decision.**

The judgment of the Supreme Court of Appeal will lead to a decline of realization entities, except when one is created for special cases. After this judgment the existence of realization companies will invite analysis from the Commissioner. The impact of the judgment will have a wide-ranging effect that is not just limited to realization companies. It will affect the way courts apply established cases when determining whether proceeds are of a revenue or capital nature. The Supreme Court of Appeal questioned the very creation of a realization company saying that a company needed to have a commercial reason for disposing of assets through a realization company. As realization companies have been a tool in the tax community when it comes to the realization of assets, this decision will limit the tax community in disposing of assets through the use of a realization company. A person will think twice before incorporating a realization company. In the wake of *Founders Hill*, it would seem that only where there is more than one shareholder involved and where the realization of the assets would otherwise have been close to impossible, would a realization company have its proceeds be of a capital nature.



## **Chapter 6: CONCLUSION**

In determining whether the proceeds from the disposal of an asset are capital or revenue in nature, the intentions of the taxpayer should be determined. Where a taxpayer acquires an asset with the intention to resell it, the proceeds from the disposal of that particular asset are revenue in nature. This means that in order for the proceeds to be revenue in nature, there should be a trade carried on. Where there is no trade, the proceeds can never be revenue in nature. In the case of a realization company, the company can be formed for realizing the asset of the shareholders to best advantage, and in that case, the proceeds from the disposal of that asset are capital in nature.

When a court is dealing with a case, the judgments from prior cases that are similar to the case the court is hearing should be taken into consideration when a decision is made. As mentioned above, the courts in the Republic and abroad held that realization companies are not taxable on the proceeds of the disposal of their assets and this means that a court dealing with a realization company case can reliably use the judgment from previous cases dealing with realization companies. However, previous case law should not be the main focus but also the Act and other regulatory documents that are in place should be used to make the correct decision.

In the Founders Hill case, the issue was whether the proceeds from the disposal of property were of a capital or revenue nature. Both the Commissioner and Founders Hill agreed that the property acquired by Founders Hill from AECI was acquired as a capital asset. The confusion is brought about by the fact that it was not clear as to whether Founders Hill had crossed the Rubicon and entered into a scheme of profit-making. If Founders Hill actually crossed the Rubicon, then the proceeds would be taxable as they would be of a revenue nature. Founders Hill relied on the fact

that its sole purpose was to sell the land which AECI had held for decades and its intention therefore was to realize a capital asset to its best advantage .The Founders Hill court looked at relevant cases prior to making a decision with regards to the proceeds from the disposal of the property by Founders Hill. The court held that the proceeds from the disposal of the property by Founders Hill were revenue in nature and therefore taxable. It appears that the court ruled under the impression that the general rule is that a realization company acquires its assets as trading stock. However, the general rule always has been that a realization company acquires its assets as fixed capital.

The court should have looked at the previous judgments made by the other courts which have dealt with a similar case in the past. For instance, the Berea West case is very similar to the Founders Hill case and in that case, it was decided that the proceeds are capital in nature since the general rule states that a realization company acquires its assets as fixed capital. Therefore, I believe the decision in the Founders Hill case was incorrect as the court had swept away the general rule when deciding the outcome of the case.

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