

CML602 W - MASTER OF LAWS

TAKING THE WRONG ROAD IN THE
CAPITAL / REVENUE ENQUIRY - THE
CONTROVERSIAL CASE OF THE
SHARE INCENTIVE TRUST

BY

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PART ONE: THE SHARE INCENTIVE TRUST

INTRODUCTION

It is sometimes said that taxation is the price we pay for civilisation.¹ What is perhaps not said as often is that not every citizen or organisation pays taxes, nor are many of them, and justifiably at that, obliged to do so. The share incentive trust, according to the highest court of the land, is one such organisation.

After a chequered, controversial, and sometimes protagonistic seven-year history, the Appellate Division of the Supreme Court, in C.I.R. vs Pick 'N Pay Employee Share Purchase Trust² ruled, by a majority of 3-2, that share incentive trusts, as presently structured, are not liable for normal income tax on profits made through dealing in its founder company's shares.

The Rise of the Share Incentive Trust

During the boom years of the stock exchange in the late 1960's, the idea of providing a tax-free employment fringe benefit for corporate employees by the use of stock option plans gained widespread popularity.³ Key management staff were granted options to purchase shares in their employer company exercisable in the future (subject to continued employment) at the market value prevailing on the date the options had been granted.

It was intended that the stock option plan fulfil, to a greater or lesser extent, three objectives. Firstly, to promote the image, amongst corporate staff, of an organisation striving towards the ideal of greater worker participation in corporate control through the medium of share acquisitions made possible by the provision of easy

1 This quotation has been attributed to Justice Holmes.
2 (1992) 52 SATC 271; 1992 (4) SA 39 (A).

3 See Broomberg - Tax Strategy 2nd Ed (1983) @ P 179/180 and also Richard D Jooste: Share Incentive Schemes - A Recent Case May Have Reduced Their Appeal - Income Tax Reporter (1987) 26 @ 9.

credit terms. (Under the then Companies Act partly-paid shares were permissible).

Secondly, and rather more importantly, to dangle the carrot of temptation for key employees to remain with the company in the hope that on maturity of their share options, they would be able to acquire the company's shares at bargain prices.

Thirdly, to provide key employees with a non-taxable employment benefit. The gain on maturity of the stock option plan, though unrealised, was tangible and tax-free. This tax-free status stemmed from the fact that there was no 'amount' in cash or otherwise accruing to the employee on the date of grant of the option within the meaning of the gross income definition in section 1 of the Income Tax Act No. 58 of 1962 (hereinafter "the Act"). Moreover, the stock option plan was personal to the employee and, therefore, not cedable or convertible into cash.

When the employee's right to exercise the option matured and he purchased at the market-value prevailing at the time of grant, there was no 'receipt' or 'accrual' to tax.

Finally, when the employee sold his shares, the proceeds would constitute tax-free receipts, assuming the absence of a speculative intention, or a scheme of profit-making.

This rather neat corporate arrangement was met, not unexpectedly, with a distinct lack of enthusiasm by the Revenue authorities and, as the stock option plan gained in popularity, it achieved a concurrent notoriety directly proportional thereto, as a tax avoidance mechanism.

Revenue's response, delivered swiftly, was effected by way of the legislative enactment of Section 8A.⁴ That section, departing from traditional taxation principles, rendered

4 Section 11 of Act 89 of 1969.

assessable any unrealised gains on stock option plans. The section also rendered the stock option plan, in its existing form, summarily and effectively obsolete !

Given the eternal resourcefulness of taxpayers - and their advisers - it was not long before the utilisation of the share option as a tax incentive for company employees was resuscitated in a new garb. The delectable product of this painless metamorphosis was the employee share incentive purchase trust (hereinafter "the share incentive trust"), an innovation that has survived through two decades of persistent tax hostility - Revenue's bete noire, Judges' bane and academics' frustration !

Commenting on the transformation, the Standing Commission of Inquiry on Taxation of Fringe Benefits Attaching to Employment lamented:⁵

"The introduction of s.8A virtually killed the option schemes, and since then, a new type of share incentive scheme for employees of companies has developed. These schemes achieve precisely the same end as did the old share option schemes - the employee is able, without any risk whatsoever, to acquire shares at undervalue. The schemes are so framed that they fall outside the scope of s.8A."

The Influence of the Companies Act

The Green Committee in England, in its report, censured the corporate practice of providing financial assistance to buyers and subscribers for the purchase of a company's own shares.⁶ These criticisms were noted by the legislature in South Africa and the 1926 Companies Act prohibited the practice, with a few important exceptions. One such exception was the share incentive trust. The 1926 provisions were incorporated with only minor textual changes, in the 1973 Companies Act, which is the Act currently in force.⁷

5 Government Gazette 6603 of 27/7/79, Notice 570/1979 @ Para 5.3.

6 English Company Law Reform Committee (1926) para 30.

7 Companies Act 61 of 1973, Sec 38.

In terms of section 38(2)(b) of the Companies Act, 1973, a company is permitted to provide a trust, formed for the purpose, with money to enable its trustees to subscribe for, or purchase, the shares of that company (or its holding company) to be held by, or for the benefit of, such company's employees, without contravening the share financing prohibition in Section 38(1).

Since the enactment of section 8A, the share incentive trust has, by all accounts, become the vehicle of choice for companies wishing to pursue the share incentive option for its employees. The extent to which the share incentive business has proliferated in the last twenty two years or so is manifest from the Commissioner's disclosure in the Pick'n Pay case⁸ that no less than fifteen similar cases involving share incentive trusts, and some R18,5 million were pending as at 2nd March 1992.⁹

The Mechanics of the Share Incentive Trust

Although not all share incentive trusts formed are identical, the mechanics of their operation, their objectives, and even the contents of their founding documents are largely co-incident. For the purpose of the case law under discussion, they will be treated as one generic form, minor variations being ignored. Where material differences arise, these will be highlighted.

The Standing Commission of Inquiry described the share incentive trust in the following terms:¹⁰

- "(i) A trust is formed.
- (ii) It buys or subscribes for shares in the company, or other companies in the group.
- (iii) The acquisition of the shares is funded by loans by the company or group.

8 Supra fn 2, @ 283.

9 This figure presumably does not include Trusts not disputing the C.I.R.'s decisions, or returning losses on their activities.

10 Supra fn 5.

- (iv) The trust offers the shares to selected employees in the company or group, usually the middle market price on the J.S.E. on the day of the sale.
- (v) A down payment of some nominal amount is required against the purchase price and the balance remains on loan account, payable either on termination of employment or on retirement or earlier death, or at the end of some predetermined period.
- (vi) The loan account is sometimes interest-free, and sometimes interest is charged but rarely at a commercial rate and there is always a safeguard limiting the interest charge for a year to the amount of the dividends received for the year.
- (vii) The shares become the property of the employee immediately and are transferred to him but are pledged to the trustees as security for the loan debt.
- (viii) The shares rank pari passu with the other shares in the company's capital but the dividends are usually appropriated (after tax) towards the payment of the interest and against the loan debt.
- (ix) There are 'stop loss' provisions which protect the employee against any loss caused by a fall in the value of the share at the time when settlement of the loan debt becomes due. Either the trustees buy back the shares at the price at which they were acquired or alternatively payment at the current value of the shares is accepted as satisfying the outstanding balance of purchase money."

To this list the following might usefully be added:

- (x) Even if the shares are fully paid for, the employee may not receive his shares, except after the lapse of a minimum period (usually 3-5 years) calculated from the date of sale, and at the latest on termination of the credit plan (usually 10 years), unless forfeited in the interim.
- (xi) Where an employee's service is terminated due to dishonest or fraudulent conduct, or he leaves within the minimum period, his shares are forfeited to the trust as against the balance of the share debt outstanding.
- (xii) Thus the trust acquires shares in four ways¹¹ :

11 See the Pick 'n Pay case supra fn 2 @ P. 285-286 & Unreported 1987 Taxpayer @ 211.

- (1) by an initial allotment of shares by the company.
 - (2) by repurchase from employees who have fully paid up their shares and endured the minimum period, thus entitling them to realise their holdings.
 - (3) by forfeiture of shares from employees leaving within the minimum period or who were dismissed for fraud or dishonesty or who declined to follow through their purchases.
 - (4) by purchase on the open market when the trust does not have sufficient shares available on hand for issue to eligible employees.
- (xiii) The price payable for shares in (1) above is the issue price; in (2) it is the then current middle market price on the J.S.E. (compulsory for listed companies' shares); in (3) the balance of the share debt owing by the employee,¹² and in (4) the prevailing market price.
- (xiv) Losses are for the account of the company.
- (xv) Profits are payable to the company either by direct vesting in terms of the trust deed, or at the discretion of the trustees, but subject to the condition that they are utilised solely for the benefit of the company's employees.¹³

The objectives of the share incentive trust are identical with those of the old stock option plan. For example, clause 1.2. of the trust deed in ITC 1413¹⁴ stated that the trust was constituted 'for the purpose of attracting and retaining management talent and providing incentives to employees of the group (ie. the company and others controlled by it) to advance the group's interests by encouraging the acquisition by them of shares in the capital of the company.'

12 See the Pick 'n Pay case supra fn 2 @ P 286 and ITC 1413 (1985) 48 SATC 167.

13 See: ITC 1413 supra fn 12 (discretionary trust) and ITC 1450 (1988) 51 SATC 70 (non-discretionary trust) and Unreported Judgment (1987) Taxpayer 211, @ 214 (discretionary trust) (later the Pick 'n Pay case).

14 Supra fn 12.

By selling its shares to key employees, (through the medium of the trust), the company is seen to advance the interests of its staff, giving them a voice in the general meeting of the shareholders and engendering in them the feeling that they are part of the company itself. Then, by withholding the right of the employee to deal with his shares for five years (or similar period), the company creates an incentive for such employee to remain in the employ of the company in the knowledge that sticking it out holds the reward of the ultimate delivery of his shares, hopefully at an enhanced value. The unrealised gain (if any) in the shares is not subject to tax (not falling within s.8A) unless and until the employee decides to sell and then if, and only if, he acquired them with a speculative intention, or sold them as part of a business or scheme of profit making (the normal capital-revenue enquiry).

The whole scheme is thus based on the premise that the company's shares will rise in value with the decline of money (inflation), the anticipated growing fortunes of the company (appreciation) and increased marketability (demand). As T.S. Emslie and D.M. Davis correctly observed:

"A rising market value of the shares is surely the raison d'etre of any share incentive, from the perspective of both employer and employee."¹⁵

15 The Taxation of Employee Share Incentive Trusts - A Polemic at the Heart of the Distinction Between Capital and Revenue (1990) 107 SALJ 1 @ 4.

PART TWO: THE TRUST GOES TO COURT

Revenue Responds

Regrettably for stock market speculators and investors, the expected hypergrowth of the stock market in the 1970's did not materialise.¹ The gains for employees were, therefore, seemingly of insufficient magnitude to warrant Revenue's attention. Broomberg, writing in 1983, commented:²

"As far as can be established, the Commissioner has not yet sought to attack any of these share purchase schemes. This may, however, be due to a different cause altogether. Thus, it is notorious that the provisions of s.8A were introduced into the Income Tax Act in 1969 as a direct counter-measure to the spate of stock-option schemes that were being introduced consequent upon the 1968 stock exchange boom. Since that time, it is equally notorious that the stock market prices have descended, gradually or not so gradually, with the result that there are very few share-purchase schemes which are proving advantageous to the purchasers. In other words, very few tax issues are likely to have arisen in this respect..."

The proverb 'ignorance is bliss' could not have rung truer. Even as Broomberg wrote those words, Revenue was at an advanced stage of execution of its plotted demise of the share incentive trust. In default of the tax net of s.8A, Revenue chose a new line of attack, a new battleground and its new victim.

With the gradual rise of the stock market and the large numbers of shares forfeited from employees, the trust began to return healthy profits. Revenue, armed with the gross income definition in s.1, pounced, seeking to tax the trust on the basis that its profits were of a revenue nature and, therefore, assessable to tax. It was now a question of the sins of the son (the employees) being visited upon the father (the company/trust). The battle joined, the struggle was only just beginning.

1 Broomberg Tax strategy, 180

2 Ibid.

First Blood

The Trust in ITC 1413³ mirrored the standard trust in all material respects, and was discretionary, hence the attempted taxation of the trust, as opposed to the company⁴ (the Commissioner did not seek to apply s.7(5) of the Act⁵).

From its activities, the Trust incurred a loss of R25 701 in the 1980 tax year, but returned a profit of R92 413 in its 1981 tax year. The Commissioner treated the R25 701 as an assessed loss and carried it forward to the 1981 year of assessment to offset against the profits for that year. He then sought to levy normal tax on the balance of R66 712. The Trust objected. The objection disallowed, the matter came before the Cape Special Court.

The issue before the Court was superficially a very simple one: whether the receipts (the Act includes accruals as well but these will be referred to collectively as "receipts" for convenience) were of a capital or of a revenue nature. If they were revenue, as the Commissioner contended, then they would have to be brought to account and taxed. If capital, then there was no question of liability for normal tax.

Grosskopf J (as he then was, now JA), found for the Commissioner. In his judgment, he relied on the application of two tests: the permanency test and the fixed/floating capital test. With regard to the former, he reasoned that a lack of permanency of the Trust's shareholdings was

3 (1985) 48 SATC 167

4 This is by virtue of the application of Section 25B of the Income Tax Act, 1973.

5 For a discussion of the possible application of s.7(5) of the Act to the share incentive trust situation in order to render the company liable for any taxable profits of the trust (which would be deemed to have accrued to the company), see R.D. Jooste's article supra, part one, fn 3 @ 16, for a useful analysis. The point is now academic in view of the Pick 'N Pay decision.

indicative of floating capital rather than fixed capital. The profits were thus, he concluded, the proceeds of the sale of floating capital and hence revenue in nature.⁶

With regard to the Trust's reliance on the 'operation of business in carrying out a scheme of profit-making' test (hereinafter the 'scheme of profit-making test') as conclusively excluding tax liability, Grosskopf J ruled that whilst such a test could be applied where the organisation's raison d'etre was to make profits, it was wholly inappropriate "when dealing with an organisation which carries on ordinary economic activities but would prefer not to make a profit therefrom."⁷

In any event, even on this test, the Trust must be taken to have had the necessary intention as the nature of the scheme was such that the Trust "will almost inevitably be making profits."⁸ Thus the Trust had confused its *desire* not to make profits with its *intention* which at all times *had to be* to make profits. In concluding, Grosskopf J said:

"[the Trust's] activities are not limited to the selling of shares to it. It also re-purchases shares and may buy shares from other sources. For the purpose of the share purchase scheme, it trades actively in the shares of the company..."

In the result [the trust] has not persuaded us that the surplus on the sale of shares was a receipt or accrual of a capital nature."

Revenue had thus bagged its first catch ! Writing in the Income Tax Reporter one of the editors commented:⁹

"This is the first reported case dealing with the taxability of amounts derived by a share purchase trust, and we would be surprised if we have heard the last word from the Courts on what could be a controversial issue."

6 Supra fn 3 @ p. 170-171.

7 Ibid @ p. 171.

8 Ibid @ p. 172.

9 Share Purchase Scheme (1986) 25 ITR 333 @ 335.

Just how controversial, that august writer was about to find out...

Dissent In The Ranks

The Pick 'N Pay Employee Share Purchase Trust was formed in 1977 and functioned, in all material respects, as did the trust in ITC 1413. Five years was the minimum period within which the employee's right to deal with his shares was restricted. In the 1982-1985 years of assessment, the Trust enjoyed profits and suffered losses, as follows:

1982	Profit	R28 006
1983	Profit	31 699
1984	Profit	39 782
1985	Loss	(70 619)

As it was now the Commissioner's policy to tax, these profits were assessed, and the 1985 loss allowed. Pick 'N Pay objected. Encouraged by his success, the Commissioner refused the objection, and shortly found himself appearing again in the Cape Special Court. This time, Tebbutt J presided.¹⁰

Once again, there was little dispute on the facts, the critical question being the capital or revenue nature of the Trust's receipts. Counsel for the Trust faced an uphill battle, it being necessary to persuade the Court that the judgment of Grosskopf J in ITC 1413 was wrong.

With regard to the test of permanency, Tebbutt J was of the opinion that it had been incorrectly employed by Grosskopf J. The test was nothing more than a subsidiary aid in determining the true test for capital-revenue, that is, the intention on the part of the taxpayer to engage in a scheme of profit-making. Permanency was only one indicator whether a scheme had been embarked upon or not. After reviewing the authorities, he opined that the true test to employ was as follows:

¹⁰ This is the unreported judgment published in the (1987) Taxpayer @ p.211.

"We are, therefore, of the view that if the Trust can show that what it did in acquiring the shares and then selling them to its employees, was not in pursuance of a scheme of profit-making, it will have discharged the onus of showing that such profits as it made, or losses it sustained, were of a capital nature."¹¹

In reaching this conclusion, Tebbutt J adopted the famous "operation of business in carrying out a scheme of profit-making" test elucidated by Lord Justice Clerk in the Scottish case of California Copper Syndicate Ltd vs Edward Harris (Surveyor of Taxes),¹² a test which Grosskopf J had expressly ruled as being inappropriate when dealing with an organisation like the share incentive trust. Grosskopf J had, in the event that he was wrong, applied the test, holding that there had been, on the facts of the case, an intention to profit on the part of the trust. With regard to this finding of intention, Tebbutt J felt constrained to disagree:

"The distinction which Grosskopf J sought to draw between desire and intent appears to us a somewhat confused one. What must be sought in our view is the purpose or object of the taxpayer. In the present case the purpose or object was to provide an incentive scheme for the employees in question. It was not a business operation for the purpose or object of carrying on a scheme of profit-making."¹³

Earlier in the judgment, Tebbutt J had made the following findings:

"Moreover, the Trust had no control over the time at which it may have to repurchase a share, particularly when such shares are forfeited. It also had no control over the market price of the share at that time. Any profits or losses was therefore purely fortuitous... The thing furthest from the mind of the company or the Trust was that the Trust would make a profit; the idea was merely to get the shares into the hands of the eligible employees...

It seems to us clear that the Trust's main or dominant purpose was not the making of any profit on the buying and sale of the shares, but to give effect to the

11 Ibid @ 217.

12 [1904] 41 Sc LR 894 (5d).

13 Supra fn 10 @ 218-219.

incentive scheme. Indeed, on Hurst's evidence, there was no other purpose. As he said, making a profit never entered into the picture. It was not even a subsidiary purpose."¹⁴

Tebbutt J went on to conclude:

"We cannot agree therefore with the finding in ITC 1413 that the appellant, as it was held in that case, was engaged in an operation of business in carrying out a scheme of profit-making."¹⁵

Revenue's victory in ITC 1413¹⁶ was neutralised. Disgruntled, the Commissioner noted an appeal and leave was granted for it to be made directly to the Appellate Division. However, it was to be some time before the matter reached the hallowed halls of Bloemfontein.

Taking Sides

Academic response was as patently polarised as judicial opinion. The editor of the November 1987 Taxpayer threw his lot in with Tebbutt J:

These cases lend substantial authority to the submission that our law has adopted a subjective approach to determining the distinction between capital and revenue profits...

Although Tebbutt J considered that ITC 1413 could be distinguished on the facts, the major principle on which both judgments were based is the same, namely whether the profits made by a share incentive trust in the course of the implementation of its objectives are taxable. For this reason, the approach of Tebbutt J, being in accordance with general principles is to be preferred over that followed in ITC 1413"¹⁷

However, many other academics supported Grosskopf J's conclusions, if not his entire reasoning. Emslie, writing in the Taxplanning journal, was emphatic:

"I submit that in both of the cases dealing with share purchase trusts the shares concerned were acquired by the trusts for the purposes of sale to employees and

14 Supra fn 10 @ 217 & 218.

15 Supra fn 10 @ 219.

16 Supra fn 3.

17 Supra fn 10 @ 212-213

for this reason fell squarely within the definition of 'trading stock'.

They were thus, like the property acquired in ITC 1418¹⁸ bought on revenue account, and the proceeds arising upon their sale were barring some novus actus interveniens, such as a change of intention - irrefutably of a revenue nature..."¹⁹

Determined lest the Cape attain a monopoly on the polemic industry, the Natal Special Court seized the opportunity to air its learned views on the now bubbling share incentive trust debate when Revenue launched a further test case.

ITC 1450²⁰ came before Friedman J on 23rd June, 1988, nearly one year after the (unreported) judgment of Tebbutt J in Pick 'N Pay. The share incentive trust here operated in the classic fashion. It differed from ITC 1413 and the unreported Pick 'N Pay case only by virtue of the fact that it was non-discretionary, the founder company possessing a vested right to the profits of the Trust. By operation of s.25B of the Act, the receipts of the Trust were deemed to have been received by the company. Therefore, it was the company, and not the Trust, in fact, that the Commissioner sought to tax. However, Friedman J accepted Revenue's contention that this factor did not alter the fundamental character of the profits nor did it serve to distinguish the facts in ITC 1413 and the unreported Pick 'N Pay case²¹

Perhaps the other point to mention is that one of the motivating causes behind the formation of the share incentive trust, a cause not featuring in the other two cases, was the director's stated objective of frustrating a threatened takeover bid.²² This they aimed to achieve by increasing the number of shares under their indirect control. The formation of the Trust enabled them to allocate up to 5% of the issued share capital of the company

18 (1986) 49 SATC 42.

19 (1988) 4 Tax Planning 29 @ 31: "Motive, Intention & Profits: The Taxation of Reluctant Profitmakers".

20 (1988) 51 SATC 70.

21 Ibid

22 Ibid H/Note @ 71 & Judgment @ 73.

to the trustees who effectively would exercise their voting powers in accordance with the director's wishes. The significance of this will be explicated later when dealing with the assessment of 'intention' 'purpose' and 'motive' in the capital-revenue enquiry.

During the 1983 and 1984 years of assessment the Trust showed profits of R132 705 and R55 535 respectively. Friedman J, after considering the conflicting views of Grosskopf J and Tebbutt J, found for the company (and thereby for the Trust). Despite holding that the various tests for capital-revenue "do not, and are not intended to, lay down any immutable standards of universal application" and that "whatever guideline one chooses to follow one should not be led to a result in one's classification of a receipt as income or capital which is... contrary to sound commercial and good sense," Friedman J effectively approved and applied the scheme of profit-making test. At p. 77, he said:

"Like Tebbutt J, we are of the view that the profits made by the appellant were not made as part of a scheme of profit-making. It was never the intention of the appellant to make a profit out of its share trust - the purpose of this trust was, as stated by Tebbutt J in the case before him, 'merely to get shares into the hands of eligible employees' and not to trade in the shares. That the unallocated shares were ultimately sold on the open market was simply the culmination of a series of fortuitous and unexpected events and developments in the life of the appellant."²³

Friedman J also felt constrained to deal with Grosskopf J's finding²⁴ that the Trust was undoubtedly engaged in trading activities. At page 78, he responded:

"In our view to say that the share incentive trust actively trades in the shares of the company is to adopt an unduly narrow approach to the overall scheme in which the Trust plays a part. The trust does not trade in the true sense of that word. It acquires shares for a particular purpose and that is to allocate these shares to employees who hold important positions

23 Ibid @ 77.

24 ITC 1413 Supra fn 3.

in the company and whose continued employment with the company the company seeks to maintain and preserve. There is, in our view, no intention on the part of the company responsible for creating the trust that the trust should, in its own right, operate for the purpose of making a profit. Whether or not the trust makes a profit is entirely fortuitous...

The so called activities of the trust in re-purchasing the shares also ought not, in my view, to be unduly emphasized. They certainly do not justify the conclusion that because of this, the trust is engaged in a trade..."²⁵

For Friedman J then, the buying and selling of shares by the trust cannot constitute trading unless the trust consciously seeks to make a profit. Whether this holds true is fundamental to the enquiry, and it is a point that will be addressed later.

Rather than serving to clarify the law, the judgment plunged the academic and legal world into greater confusion, debate and disagreement. Even those supporting the Tebbutt line of cases were perplexed, and criticized some of Friedman's reasoning. On the test of intention, Jooste had this to say:

"Whilst the conclusion reached, namely that the profits in question were of a capital nature, is supported, difficulty is experienced with Friedman J's thought process which appears to mesh one reason for the conclusion with another..."

As indicated in a previous issue of Income Tax Reporter ²⁶ it is submitted that motive and desire are all important.

Friedman J's emphasis on the fact that the various tests laid down to assist in the capital/revenue enquiry "are not intended to lay down any immutable standards of universal application" is questionable. Despite the fact that these tests are not legislative enactments, an examination of our case law clearly indicates that the courts generally attribute far more significance thereto than Friedman J, and this approach has the endorsement of the Appellate Division.²⁷

25 Supra fn 20 @ 78-79.

26 (1987) 26 ITR 9.

27 Good News REgarding share Incentive Schemes (1989) 28 Income Tax Reporter 88 @ 93.

Jooste argues that the scheme of profit-making test is universal and that, therefore, an intention to make a profit is not merely an aid to the enquiry but the critical determinant. He says that Friedman J failed to acknowledge the position.

Most other published comments were less generous, and almost wholly supportive of the Grosskopf approach. The (new) editors of the Income Tax Reporter submitted:

"On an objective examination of all the cases there can be no doubt that the trust-taxpayers were carrying on the trade of buying and selling shares and that the shares fall within the definition of 'trading stock'. Taken together, the legal nature of the transactions carried out, (purchase and sale), the function of the assets (trading stock), the frequency of the transactions and the short period for which they were held before their sale all point to an objective activity of trading on the part of the trusts."²⁸

In this passage there is clear and unqualified support for Grosskopf J's objective treatment of the trading issue. When contrasted with Tebbutt J's reasoning and Jooste's comments above one of the most critical issues in the trilogy of cases becomes apparent: whether subjective intention to profit on the part of the taxpayer is a sine qua non for a finding that its receipts are revenue in nature or whether trading and the capital/revenue nature of receipts depends upon objective factors in which an intention to profit is only one consideration. This conflict is at the very root of the dilemma.

Other writers focussed the issue only slightly differently. In their article The Taxation of Employee Share Incentive Trusts - A Polemic At The Heart of The Distinction Between Capital and Revenue, Emslie and Davis expressed it in classical fashion:

"It is submitted that the subjective approach of Tebbutt J - to look for the presence of a *scheme of*

profit-making unquestionably reveals when an amount is of a revenue nature. Where a scheme of profit-making is present, an amount is clearly of a revenue nature, and it follows that such an amount is not of a capital nature. What is questionable, however, is whether the absence of a scheme of profit-making, *ceteris paribus*, necessarily establishes that an amount is of a capital nature."²⁹

In essence, the view taken by these commentators is that the scheme of profit-making test is a one-way test: the presence of a subjective intention to profit, in terms of a scheme, will lead to a finding that the receipts are revenue in nature, but the absence of such an intention does not lead to a conclusion that the receipts are capital. The implication here is that further testing is necessary. The suggested test was whether the receipts flowed from 'trading stock'.

This objective trading stock approach also characterises the viewpoint of the accountants, Huxham and Haupt, as evidenced in the 1992 edition of their work:

"It is submitted that shares acquired by the trust for resale fall into the definition of 'trading stock' and are, therefore, revenue assets. They are in the nature of "floating capital" and not "fixed capital" in the hands of the trust. Any profit on the resale of such shares will therefore be taxable..."³⁰

The triumvirate of Justices Grosskopf, Tebbutt and Friedman having auspicated, then catalysed, a raging debate amongst academics, writers, commentators, jurists, students and even judges, the stage was set for an intriguing legal battle in the remote, and normally withdrawn, ivory towers and rarefied atmosphere of Bloemfontein.

29 (1990) 107 SALJ 1 @ 5.

30 Notes On South African Income Tax 1992, @ p 40.

PART THREE: IN THE APPEAL COURT

The Highest Court Decides

The Natal Court having edged into the picture in the interim, (in ITC 1450) the matter was finally argued and adjudicated upon in the Appellate Division. As it turned out, the matter was decided in favour of the trust by only the narrowest of margins. In a split 3-2 decision, (reported as CIR vs Pick 'N Pay Employee Share Purchase Trust ¹) the majority of the Judges voted to affirm the unreported judgment of Tebbutt J in the Court below.

In delivering a terse five-page judgment for the majority, Smalberger JA held that the scheme of profit-making test was the proper test to apply notwithstanding the fact that the case involved a body carrying out a series of transactions and despite the judicially defined distinction between the 'carrying on of a business' and the 'pursuance of a scheme of profit-making':

The basis for such a distinction is that it is more appropriate to refer to a profit-making scheme where a single transaction is involved. I accept that a series of transactions is characteristic of the carrying on of a business. But irrespective of the number of transactions whether the receipts that flow from the carrying on of a business are revenue *still depends on whether the business was conducted with a profit-making purpose,* ie, as part of a profit-making venture or scheme."² (emphasis added).

It is manifest from the above passage, and from the judgment as a whole, that Smalberger JA applied the scheme of profit-making test as if it were conclusive of the capital/revenue enquiry. No doubt many commentators will interpret it in this way.

1 (1992) 52 SATC 271, also reported in 1992 (4) SA 39 (A).

2 Ibid p. 280.

However, there are other passages in Smalberger JA's judgment that are, with respect, contradictory and difficult to reconcile with this approach. Firstly, at page 279 of the judgment, Smalberger JA, like Friedman J, explicitly refuted the existence of any such critical test:

"There are a variety of tests for determining whether or not a particular receipt is one of a revenue or capital nature. They are laid down as guidelines only - there being no single infallible test of invariable application."³

Now if this is the case then it is certain that Smallberger JA paid only lip-service, for the judgment quite explicitly discloses that only the scheme of profit-making test was applied, and in a conclusive fashion at that. None of the other tests was given serious consideration.

Secondly, Smalberger JA conceded that the trust could theoretically have carried on business even in the absence of a profit-making intention:

"While a profit motive is not essential for the carrying on of a business, its presence or absence is an important factor in determining whether a business is being conducted."⁴

If a taxpayer can be said to carry on business without a profit-making motive or intention, then logically the stock of the business will constitute the taxpayer's circulating capital the proceeds of which will result in receipts of a revenue nature. But then if, as Smalberger JA says, there cannot be revenue receipts in the absence of a profit-making intention then the proceeds *cannot* be revenue, despite the indisputable fact that they are !

3 Ibid @ 279.

4 Ibid @ 280.

Smalberger JA avoided the patently anomalous consequence of these two irreconcilable propositions by finding as a fact that the Trust was not carrying on business:

"I am unable to agree with Nicholas AJA that the trust was carrying on a business by trading in shares. Whether or not it was doing so must be determined applying ordinary common sense and business standards... There was no intention on the part of the Trust to conduct a business in shares. The Trust was to operate primarily as a conduit for the acquisition of shares by employees entitled to them in terms of the scheme's rules. The Trust did not operate along accepted business lines. The normal way in which a trader in shares operates is to buy shares and sell them at a profit...The trust had no such intention.⁵

Thirdly, this passage further discloses blatantly circuitous reasoning. The Trust, it is said, can conceivably carry on business without a profit motive. But then it is said that the Trust cannot possibly be carrying on business because it lacks a profit-making intention !

Fourthly, Smalberger JA left open the possibility that "a different conclusion might have been justified if the making of profit was inevitable."⁶ Now, if it is a profit-making intention that determines the capital or revenue nature of a receipt surely the fact that a profit inevitably results from the taxpayer's activities should not make one iota of a difference. Either the taxpayer intends to make a profit or he does not. If he does not then that is the end of the matter, the receipt is of a capital nature.

It is suggested by some observers that all Smalberger JA really meant was that the inevitability of profit might lead the Court to assail the credibility of a taxpayer in alleging that he did not possess a profit-making intention. But that is certainly not what the judgment says. The two

5 Ibid @ 280.

6 Ibid @ 281.

concepts (subjective intention and the assessment thereof by weighing objective factors, or the facta probanda versus the facta probantia) have a judicially defined distinction. If that is what Smalberger JA meant then one would have expected some indication that he was referring to inevitability as an *objective factor* in assessing a taxpayer's intention.

With regard to Grosskopf J's finding of 'constructive' intention in ITC 1413 ⁷ Smalberger JA rejected out of hand the application of criminal law concepts of intention in the domain of tax law - he said:

"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. While they might have contemplated the possibility of profit, it was not the purpose of either the company... in founding the Trust, or the trustees in conducting the affairs of the Trust, to carry on a profit making scheme."⁸

Having made a finding that the Trust did not carry on business (the correctness of which will be investigated later), it was a relatively small step to reject the argument that the Trust receipts were generated from the proceeds of floating capital, since, as Smalberger JA held "where no trade is conducted there cannot be floating capital".⁹

In delivering a powerful minority judgment, Nicholas AJA made detailed reference to the historical development of the capital-revenue enquiry in South Africa. In finding for the Commissioner, he did not seek to rely on any 'constructive' intention in order to satisfy the subjective requirement in

7 (1985) 48 SATC 167

8 Supra fn 1 @ 281.

9 Supra fn 1 @ 283.

the scheme of profit-making test, as Grosskopf J had, by way of ancillary argument, done. Instead, Nicholas AJA adopted an incisive, analytical approach which fundamentally developed and matured Grosskopf's rather inchoate, but burgeoning, proposition that the scheme of profit-making test was of limited value in circumstances akin to the case in contention.

Firstly, Nicholas AJA put the scheme of profit-making test into perspective. That test, he said, was merely subsidiary to the general principle that "receipts from an act done in the ordinary course of the vendor's business are revenue in nature." He went on to distinguish between two situations:

"In this passage the learned judge of appeal [Corbett JA] pointed to two situations: the sale of an asset in the course of carrying on a business and the sale of an asset in pursuance of a profit-making scheme. Compare the observations of Holmes JA as to the distinction consistently drawn by the Appellate Division between (a) realising a capital asset and, (b) selling an asset in the course of carrying on business or embarking on a scheme of profit."¹⁰

Nicholas AJA then went on to explain that the primary enquiry was whether the taxpayer was carrying on a business. In this regard, a business is "characterised by a series of transactions having an element of continuity and usually performed in the contemplation of making a profit."¹¹ However, the contemplation of profit was not essential, constituting but one of several material factors to be considered when assessing whether a taxpayer is carrying on a business.¹²

It followed, therefore, that the scheme of profit-making test was applicable only where one is dealing with a single

10 Supra fn 1 @ 291.

11 Supra fn 1 @ 292.

12 Supra fn 1 @ 292.

or isolated transaction. Where one is dealing with a series of transactions, then one must revert to the principal test, viz, 'is the taxpayer carrying on business?':

"Corbett JA pointed out that where a single transaction is involved it is usually more appropriate to limit the enquiry to the simple alternative of a capital realisation or a profit-making scheme. The corollary is that where a series of transactions is involved, the appropriate enquiry is usually whether or not the receipts flow from the carrying on of a business."¹³

Nicholas AJA further considered the distinction between fixed and floating capital. The implication here was that once it is found that the taxpayer carries on business, then one must look to see whether the proceeds realised were from the sale of fixed capital, in which case they would be of a capital nature, or floating capital, in which case they would be revenue.

In applying the facts of the case to the law, Nicholas AJA agreed with the majority judges that the Trust did not have as its purpose the making of a profit. However, he felt that despite this, the Trust did contemplate profits and that this was borne out by a provision in the trust deed vesting any 'surpluses' of the trust in the company.

Finally, Nicholas AJA held that not only did the trust, on a consideration of the facts, carry on business, but, in addition, the receipts in question were the proceeds of floating capital. It followed that the taxpayer failed to discharge the onus of establishing that the receipts were of a capital nature:

"In each of the years of assessment, the Trust engaged in share-dealing activities which were characteristic of a business. They were part of a series and they were continuous. In regard to the profit element, it was inherent in all the activities, which were

13 Supra fn 1 @ 291.

conducted in a fluctuating market, that in the ordinary course they would result in profits/losses. And in the case of forfeited shares which had been held for some time, the accrual of a profit to the trust was 'inevitable'."¹⁴

Further on in the judgment Nicholas AJA elaborated on the point:

"...it is irrelevant to the real question for decision that the share-dealing activities carried on by the Trust differed from those of the ordinary share dealing business. The fact is that the Trust was engaged in trading in shares and not in realizing investments. The essential idea underlying trade is buying and selling... The receipts from such trading had all the attributes of income: they were produced by the Trust's capital, they were recurrent, and they were not fortuitous in any relevant sense."¹⁵

Here then we have, it is submitted, more or less, the fully, developed concept that the distinction between capital and revenue receipts, at least in the commercial sphere, is based not on any subjective purpose on the part of the recipient - although such purpose is a consideration of importance, the degree of materiality varying with the category of the particular set of facts - but rather on whether, objectively, the recipient can be said to have carried on business.

This approach emphasizes, or gives credence to, objective indicators, such as continuity, frequency, permanency, etc, in addition to subjective factors such as intention, motive and contemplation of the recipient.

In what follows, this viewpoint will be referred to, for want of a better adjective, as the 'objective' or 'objectivist' theory. It should be noted, however, that this is only a label of convenience, as the objectivist

14 Supra fn 1 @ 296.

15 Supra fn 1 @ 297.

school does not reject a role for subjective criteria - it merely allots to these criteria a less critical role than does its adversary. More accurately, the objectivist theory asserts that the existence of a scheme of profit-making intention renders the proceeds of floating stock revenue. However, the absence of such an intention does not, per se render the proceeds capital in nature.

Moreover, it should be noted that 'objective' here does not in any way refer to the method by which intention, purpose or motive of the taxpayer is tested. There is a great deal of confusion in this regard, as is evidenced by the writings of some commentators,¹⁶ and it is a point that is considered in detail in the next part.

It is this objective theory that Grosskopf J cursorily exposed in ITC 1413, and it is a theme that has found recurrent, if untrumpeted, expression in many watershed tax cases throughout the history of income taxation in South Africa.

By contrast, is the hypothesis propounded by the majority judges in the Pick 'N Pay case, or what could be styled the 'subjective' (or 'subjectivist') theory. This is the theory that irrespective whether the recipient of an amount carries on business or engages in a single commercial transaction, the capital or revenue nature of a receipt is conclusively determined by the recipient's accompanying intention. If his intention was to make a profit or to embark on a scheme of profit-making, then the receipt is of a revenue nature and, if not, then it is capital. Most of the other tests formulated in the past by the Courts are but subsidiary tests - employed solely to ascertain what the recipient's true intention was, as opposed to his stated intention.

16 See eg. T S Emslie & D Davis - article in (1990) 107 SALJ 1.

The objective versus subjective debate is not a novel one, the Margo Commission having noted the dilemma in its Report.¹⁷ But, never before have the two theories clashed in such an acute or transparent fashion as they have in the case of the share incentive trust, a conflict of an academic magnitude presaged by observers as far back as 1986 and fuelled by academics and writers throughout the paths of the trust cases.

The Pick 'N Pay case, rather than establishing clarity, finality and certainty is sure to inflame further debate, greater speculation and heightened uncertainty. The share incentive trust will remain free of the burden of taxation by sheer dint of authoritative force, rather than settled legal reasoning. It is still open to the Appellate Division, moreover, to take a different course in future given the narrow margin of the decision.

Barely eight weeks following the publication of the judgment, two conflicting academic commentaries have already emerged. The editors of The Taxpayer greeted the decision with affirmation:

"This case, in our view now a leading authority in the distinction between capital and revenue receipts and accruals, confirm that the paramount test for distinguishing between capital and revenue is the inquiry whether a taxpayer is engaged in a 'scheme of profit-making'...

...it is now settled that in the absence of a 'scheme of profit-making' receipts and accruals from the disposal of assets must be regarded as being of a capital nature, except, perhaps where the making of profits can justifiably be regarded as 'inevitable'."¹⁸

17 Report of the Commission of Inquiry into the Tax Structure of The Republic of South Africa; 1986, @ 218-222.

18 (1992) @ p192 & 193.

However, writing in the 1993 edition of their work, Huxham and Haupt were rather less gratifying:

"The majority finding was based on an application of the scheme of profit-making test to the exclusion of all other tests. The majority felt that it was irrelevant to consider whether or not the Trust was carrying on a business or whether or not the shares constituted floating (as opposed to fixed) capital if there was no 'profit-making scheme' involved. It is submitted that this approach to the problem is based on the misguided belief that the question of capital or revenue is solved by proving that an amount is not revenue and therefore by implication is capital...

The minority held that because the shares were acquired for the purpose of resale they were floating capital and therefore did not (when sold) result in amounts which were of a capital nature. It is submitted that this is the more correct approach..."¹⁹

Which then accurately reflects the legal position? Were the majority judges in the Pick 'N Pay case mistaken in adopting the subjectivist theory and approach? Or did the minority pervert the law by dissenting in favour of the objectivist school?

In what follows consideration will be given to the origins, foundations and character of the capital - revenue distinction; whether in relation to commercial receipts the distinction is to be drawn purely along subjective lines, or whether objective factors also have a role to play. In the process, economic theory will be briefly examined, the relevancy of English and Australian taxation law - especially with regard to the scheme of profit-making test investigated, the concepts of fixed and floating capital reconciled with the definition of 'capital' as used in the Act, and the place of other tests determined.

19 Notes on South African Income Tax, 1993 ed., 40.

But first, an attempt will be made to unravel the murky concepts of 'intention', 'purpose', 'motive', 'desire' and 'contemplation', concepts that have caused deep consternation, and, often, outright confusion.

PART FOUR: DEFINING 'INTENTION'

The Subjective Test for Intention

Whether one subscribes to the objectivist school or to the subjectivist school, it is explicit that at some point the need arises to define exactly what the Courts mean by 'intention' when considering whether the recipient of an amount had a profit-making purpose.

It will be recalled that Grosskopf J in ITC 1413¹ accused the Trust of "confusing desire with intent". The Trust did not desire to make a profit but, due to the inevitability of profits, it could "have no intention other than to sell, on the whole, at a profit". What did Grosskopf mean?

Emslie and Davis suggest the following:

"In each case the issue was: if there is no desire (or motive) to make a profit from the purchase and sale of shares by a share incentive trust, but as a result of legal and economic circumstances profits are foreseeable and are in fact made, are the resultant profits of a revenue nature and taxable or are they of a capital nature and tax-free? The answer to this question depends on whether one adopts a *subjective or objective test* when determining the taxpayer's intention..

Conradie AJ [in ITC 1185²] appears to have adopted the concept of *dolus eventualis* in the context of income tax by examining what was *reasonably* foreseeable. This *objective* approach constitutes the hallmark of Grosskopf J's Judgment in ITC 1413³." (emphasis added)

Now that definitely will not do. In criminal law (as in delict) it is trite that there are two methods of attributing guilt (*mens rea*) to an accused - the subjective test and the objective test. The subjective test depends

1 (1985) 48 SATC 167

2 (1972) 35 SATC 122 @ 123-4.

3 Supra fn 1.

upon proof of the accused's state of mind (or intention) accompanying the actus reus. It is called a subjective test purely because the test aims at establishing what actually occurred in the accused's mind at a given point.

However, that proof may emanate from both the accused's ipse dixit (which may be untruthful or inaccurate) and from objective factors, ie, the surrounding circumstances. What the accused says about his alleged intention must stand up to scrutiny against independent verifiable evidence. Furthermore, despite what the accused says, if he says anything at all, a criminal intention may be inferred from the surrounding objective factors.

Criminal intention may take one of two forms: actual intention (dolus directus) or legal intention (dolus eventualis). Actual intention is present in two circumstances; firstly, where "the accused's aim or object was to do the unlawful act or to cause the consequence" and, secondly, also where "he foresaw the unlawful act or consequence as certain"⁴.

Legal intention, on the other hand, consists of "foresight on the part of the accused that the consequence may possibly occur coupled with recklessness as to whether it does or not"⁵.

As the test for intention has come to be accepted in criminal law as a subjective test, since the accused's actual state of mind must be proven, proof of intention is synonymous with the "subjective test". For a time, however, it was thought that the test was one of "objective intention". This terminology is regrettable as it is deceptive and leads to a great deal of confusion. "Objective intention" is not intention at all, as the Court is requested not to enquire what the accused's state of mind

4 Burchell & Milton Criminal Law & Procedure In S.A. Vol 1, 2nd ed, 1983, 137.

5 ibid @ p 137.

was, but to theorise as to whether a reasonable man in accused's shoes would have foreseen the result as a possible consequence of his acts. The corollary is, if the answer is a positive one, that the accused ought to have foreseen the unlawful consequences.⁶

"Objective intention" as herein described, not depending upon proof of any intention, has been categorically rejected by our Courts for the purpose of the criminal law.⁷

Moreover, the existence of a "presumption that a man intends the natural and probable consequences of his act", which Davis and Emslie rely upon, echoing as it does the false concept of 'objective intention' has been authoritatively refuted.⁸

Therefore to associate dolus eventualis, a purely subjective concept, with 'reasonable foreseeability', 'objective intention' and a presumption of intention, as Davis and Emslie have done is not merely misleading but, with respect, reflects a fundamental misunderstanding of the criminal law. Doubtless, these otherwise distinguished commentators were misled by the very dubious remarks of Conradie AJ in ITC 1418⁹ (a decision which, one might add, must be regarded as wrong in light of both the majority and minority findings in the Pick 'N Pay case):

"As in the criminal law, I believe that in this context a person must be taken to intend the reasonable and natural consequences of his acts...."¹⁰

It is submitted that, in truth, the test is a subjective one, ie, only positive proof of an actual subjective intention will suffice. The Court is not in the least bit concerned with 'objective intention', viz whether

6 ibid @ p 141.

7 ibid @ 141.

8 ibid @ 189-90 and the authorities cited therein.

9 (1986) 49 SATC 42.

10 ibid @ 45.

theoretically a reasonable man standing in the shoes of the taxpayer would have foreseen the possibility of profits and, therefore, the taxpayer ought to have done as well. The Court seeks to establish whether the taxpayer, as a fact, intended to make a profit. In doing so, the court will take into account the taxpayer's ipse dixit and objectively the accompanying circumstances to see whether the taxpayer is being truthful about his stated intention. In doing so, the Court does not transform what is essentially a subjective test into an objective one. Thus, to quote Silke¹¹ :

"The taxpayer's own evidence about his intention and his credibility will be considered by a Court but, because of subjectivity, self-interest, the uncertainties of recollection, and the possibility of mere reconstruction, it will test that evidence against the surrounding facts and circumstances in order to establish his true intention, it may also test that evidence in light of general human and business probabilities."

Miller J presiding in ITC 1185¹² expressed it rather accurately as follows:

"It is the function of the Court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention were.... This is not to say that the Court will give little or no weight to what the taxpayer says his intention was...but direct evidence of intent and the purpose must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts."

It is clear that, contrary to what Davis and Emslie say, when Grosskopf J found the existence of an intention to profit on the part of the trust, he was not thereby advocating an objective test, ie, an enquiry into whether

11 (1989) 11th memorial ed. (1992 service) p 3-8 see also extensive authorities cited therein.

12 (1972) 35 SATC 122 @ 123-4.

13 Mills vs Mills (1938) 60 CLR (High Court of Australia) 185-186.

the reasonable man would have foreseen the probability or possibility of profit - but rather posturing the application of the criminal law variant of actual intention (dolus directus). On this basis the test would be : 'did the taxpayer, as a fact, foresee the certainty (or inevitability) of profits ?

The test under legal intention (dolus eventualis) would be : 'did the taxpayer, as a fact, foresee the possibility of profits? Clearly, Grosskopf did not go so far as to propose the equivalent of dolus eventualis in tax law either.

The Equivocal Concept of 'Intention'

Now the phrases 'intention', 'purpose', 'object', 'motive', 'desire' and 'contemplation' are all used to express varying states in the spectrum of human subjectivity. Sometimes these phrases are used interchangeably and often they are merely synonyms for 'intention'. To quote Dixon J, an eminent Australian Judge, describing, for purposes of company law, the range of meanings implicit in the term 'intention'.

"When the law makes the object, view or purpose of a body of men the test of the validity of their acts, it necessarily opens up the possibility of an almost infinite analysis of the fears and desires, proximate and remote, which in truth, form the compound motives usually animating human conduct."¹³

Having to ascribe a particular colour of meaning to the requirement of intention for the purpose of interpreting a statute or defining a rule of law can be a vexing task indeed. More especially since the motley array of phrases utilised to describe subjective states are neither terms of art nor precision. Nomenclatural inexactitude regrettably pervades this field of legal enquiry.

14 Share Incentive Schemes - A Recent Case May have reduced their Appeal (1987) 26 ITR 9.

If we analyse the word 'intention' as is broadly used in law, we can perhaps identify three distinct senses in which the phrase may be employed.

Firstly, it can be used in the sense utilised in the criminal law. Intention here has, as is apparent from the discussion above, been attributed a highly specialised, if clinical, definition. Criminal law seeks to establish whether the accused intended the consequences of his acts. In this regard, intention means 'proximate intention' and not 'purpose' or 'motive'. As Jooste correctly observes:

"In criminal law when the Court seeks the intention of the accused with regard to a particular consequence which has resulted from an act of the accused the Court is trying to determine whether or not the accused's state of mind at the time of his act was such that he meant the consequences of his act. The Court is not concerned with the accused's purpose or object in achieving these consequences."¹⁴

Secondly, intention may be used in its ordinary day-to-day sense of 'purpose' or 'object', ie, "the reason for which anything is done" or "a fixed design, outcome, or idea that is the object of an action or other effort."¹⁵ In the absence of a separate or different 'motive' the 'but for' test, outlined below, may be applied to determine a man's purpose.

Thirdly, intention can be employed to mean 'motive', 'desire', or 'motivating purpose'. This would relate to a man's secondary, ulterior, or more remote purpose or object, the sine qua non of the actor's conduct. The question to be asked is 'whether the actor would have acted as he did but for the particular desire.' This is the sense in which 'intention' or 'purpose' is used in company law

15 Collins Dictionary p 124.

16 See Mills vs Mills Supra fn 13.

when testing whether a director has breached his common law duty not to exercise his powers for an improper purpose.¹⁶

Thus in Hogg v Cramphorn¹⁷ the directors of a company, in response to a takeover bid from one B and fearing ultimate ouster, created a share incentive trust for the employees of the company, allotting all remaining unissued shares to it so as to give them, indirectly, an effective veto. Although the direct purpose of the Trust was to benefit the company's employees, the Court held that the Directors had breached their fiduciary duty to the company not to use their powers for an improper purpose - in this case an ulterior motive to frustrate a takeover bid.

'Contemplation', of course, does not really mean 'intention' in any sense (except when used in a very broad context). A man may contemplate or foresee the possibility of a particular consequence of his actions without in any way, directly or indirectly, intending it. One would still have to ask whether the actor *intended* the consequences in addition to having foreseen them.

By way of illustration, let us apply these concepts to the facts of ITC 1450. The 'proximate intention' of the directorate was to form a share incentive trust, lend money to it and allocate it shares. These shares were to be resold to eligible employees, and, where necessary, forfeited or repurchased from them for re-allocation. In this regard, the intention of the trust was no different from that of the company, being used merely as the company's simulacrum. The directorate's 'purpose' was to provide an incentive for its employees. Its ulterior 'motive', however, was really to defeat a threatened takeover bid but for which it would not have embarked on the whole scheme.

17 [1966] AER 420 (Ch).

18 1952 (2) SA 413 (A).

In the absence of s.38(2)(b) of the Companies Act, 1973, exempting the share incentive trust from the statutory prohibition against providing financial assistance for the purchase of a company's own shares, the action of forming the trust, would constitute a criminal offence. If the criminal law was concerned with an intention at all, then the only sense of intention that would be relevant would be the 'proximate intention'. The fact that the purpose was to achieve a lawful object, viz, an incentive for its employees would be irrelevant. So too would be the directors' motive to frustrate a takeover bid. The various consequences which the directors' may have contemplated, eg, profits, whether they would face prosecution or a lawsuit would similarly be irrelevant.

For the purposes of the company law, however, the 'proximate intention' would not be a consideration nor would 'contemplation' or 'purpose'. The directorate would have breached its duty to act for proper purpose in exercising its power to issue shares if it acted from improper motive. On an application of the 'but for' test, it appears that the directors did, in ITC 1450, breach their fiduciary duty to the company - they would not have formed the Trust but for an ulterior motive to defeat the takeover bid.

Quite often a motive different from purpose will not be identifiable. Thus in ITC 1413 and Pick n Pay there was no ulterior purpose, eg, to frustrate a takeover bid, as there was in ITC 1450. Moreover, there may be situations in which a man will have dual purposes and it will not be possible to relegate one or other to the position of 'motive'.

Intention In the Capital - Revenue Enquiry

It is submitted that for the purposes of the scheme of profit making test 'intention' means 'purpose', as described in the second sense above, and in contradistinction to the 'proximate intention' of criminal law, and the 'motive' of

company law. Where there are dual purposes, the Court will seek the taxpayer's dominant purpose. (See the leading Rhodesian case of COT vs Levy¹⁸).

It is interesting to note that this is the one point that all the Judges in the Pick 'n Pay case¹⁹ were agreed upon. Smalberger JA cited²⁰ the following statement from SIR vs Trust Bank of Africa Ltd²¹ with approval:

"...in an enquiry as to the intention with which a transaction is entered into for the 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 the criminal law, but rather with the purpose for which the transaction was entered into."

Significantly, the minority did not pursue Grosskopf J's formulation of intention, and that should settle the matter once and for all!

It should perhaps be noted here that Judicial authority as exists in U.K. and Australia have held that for the purposes of ascertaining whether the taxpayer is *carrying on business* or trading, the test is an objective one and, therefore, the state of mind of the taxpayer is not decisive. The Court does however, take into account all the subjective states of the taxpayer including proximate intention, purpose, motive and contemplation. It is submitted that this is the correct position, as appears from the argument in part seven.

There is a further serious inherent limitation in any intention test, which the Margo Commission of Inquiry into the Tax Structure of the RSA adverted to in its report²² :

19 (1992) 52 SATC 271; 1992 (4) SA 39 (A).

20 *ibid* @ 281.

21 1975 (2) SA 652, 669 E-G.

22 The report of the Commission was submitted to the President on 20/11/86, released for publication on 20/8/87 and tabled in Parliament on 16/3/88.

"The tests applied by the Courts over the years, as emerges from the illustrative passages cited above, involve for the most part subjective criteria relating to the intention on the part of the taxpayer. Sources of difficulty in this regard include the absence of a clear intention on the part of the taxpayer at the date of acquisition of an asset, a multiplicity of intentions, alternative intentions, changes of intention and the ascertainment of the intention of an artificial person to list but a few."

This is the difficulty, having determined the type of intention legally required to be sought, of ascertaining on the evidence what the taxpayer's intention actually was at the critical time.

PART FIVE : DISTINGUISHING CAPITAL FROM REVENUE

Historical Origins

The history of the capital - revenue distinction is the history of taxation itself. William Pitt the Younger (1759-1806), the youngest prime minister ever to serve Britain (he was just 24 when he took office) is remembered for his many achievements whilst in office. It will be disputed by hard-hit taxpayers that the levy of an innovative tax - income tax - was one of them.

Income tax was introduced in 1799, as a 'temporary measure' in order to finance the Napoleonic wars¹. Except for the period from 1815-1842, income tax has been with us ever since. In devising a system of income tax, Pitt was heavily influenced by Adam Smith (1723 -1790), a Scottish political economist and moral philosopher whose works had a vast impact on political and economic thinking in the eighteenth and nineteenth centuries.²

Smith lectured at Edinburgh University from 1752-1763 and in 1776 published the work that was to immortalise him forever: An Inquiry into the Nature and Causes of the Wealth of Nations. It is also the work that Pitt used to devise his income tax.

The Act of 1799 introduced a unified system of taxation (as is the South African system). However, it was very unpopular because it required the taxpayer to make a return of all his income. This was felt to be a gross infringement of the personal liberty of the subject.³ So when Addington introduced the succeeding Tax Act of 1803, he substituted the multipartite or schedular system that is still the basis of English income taxation today.

1 Whiteman & Wheatcroft - On Income Tax, 2nd ed by Whiteman & Milne (1976) @ 5.

2 The MacMillan's Encyclopaedia - Revised 1983 @ 962.

3 Supra fn 1.

The Act of 1803 divided income into five schedules, and required subjects to render a separate return for each, which went to different officials so that no official knew the total income of any one subject.⁴ These schedules survive till today although their contents have been extensively amended over time.

In South Africa, the first tax that was levied after Union was in terms of the Income Tax Act No 28 of 1914. The Act was modelled along the lines of the tax statute of New South Wales, Australia and has remained structurally the same ever since despite revision. Like Pitt's original tax, it established a unified, and not a multipartite, system of income taxation. Moreover, like its Australian, but unlike its English, counterparts, it introduced an artificial system of deductions for expenses.⁵ In this regard the English system was (and still is) 'natural', based on the taxation of net gains or profits. The South Africa Act was consolidated by the Income Tax (Consolidation) Act No 41 of 1917.

'Capital' and 'revenue' are first and foremost economic concepts. They are not legal or even accounting ideas, although they have been utilised for the purposes of both law and accounting. This fact has been recognised by many Judges the world over, including South Africa, and is a fact that should be borne in mind when seeking to distinguish between capital and revenue.

The Capital - Revenue Distinction

Lord McNaghten in London County Council vs Attorney-General said:

4 Supra fn 1.

5. In Pyott vs CIR 1945 AD 128 at 136, Davis AJA attributes the introduction of the artificial system to the 1917 Act but this is not correct. See below.

6 [1901] AC 26 @ 35-36.

"Income Tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else."⁶

In stating the obvious, Lord McNaughten desired to make a point - that the tax is a tax on *income* receipts only and not on *capital* receipts.

This distinction between capital receipts and revenue receipts lies at the very root of our system and indeed is the basis of all English derived taxation systems. It is a distinction that Pitt drew when creating his tax and the theoretical basis for which he also relied upon Adam Smith. In South Africa, the exclusion of capital receipts from the ambit of taxation is contained in the gross income definition in s.1 :

"'gross income'...means... the total amount, in cash or otherwise, received by or accrued to, or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic, *excluding receipts or accruals of a capital nature*".

Neither 'Capital' nor 'Income' are defined in the act. In view of this it has been left to the Courts to work out the boundary where the one ends and the other begins. Even then, Judges have been largely reluctant to endeavour a summary definition, since capital and revenue are concepts that are not susceptible of concise, accurate statement. Their essence must be grasped and that is all. As Lehman and Coleman point out in their book Taxation Law in Australia.⁷

"'Income' and 'capital' are complex, multifaceted concepts shaped and defined by experts. They are not terms of art because they are too fundamental and universal to be confined to neat and permanent categories."

7 1989 @ 36.

8 Report of the Commission of Inquiry into the Tax Structure of the Rep of South Africa, 20/11/86.

The difficulties associated with attempting a comprehensive definition were recognised by the Margo Commission⁸. At page 219 of the Report, the Commission advised:

"It is noteworthy that, although the distinction between capital and income is of cardinal importance in the South African system of income tax, the Income Tax Act makes no attempt to define these concepts comprehensively. There was good reason for this omission, namely that the legislature recognised the limitations inherent in any definitions that might have been attempted in this area.

For the same reason, but subject to the remarks which appear later in this chapter, the Commission does not recommend a comprehensive statutory definition of capital and income."

Nevertheless, a definition of sorts that is occasionally quoted emanates from an American Judge, Justice Pitney, who said, in the course of his Judgment in Eisner vs Macomber⁹:

"Here we have the essential matter : not a gain accruing to capital, not a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invented or employed, and *coming in* being derived, that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal, that is, income derived from property. Nothing else answers the description."
(emphasis added)

This passage captures the fundamental essence of revenue, an essence that classical economists have described as *income flow*. The idea of capital, by contrast, is best conveyed to use the words of Innes CJ in CIR vs George Forest Timber Company Limited as "*wealth employed in creating fresh wealth, invested to produce an income.*"¹⁰

9 (1919) 252 U.S. 189 @ 206-7, cited with approval by Sankey J in Pool vs Guardian Investment Ltd (1921) 8 TC 167.

10 (1924) 1 SATC 20, @ 25.

Capital (the wealth that creates fresh wealth), and revenue (the income or wealth flowing therefrom) can only be defined and perceived in relation to each other. They are mutually exclusive concepts. There is no third category. Therefore, if a receipt is not capital then it must be revenue and vice versa.¹¹

The Tests for Capital and Revenue

Over the decades that have passed since the first Union Income Tax Act of 1914 the Courts have applied a number of so-called 'tests' for distinguishing between capital and revenue receipts. Very few, if any, of these tests originated locally. Most of them emanated from England as applied in English taxation law.

Many of the capital - revenue tests are based on metaphor or are generalised in nature. Others are subsidiary indicators rather than conclusive tests. Even those that are regarded as substantive have serious limitations. It was for this reason that the Courts everywhere early recognised the dangers of adopting one test over another as decisive. Lord McDermott LCJ in delivering a Judgment of the Court of Appeal of Northern Ireland in Harry Ferguson (Motors) Ltd vs IRC said:

"During the debate many cases were cited in which a decision was reached as to whether particular payments were capital or income... There is so far as we are aware *no single infallible test* for setting the vexed question whether a receipt is of an income or a capital nature. Each case must depend upon its particular facts and what may have weight in one set of circumstances may have little weight in another"¹² (emphasis added).

11 Pyott vs CIR 1945 AD 128.

12 Harry Ferguson (Motors) Ltd vs IRC (1951) 33 tc 15, @ 42.

Those words 'no single infallible test' have resonated unrelentingly in every major English-based tax jurisdiction since Lord McDermott first pronounced them in 1951.¹³ A classical restatement of that view in South Africa is that of Silke :

"No doubt the legislature has realised that it is impossible to define the qualities that render a receipt or an accrual either income or capital. From the large mass of Judicial decisions on the question whether a receipt or an accrual is of an income or a capital nature it is obvious that the expression 'of a capital nature' is not precise, and that there is no *single infallible test* for settling the question whether a particular receipt or accrual is income or capital".¹⁴

The appeal Judges in the Pick 'N Pay case were unanimous in accepting that verdict. So too were all the Judges of the Cape and Natal Special Courts in the three trust cases.

The absence of a single, decisive test has resulted in great uncertainty in determining the capital or revenue nature of a receipt, where such falls on the borderline. This led Lord Greene MR into making the following cynical observation whilst giving Judgment in IRC VS British Salmson Aero Engines Ltd¹⁵:

"There have been many cases which fall on the borderline. Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons."

With these caveats in mind, an attempt will be made to review some of the main tests in order to ascertain their origins, their purposes, the scope of their intended operation and some of their strengths and weaknesses.

13 See eg Halsbury's Laws of England 4th edition, vol 23, p27 fn 1; Whiteman and Wheatcroft on Income Tax, 2nd ed by Whitemann and Milne @ 330; Hallstrooms vs FCT (1946) 3 AITR 436 (per Dixon J).

14 Silke @ para 3.1.

15 [1938] 2 KB 482 @ 498.

1. The Tree and Fruit Analogy

This is perhaps the most classical of the legal metaphors in current usage. Capital is likened to a tree and revenue to the fruit of the tree. Receipts emanating from the sale of the fruit are income whilst receipts from the sale of the tree, or any part thereof are of a capital nature.

Similarly, the costs incurred in acquiring and developing the tree are capital expenses and not deductible under the corresponding provision in s.11(a), whilst any expenditure in harvesting, packing and producing a saleable product will be revenue in nature and deductible.

The metaphor is a favourite of Judges, as is evidenced by, for example, the comments of Maritz J in CIR vs Visser¹⁶

2. The Machine and Products Analogy

Another metaphor in common usage is to liken capital and revenue to a machine and its products. The machine corresponds with the capital element, the tree, or the principal, whilst the products of the machine correspond with the revenue output, the fruit or the the interest acceding to the principal.¹⁷

Upon alienation of the income generating machine or any part thereof in the ordinary course the receipts will constitute capital. Per contra upon disposal of the products the income will bear the imprint of revenue.

The position with deductions is similar. Moneys expended in acquiring, expanding or improving the income producing machine will not be deductible as they constitute a capital outlay. Constat that moneys spent

16 1937 TPD 77.

17 Meyerowitz & Spiro @ p 93, para 279.

working the machine and improving, promoting and marketing its products are revenue in character and deductible. This is subject always, of course, to the other requirements of s. 11 (a) being met.

3. Income - Earning Structure and Profits

A further method whereby the essence of capital items can be grasped in contradistinction to revenue items, is by visualising capital as all the parts of the income-earning structure or apparatus of the taxpayer as contrasted with the income generated therefrom. The idea of 'structure' versus the 'profits' thereof was described in the context of capital - revenue outgoings by Watermeyer CJ in New State Areas vs CIR¹⁸ and applies equally to incomings.

In Van den Berghs Ltd vs Clark Lord McMillan observed:

"The cancelled agreements related to the whole structure of the appellant's profit-making apparatus. They regulated the appellant's activities, defined what they might and might not do, and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure or money received for the cancellation of, so fundamental an organisation of a trader's activities can be regarded as an income disbursement or an income receipt."¹⁹

4. Revenue from Capital Productively Employed

This is one of the earliest and most general formulations of a test to distinguish capital from revenue. This is effected by asking 'Is it revenue from capital productively employed?' If the answer is a positive one then the receipt is revenue in nature. Innes CJ in COT vs Booyens Estate Ltd and South Deeps Ltd expressed it in this way :

18 1946 AD 576 @ 595.

19 [1935] AC 431 (CA).

"....income considered in relation to capital is revenue derived from capital productively employed. In a transaction of this nature, therefore, where profit has undoubtedly resulted from the disposal of the company's assets, we have to enquire whether profit has resulted from the productive use of capital employed to earn it, or whether it has resulted from the realisation of capital at an enhanced value."²⁰

The test flows from the basic import of the capital definition as explicated by the same distinguished Chief Justice in the watershed case of CIR vs George Forest Timber Co Ltd :

"In the absence of any authoritative and comprehensive definition of capital expenditure it is well to bear in mind the characteristic quality of capital that it was wealth employed in creating fresh wealth, invested to produce an income".²¹

5. The Scheme of profit-Making Test

This test, along with the fixed and floating capital test (below), are the most vaunted and publicised of the so-called capital-revenue tests.

It finds its origins in the Scottish case of California Copper Syndicate vs Edward Harris (Surveyor of Taxes)²². In that case the taxpayer was a company formed in 1901 to, inter alia, acquire, prospect, work and alienate copper mines. Shortly afterwards, it acquired 480 acres of copper bearing land at a cost of 24 000 pounds. In April 1902 the taxpayer sold 80 acres of the land to the Fresno Copper Company Ltd at a price of 105 000 pounds payable by an issue of shares in the Fresno Company. In August 1903 the taxpayer

20 1918 AD 576 @ 595. See further CIR vs Leydenburg Platinium 1929 AD 137, Crowe vs CIR (1930) 4 SATC 133 @ 136.

21 (1924) 1 SATC 20 @ 25.

22 (1904) 41 SCLR 894 (5th Series).

sold the remaining 400 acres again to the Fresno Company for 195 000 pounds also payable by an issue of its shares. The Surveyor of Taxes sought to tax the profits.

The Court held that the taxpayer had been correctly assessed as it had never intended to work the land itself. Its purpose had been to speculate in the land for a profit.

In the course of his Judgment, Lord Justice Clerk said; of the the dividing line between the realisation of an investment at an enhanced value and an operation of business :

"What is the line which separates the two classes of cases may be difficult to define and each case must be considered according to its facts, the question to be determined being, is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made by an operation of business in carrying out a scheme for profit-making".²³

Here then was the initiation of the scheme of profit-making test, a test which seeks to question the transaction giving rise to the receipt by asking 'was it an operation of business in carrying out a scheme for profit-making?' If the answer is in the affirmative then the resultant receipt is revenue in nature.

23 Supra fn 22 @ 896.

The test was approved of by Innes CJ in COT vs Booyens Estates Ltd and South Deeps Ltd²⁴ in 1918 and thus received into our law. In that case the taxpayer company was formed in 1899 to carry on mining operations principally for gold on specified mining claims. These claims were acquired at a price of 31 000 pounds but due to an inadequacy of capital mining operations were never actually commenced.

In 1906 one-eighth of the claims were sold and the proceeds utilised to reduce the purchase price outstanding on the other claims. In 1915 all the remaining claims were sold to Robinson Deep Ltd for 441 000 pounds, the price payable by an issue of shares in that company to the taxpayer. The taxpayer company then went into voluntary liquidation and the shares distributed to the members as an in specie dividend.

The Commissioner sought to assess the taxpayer company on the profits in terms of the 1914 Act. In court he argued that, as in the California Copper Syndicate case²⁵, an inference was to be drawn that the claims had been acquired for speculative purpose, and that the taxpayer had thus effected an operation of business.

The Appellate Division, however, rejected that argument. It pointed out that on the evidence the mining claims had been acquired for the purpose of working as a gold mine but that this was not effected due solely to a lack of capital. The claims were eventually sold and the taxpayer company wound up, having failed to achieve its stated object of gold mining.

24 Supra fn 20.

25 Supra fn 22.

The court went on to distinguish California Copper Syndicate on the basis that the probabilities in that case showed that the land had been acquired not to work as a copper mine but for resale at a profit. The memorandum of the taxpayer company had, moreover, authorised speculation in mining claims as a business activity.

The court concluded that the taxpayer company was merely realising its capital assets at an enhanced value and had not effected an operation of the business of buying and selling claims.

What is manifest from these two cases is that the scheme of profit-making test was devised to deal specifically with a certain type of case - the single transaction. In the Californian Copper Syndicate case it was the purchase and resale of 480 acres of copper-bearing land, whilst in the Booyesen's Estate case it was the acquisition and alienation of a group of mining claims.

Two critical points flow from this. Firstly, the Scottish Court Session in the Californian Copper Syndicate case did not attempt to formulate a test for the position where a series of transactions would be in issue. The scheme of profit-making test was intended to constitute a *corollary*, an adjunct, an accessory to the principal test for capital-revenue in commercial cases. This principal test, applicable in all cases other than the single transaction, was and at least in the United Kingdom and Australia, still is, whether the taxpayer carried on business in order to produce the receipt.

Thus, Lord Justice Clerk in the same case also said :

"It is quite a well settled principle in dealing with questions of assessment to income tax that where the owner of an ordinary investment chooses to realise it and obtains a greater price for it than that for which he originally acquired it, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842, and therefore is not assessable to income tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment but is an act done in what is truly the *carrying on or carrying out of a business.*"²⁶
(emphasis added)

That this is the position has long been recognised, accepted and applied in both the United Kingdom and Australia. A long line of cases, including, for example, Ducker vs Rees Roturbo Development Syndicate²⁷ (House of Lords) Edwards vs Bairstow and Harrison²⁸ (also a House of Lords decision) in the United Kingdom, and FCT vs Whitfords Beach (Pty) Ltd²⁹ and FCT vs Myer's Emporium Ltd³⁰ in Australia, merely provide affirmation for what is regarded as trite in those jurisdictions. The scheme of profit-making test in these countries is not accorded the independent and sacred status which our courts increasingly seem to attribute to it.

However, the proposition, as pointed out by Nicholas AJA in the Pick 'n Pay case, is not a novel one in South Africa. In the Booyesen's Estate case Innes CJ

26 Supra fn 22 @ 897.
 27 [1928] AC 132 @ 140.
 28 [1956] AC 14, 36-37.
 29 (1982) 12 ATR 692, 698-9.
 30 (1987) 18 ATR 693.

cited the above dictum of Lord Justice Clerk with approval and added :

"Now a company can employ its capital in order to earn profit by *embarking it in some enterprise or business* which the company was formed to undertake. The line of enquiry under our Act therefore approaches so close to the English test, that in a case like the one before us there is no practical difference."³¹

It is explicit that not only the corollary (ie, the scheme of profit-making test) but also the principal test (ie, the carrying on business test) was received into our law in the Booyesen's Estate case. This is not only supported by the language of the Judgment but is wholly logical in relation to the complex capital-revenue concept. In an oft-quoted dictum, Corbett JA in Elandsheuwel Farming (Edm) Bpk vs SIR³² provided confirmation :

"Where a taxpayer sells property, the question as to whether the profits derived from the sale are taxable in his hands by reason of the proceeds constituting gross income or are not subject to tax because the proceeds constitute receipts or accruals of a capital nature, turns on the further enquiry as to whether the sale amounted to the realisation of a capital asset or whether it was the sale of an asset in *the course of carrying on business OR in pursuance of a profit-making scheme*. Where a single transaction is involved it is more appropriate to limit the inquiry to the simple alternatives of a capital realisation or a profit-making scheme." (emphasis added)

The second crucial point is that the scheme of profit-making test was devised to distinguish the speculative case from the investment case. It thus presupposes a finding of an intention to resell at a profit at the

31 Supra fn 20 @ 595.

32 (1978) 39 SATC 163.

time the asset was acquired. Thus if the asset was acquired with such a speculative intention, then the proceeds on resale will be revenue in character. Conversely, if the acquisitive intention was to establish an income-earning structure, the tree or the machine, then the proceeds on resale will constitute a capital inflow.

However, the test has, in South Africa been applied to a rather different situation, that of a *change of intention*. Where the taxpayer acquires an asset for investment but then changes his mind and appropriates the asset to trading stock, the proceeds are revenue. Likewise, where an asset is acquired for resale and then converted to form part of the income-earning structure, it becomes capital as there is a change of intention.

In a simple case there is little difficulty. For example, if a car dealer takes one of the vehicles from his stock to use in his business he converts revenue into capital. If he later returns the vehicle to his stock for resale he converts it back to a revenue asset.

In difficult cases there is no express appropriation by the taxpayer and it becomes a matter of fact and degree whether a conversion has taken place. The courts have adapted the scheme of profit-making test to ask whether despite an acquisitive investment intention on the part of the taxpayer, he has subsequently embarked on a scheme of profit-making. If he has, then a conversion has occurred, and he is assessable on the income.

The most illustrative of the change of intention cases reflecting this adaption of the test are CIR vs Stott³³ and Natal Estates vs SIR.³⁴ In Stott's case the main issue revolved around a 50 acre plot of land which the taxpayer, an architect and land surveyor, acquired with the intention of establishing a seaside reside - clearly not a revenue intention. He built a cottage on one portion of the land for his own use. He then proceeded to subdivide half the plot into numerous lots, which he sold at a handsome profit.

The Secretary sought to tax the profits. In the initial enquiry, Wessels JA found as a fact that the taxpayer had not carried on the business of landjobber. He then proceeded to apply the scheme of profit-making test to determine whether a change of intention had occurred :

"His Lordship would proceed to enquire whether the evidence supported the contention that the taxpayer was carrying on a scheme for profit-making by buying up land, cutting it up and selling it in lots....

'For the purpose of ascertaining whether profits made upon the sale of an article are taxable profits, I think it is sufficiently accurate that it depends upon whether the article was acquired for purposes of the trade or not'.... [citing Rowlatt J]. It was unnecessary to go so far as to say that the intention with which an article or land was bought was conclusive as to whether the proceeds derived from a sale were taxable or not. It was sufficient to say that the intention was an important factor and unless some other factor intervened to show that when the article was sold it was sold *in pursuance of a scheme of profit-making*, it was conclusive in determining whether it was capital or gross income."³⁵

33 1928 AD 254.

34 1975 (4) SA 177 (AD).

35 Supra fn 33 @ 261-62.

On the facts of the case, Wessels JA held that there was no such scheme. The mere fact that the taxpayer had used his skill as an architect and land surveyor to subdivide the land and dispose of it in plots in order to realise his investment to best advantage was not sufficient to justify the conclusion that he had embarked on a scheme of profit-making and gone over to the business.

The decision in Natal Estates' is to the same effect but it is useful to contrast the facts. The taxpayer was a sugar cane grower and miller. It purchased a sugar cane farm near Durban in 1920, as a going concern, with the intention of growing and milling sugar cane and manufacturing sugar.

The central issue inter alia related to part of the farm extending into La Lucia and Umhlanga Rocks. Between 1957 and 1965 the taxpayer began developing townships there by subdividing land, designing roads and services and constructing some housing. It then proceeded to sell individual stands to members of the public, but the bulk was sold to associate companies. The associates intended to and did resell to the public. The taxpayer earned huge profits and the Commissioner assessed to tax despite the taxpayer's protestations.

In the Appellate Division, Justice Holmes JA, applying the scheme of profit-making test, upheld the assessments. He found that the intensive preparatory planning and organisation, the intention to create a luxury township, the lavish expenditure therefor, the construction of some houses to set the tone and the marketing of township land on a grand scale proved that the taxpayer had engaged in a scheme for profit-making.

It is submitted that, taking all the leading caselaw into proper perspective, three separate and distinct situations may be identified which are susceptible of, and indeed require, different treatment:

- (i) 'The carrying on of business' cases. This has always been the first line of enquiry in the cases and undoubtedly constitutes the principal test to which the scheme of profit-making test is but a mere corollary. Where the taxpayer has carried on business to produce the receipt then it is revenue in nature. As to what constitutes the carrying on of a business is considered in detail in part seven. It is sufficient to state that generally speaking there must have been continuity or a series of transactions before a taxpayer can be said to have traded.³⁶

The other point of critical importance is that the test is a purely objective one in which the taxpayer's intention to profit is but one of several factors to be evaluated amongst others.

- (ii) 'The operation of business' (or 'speculative acquisitive intention') cases. These are the cases where, strictly speaking, no business was carried on because of the absence of continuity. There is but a single or 'one off' transaction. A commodity is purchased with the intention that it is resold at a profit and not for holding as an investment. It thus constitutes a single 'operation of business'.

36 per Wessels JA in Stott, Supra fn 33 @ 260.

As to what is or is not a 'speculative' intention, the California Copper Syndicate and Booyesen's Estates cases should be compared and contrasted with CIR vs Paul³⁷ and Crowe vs CIR³⁸. In Paul's case the resale of excess farming land, which P had been compelled to buy, by subdivision into plots, was held not to fulfil the requirement. Similarly, in Crowe's case where the taxpayer had insufficient capital to pay the price for a farm he wanted to purchase sold the wattle bark and timber to make up the shortfall, it was held that the intention had not been a speculative one.

The test in these cases is a wholly subjective one although in determining what the taxpayer's intention really was, the court can and will take into account objective surrounding factors (see part four above).

- (iii) The 'Scheme of profit-making' (or change of intention) cases. These cases also relate to the single transaction. They differ materially from the single 'operation of business' in the sense that proof of a change of intention from capital investment to a business transaction is required. That proof is in the form of a *scheme* establishing, to use the colourful words of Holmes JA in the Natal Estate case, that the taxpayer 'had crossed the Rubicon and gone over to the business'³⁹

Thus a mere intention to realise an investment at a profit or to best advantage is insufficient. Objectively, there must, in addition, be proof of 'something more' indicative that the taxpayer had embarked on a scheme of profit-making.

37 1956 (3) SA 335 (AD).

38 1930 AD 122.

39 Supra fn 32 @ 203.

In Stott's case Wessels JA said :

"As had been pointed out in the Booyesen's Estate case there was no definite test which could always be applied in order to determine whether a gain or profit was income or capital but in order to convert what was on the face of it an ordinary investment of surplus funds into a profit making business *there must be proof of some special acts* which in the ordinary experience of men showed that the taxpayer had conceived some scheme for profit-making and had made it his business to carry it out".⁴⁰

It is this addition of an objective requirement to the subjective test that categorically distinguishes this situation from the purely subjective test in the speculative acquisitive intention cases in (ii) above, and from the wholly objective test in the carrying on of business cases in (i) above.

The scheme of profit-making test has no application at all in the carrying on business cases but can be utilised in the two single transaction cases in (ii) and (iii) above, subject to the critical variation in the method of application depending on whether it is a single operation of business case or a scheme of profit-making case.

It should be noted that the terms 'carrying on business', 'operation of business' and 'scheme of profit making' are not terms of precision. In a broad sense they are all variations of the same fundamental activity : the continuance of a business that generates an income.

40 Supra fn 33 @ 262.

It is submitted, however, that the case law discloses material differences that necessitates the foregoing crucially different testing treatment. These differences are not always recognised and appreciated by Judges and academics alike. This may be attributed to the fact that nearly all the cases that have come before the courts since the landmark decision in Booyesen's Estate have involved only the changes of intention circumstance.

The law, in South Africa at least, remains wholly undeveloped on the other fronts. As we shall see, this is not the case in the United Kingdom and Australia where a level of sophistication has been achieved in dealing with the carrying on of business cases.

6. Tests Ancillary to the Scheme of Profit-making Test

It is evident that many ancillary tests can be employed to determine whether a speculative intention existed at the time the asset was purchased, or a change of intention occurred so that the taxpayer can be said to have embarked on a scheme of profit-making with an asset originally bearing the status of capital.

These tests are necessary because a taxpayer is either being untruthful about his intention, or has indulged in a degree of creative thinking, or has merely descended into a haze of recollective incapacity. The courts have had regard to factors such as the length of time the asset was held (as in ITC 1418⁴¹), whether the taxpayer engaged in similar transactions before (Stephan vs CIR⁴²), the nature of the taxpayer's trade,

41 (1986) 49 SATC 42.

42 1919 WLD 1.

profession or business (SIR vs The Trust Bank of Africa Ltd⁴³) and the motive behind the disposal (CIR vs Paul⁴⁴).

These tests are, in truth, nothing more than indicators for the presence or absence of a speculative or profit-making intention and as such are not really capital-revenue tests. In themselves they do not resolve the problematic classification of a receipt as capital or revenue.

7. The Fixed and Circulating Capital Test

Like the scheme of profit-making test, the fixed and circulating capital test is utilised on a widespread basis in South Africa and in other English-based tax Jurisdictions.

In terms of this test, business capital is divided and distinguished as between fixed capital and circulating capital ('floating' is often used instead of 'circulating', but the latter is to be preferred as it was the term originally used by Adam Smith). Fixed capital is the sum total of all the assets retained in the taxpayer's business with the object of producing an economic utility for the holder. In the hands of a manufacturer the land, buildings, plant, machinery, goodwill, vehicles, etc, will constitute fixed capital.

On the other hand, circulating capital is comprised of a dealer's stock - that which the owner parts with, so that it may return to him in cash or other consideration with an increment. So vehicles in the hands of a car dealer, land of the landjobber, grain of the corn merchant, produce of the farmer, etc are trading stock and thus circulating capital. The

43 1975 (2) SA 652 (AD).

44 Supra fn 33.

proceeds of the sale of fixed capital are capital in nature whilst the proceeds of the sale of circulating capital are revenue and assessable to tax.

Of the distinction, Romer LJ in Golden Horse Shoe (New) Ltd vs Thurgood said :

"Land may in certain circumstances be circulating capital. A chattel or chose in action may be fixed capital. The determining factor must be the nature of the trade in which the asset is employed. The land upon which a manufacturer carries on his business is part of his fixed capital. The land with which a dealer in real estate, carries on his business is part of his circulating capital. The machinery with which a manufacturer makes the articles that he sells is part of his fixed capital. The machinery that a dealer in machinery buys and sells is part of his circulating capital, as is the coal that a coal merchant buys and sells in the course of his trade."⁴⁵

The distinction between fixed and circulating capital was first drawn by classical economists, notably Adam Smith. This Lord Haldane acknowledged in John Smith and Son vs Moore in the following passage :

"My Lords, it is not necessary to draw an exact line of demarcation between fixed and circulating capital since Adam Smith drew the distinction in the Second Book of his *Wealth of Nations* which appears in the chapter on the Division of Stock, a distinction which has since become classical, economists have never been able to define much more precisely what the line of demarcation is. Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters. The latter capital circulates in this sense."⁴⁶

45 [1934] 1 KB 548, 563.

46 [1921] 2 AC 13, 19-20.

In Ammonia Soda Company Ltd vs Chamberlain, Lord Swinfen-Eady summarised the division in this oft-quoted passage :

"In these cases that capital is fixed in the sense of being invested to be retained by the company more or less permanently and used in producing an income. What is circulating capital? It is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulated in business in the form of money, goods or other assets and which are intended to return to the company with an increment, and are intended to be used again, and always to return with some accretion'.⁴⁷

The distinction has found acceptance and exposition in our own courts. Indeed, it is difficult to visualise how so fundamental a concept as that behind the difference between fixed and circulating capital can be ignored in any income taxation system.

In CIR vs George Forest Timber Ltd, Innes CJ said :

"Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital was consumed and disappeared in the very process of production, while fixed capital did not, though it produced fresh wealth it remains intact. The distinction was relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed. But...the two phrases have an ascertained meaning in accountancy as well as in economics. Ordinary merchandise in the hands of a trader would be floating capital. Its use involved its disappearance and the money obtained for it was received as part of the ordinary revenue of the business."⁴⁸

47 [1918] 1 ChD 266, 286-7.

48 Supra fn 20 @ 25.

No discussion on the subject would be complete without citing Watermeyer CJ's elaboration of the definition of floating capital in New State Areas Ltd vs CIR :

"As to the latter the distinction must be remembered between floating or circulating and fixed capital. When the capital employed in a business is frequently changing its form from money to goods and vice versa (eg the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a manufactured article) and this is done for the purpose of making a profit, then the capital so employed is floating capital."⁴⁹

The first point to be made here, a point that is not often grasped, is that before assets can be classified as either fixed capital or circulating capital the taxpayer must be carrying on business ie, only business capital is susceptible of capital allocation in this way. All the Judges in the Pick 'n Pay case accepted this proposition as correct⁵⁰ based on a dictum in S.B.I. vs Aveling.⁵¹

Secondly, it is submitted that since the single 'operation of business' and the 'scheme of profit-making' (as defined above) are but species of business, assets sold in pursuance thereof are capable of assignment as business capital either to fixed capital or to circulating capital.

Thus in the California Copper Syndicate case the copper bearing land was the company's circulating capital, it having been established that the company had effected an operation of business. Similarly, in the Natal Estates case the La Lucia and Umhlanga Rocks township constituted the taxpayer's circulating capital, the

49 (1946) 14 SATC 155, 163-4, 1946 AD 610, 620-21.

50 (1992) SATC 271, 283 (per Smalberger JA)

51 1978 (1) SA 862 (A), 880B - 881A, 40 SATC 1,17-18.

court having found as a fact that the taxpayer had launched a scheme of profit-making.

It is apparent, therefore, that the primary line of enquiry before one can consider a capital division, is to ascertain whether the taxpayer carried on business or effected a single operation of business or embarked on a scheme for profit-making. If one of these activities is established then, and only then, can the fixed-circulating capital test be applied.

It ought to be borne in mind that in the case of the single operation or scheme it will almost invariably follow that the assets were items constituting circulating capital.

8. Tests Ancillary to the Fixed-Circulating Capital Test

The most important test to distinguish between fixed and circulating capital is the test of permanency.

As fixed capital consists of assets which the taxpayer intends to hold as part of his income earning structure one would expect those assets to be held with some degree of permanency. Stock, to the contrary, is intended to move, circulate or be consumed in the process of working.

Essentially, therefore, the test is one of intention, viz, whether the taxpayer intends to hold the asset as part of his machine, tree or income-earning structure or whether he intends to float it as part of his stock. An item may be fixed capital despite the absence of permanency. For example, where a taxpayer purchases a machine for his manufacturing business but then immediately resells it due to its unsuitability after trial, the proceeds will be capital as his intention at all times was that it form part of his permanent assets.

On the other hand, an unpopular model of vehicle that lies unsold in a car dealer's yard for years due to a lack of demand remains stock despite the length of time for which it is held. On sale the proceeds will be revenue.

Despite a dictum to the contrary in S.B.I. vs Aveling⁵² Vos J in Bloch vs SIR⁵³ felt that fixed capital did not have to be held by the taxpayer directly for the production of income. He preferred to define fixed capital as 'that which is held with an element of permanency and with the object that it should produce an economic utility for the holder.'⁵⁴

This aspect of 'economic utility' is to be preferred over 'production of income' because it is all-encompassing in relation to fixed capital assets. Thus a set of Sombrero hats in a Mexican restaurant to set the atmosphere, or a collection of antique cars in an upmarket car dealer's showroom to promote a business image, would fairly constitute part of the business's fixed capital, although not directly productive of income.

In ITC 1413, Grosskopf J went even further to suggest that "it may be doubted whether even 'economic utility' is always necessary for the purposes of the Act (thus an object with only sentimental or aesthetic value for the holder may generate a capital surplus if sold...)"⁵⁵ In this Grosskopf J must surely be wrong. There cannot be fixed or floating capital unless there is a business, so economic utility is a prerequisite for fixed capital.

52 Ibid.

53 1980 (2) SA 401 (C).

54 Ibid, @ 411 D-E.

55 (1985) 48 SATC 167, 171.

However, the sale of an asset held personally by a taxpayer for aesthetic purpose, eg, a painting, will undoubtedly generate capital proceeds, but this is because it formed part of the taxpayer's reserve (or non-business) capital (a concept which is fully explicated in part seven) and not because it is fixed capital (which it cannot be).

It is obvious that the permanency test is, in truth, a subsidiary test which is an aid to differentiating between the fixed and circulating capital of a business. Mostly it is employed to test whether a taxpayer is being truthful about his alleged intention to hold a particular asset as a component of his income-earning structure rather than as stock.

Sometimes, as was attempted by Grosskopf J in ITC 1413, it is utilised to delimit the circulating capital element from the fixed capital of a business continued by the taxpayer for a purpose other than profit-making.

SUMMARY OF THE CAPITAL-REVENUE TESTS

The various analogies adverted to, viz, the tree and fruit, the machine and products and the income-earning structure and profits, are, in truth, nothing more than useful metaphors that assist the inquirer to visualise the essence of the capital-revenue distinction. This is also true of the 'capital productively employed' test.

As such, they provide only very broad and generalised guidelines as to the route to be followed in establishing whether a particular receipt is capital or revenue in character. They do, however, perform the vital function of serving as sources of, and censors for, the other more substantive tests. Moreover, they constitute useful maps and beacons against which the result of any inquiry can be verified.

Many Judges have emphasised that whatever guideline one chooses to follow, 'one should not be led to a result in one's classification of a receipt as income or capital which is...contrary to sound commercial and good sense'.⁵⁶ This view has pervaded other tax Jurisdictions too. In the Australian case of Hallstroom (Pty) Ltd vs FCT, Dixon J said, in the context of deductions :

"What is an outgoing on account of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the Juristic classification of the legal right, if any, secured, employed or exhausted in the process."⁵⁷

What is or is not 'practical' or of 'sound commercial and good sense' depends upon highly nebulous and subjective concepts. It seems that what these Judges are in reality endeavouring to convey is that a slavish devotion to any particular test ought not to be observed if the result is contrary to the quintessential nature of the capital-revenue distinction.

As Grbich, Bradbrook and Pose state :

"Income is not a thing. if you look too hard for its physical embodiment, as many of the authorities and textbooks have, you will miss its essential connotation. Its essence cannot be captured by looking merely at its source. Income as it is used in Australian tax law is a term connoting a flow of cash (or something convertible to cash) into the hands of the taxpayer. It is a flow generated by certain purposive activities or having certain defined characteristics."⁵⁸

56 per Friedman J, ITC 1450 (1988) 51 SATC 70, 76.

57 (1946) 3 AITR 436.

58 Revenue Law: Cases and Materials, 1990 @ 48.

This leaves us with only two substantive tests - the scheme of profit-making test and the fixed-circulating capital test. The evidence so far points towards the achievement of a positive reconciliation of these tests. However, broad claims have been made for, and profound criticisms levelled against, the scheme of profit-making test such as hinders the way to a final reconciliation.

In the next part these claims and criticisms are analysed with a view to disencumbering the road to a possible resolution of the dire conflicts surrounding the share incentive trust.

PART SIX: THE SCHEME OF PROFIT-MAKING TEST -
SEPARATING MYTH FROM REALITY

Is the Scheme of Profit-Making Test Alien and/or Redundant ?

In the last part the various tests for capital and revenue were examined. In theory, at least, whatever test or guideline the Court chooses to apply the end result should be the same. That this was not the case in the trust trilogy of cases must be cause for some measure of distress.

The majority appeal judges in the Pick 'N Pay case, and Tebbutt J and Friedman J in the Special court, chose to apply the scheme of profit-making test thereby finding in favour of the trust. The minority appeal judges, and Grosskopf J in the Special Court, opted to apply the fixed-circulating capital test and found for the Commissioner !

What went wrong ? Why should the one test produce a result that is diametrically opposed to the result of an application of the other ? Such conflicting results are, in the overlapping worlds of mercantile law, economics, accountancy and business not merely anomalous but positively perverse.

Huxham and Haupt go so far as to suggest that the scheme of profit making test was rendered defunct by the repeal of the 1914 Act and its replacement with a consolidated Income Tax Act in 1917. They state:

"The 'scheme of profit-making' test has its origins in the California Copper Syndicate¹ case...and the Tebräu Rubber Syndicate² case... Reliance was placed on these cases under our 1914 Income Tax Act, which had no

1 (1904) 41 SCLR 894 (5th Series)

2 (1910) 47 SCLR 691 (3rd Series)

reference to 'capital'. It is considered that the continued reliance on the tests set out in these cases is therefore incorrect."³

This is, on the face of it, a rather bold submission considering that the scheme of profit-making test has been applied in our Courts, without demur, for nearly seventy five years. However, there is apparently some high authoritative support for this submission. In Pyott v CIR, Davis AJA, remonstrating with taxpayer's counsel for seeking to rely on certain U.K. cases, said:

"Reliance was, however, placed, for the making of this [accounting] provision, generally upon the principles of sound accountancy and upon English cases... As to the English cases cited, it must be remembered that, as is pointed out by Lewis AJ, who delivered the judgment of the court *a quo*, the whole basis of our taxation was changed in 1917. Under the Act of 1914, the subject of the charge was 'profits or gains,' and it was consequently the same as it is today in England. But since 1917, we have had in South Africa an artificial and purely statutory definition of 'taxable income' derived ultimately from the definition of gross income as set out above - that is, the total amount of receipts and accruals (excluding those of a capital nature) from any source within the Union (or deemed to be such), and it is by no means necessarily synonymous with 'profits or gains'. Consequently, remarks such as those of Lord Sumner... and the reasoning in the cases relied upon by the appellant, have no application to the present case".⁴

There are three points which emerge from these two quotations that require scrutiny. First, that in 1917 South Africa went from a natural to an artificial system of income taxation. Secondly, that the exclusion of the word 'capital' in the 1914 Act and its subsequent inclusion in the 1917 Act had the effect of altering the approach to taxation and rendering the scheme of profit-making test redundant and, thirdly, the apparent discrediting of reliance on English decisions.

3 Notes on S.A. Income Tax 1992 ed, 40

4 1945 AD 128

In stating that in 1917, South Africa went from a natural to an artificial system, Davis AJA was most certainly mistaken. The Income Tax Act, No. 28 of 1914, did indeed refer to 'profits and gains'. The charging provision in s.4(1) levied income tax on 'taxable income', which was income less the sum of * 1000 pounds sterling.⁵ 'Income' was defined in s.49 as follows:

"'income' shall, in relation to any person, mean any *gains or profits* derived by, or accrued to or in favour of, such person in the year for which the assessment is made, from any source within the Union, and, shall include profit, gains, rents, interest, salaries, stipends, wages, allowances, the estimated annual value of any quarters or board or residence or any other benefit or advantage of any kind whether in money or otherwise granted to him in respect of his employment, or any pension, stipend, charge or annuity,".

Prima facie this appears to have established a natural system for taxing gains and profits. Clearly this was not the case for in s.14(1)(a) of the 1914 Act provision was made for deductions, something wholly absent in the 'natural' - based English system. This meant that deductions had to be made artificially in terms of s.14 and not by a natural computation of gains and profits.

The wording was, of course, defective as it was open to a taxpayer to argue for double deduction, first, in computing the gain or profit, and then again in terms of s.14. This was one of the apparent reasons for the repeal of the income definition in the Income Tax Act, No. 41 of 1917, and the substitution of the 'gross income' definition we still have (substantially) today.

The 1917 Act did not, therefore, fundamentally alter the unitary and artificial system introduced in 1914. It was

5 Income Tax Act 28 of 1914, s4(2)

nothing more than a consolidation statute intended only to tidy up some wretched drafting contained in the original Union income tax statute. (The opportunity was taken to introduce super tax). Broomberg in his article The Basis of Income Taxation In S.A.⁶ reached a similar conclusion which is expressed in his usual vivid and colourful fashion:

"Now this 1917 Act was a consolidation statute. There is thus a strong presumption that it did not bring about any amendments to the law at all. Putting the matter at its lowest, one could hardly expect to find a less likely package in which to wrap a change in the very basis of the law. Yet one must acknowledge the radical alteration in the wording of the corresponding key definitions in the 1914 and 1917 Acts. '... Any gains or profits derived by, or accrued to or in favour of any person...' now becomes '... the total amount received by or accrued to or in favour of any person other than receipts or accruals of a capital nature...' We have a counter-inference that a difference in meaning was intended.

If a difference in meaning was intended, what is the difference? As far as can be ascertained, no court and no writer has thus far attempted to give the difference a content, except on a strictly ad hoc basis."

Broomberg advances further cogent reasons why the 1917 Act ought to be regarded purely as a consolidation rather than a revolutionary statute. Firstly, the 1914 Act was 'repetitious, ungrammatical and inappropriate'⁸ and required 'cosmetic surgery which the draftsman of the Consolidation Act was able to administer'⁹

Secondly, the drafting of the 1914 Act was so defective that an attempt in s.38 to switch the onus of proof that an amount was income or capital to the taxpayer was unsuccessful. As this was the one onus 'the fisc needed to

6 (1972) 89 SALJ 179

7 Ibid, @ 185-86

8 Ibid, @ 187.

9 Ibid

avoid,¹⁰ the 1917 Act aimed to achieve the movement of onus by framing an exclusion from gross income of capital items.

There is, one might add, also the fact that no mention of any purported change of system of taxation is contained in any of the Parliamentary deliberations on the bill to the 1917 Act nor in the then Minister of Finance's introductory speech to the House.

It was further noted in part five that the 1914 Act was based on the tax statute of New South Wales, Australia, which region has a history of the utilisation of the artificial system. Taxation in Australia is now a Commonwealth responsibility but remains on an artificial basis.

It is submitted that South Africa has always since Union, had an artificial system of taxation and that watershed cases based on the 1914 Act, such as COT v Booysen's Estates Ltd and South Deeps Ltd¹¹ importing English law tests cannot be discounted on the basis of the Consolidation Act of 1917.

This brings us on to the second point, a point made by Huxham and Haupt, regarding the exclusion of the word 'capital' in the 1914 Act and its inclusion in the 1917 Act. It is difficult, with respect, to comprehend why this ought to make any difference. Neither the English Act, nor any of its predecessors, mentions the word 'capital'. Rather, the tax is imposed on income. Thus capital receipts are excluded by necessary implication.¹² This method of indirect exclusion of capital receipts was employed in the 1914 Act, but, as mentioned above, in order to achieve a

10 Ibid, @ 188

11 1918 AD 576

12 See the remarks of Lord McNaghten in London County Council v Attorney-General [1901] AC 26, 35-36

shifting of the onus from Revenue to the taxpayer, and in line with a general restructuring of the Act, capital receipts came to be expressly excluded.

As capital and revenue are antithetical concepts - 'there is no tertium quid'¹³ it follows that exactly the same result is achieved by negatively excluding capital receipts from the ambit of taxation as it is by positively including income receipts. Lest there exist any doubt on the point reference may be made to the judgment of Mason J in the Court a quo in CIR v Collins:

"We come now to the wording of our Income Tax Act 41 of 1917. In s.6 gross income... is defined as the total amount received by or accrued to or in favour of any person during the assessable period other than receipts or accruals of a capital nature. There does not seem to be any substantial difference between the English and South African Acts on this point."¹⁴

What of the value of English judicial learning on the subject? There is, unfortunately, a great deal of ignorant reluctance to have recourse to foreign law - English law in particular. As Broomberg observes: "At present a faltering resort is made to these sources in the gloom of a murky twilight right to do so at all."¹⁵

In part five it was established that the scheme of profit-making test and its principal, the carrying on business test, were inherited from the English law. If Davis AJA is correct in saying what he appears to be saying, viz, that English decisions are to be excluded because our systems are different, then these tests were wrongly received into our

13 Per Broomberg, supra fn 6, @ 186

14 1923 AD 347, 350; and see further CIR v Delagoa Bay Cigarette Co. Ltd 1918 TPD 391 and De Beers Consolidated Mines Ltd v CIR 1922 WLD 184, where this was presumed.

15 Supra fn 6, @ 189

law, and, have no place in a unitary artificial taxation system such as South Africa's is.

Now the English tax Act is multipartite, income being divided according to origin and taxed in terms of the relevant schedule amongst several contained in the Act.¹⁶ Schedule D (cases contained in I and II) deals with 'profits of the trades, professions and vocations' carried on wholly or partly in the United Kingdom. The primary enquiry is whether the taxpayer carried on a trade, profession or vocation and, if so, whether the receipt falls within the scope of such trade, profession or vocation.¹⁷

This is in order to, firstly, bring the receipt within the Schedule and, secondly, to meet the first step in the capital-revenue enquiry. Thus Pinson in Pinson on Revenue Law says:

"If a manufacturer acquires a new factory and disposes of his old factory at a profit, such profit is not assessable under Schedule D, for it is an accretion to capital. This inclusion can be reached by saying that the factory forms part of the fixed capital of the manufacturer and that a sum realised on the disposal of fixed capital does not have to be brought into the computation of the profits for income tax purposes: it is a capital receipt, not a revenue receipt. Alternatively, it can be said that it is excluded because it is not a receipt of the trade because the trade of manufacturer does not include dealing in factories."¹⁸

If the receipt falls within 'trading' or 'business', then the next step is to determine whether it is fixed or circulating capital. If the receipt is circulating capital and therefore, revenue then the net gain or profit is computed according to natural accounting principles, closing

16 See part five.

17 See, eg, Pinson on Revenue Law, 17th ed, @ 14; Whiteman and Wheatcroft on Income Tax, 2nd ed, @ 325.

18 Ibid, @ 32-33

stock and work-in-progress accounted for (if any), and the resultant 'assessable income' carried forward for accumulation with assessable income from the other five schedules: A and B (income from land), C (income from government interest and dividends), E (income from offices and employment) and F (income distributed by companies).

The final deduction system consists of the offsetting of any reliefs (roughly corresponding to our rebates) that the taxpayer may be entitled to, against the total assessable income.

Three significant differences are disclosed : the U.K. system is multipartite, it is also natural, and, it is based on residency. It is submitted that none of these differences fundamentally affects the capital-revenue enquiry, which is identical in both systems, for the following reasons:

Taxation on a residency basis, as opposed to source, determines *which receipts* (or whose receipts), viz, those of residents in the case of U.K., and those emanating within the jurisdiction, in the case of S.A., are assessable. The natural system as against the artificial, pertains to the *method* of computing assessable, or taxable, income. Finally, the multipartite system, vis-a-vis the unitary, merely *pigeonholes* different types of income according to origin (land, employment, etc) for different tax treatment in terms of the special provisions of each Schedule.

None of these differences affects the *quality* of the receipts, ie, whether of an income or capital nature. In London County Council v Attorney-General Lord McNaghten, speaking on income taxation in the multipartite system, remarked as follows:

"It is one tax, not a collection of taxes essentially distinct... The standard of assessment varies according to the nature of the source from which the taxable income is derived. That is all... In every case the tax is a tax on income, whatever may be the standard by which the income is measured."¹⁹

Obviously, English law cannot be relied upon when dealing with source, method or pigeonholing, and this is what counsel for the taxpayer was attempting to do in Pyott's case by arguing that an accounting provision for the prospective refund of container deposits to customers ought to be 'deducted' from gross income, not because it fell with the deduction provisions, but because it was part of the method used to compute profits under the English 'natural' system.

Davis AJA was quite correct in ruling on the inapplicability of English caselaw on the facts of that case. But, Davis AJA meant his ruling to apply only in context, for he went on to deny that English caselaw was always inappropriate:

"I am not prepared to go as far as that, but I will say that the decisions of other countries must be cautiously approached with a due appreciation of any difference in the basis of taxation and that, when they are so approached, it may be found - as is in my opinion the position here - that they are inapplicable to the case under consideration."²⁰

The capital-revenue differentiation comes to us from English law and as both our tax systems are identical in that they are *income* - based, English authority is pertinent, applicable and of superior persuasive value.

The decision in the Booyesen's Estates case is directly in point. After noting that the English system was multipartite, Innes CJ concluded that this did not affect

19 [1901] AC 26, 35-36

20 Supra fn 4, @ 136

the nature of the capital-revenue enquiry, which was identical in S.A., despite it being a unitary system. He said:

"A transaction like the present would in England fall under Schedule D, and the question of liability would depend upon whether the particular profits had been made 'in respect of any trade, manufacture, adventure or concern in the nature of business.' If it did, the tax would be due. But if it were only a realization or change of investment, it would not be subject to income tax. Our legislation proceeds upon somewhat different lines. It provides in general terms for the levy of an income tax...

The definition [of 'income']²¹ makes no reference to trade or business; its scope is not expressly limited in that direction. Yet rightly regarded it will be found that there is little if any practical difference, in a transaction like the present, between the operation of our definition and the effect of the English Schedule. The expression 'any gains or profits' cannot be taken in its widest and most literal sense. The Act imposes a charge upon income only, not upon capital, and the definition cannot be read so as to cover accruals which are really capital. The gains and profits referred to must be gains and profits in the nature of income. Else the definition would extend beyond the scope of the Statute...

Now a company can only employ its capital in order to earn profit by embarking it in some enterprise or business which the company was formed to undertake. The line of enquiry under our Act therefore approaches so close to the English test, that in a case like the one before us there is no practical difference. And that being so, we are free to refer for guidance to the English decisions."²²

And that, it is submitted, ought to place the matter beyond the grasp of even the most cynical and sceptical of critics !

The Australian taxation system is income based. Like South Africa's it is also unitary and artificial but, unlike S.A., it combines source and residency to determine which receipts

21 For the full definition see part five

22 Supra fn 11, @ 594-95

fall within the purview of its tax jurisdiction. Residents are taxed on the basis of their residency and non-residents on the basis of source. As is to be expected, English decisions on capital-revenue are treated as highly persuasive.

Given the fact that Australia is an income-based system, its wealth of caselaw on capital-revenue, like the U.K. cases, can be accessed with little hesitation.

It follows that the scheme of profit-making test was correctly received into our law and is as applicable today as it was under the 1914 Act.

Misinterpretations of The Test

In applying the scheme of profit-making test, Smalberger JA in Pick 'N Pay relied heavily on a derivation of the test formulated by Meyerowitz and Spiro:

"the rather clumsy phrase: 'operation of business in carrying out a scheme of profit-making' in plain language really means that receipts or accruals bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for".²³

That the majority judges in Pick 'N Pay sought to rely on this interpretation of the test as decisive authority is regrettable, for it constitutes, with respect, a gross oversimplification of the law and as such is inaccurate and positively misleading.

Meyerowitz & Spiro seem to think that the capital-revenue enquiry can be resolved by choosing between two simple alternatives: was it fortuitous or was it designed? This is quite simply not the case, for if it were, then all the volumes that have been written about capital/revenue need

23 Meyerowitz and Spiro on Income Tax, 1991 (issue 17), 96(A2) para 299

not have been written, and the legal, judicial and business agonising that has occurred over the decades was all for nought.

The view presupposes that the scheme of profit-making test is one, independent wholly subjective test, which, as explicated in part five, is simply not true. Firstly, the scheme of profit-making test is not an independent test but a mere corollary of, or an accessory to, the carrying on business test. It was never intended to supplant the latter but to complement it.

Secondly, the test is, in truth, not one test but three tests. Thus, the taxpayer must either have carried on business OR undertaken a single operation of business OR embarked on a scheme of profit-making (the change of intention cases).²⁴ Either of these can result in the generation of a revenue receipt.

Whilst the test in the single operation of business cases is a purely subjective one depending upon proof of an intention on acquisition of the asset to speculate with it, this is not the case with the other two tests. The test for 'carrying on business' (or trading, etc) in English and Australian law (see part seven) has been accepted as wholly objective in which an intention (or design) to profit is only one factor to be considered amongst others.

With regard to the 'scheme of profit-making' (as defined in part five) the test has two elements : a subjective one requiring proof of a change of intention from investment to speculation, and an objective one requiring proof of the existence of a sufficient degree of organisation to justify the attachment of the label 'scheme'.

24 See part five

Needless to say, lumping these three materially distinct tests into one with an allegedly single subjective requirement of 'design' is sufficiently misleading to be regarded as wrong in law.

The other obvious criticism is the undue emphasis on the 'fortuitous' element. This element is usually singled out to explain why gifts, inheritances, lottery prizes and gambling wins are excluded from revenue and regarded as capital. But there is a more fundamental and accurate reason why these items are capital and not revenue. This is that they do not constitute wealth (revenue) created by wealth (capital).

Capital wealth can take the form of capital (money, property, etc), wits or labour. As Innes CJ said in the Booyesen's Estates case:

"Profit or gain may be made in many ways; men may earn it by their labour, by their wits, by their capital. Many of the forms of profit, specified in the definition [of Income' in the 1914 Act] are the product of skill or labour; but speaking generally, profit otherwise derived must be in whole or in part the product of capital if it is to be of the nature of income, and thus included in the definition."²⁵

Increments flowing from these activities constitute income. Thus civil fruits; ie, rents, interest, royalties, etc, are revenue whether the taxpayer designedly sought them or not. For example a taxpayer holds large funds in current account with a bank on which he earns no interest. He subsequently receives notification that the bank's policy has changed, effective retrospectively from 1st January, and that it will now pay interest on current accounts. The interest is both

25 Supra fn 11, @ 594-95

unintended and unexpected and yet there is no question that wealth has produced wealth and that the interest is revenue.

This applies equally to income from labour irrespective of the taxpayer's motive or intention in rendering services, and there is no reason why it ought not to apply in commercial cases as well. There is clearly a whole class of case - the carrying on of business or trade - where, *intention* to create wealth is irrelevant if wealth has *actually* resulted from certain defined activities.

So in B Company's Investments v COT, Fieldsend J said:

"I should like to adapt the homely analogy...of the grocer father who, wishing to retire, persuades his reluctant son to buy his business lock, stock and barrel. Assuming that the son agrees, buys the stock and continues to trade, not because he wants to trade but because he does not want to offend and upset his ageing parent, surely then he is nothing but a trader despite his motive for so becoming and any payment for trading stock is an allowable deduction for tax purposes".²⁶

In part four it was established that 'intention' means 'dominant purpose'. Certainly the son could convincingly argue that his dominant purpose was not to profit but to bring happiness to his 'ageing parent'. Therefore, the profits were not designedly sought for ('inevitability' of profits should make no difference - see part three) but purely incidental, and thus capital ! Yet it is obvious that the proceeds are revenue as wealth has generated wealth or revenue has been produced from capital productively employed. The short answer is that, in truth, the son has traded on an *objective* consideration of the circumstances and, therefore, the proceeds are revenue in character.

26 1965 (2) SA 370 (SR), cited in Employee Share Purchase Trusts, (1991) 30 ITR 313, 318.

To express the point brutally, a tree remains no less a tree, and fruit remains fruit, irrespective of the proprietor's intention, purpose, motive, contemplation or expectation. That the actor designedly seeks income, brings him squarely within the scope of 'revenue productively employed' by use of his wits. The absence of such design, however, does not mean that revenue was not produced either by labour or by capital, or by a combination of any two or more of these heads, in circumstances where a conscious intention is irrelevant to the question whether wealth has generated more wealth for the taxpayer.

The scheme of profit-making test may be clumsily phrased, but it certainly expresses its essential elements with far superior accuracy than the 'designedly sought for' test can ever hope to achieve.

That the majority judges relied on what is effectively a fatally flawed and oversimplified 'version' of the scheme of profit-making test must go a long way towards discrediting that decision.

In the next part, an approach to the capital-revenue question in commercial cases will be suggested so that a final analysis may be attempted in order to correctly determine what the nature of the share incentive trust's receipts truly was.

PART SEVEN: FINDING THE RIGHT ROAD

Subjectivist View Wrong

There is universal judicial agreement that there exists 'no single infallible test of invariable application' to determine the capital-revenue nature of a receipt. Why then do Meyerowitz and Spiro, Jooste and other commentators in the subjectivist school think that the problem can be resolved, at least in commercial cases, purely by having regard to the taxpayer's subjective intention to make a profit? Why then did the majority Pick 'N Pay judges de facto treat the subjective test as the sole, determining test?

It is submitted that the subjectivist school, and the majority judges in Pick 'N Pay, were wrong in this - there is indisputably 'no single, infallible test'. The capital-revenue enquiry, in truth, consists not of one test, but of a complex compound of complementary, and sometimes overlapping, steps, tests and indicators in which a subjective intention to profit on the part of the taxpayer is but one element, amongst several, to be taken into consideration.

The presence of a speculative intention to deal with a particular commodity at a profit marks the receipt as revenue, but its absence, contrary to canary logic, does not per se render the receipt automatically of a capital nature.

The confusion has been caused as De Koker & Urquhart state, by an overemphasis of 'intention':

"...those cases dealing with the question of the capital or revenue nature of receipts and accruals

constitute by far the largest single category of all reported tax cases. With this wealth of jurisprudence it might be expected that the law would be clear, but this is unfortunately not the case. The lack of clarity arises from two main sources:

- (a) the fact that each case must be decided on its own facts, and that in no two cases are identical; and
- (b) possibly more importantly, the relevant legal principles have been obscured by an insistence, sometimes by the courts and more often by commentators, on the dominance of a so-called test of intention."

The Philosophy of Adam Smith

In part five it was established that the concept of income or revenue taxation was pioneered by the classical economist, Adam Smith, and subsequently implemented as an integral component of state fiscal organisation by the British prime minister William Pitt (the younger) in 1799¹

Naturally, an intimate acquaintance with the economic philosophy of Adam Smith considerably enhances one's comprehension of the great capital-revenue divide which Smith postulated as the bedrock for his novel system of state taxation. That philosophy is expounded in Adam Smith's immortal works, An Inquiry Into The Nature and Causes of the Wealth of Nations²

Now Adam Smith was concerned that historically taxation had failed to consistently meet the reasonable needs of the state sovereign in governing the land, administering the colonies and fighting war in a manner that did not encroach upon the subject's right to equality in taxation, certainty of principle, convenience and reasonableness.³

1 See part five for a detailed history

2 Published in two volumes in 1776 by Strahan and Strand

3 Supra fn 2. The edition used in this paper to is the Oxford edition by Campbell, Skinner & Todd (editors), 1976, vol 2, pp 817 ff.

It was recognised that a sovereign incurred legitimate public debt and that every subject was under a duty to contribute towards the proper support of government. However, the sovereign was, in turn, duty-bound to levy taxes with due consideration towards fairness, justice and equity.

Smith advocated the view that taxation ought to be equal, ie, falling equally upon each subject according to the size of his interest in the state, or his ability to pay. It should be certain and not arbitrary with definite terms as to the amount, time of payment and manner of payment. It should also be levied at a time or in the manner most likely to be convenient for the contributor to pay it. Finally, it had to be reasonable in amount, designed 'to take out and keep out of the pockets of the people as little as possible over and above what it brings into the publick treasury of the state.'⁴

It was this aspect, the aspect of 'ability to pay', that Adam Smith, as an economist, was most concerned with. Hitherto, European nations had not been entirely successful in accurately measuring a subject's ability to pay on a fair and consistent basis. Taxation had been rooted on a variety of unsatisfactory criteria such as manorial allegiances, capitation, land ownership, expenditure and produce.

It was in light of this that Smith proposed that ability to pay be measured in accordance with the amount of revenue or income that accrued to a subject. The greater the subject's revenue-earning power, the greater his duty and liability to contribute towards government.⁵

4 Supra fn 3, @ 826

5 Ibid, @ 825.

Broomberg describes the successive evolutionary factors which, it is submitted, led to Smith's conception of a revenue tax, as follows:

"The history of taxation from earliest recorded times indicates how successive bases of taxation were tried and found wanting. Voluntary offerings, primitive fees and tolls, and poll taxes led to property being taken as the base of the tax. When property in turn failed to measure the taxpayer's ability to pay, expenditure taxes and then produce taxes were tried in vain. Finally this trial and error process bred the concept of an income tax resting primarily on the faculty principle. It was thought that ability to pay was ideally measured by the net gain or profit made by the taxpayer."⁶

The Three Fundamental Sources of Revenue

This is the starting point for any model. Smith advanced the existence of three seminal and universal sources of revenue that would constitute the sovereign's revenue base: rents of land, profits of stock and wages of labour:

"As the price or exchangeable value of every particular commodity, taken separately, resolves itself into some one or other of all these three parts, so that of all the commodities which compose the whole annual produce of labour of every country, taken complexly, must resolve itself into the same three parts; and be parcelled out among different inhabitants of the country, either as the wages of labour, the profits of their stock, or the rent of their land...

Wages, profit and rent, are the three original sources of all revenue as well as of all exchangeable value. All other revenue is ultimately derived from one or other of these.

Whoever derives his revenue from a fund which is his own, must draw it either from his labour, from his stock, or from his land. The revenue derived from labour is called wages. That derived from stock, by the person who manages or employs it, is called profit. That derived from it by the person who does not employ it himself, but lends it to another is called the

6 the Basis of Income Taxation In S.A. (1972)89 SALJ 179, 188

interest... The revenue which proceeds altogether from land, is called rent, and belongs to the landlord."⁷

These three divisions hold as true today as they did in 1776, despite the vast sophistication of economy that has occurred in the last 200 years or so. The contents of each division would today but include a greater number of derivative species of revenue. For example, under rents of land, we would today include other civil fruits such as dividends on shares and royalties for the use of intellectual property. Under 'wages of labour', we would include remuneration for the holding of an office, and so on.

Interestingly, Adam Smith classified interest on money lent not as 'rents of land' but as 'profits of stock'. This would probably explain the deductibility of irrecoverable loans in the hands of a moneylender as a revenue expense,⁸ something that is regarded by some observers as somewhat of an anomaly. The significance of this is that it tends to show that a subjective intention to profit can be quite insignificant, even under this division of revenue. Interest on money lent is always revenue irrespective whether the lender intended to profit or not.⁹

Of The Profits of Stock : Reserve Capital and Investment Capital versus Business Capital

In the case of the share incentive trust we are concerned with the revenue division of 'profits of stock'.

As this category was of fundamental importance to any revenue tax, Adam Smith endeavoured to define the origin, nature and function of stock.¹⁰ In doing so, Smith drew a crucial distinction between *reserve capital* and *business*

7 Supra, fn 3, Vol. 1, 69 - 70

8 See Stone v CIR 1974 (3) SA 584 (A)

9 See the illustrations in part six

10 Supra fn 3, Vol.1, pp 276 ff

capital. Reserve capital is that part of a man's possessions or produce that he retains for his own use or enjoyment and which does not generate revenue:

"The First [division of stock], is that portion which is reserved for immediate consumption, and of which the characteristic is, that it affords no revenue or profit. It consists in the stock of food, cloaths, household furniture, cutlery and crockery which have been purchased by their proper consumers, but which are not yet entirely consumed. The whole stock of mere dwelling - houses too subsisting at any one time in the country, makes a part of this portion. The stock that is laid out in a house, if it is to be the dwelling-house of the proprietors, ceases from that moment to serve in the function of a capital, or to afford any revenue to its owner. A dwelling-house as such, contributes nothing to the revenue of the inhabitant; and though it is, no doubt, extremely useful to him, it is as his cloaths and household furniture are useful to him, which, however, make a part of his expence, and not of his revenue."¹¹

On the contrary, business capital is that part of a man's possessions or produce which he productively employs to generate a revenue. Smith contrasted the two forms of capital as follows:

"But when he possesses stock sufficient to maintain him for months or years, he naturally endeavours to derive a revenue from the greater part of it; reserving only so much for his immediate consumption as may maintain him till his revenue begins to come in. His whole stock, therefore, is distinguished into two parts. That part which, he expects, is to afford him this revenue, is called his [business] capital. The other is that which supplies his immediate consumption; and which consists either, first, in that portion of his whole stock which was originally reserved for this purpose; or, secondly, in his revenue, from whatever source derived, as it gradually comes in; or thirdly, in such things as had been purchased by either of these in former years, and which are not yet entirely consumed; such as stock of cloaths, household furniture, and the like."¹²

11 Ibid @ 281

12 Ibid @ 279

Here then we have the most authoritative support for the primary stage of the capital-revenue enquiry: did the receipt flow from reserve capital or from business capital ?

Undoubtedly, the realisation of reserve capital in the ordinary course will result in a capital and not a revenue receipt. Included in reserve capital would be the taxpayer's personal possessions, his residence, his furniture, books, clothes, stamp and art collections, items for purely aesthetic or sensual enjoyment, etc.

Also included are inheritances and pure gifts, which are merely transfers of capital from one taxpayer to another, that fall into the recipient taxpayer's reserve capital.

Purely fortuitous gains such as lottery prizes and gambling gains based on sheer luck and not skill would constitute a further accretion to reserve capital.

Revenue (after it has been taxed !) forms part of a taxpayer's reserve capital unless and until it is ploughed back into business, thus once again form part of the taxpayer's business capital.

There is a further distinction that ought to be drawn - that between *investment capital* (that would equate broadly with 'land' in Smith's 'rents of land') and *business capital* (that falls within the 'stock' of 'profits from stock' classification). Investment capital consists of assets that are neither reserve capital, in the sense that they produce revenue, nor business capital in the sense that the taxpayer is, strictly speaking, not doing business either.

Included in this category would be interest-bearing loans where the taxpayer is not a moneylender, interest-bearing bonds, stocks and debentures, rental-earning properties

where the taxpayer cannot be said, as a fact, to be trading, and dividend-yielding securities.

The realisation of investment capital items results in capital receipts as they are, broadly speaking, 'fixed capital' assets, although this terminology ought to be avoided (despite *Adam Smith*) purely to circumvent any confusion with fixed capital as it applies to *business* assets, eg, property used to conduct manufacturing operations.

The first line of enquiry might more accurately be stated as follows: DID THE RECEIPT FLOW FROM THE REALISATION OF RESERVE OR INVESTMENT CAPITAL OR FROM THE REALISATION OF BUSINESS CAPITAL ? If it flowed from the realisation of reserve or investment capital then the proceeds are of a capital nature.

Of Business Capital And Carrying On Business

As pointed out, a man may have an over-abundance of reserve (or investment) capital and decide to go over to the business, so as to generate a revenue, utilising his reserve capital for the purpose. Whether this has occurred depends upon WHETHER THE TAXPAYER CARRIES ON BUSINESS OR TRADES, or whether he carried on business or traded in the year of assessment in order to produce the receipt.

That this is a crucial part of the enquiry cannot be doubted.¹³ In part five it was established that there exists three species of business:

- (1) the carrying on of 'business' in the full sense of that word
- (2) the single, speculative operation of business, and,

13 See also part five

(3) the scheme of profit-making (change of intention) Whilst (2) and (3) were extensively canvassed so that only the conclusions need be restated here,¹⁴ (1), the carrying on of business, requires some elaboration.

- (1) Carrying On Business - What is surprising is the great dearth of authority in South Africa on the point. Not so in England and Australia where the issue has received extensive judicial treatment. The reasons for this are threefold. Firstly, in South Africa the cases that have come before the court have for the most part involved the single transaction. Secondly, in England at least, the multipartite system necessitates the fulfillment of a 'trade', 'profession' or 'vocation' requirement to bring the receipt within the purview of Schedule D¹⁵. Finally, in both Australia and England, capital gains are taxable so that in certain circumstances, it is advantageous for a taxpayer to establish that he was trading so as to claim the deduction of expenditure and/or losses allowable under income taxation.

'Carrying on business' would appear to correspond broadly with the 'trade' requirement in s.11 of the Act that is necessary for a taxpayer to claim any of the deductions or allowances therein. 'Trade' is defined in s.1 but it is generally accepted that this is an expansive rather than a substantive definition, and that one must still have regard to the facts to establish whether the taxpayer is trading.¹⁶

The position is the same in Australia where the definition of 'business' in s.25 of the Income Tax

14 For detailed treatment see part five
 15 See part six
 16 See, eg, ITC 1292 (1979) 41 SATC 163

Assessment Act 1936, is viewed as expansive only.¹⁷ In the United Kingdom, 'trade' is likewise defined superficially in s.526 (5) of the Income and Corporation Taxes Act, 1970.¹⁸ 'Business' or 'trade' must, therefore, in those jurisdictions be defined substantially as questions of fact, although there is a minor element of law, and caution is to be exercised to this extent only.

Whether a 'trade' is carried on is further necessary to determine whether the trading stock provisions in s.22 apply, since trading stock cannot exist without trading. Moreover, if a taxpayer does not 'carry on business' in south Africa, he may become liable to pay Non-Resident Shareholders Tax in terms of s.42 (1)(b)(i). Cases on these sections (there are not many !) may be referred to with the caveat that differences in context may sometimes be material.

'Trade' was defined by Lord Wilberforce in the House of Lords in the English case of Ransom v Higgs:

"Trade involves, normally, the exchange of goods or of services, for reward... not of all services, since some qualify as a profession or employment or vocation¹⁹, but there must be something which the trade offers to provide by way of business. Trade, moreover, presupposes a customer (to this too, there may be exceptions, but such is the norm), or, as it may be expressed, trade must be bilateral - you must trade with someone...

17 Lehman and Coleman - Taxation Law In Australia 1989, @ 46

18 Pinson-Pinson on Revenue Law, 17th edition, @ 14; Whiteman and Wheatcroft On Income Tax - 2nd edition by Whiteman & Milne, @ 246

19 In the U.K., professions and vocations have to be distinguished from trading purely for pigeonholing, viz, whether case I or case II of Schedule D applies. In S.A. the difference is immaterial except for the purposes of precise definition.

Trade is infinitely varied; so we often find applied to it the cliché that its categories are not closed. Of course they are not; but this does not mean that the concept of trade is without limits so that any activity which yields an advantage, however indirect, can be brought within the net of tax."²⁰

That the test for carrying on business or trade is an objective one has never been doubted, the question being whether the actions and methods of the taxpayer constitute trading, and not what the motives and intentions of the alleged trader were in adopting those methods."²¹

Whilst an intention to make a profit on the part of the taxpayer indisputably goes some way is proving that a business was carried on; in the absence of such an intention it does not follow that no business was carried on. In IRC v Incorporated Council of Law Reporting, Lord Coleridge said:

"I should have thought it capable of strong argument that [the Council] carried on a trade, because it is not essential to the carrying on of a trade that the persons engaged in it should make, or desire to make, a profit by it... the definition of the mere word 'trade' does not necessarily mean something by which a profit is made."²²

In Griffiths v J P Harrison (Watford) Ltd, Lord Morris said:

"It is doubtless true to say that in general a trader embarks upon trade with the intention of making a profit; but it cannot be said that if this intention is lacking there is no carrying on of a trade."²³

20 [1974] 1 WLR 1594, 1610-11 (HL)

21 See Griffith v J P Harrison (Watford) Ltd [1963] AC 1; Pinson supra fn 18, @ 21; Whiteman & Wheatcroft, supra fn 18, @ 251; Lehman & Coleman, supra fn 17, @ 47

22 (1888) 2 QBD 279, 293

23 Supra fn 21, @ 23-24

In Iswera v Ceylon Commissioner of Taxation, Lord Reid confirmed that view in saying:

"If... the taxpayer has to embark on an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does. But if his acts are equivocal, his purpose or object may be a very material factor when weighing the total effect of all the circumstances."²⁴

The position in Australia is identical. As Lehman & Coleman state:

'where there are repetitive and systematic activities on the part of the taxpayer which yield profits these activities will amount to a business even of the motive of profit is absent'²⁵

Support for this view is widespread, including Tweddle v FCT²⁶ where William J said that 'it is not essential that a person who engages in business should do so with the motive of making a profit for himself'.²⁷

The only authority of note in South Africa is Platt v CIR²⁸, a case dealing with the 'trade' requirement in the forerunner to s.11. The case was undoubtedly correct on the facts, but rather superficial and unsatisfactory on the law. Juta JA seems to have accepted that a profit making purpose is not a pre-condition for trading, but rather over-emphasised the general materiality of such a purpose amongst other factors.

What is significant about Platt's case is its total reliance on English law, which, as is evident above, has become rather more fully developed since then.

24 [1965] WLR 663, 668

25 Lehman & Coleman, supra fn 17, @ p.53

26 (1942) 2 AITR 360

27 Ibid @ 364

28 1922 AD 42

In 1954 the U.K. Royal Commission on Taxation of Profits and Income²⁹, from the caselaw, identified six objective criteria or 'badges of business' as relevant in deciding when the taxpayer was engaged in a business or trading transaction. These are:

- (i) The subject-matter of the realisation.
- (ii) The length of the period of ownership.
- (iii) The frequency or number of similar transactions by the same person.
- (iv) Supplementary work on or in connection with the property realised.
- (v) The circumstances that were responsible for the realisation.
- (vi) Motive.

These 'badges of business' form convenient heads under which to discuss the criteria for 'trading'.

(i) *Subject-Matter*

Whilst any form of asset, large or small, may be the subject of trading, certain assets are recognised as possessing qualities rendering them more susceptible to trading than investment and vice versa. In Rutledge v IRC³⁰ the taxpayer bought and resold one million rolls of toilet paper. In view of the fact that the taxpayer could hardly have purchased them for their (or rather lack of !) investment potential, nor was he likely to require them entirely for his own use, it was held that he had conducted business, and that the proceeds were revenue.

(ii) *Period Held*

29 Cmd 9474, para 116
30 (1929) 14 TC 490

The length of period that the taxpayer holds an asset may indicate whether he is trading. Thus a quick resale is a positive indicator whilst a lengthy holding period is a negative one.

(iii) *Frequency, Repetition or Continuity*

Continuity of a specific type of transaction is more likely to constitute trade than a single isolated transaction. In Pickford v Quirke³¹, Rowlatt J said:

"Now, of course it is very well known that one transaction of buying and selling a thing does not make a man a trader, but if it is repeated and becomes systematic then he becomes a trader and the profits of the transaction, not taxable so long as they remain isolated, become taxable as items in a trade as a whole"³²

Whilst this is generally correct, it has been consistently held that the single transaction can amount to an operation of business, as a trader has to start that way. Moreover, the single speculative deal is no less business than the repetitive transaction, but the test therefore is wholly *subjective*, hence it has been classified differently (see below).

(iv) *Supplementary Work or System And Organisation*

The systematic preparation and organisation of a commodity for, or in the course of, resale points strongly to trading. In Martin v Lowry³³ a machinery dealer purchased surplus aeroplane linen and resold it in lots to over a thousand purchasers earning a profit of * 1,6 million. It was held that the systematic preparation for resale and the degree of organisation undertaken indicated conclusively that a business had been conducted.

31 (1927) 13 TC 251

32 Ibid @ 261

33 [1927] AC 312

In Martin v FCT³⁴ the systematic methods employed by the taxpayer in racing his horses and betting on the turf, led the Court to conclude that his winnings were the proceeds of the carrying on of a business.

(iv) *Supervening Factors*

There may exist special circumstances pointing to a realisation of reserve or investment capital assets in a short space of time for reasons other than business dealing. sudden emergencies or shortages of cash could lead to sales much sooner than anticipated.

(vi) *Subjective Factors*

These are always relevant considerations. Where the taxpayer's purpose is to make a profit with his stock of goods then this is indicative of trade. As discussed, a purpose other than to profit, eg. for philanthropic, charitable, or vocational purpose, does not lead to the conclusion that the taxpayer is not trading, if other objective criteria indicate that this is, in fact, what he is doing.

It is submitted that in this regard the courts will have regard to most of the taxpayer's subjective states including his proximate intention, his purposes and his motives (as defined in part four). Moreover, the contemplation of profits will also constitute a very relevant consideration.

In the case of the single speculative transaction (the single operation of business cases) a profit-making

purpose alone will lead to the conclusion that business was conducted.

It should be observed that the use to which the profits are to be put is the one subjective sate that is totally irrelevant. In Mersey Docks and Harbour Board v Lucas,³⁵ Lord Blackburn remarked:

"There is nothing in the nature of things, nothing in the words of the Act to say that when an income has been actually earned, when an actual profit upon which the tax is put has been earned and received by any person or corportion, Her Majesty's right to be paid the tax out of it in the least degree depends upon what they are to do with it afterwards."*

In that case it was held that a harbour authority that had earned profits, which profits were required by law to be applied to the improvement of port fcilities, was nonetheless assessable for income tax.

Save in the case of the single transaction ³⁶, it is clear that no single 'badge of business' will necessarily be conclusive. The Court will have regard to these, and other, relevant considertions, according each weight depending upon the circumstances in order to adjudicate whether business was, in fact, conducted in order to generate the receipt. As Jacobs J said in London Australia Investments Ltd v FCT: 'It is not possible to exhaustively enumerate the facts or circumstances which will support the inference that a course of activity is a business'.³⁷

(2) The Single Operation of Business - This is no less the continuance of business but should be singled out and distinguished since the test is

35 (1883) 8 App Cases 891; 2TC 25
36 For detailed discussion, see part five
37 (1977) 7 ATR 757, 771

different. Whilst the test for carrying on business is objective, that of the single operation is subjective. This is because in the case of the single transaction, the various objective criteria, eg, continuity, organisation, magnitude, etc, are necessarily absent. The lone act is transformed into business purely by the speculative intention of the taxpayer.

(3) The Scheme of Profit-Making -

Where a taxpayer acquires an asset as part of his reserve, investment or fixed capital but then later changes his intention and embarks on a scheme of profit-making, ie, he goes over to the business, using assets acquired for a non-business or non-stock purpose, then indisputably he has 'carried on business.'

In Stott's case,³⁸ the Commissioner's contention was that the land acquired as a sea-side residence became the subject of a scheme of profit-making as the taxpayer had divided a portion into lots and resold them. The facts disclosed, however, that the taxpayer had not converted his reserve capital into business capital, and had merely realised his reserve capital to best advantage.

In the Natal Estate Ltd case,³⁹ the sale of land at La Lucia and Umhlanga Rocks acquired as a sugar cane farm by subdivision into township lots constituted the conversion of fixed capital into stock.

38 1928 AD 252

39 1975 or (4) SA 177 (A); 37 SATC 193

Perhaps the fixed capital to stock change of intention cases ought to be distinguished on the basis that a business is already being carried on (albeit not necessarily the same business as the dealing in fixed capital). Thus a car dealer who holds some of his vehicles as stock and some as fixed capital then changes his mind and returns the latter to stock, there is no dispute that he is, and always has been, carrying on the business of a car-dealer. All he has done is to convert one item of his business capital (fixed) into another item of business capital (circulating).

The reason for identifying the scheme as a separate species of business is that the test has both subjective and objective elements, both of which are essential. There must be a profit-making intention coupled with 'something more' to prove that the taxpayer had 'crossed the Rubicon and gone over to the business'.⁴⁰

The scheme of profit-making is confined to the single transaction. Where there are a series of transactions then it is no longer appropriate to speak of a 'scheme'.

Of Fixed and Circulating Capital

Having determined that a taxpayer is carrying on business or trading brings us on to the second stage of the enquiry: WAS THE RECEIPT THE PROCEEDS OF THE SALE OF FIXED CAPITAL OR CIRCULATING CAPITAL ?

In part five the division of stock of a business into fixed and circulating capital was extensively canvassed. As explicated, the sale of the fixed capital assets of a

40 Ibid, @ 203

business yields capital receipts whilst the sale of circulating capital assets yields revenue receipts. Both fixed and circulating capital nonetheless constitute integral parts of the taxpayer's business capital.

Adam Smith, in defining business stock, endeavoured to illustrate the distinction. He defined fixed and circulating capital as follows:

"The Second of the three portions into which the general stock of society divides itself, is the fixed capital; of which the characteristic is, that it affords a revenue or profit without circulating or changing masters...

The Third and last of the three portions into which the general stock of society naturally divides itself, is the circulating capital; of which the characteristic is that it affords a revenue only by circulating or changing masters."⁴¹

In determining whether an asset of the business is held as fixed or circulating capital the permanency test may be applied.⁴² The test would appear to be subjective, ie, whether the taxpayer intends to hold the article as part of the permanent assets of the business, for economic utility, or whether he intends to part with it and let it change masters.

Scheme of Profit-Making Test Only a Subsidiary Test

It is submitted that the evidence leads overwhelmingly to the conclusion that the scheme of profit-making is but a subsidiary test that may be employed to determine whether a single operation of business has occurred due to the subjective speculative intention of the taxpayer.

It may also be employed to ascertain whether the taxpayer has changed a capital asset into a revenue asset by

41 Supra fn 3, @ 282-83

42 See part five

embarking on a scheme of profit-making as evidenced by a subjective profit-making intention coupled with an objective element indicative of a degree of systematic organisation or magnitude justifying the view that he has gone over to the business. In assessing whether the taxpayer had a speculative intention the court will have regard to various indicators, viz, length of time the asset was held, whether the transaction was repeated, the nature of the taxpayer's work, motive and other relevant factors. These are but subsidiary 'tests'.

Upon an affirmative finding of an operation of business or a scheme of profit-making, it invariably follows that the asset generating the receipt was circulating capital. In this the test can lead to confusion between the two fundamental, though distinct, stages of the enquiry. These two stages ought always to be borne in mind:

(1) Was the asset giving rise to the receipt part of the taxpayer's reserve or investment capital (receipt is capital) OR was it part of the taxpayer's business capital, viz, was he carrying on business with it in order to generate the receipt? (Move on to stage two)

(2) If business capital, was the asset part of the taxpayer's fixed capital (capital nature of receipt) or circulating capital (revenue nature of receipt).

Although the scheme of profit-making test telescopes the two stages of the enquiry into one, in its sphere of operation, it is proper to keep the two stages apart in order to avert confusion. For example, utilising the facts of the California Copper Syndicate⁴³ and Booyesen's Estates⁴⁴ cases by way of illustration. In the former case, the

43 (1901) 41 ScLR 894 (5th Series)

44 1918 AD 576

speculative intention of the taxpayer marked the sale of the copper-bearing land as an operation of business. The land was the taxpayer's trading stock or the circulating capital of that operation, therefore, the proceeds were revenue.

In Booyesen's Estates case the taxpayer embarked upon the business of working gold mines. The mining claims were part of its fixed capital which on realisation resulted in a capital receipt. The taxpayer had not, on the facts, switched over to the business of dealing in mining claims so that the fixed assets metamorphosed into circulating assets. They remained fixed assets of the gold mining business.

That the subjectivist school relies on the scheme of profit-making test to promote subjective intention into the pivotal criterion for stamping a receipt as capital or revenue in character is certainly mistaken, for that test, given its subservient nature and the limited scope of its application, aspires to nothing like the revered, awesome and dynamic status to which it has been unceremoniously elevated in South Africa.

Neither in the United Kingdom, where the test originated, nor in Australia, is the test regarded as if it were central or critical to the entire capital-revenue enquiry. All the overseas authoritative writers either give the California Copper Syndicate case a passing mention - usually relegated to the footnotes - or omit the case altogether !

Why then has the test assumed a stature in South Africa that is patently out of all proportion to its true dimensions ?

It is submitted that the view taken by Emslie and Davis that 'where a scheme of profit-making is present, an amount is clearly of a revenue nature' but that 'what is questionable, however, is whether the absence of a scheme of profit-

making, ceteris paribus, necessarily establishes that an amount is of a capital nature⁴⁵ is correct.

In truth, the scheme of profit making test is a one-way test. Despite the absence of a speculative intention or scheme of profit-making the taxpayer may nevertheless be carrying on business, and, if the proceeds result from the realisation of circulating capital, they will constitute revenue receipts assessable to tax.

In this regard, it is submitted that 'capital' as used in the 'gross income' definition in s.1 means 'reserve, investment or fixed capital' as defined herein.

45 The Taxation of Employee Share Incentive Trust, (1990)
107 SALJ 1,5

PART EIGHT : CONCLUSION

Pick 'n Pay Case Wrongly Decided

Having in the last part defined the correct approach towards resolving capital-revenue disputes all that remains is to apply the suggested interpretation of the law to the facts of the share incentive trust. For convenience, the facts of the Pick 'n Pay case will be adopted for the purpose.

1. *Were the shares reserve or investment capital OR were they business capital? Did the Trust carry on business or trade using the shares as its business capital?*

1.1 *Nature of the subject-matter* - Very little assistance, it is submitted, can be derived from the nature of the subject-matter. Shares may be the subject of trade as easily and ordinarily as they may constitute investments to earn dividends. They are not per se indicative of the presence or absence of trading.

1.2 *Period held* - it was common cause that the Trust did not hold the shares for any length of time. It acquired shares by an initial allotment from Pick 'n Pay Ltd which shares were rapidly reallocated and sold to selected key employees. Often there were insufficient shares for the purpose, so quantities thereof were purchased on the open market. In addition, shares were forfeited from defaulting employees or ex-staff members or otherwise repurchased from employees entitled to sell them. None of the shares were held for any significant period, but were resold to other eligible employees.

The minimal period for which the shares were held is highly characteristic of a trading activity rather than the holding for personal use or for investment purpose.

- 1.3 *Frequency, repetition or continuity* - The entire object of the Trust was to buy and resell shares to company employees. That was the principal, if not the sole, activity the Trust was engaged in. It was common cause that the Trust had engaged in a vast number of share transactions so that there was unmistakably an advanced degree of continuity and a magnitude that one would only expect to find in a sharedealer's business.
- 1.4 *System and organisation* -The purchase and resale of the shares was most systematic and organised. The fact that the time of purchase and resale and even the price at which the shares were purchased and resold for, was dictated by the terms of the Trust Deed, may be regarded as unusual on the one hand. On the other hand, it reflects a complex degree of stock organisation, a highly efficient system for dealing therewith and the employment of predetermined methods to ensure a smooth and rapid turnover of shares. These factors point, in large measure, to an organised business.
- 1.5 *Subjective factors* - The proximate intention of the Trust was principally to buy and sell shares. Its purpose was to provide an employment incentive for key staff so as to encourage them to remain in the employ of the company.

It was not part of the purpose of the Trust to make profits. However, there are two counter balancing factors to be taken into the reckoning. Firstly, the entire raison d'être of the scheme

was based upon the assumption of a rising market value for the shares. The progenitor of the scheme designed his model entirely on the premise that the share prices would escalate in time due to anticipated inflation, appreciation and demand of, and for, the shares. In the absence of such a premise it would be nonsensical to foster any idea of a share *incentive* for employees at all.

The scheme of the Trust was such that if there was a rise in the market value of the shares, the Trust would make a profit, whereas, if there was a decline the Trust would generate a loss. That is a premise which every sharedealer makes when embarking on the business of sharedealing. And, with regard to the forfeited shares at least, the making of profits by the Trust was inevitable.

The second point that flows logically from the first is that the Trust did *contemplate* profits even if profit-making was neither a primary nor a secondary purpose. Based as it was on the expectation of a rising market value, the progenitor of the scheme certainly did not design it to make a loss. On the contrary, profits were anticipated and provided for in the Trust Deed.

Moreover, there was no intention on the part of the Trust to acquire or hold the shares either for personal enjoyment as reserve capital or for investment to earn dividends as investment capital.

Finally, the fact that the Trust was empowered to pay over any profits to the company for utilisation for the benefit of employees cannot

change the 'ineluctable fact'¹ that the Trust traded in the company's shares.

1.6 *Scheme of profit-making test* - The scheme of profit-making test is manifestly irrelevant and inappropriate, as that test was designed to apply only in the case of the single speculative operation of business. It may also be applied to the change of intention cases. As we have seen, its improper application by employment in cases for which it was never designed can lead to wrong or anomalous results.

1.7 *Conclusion on trading* - There is no doubt at all that the Trust was trading in its founder company's shares. Its proximate intention was to buy and sell shares on a large scale, which intention it, in fact, carried out. There was a sophisticated degree of system and organisation, a high frequency and continuity of share transactions and a magnitude of operation wholly indicative of a share dealing business. Given the rapid turnover of shares (the Trust held no permanent stocks), it is obvious that the shares were not held for any significant period of time. Profits were contemplated and provision expressly made therefor.

The fact that the Trust's purpose was not to make profits cannot alter the plain fact that it had selected a recognised *trading activity*, that of sharedealing, in order to achieve its object of providing a share incentive for key employees of its founder company.

That being the case the Trust carried on business utilising the shares of the company as its business capital.

1 per Groskopf J in ITC 1413.

2. *Did the receipts flow from the realisation of fixed capital or circulating capital?*

Applying the permanency and intention tests, the short answer is that the proceeds emanated from circulating capital. The shares were very rapidly disposed of and not held permanently. The Trust had no intention to hold the shares as part of the permanent assets of the business in order to derive an economic utility therefrom. Its admitted intention was to float the shares as stock.

In the result, the Trust's receipts were generated from the circulating assets of its business capital. They were profits of stock no less than the profits earned by an ordinary merchant or sharedealer. The shares were not part of the tree, the machine or the income-earning structure of the Trust. They were part of the fruits, the products or the profits, whether purposive or not. They were, indisputably, 'wealth flowing from wealth', 'revenue from capital productively employed'.

In the light of this, it is submitted, with respect, the the judgment of Nicholas AJA (except to the extent that the profit element was over emphasised) and the minority is to be preferred, according as it does, in all material respects, with economic theory, history, law and logic

By contrast, the simplistic judgment of Smalberger JA has been tried and found wanting. Earlier on in this paper,² the view was expressed that vital aspects of Smalberger JA's judgment were unsatisfactory, based as they were on canary logic, circuitous reasoning and

2 See part three.

anomalous interpretation. These views have been confirmed by the subsequent investigation of the law as interpreted in proper context and perspective.

Moreover, not only did Smalberger JA adopt the scheme of profit-making test where it was wholly inappropriate to do so, but the wrong was compounded by its adoption in a form (the so-called 'designedly sought and worked for' test) that has no authoritative basis in law and is quite misleading and inaccurate in content.

The contrary state of the law in foreign income-based tax jurisdictions, specifically the U.K., where the tax was first created, and 'sound commercial and good sense' ought to have served as a warning to the majority that the right road was being deviated from. Regrettably, recourse was had, neither to the more sophisticated judicial learning in those countries, nor, in truth, to 'commercial sense'.

Ramifications

The repercussions of the Pick 'N Pay judgment have yet to be felt. The least taxpayer can expect is a new addition to the special inclusions in the gross income definition in s.1 in order to statutorily encompass the receipts of the share incentive trust. Whether this is good policy or not is certainly debatable, but it does accord with the law (as it really is).

Prima facie there is no good reason why the trust, constituting nothing more than an arm of large public corporations, ought not to bear their full share of the burden of taxation. Profits similarly made by a sharedealer in the normal course would undoubtedly have attracted income tax.

The long-term ramifications are less obvious. The question that arises is whether the capital-revenue distinction ought to be maintained. There exists a powerful economic argument to the effect that capital gains should not be distinguished from income gains as they both equally enhance the taxpayer's economic power.

A growing school of economic thought espouses the heterodox view.³ The Canadian Carter Commission in 1966 recommended an alteration of the tax base on the basis of the 'economic power' theory:

"However, it is impossible to draw an unambiguous distinction between 'capital' gains and 'income' gains and the attempt to do so necessarily results in great uncertainty for the taxpayer because a particular transaction may or may not be found by the courts to fall on one side of the line or the other... After the most careful and exhaustive consideration of this complex question, we have arrived at the conclusion that the present distinction between kinds of gain is inconsistent with our concept of what we believe income is for purposes of determining the individual's capacity to pay real tax... A dollar gained through the sale of a share bond or piece of real property, bestows exactly the same economic power as a dollar gained employment or operating a business... To tax the gain on the disposal of property more lightly than other kinds of gains or not at all would be grossly unfair. These radical reforms were advocated because equity can be achieved in no other way, because in our opinion there would be no adverse economic effects

3 See eg. Henry Simons - Personal Income Taxation, Univ Chicago, (1938) 49 & RM Haig - 'The Concept of Income Economic & Legal Aspects - The Federal Income Tax, Columbia Univ. Press, 1921.

through their adoption when combined with our other proposed changes, and because they would simplify the tax system and reduce uncertainty".⁴

The Margo Commission, however, refused to adopt these recommendations in South Africa. In its 1986 Report, the Commission demurred:

"Having regard to its approach to the taxation of wealth and consumption, the Commission has not been persuaded that the theoretically attractive comprehensive tax base, as described above, is in practice superior to a base distinguishing between capital and revenue gains."⁵

The Margo Commission advocated that the capital-revenue distinction be retained but that more objective criteria be adopted in order to enforce it. At page 222 of the report, the Commission concluded:

"The Commission has arrived at the conclusion that the optimum method of curing the defects of the present system would be, where feasible, to substitute objective criteria applied in distinguishing capital gains from those of an income nature. The application of objective criteria may in certain circumstances produce inequitable results and may of necessity be arbitrary. However, as justification for its recommendation in this regard the Commission is of the view that, having regard to the objectives it is seeking to achieve, this is one area where equity may in certain instances have to yield to certainty... The Commission considers that the factors which could form the basis of the objective criteria include the duration of the period of holding the relevant asset,

4 Carter Report Pt 1; cited in the Report of the Commission of Inquiry Into the Tax Structure of The R.S.A. 1986, @ p 281-19.

5 Supra, fn 4 @ 219.

the turnover during the year in which the asset was disposed of in respect of all assets falling within the category of which the asset disposed of formed part, the frequency of transactions, the trade carried on by the taxpayer, and the way in which the asset is treated in the taxpayer's own financial statements. The Commission has endeavoured to follow certain foreign tax jurisdictions in formulating recommendations as to the objective criteria which could be used. The Commission realises, however, that the results of these endeavours reflect deficiencies and that they still require much further research."⁶

These recommendations were accepted by government in its 1987 White Paper:

"The Government has appreciation for this recommendation, but foresees many problems in the setting of generally acceptable objective criteria. The Commission itself, indeed could not agree on the form of such criteria. Inland Revenue is directed to investigate the matter further."⁷

These comments were made long before Pick 'N Pay was decided. Now the argument arises that if the highest court in the land, presided over by the keenest minds, is unable to draw the line of demarcation between capital and revenue receipts, how is the corner shop merchant, the tradesman, the farmer and the ordinary layman expected to do so?

Whilst the efficacy of a novel, comprehensive all-encompassing gains-based taxation system requires an entire investigation of its own, certainly the proven inability of judges, lawyers and revenue officers to faithfully and consistently uphold the capital-revenue divide must constitute a powerful argument in favour of the adoption of

6 Ibid @ 222, para (2.29).

7 @ p. 24, para 9.3.1.

such a novel system in substitution for the present income-based one. The complex capital-revenue distinction is demonstrably inaccessible to the ordinary man who, in the final reckoning, must bear the burden of maintaining his government. In this the sovereign's duty of certainty is not enhanced.

Adam Smith's plea for 'equality' in sharing the tax burden based on the faculty principle may, in modern times, with the advent of sophisticated registration systems, recording methods and computerisation, be better served by abolition, and the final putting to rest of, the capital-revenue distinction.

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