

**A CRITICAL ANALYSIS OF THE  
DEFINITION OF GROSS INCOME**

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**TRACY GERALDINE BECK**

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DEFINITION OF GROSS INCOME**

**BY**

**TRACY GERALDINE BECK**

**SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE  
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**SUPERVISOR: PROFESSOR P.J.W. PELLE**

## **DECLARATION**

This project is an original piece of work which is made available for photocopying, and for inter-library loan.

Signed at Port Elizabeth on 18 January 2008

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**SIGNATURE**

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## SUMMARY

Income tax is levied upon a taxpayer's taxable income. Various steps are taken in order to arrive at the taxpayer's taxable income. The starting point when calculating taxable income is determining the taxpayer's 'gross income'. 'Gross income' is defined in terms of section 1 of the Act. Various terms within the gross income definition are not clearly defined, except in the case of a 'resident'. Even in the case of the definition of a 'resident', the aspect of 'ordinarily resident' is not defined and nor is the 'place of effective management'.

The following components fall within the definition of 'gross income':

- The total amount in cash or otherwise;
- received by or accrued to, or in favour of, a person;
- from anywhere, in the case of a person who is a resident;
- from a South African source (or deemed source), in the case of a non-resident;
- other than receipts or accruals of a capital nature.

The 'total amount' in 'cash or otherwise' is the first step when determining the taxable income of a taxpayer for a particular year of assessment. Gross

income only arises if an amount is received or has accrued; this amount need not be in the form of money but must have a money value.

The next component, 'received by or accrued to', is related to time and implies that a taxpayer should include amounts that have been 'received by', as well as amounts that have 'accrued to' him during the year of assessment.

'Resident' and 'non-resident' unlike the other components, are defined in terms of section 1 of the Income Tax Act. There are two rules used to determine whether natural persons are residents, these are:

- To determine whether natural persons are 'ordinarily resident'; or
- where the natural person is not an 'ordinarily resident', the 'physical presence test' will be applied.

'Source' means origin and not place; it is therefore the 'originating cause of the receipt of the money'. There is no single definition for the word 'source' as circumstances may differ in various cases. The facts of each case must be analysed in order to determine the actual source of income for that particular case.

The last component of the definition of 'gross income' is the exclusion of 'receipts and accruals of a capital nature'. The Act does not define the

meaning of 'capital nature' but does indicate that receipts or accruals of a capital nature are, with certain exceptions, not included in 'gross income'. Receipts or accruals that are not of a capital nature is known as 'revenue' and subjected to tax.

This study is primarily aimed at an examination of court cases related to the various components falling within the definition of 'gross income'.

Key words: Taxation, taxable income, taxpayer, capital, income, persons.

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- Booyesen's Estates, COT v* 1918 AD 576, 32 SATC 10
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- Lydenberg Platinum Ltd, CIR v* 1929 AD 137, 4 SATC 8
- Morrison v CIR* 1950 (2) SA 449 (A), 16 SATC 377
- Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193
- Ochberg v CIR* 1931 AD 215, 5 SATC 93
- Overseas Trust Corporation Ltd v CIR* 1926 AD 444, 2 SATC 71

*People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9  
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## 1.1 INTRODUCTION

Normal tax is a levy, which is imposed on all persons in South Africa and is determined according to a taxpayer's taxable income. Taxable income is calculated for a particular year of assessment, as it is an annual event. The starting point in the income tax calculation is the calculation of the taxpayer's gross income.

The calculation of taxable income and normal tax is shown in the following framework:

	<u>R</u>
GROSS INCOME (Section 1)	xxx
<i>Less:</i> Exempt Income (Section 10)	(xxx)
INCOME (Section 1)	<hr/> xxx
<i>Less:</i> Deductions and Allowances (Sections 11-19 and 23, mainly)	(xxx)
<i>Add:</i> Taxable Capital Gains (Section 26A)	xxx
TAXABLE INCOME	<hr/> <hr/> xxx

This treatise is based on the definition of gross income which is defined in section 1 of the Income Tax Act 58 of 1962 but more importantly, analysing the components of the definition. These components are not defined,

except in the case of a 'resident'. The courts have therefore been called upon on numerous occasions to interpret the various meanings of these components. Relevant case law will therefore be analysed in determining the meaning of these components.

Gross income is defined in terms of section 1 of the Act as follows:<sup>1</sup>

'...gross income', in relation to any year or period of assessment means -

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued described hereunder, namely -...'

The following components within the definition of gross income will be analysed:

- The total amount in cash or otherwise;
- received by or accrued to, or in favour of, a person;

<sup>1</sup> Section 1 sv 'gross income'.

- from anywhere, in the case of a person who is a resident;
- from a South African source (or deemed source), in the case of a non-resident;
- other than receipts or accruals of a capital nature.

All of the above components must be present before an amount can be treated as gross income in the hands of a person.

The question that is most often asked is whether an amount is in fact income or not. This uncertainty has led to many legal disputes where the court has provided an answer to this question providing its ruling within the facts of a particular case. The general definition of gross income has failed to clearly define the meaning of these components but the question of whether a receipt or an accrual is income or not, is possibly the most contentious. Therefore we have to look to case law to determine the true meaning of these components.

The specific or special inclusion provisions in the gross income definition deal with amounts which, even though they may fall outside of the scope of the general definition, because they are of a capital nature or from a non-South African source, are included within the definition by virtue of the following words at the end of the definition:<sup>2</sup>

‘...but including, without in any way limiting the scope of this definition, such amounts

<sup>2</sup> Section 1 sv ‘gross income’.

(whether of a capital nature or not) so received or accrued as are described hereunder, namely...'

These taxable capital amounts are found in paragraphs (a) to (n) of the definition of gross income in section 1 of the Act and are listed as follows:

- a) Annuities
- b) Alimony
- c) Services Rendered
- cA) Restraint of Trade
- d) Lump Sum Benefits
- e) Pension, Provident and Retirement Annuity Fund Benefits
- eB) Pension Fund Surpluses
- f) Any amount received or accrued in commutation of amounts due under any contract or employment or service
- g) Lease Premiums
- gA) 'Know How' Payments
- h) Leasehold Improvements
- i) Fringe Benefits
- j) Mines
- jA) Sale of Assets Similar to Trading Stock
- h) Dividends
- i) Farming and Economic Development Subsidies

- j) Key–Man Insurance Policies
- k) Recoupments and other Inclusions

This study presents an analysis of the courts' approach in determining the meaning of the various components within the gross income definition in section 1 of the Act, but mainly the approach taken in determining whether a receipt or an accrual is of a capital or revenue nature and the consistency of various case decisions over the years. As the term 'income' is defined in the Act, it is more appropriate to refer to 'revenue'. However, the courts frequently use the terms interchangeably and this will be reflected in the treatise as a whole.

## **1.2 RESEARCH GOALS AND AIMS**

The first objective of this study is to analyse the various components within the definition of gross income as a clear definition is not given except in the case of a resident. This will be achieved by analysing the approach taken by the courts in their judgements in the various tax cases over the years.

The second objective is to analyse the approach taken by the courts in answering the most frequently asked question regarding tax: whether a receipt or an accrual is of a capital or income nature and how the courts determine the answer in the various cases.

The third objective is to determine whether the courts have remained consistent throughout the years regarding their judgement in various cases based on the components of the gross income definition and also whether a receipt or an accrual is of a capital or income nature.

The fourth objective is to determine whether the courts' judgement in the various cases has, in any way, defined or made the meaning of the definition of gross income any clearer or more understandable.

### **1.2.1 Research propositions**

The following are the research propositions:

- Studying case law and analysing the courts' interpretation of the components within the definition of gross income.
- Is there no easier and clearer basis upon which a receipt or an accrual of a capital or income nature may be determined or defined?

### **1.3 RESEARCH PROCEDURES**

The following are the research procedures that will be used by the researcher:

#### **1.3.1 Sources of information**

In an attempt to achieve the objectives of this treatise, an analysis and an assessment of case law relating to the various components of the definition of gross income will be carried out, but more importantly, whether a receipt or an accrual is of a capital or income nature, will be undertaken. The following methodology will be used:

- Relevant literature on the definition of gross income and its components will be analysed, especially literature on receipts and accruals of a capital or income nature.
- Information will be extracted on case law pertaining to the findings of the various courts judgements regarding the various components within the definition of gross income and receipts and accruals of a capital or income nature.

Manual and computer search will be conducted to identify the relevant cases.

### **1.3.2 Research sample**

The sample includes all relevant cases listed in the *South African Tax Cases Reports*.

## **1.4 DEFINITION OF CONCEPTS**

The following definitions are set out in the Act.

### **1.4.1 Taxation<sup>3</sup>**

‘...taxation means any levy or tax leviable under this Act and for the purposes of Part IV of Chapter III includes any levy or tax leviable under any previous Income Tax Act; ...’

### **1.4.2 Taxable income<sup>4</sup>**

‘...taxable income means the aggregate of –

(a) the amount remaining after deducting from the income of any person all the amounts

<sup>3</sup> Section 1 sv ‘taxation’.

<sup>4</sup> Section 1 sv ‘taxable income’.

allowed under Part I and Chapter II to be deducted from or set off against such income; and all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act; ...'

### 1.4.3 Taxpayer<sup>5</sup>

'...taxpayer means any person chargeable with any tax leviable under this Act and includes every person required by this Act to furnish any return; ...'

### 1.4.4 Person<sup>6</sup>

'...person includes an insolvent estate, the estate of a deceased person and any trust;...'

### 1.4.5 Capital

The Act does not provide a clear definition for the word capital; we will therefore look at case law to determine what is regarded as capital.

### 1.4.6 Income<sup>7</sup>

'... income means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax...'

<sup>5</sup> Section 1 sv 'taxpayer'.

<sup>6</sup> Section 1 sv 'person'.

<sup>7</sup> Section 1 sv 'income'.

## 1.5 PLAN OF THE TREATISE

The plan of the treatise is as follows:

Chapter 1 discusses the calculation of taxable income. It also provides a definition of gross income and identifies the problem within the definition as being the fact that not all components are clearly defined and as a result an analysis and examination of the courts' approach in the various cases concerning these components is undertaken in order to obtain a better understanding of these various components. Chapter 1 also provides definitions of taxation, taxable income, persons, taxpayer and income. The research goals and aims; research procedures and methodology and scope of the study are clearly stated in this chapter.

Chapter 2 covers the various components within the definition of gross income in more depth by analysing and reporting on various case law from past years in order to obtain a better understanding of the various components as these components are not clearly defined in the definition of gross income in section 1 of the Act. The first component that will be discussed and analysed will be 'the total amount in cash or otherwise' where the actual amount for that particular period will be discussed and what the meaning of 'cash or otherwise' constitutes. The second component is 'received by or accrued to, or in favour of, a person'. The chapter will deal

with the fact that a taxpayer should not only include income which has been received, but also those amounts which have accrued during the year of assessment. The next component is 'from anywhere, in the case of a person who is a resident'. The definition of resident will be provided, as well as the determination of whether a natural person is ordinarily resident. If a natural person is not ordinarily resident, the physical presence test will be applied and discussed. The effect of double taxation will briefly be discussed. Lastly, the meaning of non-resident, true source and deemed source of income will be discussed.

Chapter 3 will discuss the last component within the definition of gross income, that being, 'other than receipts or accruals of a capital nature'. Case law will be analysed in order to determine the meaning of this component. A distinction between income and capital will be discussed, giving examples. Objective and subjective tests will be discussed in depth. The special inclusions under paragraph (a) to (n) will be stated.

In Chapter 4, the research findings are presented and interpreted.

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## 2.1 INTRODUCTION

The starting point in the income tax calculation is the determination of the taxpayer's gross income for each year of assessment. Gross income is central to the whole of the Act. A person must have gross income before normal tax can be levied on that person.

'Gross income' is defined in terms of section 1 of the Act as previously discussed in Chapter 1.

Within the definition of gross income there are various components. These components must all be present before an amount can be treated as gross income.

The various components are not defined within the definition of gross income, except in the case of a resident, therefore judgements from earlier tax cases have been called upon in order to provide clarity regarding these components, and thus obtain a better understanding of the meaning of these components. Decisions from earlier cases have many times been applied and referred to in recent cases.

The definition of gross income can be broken up into the following components:

- The total amount in cash or otherwise;
- received by or accrued to, or in favour of, a person;
- from anywhere, in the case of a person who is a resident;
- from a South African source (or deemed source), in the case of a non-resident;
- other than receipts or accruals of a capital nature.

All of the above must be present before an amount can be regarded as gross income in the hands of the taxpayer.

In this chapter, the following components within the gross income definition will be discussed:

- The total amount in cash or otherwise;
- received by or accrued to, or in favour of, a person;
- from anywhere, in the case of a person who is a resident; and
- from a South African source (or deemed source), in the case of a non-resident.

## 2.2 THE TOTAL AMOUNT IN CASH OR OTHERWISE

The first step in determining the gross income of a taxpayer for a particular year of assessment is to determine the 'total amount' that has either been 'received by or accrued to' that taxpayer during that particular year.

Gross income can only arise if there is an amount that has been received or accrued; therefore an amount can only form part of gross income once it has been determined.

This amount need not necessarily be in the form of money, as was the case in *Lategan v CIR*, where Watermeyer J, who gave the judgement, said the following:<sup>8</sup>

'The definition seems to contemplate that "gross income" shall...always be a sum of money, because it uses the words "total amount", and amount usually means an amount of money. But the word "income" in its ordinary sense does not always consist of money, as was pointed out in *Booyesen's case*<sup>9</sup>. "Income", unless it is in some form such as pension or annuity, is what a man earns by his work or his wits or by the employment of his capital. The rewards which he gets may come in the form of cash or of some other kind of corporeal property, or in the form of rights.

<sup>8</sup> 1926 CPD 203, 2 SATC 16 at 19.

<sup>9</sup> 1918 AD 576.

In *CIR v People's Stores (Walvis Bay) (Pty) Ltd*, Hefer JA delivered the following judgement:<sup>10</sup>

'The first and basic proposition is that income, although expressed as an *amount* in the definition, need not be an actual amount of money but may be 'every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value...including debts and rights of action'.<sup>11</sup> This proposition is obviously correct so that very little need be added to what Watermeyer J himself said in support thereof.'

Hefer JA accepted the judgement made by Watermeyer J in *Lategan v CIR*<sup>12</sup> where it was held that an amount need not only be in the form of money, but the value of every form of property earned by the taxpayer, as long as it has a money value.

In the case of *CIR v Delfos*, the following was held by Wessels CJ:<sup>13</sup>

'The tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not money's worth or cannot be turned into money, it is not to be regarded as income.'<sup>14</sup>

<sup>10</sup> 1990 (2) SA 353 (A), 52 SATC 9 at 21.

<sup>11</sup> 1926 CPD 203, 2 SATC 16 at 19.

<sup>12</sup> 1926 CPD 203, 2 SATC 16.

<sup>13</sup> 1933 AD 242, 6 SATC 92 at 251.

<sup>14</sup> 1892 AC 150, *St Lucia Usines Co v Treasurer or St Lucia* 1924 93 LJPC 212.

An amount must therefore be in cash or have a money value in order for it to be included in gross income.

In *CIR v Butcher Bros (Pty) Ltd*<sup>15</sup>, the court was called upon to decide whether the right to have improvements effected to leasehold property in terms of a lease agreement gave rise to gross income in the hands of the lessor (the owner of the property). The court decided that because the Commissioner was unable to establish an amount, the benefit did not constitute gross income in the hands of the lessor.

Carlisle J held the following:<sup>16</sup>

'It may, perhaps, fairly be objected to the above definition as so amended that it is too wide in that it might have the effect of including certain obligations frequently accepted by a lessee in respect of matters normally incidental to relations between landlord and tenant such as undertakings to pay all rates and taxes imposed on or in respect of property leased, to maintain buildings in good repair, and insure buildings. It has not been suggested that such undertakings on the part of a lessee should be regarded as constituting 'a premium or like consideration', and I think it is clear that the consideration constituted by such undertakings should not be so regarded, and that such consideration should therefore be excluded from the suggested definition.'

<sup>15</sup> 1945 AD 301, 13 SATC 21 at 34.

<sup>16</sup> at SATC 34.

This decision is important in that it establishes the principle that there must be an amount; and furthermore that the onus of establishing an amount lies with the Commissioner.<sup>17</sup>

In the case of *Stander v CIR*<sup>18</sup>, the taxpayer was adjudged one of the top five accountants of certain franchise dealers. In recognition of achieving excellent standards of performance in financial management, there was an award consisting of an overseas trip for two. The prize was awarded to Stander by Delta Motor Corporation (Pty) Ltd, which was not Stander's employer. The Commissioner for Inland Revenue assessed the value of the prize being R14 000, this amount was assessed to be income tax. The appellant argued that the award cannot be said to consist of 'money's worth', and therefore it does not qualify for inclusion in terms of paragraph (c) of the definition of 'gross income'.

The following was held by Friedman JP:<sup>19</sup>

'The question, then, is whether the prize of an overseas trip constitutes 'property' ie did

Stander, by being given his trip, acquire a right which had a monetary value in his hands.

The promise by Delta to give Stander an overseas trip amounted to an executory donation.

<sup>17</sup> K Huxham and P Haupt *Notes on South African Income Tax (2007)* in para 2.2.

<sup>18</sup> 1997, 59 SATC 212.

<sup>19</sup> at SATC 218-219.

At common law the promise by Delta gave Stander, on acceptance by him of the promise, a personal right to compel performance by Delta. However, by virtue of s 5 of the General Law Amendment Act No 50 of 1956

‘no executory contract of donation ... shall be valid unless the terms thereof are embodied in a written document signed by the donor.’

The terms of the donation were not embodied in a written document signed by Delta. Consequently Delta’s offer of an overseas trip did not give rise to a valid contract of donation which was enforceable by Stander and Stander cannot be said to have acquired a ‘right’ even if a monetary value could be placed on the trip he received. However, once he had embarked upon the trip, the donation was no longer executory and the question then is whether a value could be placed on what Stander received by going on the trip. The answer to this question is, in my view, in the negative. Having gone on the trip he had not received any ‘property’ on which a monetary value could be placed in his hands. He was no more able to turn it into money or money’s worth after accepting the award, than he was at the time when the donation was still at the executory stage.’

Friedman JP continued by saying the following:<sup>20</sup>

‘If the award cannot be said to consist of ‘money’s worth’ it does not qualify for inclusion in terms of para (c). Nor, in my judgement, is there any basis upon which, on the facts of this case, ‘money’s worth’ can be attributed to Stander’s prize by seeking to place an ‘objective’ or ‘market value’ on it. Whatever it cost Delta, or whatever a person who wished to go on such a trip would have to pay for it, does not constitute an amount which can be said to have money’s worth in Stander’s hands.’

<sup>20</sup> at SATC 220.

In a recent case, *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*<sup>21</sup>, the learned Judge President referred to the Stander case and also dealt with *ITC 701*<sup>22</sup> where Conradie J accepted the principle that in order to fall within the tax net, receipts or accruals other than money had to have money's worth. However, the argument that only benefits which a taxpayer can turn into money can have money's worth, he rejected.

The question whether a receipt or an accrual in a form other than money has a monetary value is a primary question. The Stander case therefore incorrectly reflects the law. It does not mean that if a receipt or an accrual cannot be turned into money that it has no money value; the question therefore cannot be whether a taxpayer can turn a receipt or an accrual into money.

The second component within the gross income is that the amount must be in cash or otherwise. In 'cash or otherwise' means not only receipts or accruals of money will be included in gross income, but also amounts that have a money value and can be converted into money, as was found in the case of *CIR v Delfos*.<sup>23</sup>

<sup>21</sup> 2007 SCA 99 (RSA).

<sup>22</sup> 1950, 17 SATC 108.

<sup>23</sup> 1933 AD 242, 6 SATC 92.

If it does not have money's worth or cannot be turned into money it is not income. If an asset is therefore received instead of money, the asset will have to be valued.

In the case of *Lace Proprietary Mines v CIR*<sup>24</sup>, mineral rights were disposed of from one company to another. The value of these shares were £250 000 which were not to be paid in cash but by the allotment of 1 000 000 fully paid-up shares. These shares had a nominal value of 5s in the purchasing company with a market value of at least 12s per share. The Appellate Division of the Supreme Court held that the reference in the agreement to the sum of £250 000 and to the nominal value of the shares (five shillings) could not override the true intention of the parties which was that the true consideration was the 1 000 000 shares which were to be valued at the market value in the purchasing company.

The value of these shares that were received as income may be ascertained at a given date by inquiring what price could have been received for the shares had some reasonable method of sale been adopted on that date.

<sup>24</sup> 1938 A, 9 SATC 361.

Although the market price of the shares on the given date is a relevant factor, Stratford CJ went on to say:<sup>25</sup>

'The market price on the agreed date was admittedly relevant, but it might have been fictitious and momentary. The stability of the market quotation and its approximation to value is properly tested to some extent by reference to the market quotation before and after that date.'

It can be concluded from the above case that non-cash assets which are received as income is influenced by the contracting parties, therefore should an asset be exchanged for a new asset, the new asset will be regarded as the amount received and not the value of the asset which was originally received.

### **2.3 THE MEANING OF 'RECEIVED BY OR ACCRUED TO'**

The words 'received by or accrued to' falls within the definition of gross income as follows:<sup>26</sup>

'...the total amount, in cash or otherwise, received by or accrued to a person during such a year or period of assessment...'

<sup>25</sup> at SATC 361-362.

<sup>26</sup> Section 1 sv 'gross income'.

The meaning of *or* in the phrase 'received by or accrued to' implies that a taxpayer should not only include income which has been received by him, but also those amounts which have accrued to him during the year of assessment. This phrase within the gross income definition is mainly related to time, and determines the particular tax year in which the gross income arises.

According to the wording in the Act, an amount may be included in the taxpayer's gross income either when it is received, or when it accrues.

The court's interpretation of the wording within the Act does not always agree with the above, as was found in the case of *Delfos*, where Wessels CJ said the following:<sup>27</sup>

'It was for the Legislature to say how it wished to determine the taxable income of the citizen, and we cannot say that where in a definition it said 'received by', it did not mean to include everything that the taxpayer received in the year of assessment (not being something of a capital nature): nor can we say that when the Legislature said disjunctively 'received by or accrued to' it meant 'received by and accrued to'.

<sup>27</sup> at SATC 102.

Stratford JA concluded by saying:<sup>28</sup>

'Tax is, therefore, payable both on 'receipts' and 'accruals'. The difficulty lies in giving a literal meaning to receipts irrespective of when the sums received accrued to the taxpayer. My view is that receipts must, on a proper reading of the Act as a whole and regarding its manifest object be limited to receipts which are truly and properly income for the tax-year and, therefore, have accrued in the year.'

De Villiers JA added:<sup>29</sup>

'It seems clear to me therefore that an amount accrues under s 7 at the moment when it becomes due and payable, irrespective of the financial position of the debtor.'

It can be concluded from the above, that the meaning of the various quotations are, that the Commissioner may not include the amount when it both accrues, and when it is received, as this would lead to a double taxation. For this reason, an amount should be included either when it is received, or when it accrues.

<sup>28</sup> at SATC 108.

<sup>29</sup> at SATC 111.

In *SIR v Silverglen Investments (Pty) Ltd* Steyn CJ expressed himself as follows:<sup>30</sup>

'The requirement that receipts as well as accruals must be disclosed, with the provision for penalty and additional taxation, and the levy of the tax on both receipts and accruals, clearly indicate that Parliament contemplated an assessment of the tax in every year also on accruals during that year; and if that is what Parliament contemplated, I know of no ground on which the Secretary could as of general right postpone the assessment of disclosed accruals to a subsequent tax year when it may be more advantageous to the Treasury to tax them as receipts in respect of that year.'

In this case the court found that the Commissioner did not have a choice to include the amount either when it is received, or when it accrues.

As stated before, this section of the gross income definition is related to time. In practice, gross income arises at the earlier of either the date of receipt; or the date of accrual. As a result, the event which occurs first determines the date of the inclusion of the amount.

<sup>30</sup> 1969 (1) SA 365 (A), 30 SATC 199 at 208.

### 2.3.1 The meaning of 'received by'

The word 'received' may be interpreted as an amount which is received by the taxpayer, on his own behalf for his own benefit. This was held in *Geldenhuys v CIR*<sup>31</sup>, where the widow of a farmer had sold livestock after her husband's death.

The court had found that the proceeds of the sale did not accrue to her personally as it did not form part of her income but belonged to the heirs.

The fact that the widow received the proceeds was irrelevant as they were not received by her for her own benefit.

The following was held by Steyn J:<sup>32</sup>

'In my opinion, therefore, when the appellant sold the flock of sheep and converted it into cash she was not acting in pursuance of her legal rights as usufructuary or, as held by the Income Tax Court, as quasi-usufructuary; and the proceeds did not accrue to her personally. The proceeds accrued to the heirs.'

<sup>31</sup> 1947 (3) SA 256 (C), 14 SATC 419.

<sup>32</sup> at SATC 429.

Steyn J continued on by saying the following:<sup>33</sup>

'Section 14 does not purport to create a new definition of 'taxable income' for a farmer's income. His 'taxable income' continues to be *his* income, i.e. his gross income less deductions; in other words, the total amount received by, or accrued to, him or in his favour less receipts of a capital nature, less deductions. So that in determination of a farmer's taxable income we continue to be concerned with amounts to be received by or accrue to him, i.e. such amounts as are received by him for his own benefit.'

If a receipt arises prior to the date of an accrual, gross income would then be at the date of receipt.

When an amount has been received by a person for his own benefit, it would fall into his gross income even if the amount has not yet accrued to him.

There is little difficulty with income that has been received, as it is relatively easy to determine whether an amount has been received within a particular year of assessment or not.

<sup>33</sup> at SATC 431.

### 2.3.2 The meaning of 'accrued to'

The interpretation of the meaning of 'accrued to' has caused difficulty and many problems throughout the years. An amount has accrued to a person when the income has become due to that person, even if the amount is not yet payable. The meaning of 'accrued to' can, from the above sentence, be interpreted as 'become entitled to'.

This interpretation was given in the case of *Lategan v CIR*, where judgement was delivered by Watermeyer J, who said:<sup>34</sup>

'In his Lordship's opinion the words in the Act 'has accrued to or in favour of any person' merely meant 'to which he has become entitled'. So far as a debt was concerned which was payable in the future and not in the year of assessment, it might be difficult to hold that the *cash amount* of the debt had accrued to the taxpayer in the year of assessment.'

In the case of *CIR v Delfos*<sup>35</sup>, not all of the judges were in agreement regarding the *Lategan* principle.

Two of the judges interpreted 'accrual' as taking place when debt is 'due and payable', meaning that an amount may be 'due' to a taxpayer during the

<sup>34</sup> 1926 CPD 203, 2 SATC 16 at 20.

<sup>35</sup> 1933 AD 242, 6 SATC 92.

year of assessment, but only become 'payable' the following year of assessment.

Only two out of five judges agreed with the 'due and payable' principle and thus the Appellate Division decision in *Delfos* neither approved of, nor rejected the decision of the Cape Provisional Division in *Lategan*.

In the case of *CIR v Delfos*, De Villiers JA said the following.<sup>36</sup>

'It seems to me clear therefore that an amount accrues under s 7 at the moment when it becomes due and payable, irrespectively of the financial position of the debtor.'

The correct interpretation of 'accrued to', remained unresolved for many years up until the decision taken in the case of *CIR v People's Stores (Walvis Bay) (Pty) Ltd*<sup>37</sup>, where an Appellate Division decision confirmed the decision taken in the *Lategan* case that the interpretation of 'accrued' means 'becomes entitled to'.

The Inland Revenue did not accept the second leg of the *Lategan* principle.

The principle that a debt which is payable in a future year of assessment

<sup>36</sup> at SATC 111.

<sup>37</sup> 1990 (2) SA 353 (A), 52 SATC 9.

must be included in the taxpayer's gross income in the year of accrual at its 'present value'. An amendment to the definition of 'gross income' was obtained which added a proviso to the definition. This proviso was that the full value of a debt which becomes payable after the end of the year of assessment is included in gross income in the year of accrual.

The proviso came into use in 1990, in order to nullify the principle laid down in *People's Stores*. The amendment applies to all amounts, which accrued on or after the date 1 July 1962.

The proviso agrees with the *Lategan* case that the interpretation of 'accrue' means 'become entitled to'. It also confirms that if during the year of assessment the taxpayer becomes entitled to any amount, the full amount is included in that year and no present value can be used.

If there is no receipt or accrual, then no liability for tax can arise, although a person may be subjected to tax in terms of certain sections of the Act, on amounts that have not been received by or accrued to him. An example of these are the provisions of section 7(2), (3), (5), (6), (7) and (8). There are many more provisions to be found throughout the Act.

## 2.4 THE MEANING OF 'RESIDENT' IN TERMS OF NATURAL PERSONS

The term 'resident' falls within the definition of gross income as follows:<sup>38</sup>

'...gross income', in relation to any year or period of assessment means -

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

South Africa applies a residence-based (or world-wide) system of taxation. This system is effective as from 1 January 2001 and applies in respect of years of assessment commencing on or after that date. The residence basis of taxation which applies in South Africa can be referred to as the 'residence minus' system, which means that receipts and accruals of income derived by 'residents' from all sources are subject to tax, but certain categories of income arising from activities undertaken outside the Republic are exempt from tax. For 'non-residents', that is, persons who do not qualify as residents, only receipts and accruals of income derived from sources within or deemed to be within the Republic are subject to tax, in

<sup>38</sup> Section 1 sv 'gross income'.

terms of the definition of the 'gross income' in section 1 of the Act, again subject to certain exceptions. This is commonly referred to as 'source taxation'.<sup>39</sup>

Unlike the other components within the gross income definition which are not defined, 'resident' and 'non-resident' are defined. Section 1 of the Act provides a definition of a resident as follows:<sup>40</sup>

- 'Resident' means any –
- (a) natural person who is –
- (i) ordinarily resident in the Republic; or
  - (ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic -
    - (aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and
    - (bb) for a period or periods exceeding 915 days in aggregate during such five preceding years of assessment,
      - in which case that person will be a resident with effect from the first day of that relevant years of assessment...'

<sup>39</sup> *Silke on South African Income Tax* in para 5.1.

<sup>40</sup> Section 1 sv 'resident'.

Two rules used to determine whether natural persons are residents. Both of these rules are mutually exclusive. These rules are as follows:

- To determine whether natural persons are 'ordinarily resident'; or
- where the natural person is not an 'ordinarily resident', the 'physical presence test' will be applied.

#### **2.4.1 Ordinarily resident**

The Act does not define 'ordinarily resident'. The courts however, are still called upon in order to provide a definition for this term. If a person who is ordinarily resident emigrates, therefore stops being ordinarily resident, or immigrates, starts being 'ordinarily resident' in the year of assessment, only the 'ordinarily resident' test can be applied in order to determine whether the natural person is a resident or not. The words 'ordinarily resident' is a narrower concept than that of the word 'resident'.

A person is ordinarily resident where he or she normally resides, apart from temporary or occasional absence.

In *CIR v Kuttel*, Goldstone JA held the following about 'ordinarily resident'.<sup>41</sup>

'In the present case we are concerned with the words 'ordinarily resident'. That is something different and, in my opinion, narrower than just 'resident'.

Goldstone JA continued by saying the following:<sup>42</sup>

'I would respectfully fully adopt the formulation of Schreiner JA and hold that a person is 'ordinarily resident' where he has his usual or principle residence, i.e. what may be described as his real home.'

In *Cohen v CIR*<sup>43</sup>, Schreiner JA said the following about the words 'ordinarily resident' which was adopted by Goldstone JA in *CIR v Kuttel*<sup>44</sup> case:

'...(H)is ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home.'

<sup>41</sup> 1992 (3) SA 242 (A), 54 SATC 298 at 304.

<sup>42</sup> at SATC 306.

<sup>43</sup> 1946 AD 174, 13 SATC 362 at 371.

<sup>44</sup> 1992 (3) SA 242 (A), 54 SATC 298.

Schreiner JA therefore suggests that a person is an ordinarily resident in a country where he would return to after his wanderings. That country would therefore be regarded as his 'real' home.

Natural persons may be residents in more than one country for tax purposes. There has been no ruling whether a person may simultaneously be ordinarily resident in more than one country.

Other criteria laid down by the courts are that 'ordinarily resident' or 'ordinary residence' connotes the following.<sup>45</sup>

- Living in a place with some degree of continuity, apart from accidental or temporary absence. If it is part of a person's ordinary regular course of life to live in a particular place with a degree of permanence, that person must be regarded as ordinarily resident there.<sup>46</sup>
- The place of a person's permanent place of abode, where belongings are stored which were left for temporary absences and to which the person regularly returned after such absences.<sup>47</sup>

<sup>45</sup> RC Williams *Income Tax in South Africa – Law and Practice (2006)* page 35.

<sup>46</sup> *Levene v IRC* (1928) ALL ER Rep. 746 (HL).

<sup>47</sup> *H v COT*, 24 SATC 738.

- The residence must be settled and certain and not temporary and casual.<sup>48</sup>
- ‘Ordinarily resident’ is a narrower concept than ‘resident’. A person is ordinarily resident where he or she normally resides, apart from temporary or occasional absences.<sup>49</sup>

The words ‘ordinarily resident’ are therefore not determined by physical presence, regardless of how many days the person is in the Republic. The person will be regarded as ordinarily resident in South Africa from the time he becomes ordinarily resident and not the whole year of assessment in which he becomes ordinarily resident. The person as a result will be taxed as a non-resident for the period from the beginning of the year of assessment until the time he becomes ordinarily resident in South Africa.

#### **2.4.2 Physical presence test**

If a person physically spends a certain number of days in the Republic he will be treated as a resident for tax purposes, even if he is not regarded as ordinarily resident.

<sup>48</sup> *Soldier v COT* 1943 SR.

<sup>49</sup> *CIR v Kuttel supra*.

He must therefore meet the requirements of the 'physical presence test' as stated in the definition of a resident:

- For a period or periods exceeding 91 days in aggregate during the relevant year of assessment; and
- for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and
- for a period or periods exceeding 915 days in aggregate during the five years of assessment preceding the current year of assessment (para (a)(ii) of the definition of 'resident' in section 1).

This provision was amended during 2005 and will apply from the 2007 year of assessment in respect of a person who was a resident by virtue of the physical presence test on 28 February 2005, and from the 2006 year of assessment in respect of any other person. Prior to 1 March 2006, the same three requirements for the physical presence test were used except that the five years in requirements two and three were three years and the 915 days in requirement three were 549 days.

When determining whether a person is physically present in South Africa, a part of a day will be included as a day. It is not included as a day if it is a day spent in transit through the Republic between two places outside the Republic if he does not formally enter the Republic through a 'port of entry'

as 'contemplated in' section 9(1) of the Immigration Act 13 of 2002 or at any other place in the case of a person authorised by the Minister in terms of s 31(2) (c) of the same Act, provided that the person does not formally enter South Africa.

A person will be liable for tax in South Africa when he is not an ordinarily resident but becomes a resident through meeting the requirements of the physical presence test. A person who meets the requirements becomes a resident from the first day of the year of assessment during which all the requirements of the test is met. He will be subject to tax in South Africa on his worldwide income from the first day of that year of assessment.

A person who meets the requirements of the physical presence test is therefore a resident but if he is absent from the Republic for a continuous period of at least 330 full days immediately after the day the person ceases to be physically present in the Republic, a person is deemed not to have been a resident from the day he ceased to be physically present in the Republic.

A person is required to be physically present in South Africa for the five years of assessment prior to the current year of assessment; only in the sixth year of assessment in which the person has a physical presence in the Republic will he become a resident.

The 91 and 915 day periods of physical presence in South Africa need not be continuous. The requirement will be met if a person is present for several periods which in aggregate exceed 91 or 915 days.

The physical presence test will not apply to persons who are ordinarily resident in South Africa. The ordinary residence test should first be applied to determine whether a person is a resident, if the test fails only then should the physical presence test be used.

### **2.4.3 Double taxation**

When determining the South African normal tax liability of a resident on that person's receipts from a foreign country, the effect of any double tax agreement between South Africa and that foreign country must be kept in mind. Double taxation is the same income being taxed twice in the hands of the same taxpayer.

The effect of a double tax treaty:<sup>50</sup>

- Any person who is exclusively deemed to be a resident of another country

<sup>50</sup> K Huxham and P Haupt *Notes on South African Income Tax (2007)* on page 296.

for the purposes of the application of a double tax treaty between that country and South Africa is not a resident as defined.

- The words 'for the purpose of the application' suggest that the person must be subject to the provisions of a treaty.
- It is a universal requirement of treaty law that for the purposes of the treaty a person can only be a resident of one of the countries which is party to the treaty. For this reason the treaties have their own definition of residence.

The National Executive of the government of South Africa may enter into an agreement, here referred to as a 'double taxation agreement', with the government of any other country in terms of which arrangements are made with a view to the prevention, mitigation or discontinuance of the levying under the laws of the Republic and of the other country of tax in respect of the same income, profits or gains or tax imposed on the same donation, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the laws of the Republic and the foreign country.<sup>51</sup>

<sup>51</sup> *Silke on South African Income Tax* in para 26.1.

## 2.5 THE MEANING OF 'NON-RESIDENT'

'Non-resident' refers to those persons who do not fall within the definition of resident in the Republic of South Africa.

The difference between residents and non-residents is that residents are taxed on their worldwide income while non-residents are taxed according to the source and deemed source rules of the Republic of South Africa. Certain types of income are then exempt in terms of section 10 of the Act.

Non-residents would therefore pay normal tax at the same rate as residents. They are entitled to the same deductions from income and rebates as residents. However, in the case of royalty income, a special withholding tax is applied in terms of section 35 (assessment of persons not ordinarily resident or registered, managed or controlled in the Republic who derive income from royalties or similar payments) of the Act.

The following are various types of income that can be earned by non-residents:

- Interest (this is taxed if the investment is located in South Africa or if the source is deemed to be in South Africa).

- Dividends (South African dividends are included in gross income but are exempt in terms of section 10(1)(k)).
- Royalties (royalties are taxed in South Africa if the intellectual property which produces them was developed in South Africa or is used in South Africa. This includes patents, trade marks, copyrights, commercial knowledge, etc.).
- Rental income – immovable property (this is taxed in South Africa if the property is situated in South Africa).
- Rental income – movable property (this is taxed in South Africa if the dominant cause of the income arising is in South Africa).
- Services rendered (this is taxed in South Africa if the services are rendered in South Africa).
- Business income (this is taxed in terms of the normal source rules. It is taxed in South Africa if the business is carried on in South Africa).

## 2.6 **SOURCE**

Non-residents will be taxed on income which has been derived from a source within South Africa or deemed to be in the Republic unless it is specifically exempted. The courts have been called upon to provide an answer to the question whether income is from a source in the Republic; this

has led to many tax cases as the meaning of 'a source in the Republic' is not defined in the Act.

### 2.6.1 True source

The Act does not define the meaning of 'a source in the Republic' as it is impossible to provide a definition for all circumstances within each case and for this reason the courts have been called upon in order to provide judgement regarding the various facts within a case on whether income has, or has not derived from a source within South Africa.

In *CIR v Lever Brothers & Unilever Ltd*, Watermeyer CJ had the following to say regarding the determining of a 'source'.<sup>52</sup>

'Furthermore, the word 'source', when used as it is in this Act in order to symbolise the origin of 'gross income' received by a taxpayer, is also a metaphorical expression, and in the sense in which it is used in the Act must be determined.'

Watermeyer CJ continued on by explaining 'source' as follows.<sup>53</sup>

'The word 'source' has several possible meanings. In this section it is used figuratively, and when so used in relation to the receipt of money, one possible meaning is the originating

<sup>52</sup> 1946 AD 441, 14 SATC 1 at 8.

<sup>53</sup> at SATC 8 - 9.

cause of the receipt of the money, another possible meaning is the quarter from which it is received. A series of decisions of this Court and of the Judicial Committee the Privy Council upon our income tax acts and upon similar acts elsewhere have dealt with the meaning of the word 'source', and the inference, I think, which should be drawn from those decisions is that the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form or employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.'

It is important to remember that 'source' means origin and not place. It can be concluded from the above case, that the meaning of the word 'source' is the 'originating cause of the receipt of the money'.

A problem is that once the source has been determined, the location of where it is situated must still be determined.

Therefore a two step process can be followed, namely:

- Determining the cause of the income (source); and
- the location of the source.

In *Rhodesia Metals Ltd (In Liquidation) v COT*, De Villiers held:<sup>54</sup>

'Source means, not a legal concept, but something which a practical man would regard as a real source of income; the ascertainment of the actual source is a practical hard matter of fact.'

As stated before, there can be no single definition for the word 'source' as circumstances differ from one case to another, the facts of each case need to be analysed in order to determine the actual source of income for that particular case.

In the same case, Tindall JA stated the following.<sup>55</sup>

'In *Overseas Trust Corporation Ltd v CIR* 1926 AD 444 Innes CJ stated that the source or origin of income may be said generally to be the location of the business, capital or service which produces the income and that capital which produces profit is located where it is employed.'

The location of the source is thus where the business, capital or service which produces the income is located.

<sup>54</sup> 1938 AD 282, 9 SATC 363 at 300.

<sup>55</sup> at SATC 296.

### 2.6.2 Deemed source

There is no definition for the expression 'a source within South Africa'. Section 9 of the Act, however, deems certain income to be from a source within the Republic, regardless of their actual source. In the case of non-residents the gross income definition refers to both South African source and deemed South African source of income.

Non-residents are taxed on a source-based tax system, as a result only the gross income of non-residents will be impacted by the deemed source provisions even though section 9 refers to amounts received by or accrued to 'any person'.

The following are deemed to have accrued to any person from a source within the Republic if it has been received by or has accrued to or in favour of such person:

- Royalties – s 9(1)(b)
- Know-how payments – s 9(1)(bA)
- Mining leases – s 9(1)(cA)
- Services rendered abroad for government and other bodies – s 9(1)(e)
- Prospecting leases – s 9(1)(fA)

- Pensions – s 9(1)(g)
- Alimony and maintenance – s 9(1)(h)
- Capital gains and losses – s 9(2)
- Interest – s 9(6)

There are also other provisions that provide for amounts to be deemed to be from a source within the Republic, regardless of their actual source, which fall beyond the scope of this treatise.

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### 3.1 INTRODUCTION

The last requirement of the definition of 'gross income' is the exclusion of 'receipts and accruals of a capital nature'. The Act again does not define the meaning of 'capital nature'; therefore we look at case law in order to determine the meaning of a receipt or an accrual of a capital nature.

The question whether an amount is a receipt or an accrual of a 'capital nature' has exercised the minds of the courts possibly more than any other point of South African income tax law. There have been significant developments in income tax law relating to the issue of capital and income. The definition does however indicate that receipts or accruals of a capital nature are, with certain exceptions, not subjected to tax. Receipts or accruals that are not of a capital nature are subjected to tax.

One of the most important factors to be considered is the intention and motive of the taxpayer. The courts, however, will consider other factors as the intention of the taxpayer is not always conclusive.

The courts have formulated a number of tests over the years in order to distinguish between capital and income.

The following are tests established by the courts:

- subjective tests; and
- objective tests.

### 3.2 **THE DISTINCTION BETWEEN INCOME AND CAPITAL**

Whether an amount is of a revenue or capital nature is a question of law, which has to be decided upon the facts of each case, although in some instances the determining of whether an amount is of a revenue or capital nature is easy.

*Meyerowitz* describes capital and income as follows:<sup>56</sup>

‘In the normal course there is no difficulty in determining whether a receipt or accrual is income or is of a capital nature. A phrase frequently used to illustrate the distinction is that capital is the income–producing machine, the product of which is income. A metaphor that may be resorted to is a liken capital to a tree and income to its fruits.’

*Meyerowitz* goes on to describe capital and income by providing examples:<sup>57</sup>

‘The machine or tree may take a variety of forms; it may be a farm, a factory, or a business.

<sup>56</sup> D Meyerowitz *Meyerowitz on Income Tax in South Africa* (2006) in para 8.3.

<sup>57</sup> in para 8.4.

It may be corporeal or tangible like a block of flats or incorporeal or intangible like goodwill. Thus, for example, a wool crop is the fruit of a wool farmer, rents are the fruit of letting property, fees are the fruits of exercising a profession, wages the fruit of employment. If the income-producing machine or part thereof, or the tree or part of it, is disposed of for consideration, the receipt or accrual is of a capital nature.'

*Meyerowitz* concludes the example of capital or income by explaining those receipts or accruals that do not fall into the category of either the product or fruit, it is explained as follows:<sup>58</sup>

'There may also be a receipt or accrual which is neither the product or fruit, nor the consideration for the disposal, of the machine or tree. These are fortuitous accretions like an inheritance, a sweep-stake prize; these, too, are of a capital nature.'

An amount must therefore fall into the category of either capital or income. In the case of *Pyott Ltd v CIR*<sup>59</sup>, Davis AJ held that the concept of an amount being both 'non-capital' and 'non-income' was not possible. He described the concept as being a 'half-way house' of which he had no knowledge.

It is normally not possible to have an amount which is partly capital and

<sup>58</sup> in para 8.5.

<sup>59</sup> 1944 AD 128, 13 SATC 121.

partly income, but in the case of *Tuck v CIR*<sup>60</sup>, it was held that a single amount may be apportioned between capital and income as the amount arose for two reasons. In the case of *Tuck v CIR*, the following was held by Corbett JA:<sup>61</sup>

'It is not possible to infer that the one element is more important than the other and, in all the circumstances, I consider that a 50/50 apportionment would be fair and reasonable.'

Maritz J made the following statement regarding the point that a receipt may be of a capital nature in the hands of one taxpayer but may be of an income nature in the hands of another, in the case of *CIR v Visser*:<sup>62</sup>

'This economic distinction is a useful guide in matters of income tax, but its application is very often a matter of great difficulty, for what is principal or tree in the hands of one man may be interest or fruit in the hands of another. Law books in the hands of lawyer are a capital asset; in the hands of a bookseller they are a trade asset. A farm owned by a farmer is a capital asset; in the hands of a jobber it becomes stock-in-trade.'

<sup>60</sup> 1988 (3) SA 819 (A), 50 SATC 98.

<sup>61</sup> at SATC 114-115.

<sup>62</sup> 1937 TPD 77, 8 SATC 271 at 276.

In terms of section 82 of the Act, the onus is on the taxpayer to prove that a receipt is of a capital nature as an amount that may be of a capital nature in the hands of one taxpayer may be of an income nature in the hands of another.

The following is stated in section 82 of the Act regarding the responsibility of the taxpayer:<sup>63</sup>

**'Burden of proof as to exemptions, deductions, abatements, disregarding or exclusions.** – The burden of proof that any amount is –

- (a) exempt from or not liable to any tax chargeable under this Act; or
- (b) subject to any deduction, abatement or set-off in terms of this Act; or
- (c) to be disregarded or excluded in terms of the Eighth Schedule,

shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.'

Whether an amount is of an income or capital nature is a question of law, which has to be decided upon the facts of each case as circumstances may vary from one case to another.

<sup>63</sup> Section 82 sv 'Burden of proof as to exemptions, deductions, abatements, disregarding or exclusions'.

It is often clear whether an amount is of a capital or income nature:

- Any amount for services rendered – income nature.
- Gifts – capital nature.
- If the taxpayer makes it his business to buy and sell assets, for example, proceeds from the sale of investments, paintings, houses and jewellery – income nature.
- A lump-sum inheritance – capital nature.
- Amounts which have been received by the taxpayer for allowing the use of an asset to other persons, for example, rentals, interest and royalties – income nature.
- The sale of assets by a person who does not buy these assets in order to sell, for example, a private residence, paintings or jewellery – capital nature.

### 3.3 **SUBJECTIVE TESTS**

In an article entitled 'Capital vs revenue', Advocate Broomberg wrote the following regarding objective and subjective tests:<sup>64</sup>

'If the objective test does not apply (for example, if the asset is not sold in the ordinary

<sup>64</sup> 'Capital vs Revenue' (1998) 12 *Tax Planning* 69.

course of the conduct of business), it becomes necessary to resort to the state of mind of the taxpayer, that is, to apply the subjective test. Jurisprudence recognises three main types of subjective states of mind.

- Intention: In tax terms, that would mean acquiring an asset intending not to keep it but to dispose of it.
- Motive: Given that an asset was acquired with the intention of disposing of it, the motive is the reason why the taxpayer acquired the asset with that intention; for example, the motive in acquiring shares might have been to secure control over a company, or to acquire an agency, or to operate a share incentive scheme. Of course, the motive may have been to make a profit on the resale of the asset.
- Contemplation: Given that the taxpayer acquired the asset, for example, to use it for some specific purpose and not with the object of making a profit on the re-sale; but the taxpayer did foresee that he would make a profit when the asset was resold after it had served the specific purpose for which it had been acquired.'

The intention of the taxpayer is the most important 'test' used by the courts when deciding whether income derived from the disposal of an asset is of a capital or income nature. The question that needs to be asked is 'what was the intention of the taxpayer when he acquired the asset'? The intention of the taxpayer is subjective and therefore it is difficult to determine what the true intention of someone else may be.

By determining the taxpayer's intention, it can be determined whether he is carrying on a scheme of profit-making. If the taxpayer's purpose is to sell the asset which he has acquired at a profit, it is regarded as income in nature and is therefore taxable. However, if the asset is held not for the

purpose of resale at a profit but rather to produce income from that asset, it is regarded as capital in nature.

Silke defines purpose as being of central importance in the context of a 'scheme of profit-making' and that it signifies the object or aim that the taxpayer had in mind.<sup>65</sup>

The following was held in the case of *Wairakei Court Ltd v CIR* regarding purpose:<sup>66</sup>

'It is not synonymous with intention or motive and must, naturally, be distinguished from motive or expectations. Moreover, care must be taken to avoid confusing the means by which the taxpayer achieves his purpose with the purpose itself.'

### **3.3.1 The intention of the taxpayer**

Intention is an important factor but does not on its own determine whether the proceeds of an asset upon its disposal will be of a capital or income nature. Other relevant factors revealed from the facts of a particular case must be considered together with the intention of the taxpayer.

<sup>65</sup> *Silke on South African Income Tax* in para 3.2.

<sup>66</sup> 1999, 19 NZTC 15 202 at 15 206.

The taxpayer's intention may change and with that the character of the asset, as income or capital, also changes.

In the case of *CIR v Stott*, Wessels JA said the following regarding the intention of the taxpayer:<sup>67</sup>

'It was unnecessary to go as 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 an 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.'

The taxpayer's intention can change over time and should therefore be investigated at the time the asset was acquired, during the period the asset was held and at the disposal of the asset.

In terms of section 82 of the Income Tax Act, the taxpayer must prove that he acquired the assets for the purpose of investment and not for the purpose of resale at a profit as then it would be regarded as being income and therefore taxable.

<sup>67</sup> 1928 AD 252 at 264, 3 SATC at 261-2.

It is important to remember that the intention of the taxpayer is not decisive when determining whether a receipt or an accrual is of a capital or income nature.

Schreiner JA made this point in the case of *CIR v Richmond Estates (Pty) Ltd*, where the following was said regarding the intention of the taxpayer as being decisive.<sup>68</sup>

'There is no legislative provision that makes the intention of the taxpayer decisive of whether the receipt or accrual was of a capital nature or not. The decisions of this Court have recognised the importance of the intention with which property was acquired and have taken account of the possibility that a change of intention or policy may also affect the result.'

### **3.3.2 The acquisition of assets**

The state of the market when a person acquires an asset may indicate the intentions of that person. The mode of acquisition is an important factor but is not necessarily decisive.

<sup>68</sup> 1956 (1) SA 602 (A), 20 SATC 355 at 365.

This was stated in the case of *SIR v The Trust Bank of Africa Ltd* where Botha JA said the following:<sup>69</sup>

'Where, however, as in the present case, share-dealing is carried on by banker ancillary to its banking business, the question whether a particular share transaction falls within its ordinary share-dealing operations, or was intended as an extension of or addition to its banking business and not as a dealing in shares, is a question of an entirely different kind, in the determination of which the intention with which the share transaction was entered into must necessarily be fundamental, even though it may not be decisive.'

A taxpayer who buys and sells during a boom period may indicate an income nature; the taxpayer has therefore used the asset in the course of an operation of business in carrying out a scheme of profit-making, the receipt or accrual will then be regarded as income regardless of whether the asset was acquired by way of a donation or inheritance. A depressed market may then indicate a capital intention.

If the asset was acquired by the taxpayer by way of an inheritance or donation, it is usually regarded as being of a capital nature, however should the taxpayer use the asset as part of his business operations then such an asset is then of an income nature.

<sup>69</sup> 1975 (3) SA 652 (A), 37 SATC 87 at 105.

Another factor to be considered is how the acquisition was financed. If the taxpayer makes use of borrowed funds rather than his own funds it is likely to be of an income nature. If the taxpayer makes use of his own available funds to purchase property, it may be regarded as representing an investment. The need to borrow money is not necessarily fatal.

A taxpayer, however, may not have decided what he was going to do with his asset at the date of acquisition. The choice would be to either hold it as an investment or sell it in order to make a profit.

### **3.3.3 Change of intention**

The intention of a taxpayer at the time of acquisition of an asset is not conclusive as the taxpayer may change his intention. A taxpayer may have originally had the intention to hold an asset as an investment but over time his intentions changed and now his intention may be to use the asset in the carrying out of a scheme of profit-making, and *vice versa*. This will result in a change of tax consequences to the taxpayer.

In the case of *CIR v Lydenberg Platinum Ltd*<sup>70</sup>, there was a clear change of intention. The company originally operated as a mining venture but later embarked upon buying and selling of properties. The company stopped all mining operations and disposed of its original mining assets. A profit resulted from the disposal of the mining assets, which the company argued was of a capital nature.

The court held that events pointed to change of intention, although the mining assets were acquired to be used for the purpose of carrying on the business of mining, the original asset had become merged into the general profit-making scheme of buying and selling properties, so the profit that had resulted from its disposal was taxable. The profits made were held to be income and not accruals of a capital nature.

The following was held by Stratford JA in the case of *CIR v Lydenberg Platinum Ltd*:<sup>71</sup>

‘For, even though it were assumed that these properties were originally acquired for the purpose of carrying on the business of mining the subsequent events to which reference had been made pointed to a clear change policy in regard to the use to which they were put.’

<sup>70</sup> 1929 AD 137, 4 SATC 8.

<sup>71</sup> at SATC 19.

After quoting the *dictum* of Wessels JA, in *Stott's case supra*, Stratford JA went on to say:<sup>72</sup>

'In the present case a new factor had intervened of a decisive character, namely the deliberate adoption of the policy of selling the company's properties to make profits.'

The decision to sell an asset of a capital nature rather than to hold it does not mean that it will change the nature of the asset.

In the case of *CIR v Richmond Estates (Pty) Ltd*, Centlivres CJ had the following to say regarding the sale of a capital asset:<sup>73</sup>

'The decision was to sell capital assets and the fact that a taxpayer decides to sell capital assets at a profit cannot *per se* make the resulting profit subject to tax.'

In the same case, the following was held by Schreiner JA:<sup>74</sup>

'The decisions of this court have recognised the importance of the intention with which property was acquired and have taken account of the possibility that a change of intention or policy may also affect the result. But they have not laid down that a change of policy or intention by itself effects a change in the character of the asset.'

<sup>72</sup> at SATC 19.

<sup>73</sup> 1956 (1) SA 602 (A), 20 SATC 355 at 362.

<sup>74</sup> at SATC 365.

The court considers the taxpayer's history and activities when deciding whether the taxpayer has changed his original intention. The court considers whether the taxpayer was realising a capital asset to the best advantage or using the asset as stock-in-trade in a profit-making business. This depends upon the facts of the case and is a test of degree.

In the case of *Natal Estates Ltd v SIR*, this was made clear by Judge Holmes JA.<sup>75</sup>

'In deciding whether a case is one of realizing a capital asset or of carrying on a business or embarking upon a scheme of selling land for each case. Important consideration include, *inter alia*, the intention of the owner, both at the time of buying the land and when selling it (for his intention may have changed in the interim); the objects of the owner, if a company; the owner in relation to his land up to the time of deciding to sell it in whole or in part; the light which such activities throw on the owner's *ipse dixit* as to intention; where the owner subdivides the land, the planning, extent, duration, nature, degree, organization and marketing operations of the enterprise; and the relationship of all this to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit. Those considerations are not individually decisive and the list is not exhaustive. From the totality of the facts one enquires whether it can be said that the owner had crossed the Rubicon and gone over to the business, or embarked upon a scheme, of selling such land for profit, *using the land as his stock-in-trade.*'

<sup>75</sup> 1975 (4) SA 177 (A), 37 SATC 193 at 220.

### 3.3.4 Mixed and alternative intentions

When an asset is purchased by a taxpayer with mixed intentions, difficulties arise. The course the court will take is to seek and give effect to the dominant factor.

In the case of *COT v Levy*<sup>76</sup>, Judge Beadle J was interested in finding what Levy's main or dominant purpose was. The taxpayer, Levy, acquired 2 500 shares in a company for £2 750. A few years later, one Crombie purchased all the shares in the company. Levy received a sum of £5 531 for his shares. The Commissioner included the sum of £2 781 in his taxable income, being the difference between what he had paid for the shares and what he had sold them for.

The court held that Levy's dominant purpose when acquiring the shares was to obtain an income-bearing investment and because of this the profit from the shares on its disposal was of a capital nature.

The Commissioner appealed this decision and argued that in a case of a purchase and sale of an asset, the profit is only capital if the only purpose when acquiring the asset was its retention as an income-producing investment.

<sup>76</sup> 1952 (2) SA 413 (A), 18 SATC 127.

The court held that the main and dominant purpose with which the asset was sold is the determining factor when determining the question of capital or income. The fact that the purchaser had alternative methods in mind when dealing with the property should not affect the issue, if the dominant purpose of the acquisition is clearly established.

### **3.3.5 Period for which asset is held**

The period for which an asset is held may indicate what the intentions of the taxpayer are and therefore is a factor to be considered. If the asset is held for a short period, the more likely that it is indicative of an income intention. This is not conclusive, merely a fact to be taken into consideration.

### **3.3.6 Intention of a company**

A company is separate from its shareholders as it is an artificial person. The general rule, to which there may be exceptions, is that the intention of a company will be determined separately from that of its shareholders, except in their capacity as directors of the company.

In the case of *Ochberg v CIR*, Judge De Villiers CJ held the following regarding a company being separate from its shareholders:<sup>77</sup>

'A company, being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter. To say that a company sustains a separate *persona* and yet in the same breath to argue that in substance the person holding all the shares is the company is an attempt to have it both ways, which cannot be allowed.'

The company's intention is usually represented by the actions of the directors. The intention of a company also depends on those who are in charge of the company.

The following judgement delivered by Botha JA in the case of *SIR v The Trust Bank of Africa Ltd*:<sup>78</sup>

'The respondent being a company, the Special Court held that its intention in regard to the share transaction in question had to be sought in the thoughts and acts of the persons who manage and control its affairs. That would ultimately be the board of directors but, because the evidence showed that considerable powers were conferred by the board upon the management committee consisting of Dr Marais and Messrs Burger and Home, the Special Court concluded that the intention of the management committee would, to some extent,

<sup>77</sup> 1931 AD 215, 5 SATC 93 at 100.

<sup>78</sup> 1975 (3) SA 652 (A), 37 SATC 87 at 105.

depending upon the nature of the matter and circumstances, represent the intention of the company, and in regard to matters submitted to and decided upon by the full board, the thinking of the management committee, as reflected in its reports, and recommendations to the board, would represent an important indication of the intention of the board.'

It is important that the intention of the company not be confused with the objects clause in its memorandum of association. Therefore, if in terms of the memorandum of association the company has the power to undertake a transaction; it does not mean that the proceeds from this transaction are subject to tax. The test of intention should still be applied.

In the case where the court is determining whether a transaction of a company is of an income or capital nature, the court may take the objects clause as set out in the company's memorandum into consideration, together with other evidence. It must be remembered that the objects clause in the memorandum of association is not decisive on whether a receipt or an accrual is of a capital or income nature, although they are important factors.

The test applied to companies is not quite the same as the test applied to individuals. A company generally comes into existence in order to make a profit and has no personal interests other than fulfilling its goals in order to make that profit.

### **3.3.7 Summary of tests of intention with regard to the capital or revenue nature of a receipt or an accrual**

It must be understood that this summary is always subject to the special circumstances of a particular case.

*Meyerowitz* provides the following summary with regard to the various tests of intention:<sup>79</sup>

*'Capital nature of receipts or accruals*

In the following instances the intention, mind or policy of the taxpayer (hereinafter briefly referred to as intention) will be indicative of the capital nature of the receipts or accruals involved notwithstanding the fact that profits have been made.

- sole intention when buying and subsequently up to the time of sale to hold as an investment; or
- sole intention, not when buying, but subsequently, up to the time of sale, to hold as an investment; or
- dominant intention when buying and subsequently up to the time of sale to hold as an investment; or
- dominant intention, not when buying, but subsequently up to the time of sale, to hold as an investment.

<sup>79</sup> D Meyerowitz *Meyerowitz on Income Tax in South Africa* (2006) in para 8.23-8.24.

*Revenue nature of receipts or accruals*

In the following instances the intention, mind or policy of the taxpayer (hereinafter briefly referred to as intention) will be indicative of the revenue nature of the receipts or accruals involved.

- sole intention when buying and subsequently to sell at a profit; or
- sole intention, not when buying, but subsequently, to sell at a profit; or
- dominant intention when buying and subsequently to sell at a profit; or
- dual intention, when buying and subsequently, to hold as an investment while that is the most profitable course and to sell at a profit when circumstances point to that as the best method of making a profit, there being a single business of turning the property or other subject-matter to account; or
- such dual intention, not when buying, but subsequently.'

### **3.4 OBJECTIVE TESTS**

The court will consider a taxpayer's evidence regarding his intention by having regard to certain objective factors. The nature of a receipt can therefore, in certain instances, be determined by objective rather than subjective considerations. The difference between objective and subjective tests is that for objective tests there is no bearing on the taxpayer's state of mind unlike the subjective test which attempts to establish the intention of a taxpayer. The tests used by the courts may overlap to some extent. The following are objective factors which are considered by the courts.

### 3.4.1 Continuity

A factor which is considered by the courts would be the number of similar transactions undertaken by a taxpayer. A taxpayer who continuously buys assets for himself and then sells them at a profit may be taxed on the proceeds of the sales; his actions indicate a business intention. However, this does not mean that an isolated transaction will never be taxed, as was the case in *Stephan v CIR*<sup>80</sup>, where the profits from an isolated transaction of salvaging a wreck was of an income nature as the intention was to make a profit.

### 3.4.2 Schemes of profit-making

A gain made by an operation of business in carrying out a scheme for profit-making is income. In the case of *Californian Copper Syndicate v IR*<sup>81</sup>, it was held that a taxpayer's intention towards his assets would be one of a businessman in order to make a profit out of the acquisition and disposal of the asset. The taxpayer's intention would be one of a 'scheme of profit-making' and therefore of an income nature.

<sup>80</sup> 1919 WLD 1.

<sup>81</sup> 1904, 41 Sc LR 691, VI SC 894.

Lord Justice-Clerk, who delivered the judgement, said the following:<sup>82</sup>

'What is the line which separates the two classes of cases it 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.'

This has been adopted in many court decisions including the case of *Overseas Trust Corporation Ltd v CIR* where Watermeyer J, who delivered the judgement of the court, held the following.<sup>83</sup>

'There was no difference between the realisation of an asset and the fructification of an asset, if the benefits received amounted to a gain made by an operation of business in carrying out a scheme of profit-making. And this transaction came within that description. The acquisition of the shares in question was part of the business which the company had been formed to undertake; they had been acquired on terms which inevitably secured to the company a profit not only large but definite in amount. That was no fortuitous and unforeseen enhancement. It followed from facts which were within the knowledge of the contracting parties, and the resulting benefits must have been within their contemplation and intention. The profits of such transaction were not of the nature of capital. They were plainly income.'

<sup>82</sup> 1904, 41 Sc LR 691, VI SC 894.

<sup>83</sup> 1926 AD 444, 2 SATC 71 at 76.

### 3.4.3 Reason for the receipt

If an amount is received by the taxpayer for services rendered it will be of an income nature even if it should be disguised in the form of a gift, donation or inheritance.

### 3.4.4 Legal nature of the transaction

The legal nature of the transaction is in respect of amounts received for granting the use of an asset to another person, for example, interest, rent and royalties are all income.

In the case of *Vacu-Lug (Pvt) v COT*, Beadle CJ, in delivering the judgement of the court, said:<sup>84</sup>

'On the other hand, the proceeds of the sub-letting of a business lease must be regarded as the fruits of capital productively employed, and, as such, income. It seems to me, therefore, that this case ultimately turns on the question of whether or not 'the agreement' is to be regarded as similar in legal character to a 'cession of rights' or to a 'sub-letting of rights'. If it is more similar to a cession than to a sub-lease then for the purpose of this argument the £5000 would be capital; if on the other hand it is more similar to a sub-lease it would be income.'

<sup>84</sup> 1963 (2) SA 694 (SR), 25 SATC 201 at 206.

The Commissioner included the sum of £5 000 in the company's income. The company objected and regarded the receipt as being of a capital nature and not part of its gross income. The court held that in terms of the agreement its effect was not that of an outright cession of rights but rather of a sub-letting of such rights and because of this it is an operation of business in carrying out a scheme of profit-making, the proceeds of which were income and not of a capital nature.

#### **3.4.5 Nature of the asset disposed of**

Income will arise as soon as the fruit of the land is severed and sold, provided that the fruits are not wasting assets.

In the case of *CIR v George Forest Timber Co Ltd*, the respondent company carried on business as timber merchants and sawyers. They had purchased 600 morgen of indigenous forest land. The nature of the trees in the forest was such that they did not renew themselves, and for practical purposes the value of the land without the timber was negligible. In the course of business the company felled a quantity of timber each year which was sawn up in the mill and sold as part of its stock-in-trade. The balance of stock was acquired by purchase from other sources. The company claimed, in the calculation of its taxable income for the period, a deduction in the sum of £1 000, as representing the proportion of the cost of the forest

relative to the timber felled in that year. The Commissioner for Inland Revenue refused to allow this. The company appealed to the Special Court. The Special Court allowed the appeal, but on the grounds that the amount in question constituted a receipt of a capital nature which was rightly eliminated from the return of gross income. The Commissioner requested that a case be stated to the Cape Provincial Division, which upheld the decision of the Special Court, following its previous decision in *Commissioner for Inland Revenue v Jacobsohn*.<sup>85</sup>

The Commissioner appealed stating that the total amount received for the sale of stock-in-trade in the course of the company's business came within the definition of gross income, that no part of these receipts constituted receipts of a capital nature and that no deduction was admissible from those receipts by way of provisions for redemption of wasting capital. It was held that the limitation imposed upon appellants by section 84 (3) of Act 41 of 1917 could be waived by the Commissioner.<sup>86</sup>

<sup>85</sup> 1923, C.P.D. 220.

<sup>86</sup> 1924 AD 516, 1 SATC 20-21.

In *Commissioner of Taxes v. Booysen's Estates*<sup>87</sup>, Wessels J, said that as a general rule income was revenue derived from capital productively employed. Similarly and also as a general rule, capital, as opposed to income might be said to be wealth used for the purpose of producing fresh wealth.

#### **3.4.6 Other factors to be considered**

The following factors may be considered:

- The manner of acquisition
- The manner of disposal
- The period for which the asset is held
- Occupation of the taxpayer
- No change in ownership of the asset
- The nature of the asset
- The nature of the taxpayer
- The taxpayer's activities

<sup>87</sup> 1918 AD 576, 32 SATC 10.

### **3.5 MISCELLANEOUS RECEIPTS AND ACCRUALS**

A few specific transactions and the distinction between capital and income as determined by the courts are as follows.

#### **3.5.1 Copyrights, patents, trademarks and inventions**

The tests used to determine whether an asset is of an income or capital nature are the same tests that are used to determine whether a copyright, invention, patent or trademark is of an income or capital nature. Each case differs and therefore the outcome depends on the various facts of each case.

The proceeds derived from a copyright, patent or invention will be income as it is earned in the course of the taxpayer's profit-making operations. The reason for this is that the copyright or invention is the product of the taxpayer's wits and labour. These proceeds may be by way of royalties, license or outright disposition.

If the copyright, patents or trademarks are disposed of, the amounts received by the person who originally acquired the asset and used it as an income-producing investment are of a capital nature. However, if the asset

is acquired for resale at a profit, it is regarded as being of an income nature and therefore subject to tax as it is used in a profit-making scheme.

### **3.5.2 Gambling transactions**

Where a person's gambling activities become a business or a scheme of profit-making or even where a person makes his livelihood from gambling, the receipts and accruals are of an income nature.<sup>88</sup> If gambling, however, is a form of entertainment, the proceeds are of a capital nature.

Owners or trainers of racehorses who regularly place bets will be taxed.<sup>89</sup> The Commissioner will not however tax an ordinary punter on his winnings as laying bets is irrational conduct from a business point of view.

### **3.5.3 Gifts, donations and inheritance**

A gift, donation or an inheritance is capital in nature as they are unexpected receipts and are not connected to business activities.

<sup>88</sup> *Morrison v CIR* 1950 (2) SA 449 (A), 16 SATC 377.

<sup>89</sup> ITC 712 (1950), 17 SATC 335.

If the gift or inheritance is later sold, the disposal is also capital in nature.<sup>90</sup> However, if the asset is sold in a profit-making scheme or as part of a business carried on, it is income in nature.

#### 3.5.4 Damages and compensation

If an amount is paid to reimburse a taxpayer for damages which represented trading profits lost, the amount will be taxable. If the compensation paid is to replace a capital asset lost, the compensation will be of a capital nature.

In the case of *Burmah Steam Ship Co Ltd v IRC*<sup>91</sup>, it was held that it should be determined which hole the receipt was to fill, a hole in the profits or a hole in the assets?

The Lord President (Clyde) said the following:<sup>92</sup>

'The contemplated 'hole' in the appellant's profits was unfortunately made, and in my opinion the damages recovered must go, as a matter of sound commercial accounting, to fill that 'hole', and therefore constitute a proper item of profit in the appellant's profit and loss account.'

<sup>90</sup> ITC 129 (1928), 4 SATC 129.

<sup>91</sup> 1931 SC 156, 16 TC 67.

<sup>92</sup> at SATC 70.

### 3.5.5 Goodwill

Goodwill constitutes a capital asset and is not included in gross income, as long as the goodwill is a fixed amount. If, however, the taxpayer disposes of it in the course of a profit-making scheme, the goodwill will be of an income nature.

### 3.5.6 Share transactions

The sale of shares which were acquired as an investment will be regarded as a capital receipt.<sup>93</sup> If the intention is to sell the shares at a profit, the proceeds will then be income in nature.<sup>94</sup>

When a share is sold the intention of the taxpayer in relation to the sale must be established. A person who sells shares may choose to have the proceeds treated as a capital amount in terms of the provision of section 9B.

Section 9B establishes a 5-year rule under which shareholders can dispose of their qualifying listed shares without incurring any liability for normal tax. This gives a taxpayer the right to make an election in relation to an amount

<sup>93</sup> *COT v Levy* 1952 (2) SA 413 (A), 18 SATC 127.

<sup>94</sup> ITC 31 (1924), 2 SATC 52.

received by or accrued to or in favour of him as a result of the disposal of an 'affected share'. The taxpayer may elect that such an amount will be deemed to be of a capital nature for the purposes of the definition of 'gross income' in section 1. The result is that the amount is excluded from gross income. In terms of section 9B, affected shares are any listed shares that have been held for a continuous period of 5 years.<sup>95</sup>

Although section 9B provides a degree of certainty for the sale of listed shares, this section should be expanded to provide greater degree of certainty with respect to share transactions on a more generalised basis. Continued reliance on case law often leads to unintended differences of application. The result is that some sectors of the economy are facing one standard while other sectors are facing a different standard.<sup>96</sup>

From 1 October 2007, the current 5-year rule (section 9B) will be replaced with a new rule (section 9C). The new rule will apply to a wider set of 'shares' held for at least 3 continuous years.<sup>97</sup>

<sup>95</sup> *Silke: South African Income Tax* in para 17.25A.

<sup>96</sup> SARS: *Explanatory Memorandum on the Revenue Laws Amendment Bill (2007)* at page 16.

<sup>97</sup> at page 16.

The definition of 'shares' will include all listed shares on the JSE (domestic and foreign), private company shares, interests in close corporations and certain collective investment schemes.

However, the share definition excludes certain hybrid instruments, interests in share block companies and unlisted foreign companies.<sup>98</sup>

Receipts and accruals from the sale of shares held for a 3-year period will be deemed to be of a capital nature. This rule applies equally to gains and losses. The new 3-year rule is mandatory (unlike section 9B which is elective).<sup>99</sup>

### **3.5.7 Horse-racing**

Racehorse owners are subject to tax on their winnings if their intentions are that of a scheme for profit-making.

### **3.5.8 Land and property transactions**

If the property is acquired for the purpose of resale at a profit, the proceeds will be income in nature. If property is acquired for investment purposes, for

<sup>98</sup> at page 16.

<sup>99</sup> at page 17.

rental purposes and not in a scheme for profit-making, the proceeds are capital in nature.<sup>100</sup>

### **3.6 SPECIAL INCLUSIONS**

Amounts which are of a capital nature may be included in a taxpayer's gross income in terms of paragraphs (a) to (n) of the definition of 'gross income'. Due to paragraphs (a) to (n) the general rule of capital versus income does not apply.

The following special inclusions under the gross income definition are:

- (a) Annuities
- (b) Alimony and maintenance receipts
- (c) Remuneration for services rendered from employment
- (cA) Restraint of trade
- (d) Lump sum awards for termination of services
- (e) Lump sums from pensions, retirement annuities, provident funds
- (eA) State pension fund transfers
- (eB) Pension and provident fund surpluses
- (f) Amounts received in commutation of services

<sup>100</sup> *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193.

- (g) Premiums received for granting of use of certain assets, for example, fixed property, plant, picture films, patents, designs, trademarks, copyrights
- (gA) Amounts received for imparting scientific, technical, or commercial knowledge in South Africa
- (h) The value of improvements to fixed premises leased by a lessor
- (i) Fringe benefits under the Seventh Schedule received by an employee
- (j) Recoupment of capital expenditure in respect of mining
- (jA) Amounts received from the disposal of manufactured assets (similar to trading inventory)
- (k) Amounts received from dividends whether of an South African source or not
- (l) Subsidies to combat soil erosion
- (lB) Economic development area subsidies
- (m) Key-man insurance policies
- (n) Recoupments and other inclusions

All amounts received under any of these paragraphs will be included in the taxpayer's gross income and taxed accordingly.

**CHAPTER 4**  
**SUMMARY AND CONCLUSIONS**

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#### 4.1 **INTRODUCTION**

The definition of 'gross income' in section 1 of the Income Tax Act 58 of 1962 is the starting point of the formula that determines what will be subjected to normal tax in a taxpayer's year of assessment.

The definition of 'gross income' was amended with effect from years of assessment commencing on or after the 1 January 2001. Prior to this date, South Africa's income tax system was based on source, therefore all taxpayers, whether they were a resident or non-resident, were taxed only on income which had its source in the Republic. Income which had its source outside the Republic was not subject to income tax, with a few exceptions. The 'gross income' definition was amended to provide that persons who are residents in the Republic are taxed on all their income, irrespective of its source (world-wide income), whilst non-residents are taxed in the Republic only on income which has its source or deemed source in the Republic.

From case law it is clear that no one definition for 'gross income' can cover all the possible circumstances.

The following components within the gross income definition were discussed:

- The total amount in cash or otherwise;
- received by or accrued to, or in favour of, a person;
- from anywhere, in the case of a person who is a resident;
- from a South African source (or deemed source), in the case of a non-resident;
- other than receipts or accruals of a capital nature.

The definition of gross income does not define 'income'; it simply stipulates what will fall within its ambit.

## **4.2 OUTSTANDING FINDINGS RELATED TO THE RESEARCH OBJECTIVES**

### **4.2.1 Findings: Research objective one**

The various components within the definition of gross income are not defined, as discussed throughout the treatise. However, the various tax cases that have been referred to have attempted to make the definition clearer.

#### 4.2.2 Findings: Research objective two

As previously discussed, there is no definition for the words 'receipts and accruals of a capital nature' which first appeared in the 1917 Income Tax Act.

Various tests are therefore applied in order to determine whether a receipt or an accrual is of a capital or income nature.

This was clearly stated in *CIR v Pick 'n Pay Employee Share Purchase Trust*, where Smallberger JA held that:<sup>101</sup>

'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.'

The most consistently applied test used by the court when determining whether receipts or accruals are of a capital nature is the inquiry whether a taxpayer was engaged in a scheme of profit-making. The test of determining whether the taxpayer's actions were engaged in a scheme of profit-making is mainly concerned with the object, aim and actual purpose of the taxpayer and not what might have been contemplated.

<sup>101</sup> 1992 AD, 54 SATC 271at 279.

The supreme test is always the intention and motive of the taxpayer. Other factors which are taken into consideration in ascertaining the intention of the taxpayer but are not decisive, include the acquisition of assets, change of intention, mixed and alternative intentions, period for which asset is held, continuity, reason for the receipt, legal nature of the receipt and nature of the asset disposed of.

**Findings: Research objective three and four**

The judgements laid down by the courts in the various cases regarding the components of the gross income definition, has made the meaning of the definition clearer.

It was found that the court's interpretation in *CIR v Delfos*<sup>102</sup>, did not agree with the wording within the Act. The wording of the Act stated that an amount may be included in the taxpayer's gross income either when it is received, or when it accrues. However, it was found from the *Delfos* case that the Commissioner may not include the amount when in both accrues, and when it was received as this would

<sup>102</sup> 1933 AD 242, 6 SATC 92.

lead to double taxation. This was the exact opposite in *SIR v Silverglen Investments (Pty) Ltd*<sup>103</sup>, where the Commissioner did not have a choice to include the amount either when it is received, or when it accrues.

The above cases provide an illustration that the facts of each case are different and may be unique to a certain situation. The court bases its decision on the facts of each particular case but at the same time taking into consideration the judgements made in similar cases.

It would therefore be difficult to make the definition of gross income any easier as each case has different facts to the next case.

<sup>103</sup> 1969 (1) SA 365 (A), 30 SATC 199.

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