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A study of the fiscal effects of financial discounting transuctions including zero coupon bonds in South Africa and the United Kingdom

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1 INTRODUCTION

This thesis examines the tax treatment in South Africa of financial discounting transactions. The examination covers the law up to and including 28 February 1997. In view of the fact that in South Africa there was, until recently, very little specific legislation dealing with the taxation of discounting transactions, reference is made to the position in the United Kingdom for comparative purposes. The purpose of this thesis is to examine the South African law relating to the taxation of financial discounting transactions in order to obtain a better understanding of the law. Reference is made to the position in the United Kingdom in order to elucidate this understanding.

There are a number of different types of instruments used in discounting transactions. These fall into two broad categories, namely, straight debt instruments and deep discount bonds.

Straight debt instruments include, for example, post-dated promissory notes, bonds with warrants, certificates of deposits, commercial paper, medium-term loans and floating rate notes.[1] Interest is normally payable on the face value of these types of instruments and these instruments are often issued at a discount on their face value.[2] It is beyond the scope of this thesis to examine the tax treatment of interest payable on these instruments and to examine the different types of instruments. There is an examination of the income tax treatment of

An examination of the tax position in the United Kingdom involves a review of the taxation of straight debt instruments, deep discount bonds, deep gain securities and convertible securities. A discount is treated in the United Kingdom as distinguishable from interest. It is necessary to consider the position of both the investor and the financial trader concerning the taxation of the proceeds of discounting transactions as well as the deductibility of expenses arising from these types of transactions. The legislation dealing with the taxation of deep discount bonds, deep gain securities and convertible securities is examined. It is clear that the law relating to the taxation of these types of instruments has become unduly complicated and this has had the effect of inhibiting the development of new types of instruments. In addition there are certain inequities such as the fact that the issuer of a deep gain security will not be able to deduct his full expenses relating to the issue. Thus changes to the law have been proposed and have been published in the Finance Act of 1996. Essentially, it is proposed that discounting transactions are taxed on an accruals basis.

The final conclusion contains an overview of discounting transactions and their tax effect in South Africa and the United Kingdom. Reference is made to some of the important aspects of legislation affecting the taxation of these types of transactions. There is also brief reference to the financial aspects of discounting transactions, particularly zero coupon bonds.

This is followed by a review of the other requirements of the general deduction formula In this regard, reference is made to the fact that expenditure should have been incurred in the production of income and should not be of a capital nature The law relating to these issues is examined Thereafter, there is a review of the meaning of trade This includes reference to the wholly and exclusive requirement, which has now fallen away, the general applications of the carrying on of a trade and the issue of trading for fiscal advantage

The application of s 22 is discussed The trading stock provisions are important in bringing stock to account, as are the provisions of s 24J and their application to trading stock In this regard, it should be noted that only a company may be taxed in terms of s 24J as a financial trader A financial trader will only be taxed on its trading profits from discounting transactions when the stock is sold or redeemed This is a distinct benefit In considering these issues, it is important to understand the financial aspects of the pricing of bonds, particularly zero coupon bonds

The chapters on the taxation of discounting transactions in the United Kingdom cover the taxing of the profits from such transactions and the deductibility of discounting expenses incurred by the issuer

employment of capital test In practice, the supply of credit test is likely to be applied The source of the discounting profit resulting from the negotiation of a post-dated bill, note or bond will be the employment of capital test

There is a discussion on the nature of a discounting profit The profit on the sale of certain types of short-term credit instruments, such as banker's acceptances, will generally be of a revenue nature On the other hand, it may be arguable that the discounting profit made on the realization of certain long-term bonds, such as Eskom stock, may be of a capital nature in certain circumstances

The deductibility of discounting expenditure and the relevant provisions of the Income Tax Act 58 of 1962, including the provisions of the general deduction formula, are examined There is a detailed discussion of the incurral of expenditure It is submitted that discounting expenditure should be incurred when the instrument is issued The decisions of the Special Court on this issue are discussed The decisions were conflicting Thereafter s 24J was enacted which has the effect of allowing the issuer to deduct the expenditure annually on the yield to maturity basis It is possible for the issuer to apply an alternative method of valuing the incurral of the expenses

original issue discount should have accrued to the holder of the instrument at its maturity However, in an Appellate Division decision it was held that 'accrue' means 'to become entitled to' The effect of this decision was that in the case of an original issue discount, the discounting profits accrued to the holder when the instrument was issued The court held that the debt should be valued at its present value This was changed with an amendment to the Income Tax Act Section 24J has the effect of taxing discounting profits on an accruals basis The basis for determining the annual accruals is the yield to maturity The new rules relating to accruals apply to income instruments in the case of non-corporate holders and instruments in the case of corporate holders Income instruments do not include short-term investments of less than a year such as savings accounts, call accounts and short-term fixed deposits Taxpayers may elect to apply an acceptable alternative method of reflecting the annual accrual of interest It is submitted that there should be more clarity regarding acceptable alternative methods An examination of the financial effects of applying the yield to maturity basis of valuation to zero coupon bonds indicates that the taxation of these securities prior to maturity has an adverse effect on the after-tax returns when compared to conventional coupon bonds

The source of a discounting profit and the relevant case law are examined in detail It is concluded that the source of a discounting profit arising from an original issue discount should be determined by using the

SUMMARY

In this thesis there is an examination of discounting transactions in South Africa and the United Kingdom. Two basic types of discounting transactions are discussed. The first is where a post-dated bill, note or bond is issued at a discount on its face value. The second is where a bill, note or bond is subsequently negotiated by its holder.

The thesis commences with a discussion on the nature of a discount. After an examination of the relevant cases it is concluded that an original issue discount is, in substance, a loan. The discounting profit arising from such an issue would, therefore, be regarded as akin to interest. The subsequent negotiation of a bill, note or bond will be treated as a purchase or sale and the discounting profit on such a transaction will not be regarded as interest.

The various aspects of the definition of 'gross income' in s 1 of the Income Tax Act 58 of 1962 are examined in order to determine the income tax consequences of a discounting profit. There is a discussion of receipt or accrual. In addition there is an examination of the provisions of s 24J of the Income Tax Act in relation to the accrual of discounting profits. It is submitted that prior to the enactment of s 24J, the profits arising from an

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A study of the fiscal effects of financial discounting transactions including zero coupon bonds in South Africa and the United Kingdom

BY

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'The difference between "advancing", "lending money" and "discounting" is distinct and palpable "Discounting" is purchasing, not lending The discounter whether of a bill or bond, or any other security, becomes the owner If the thing bought turns out when realised to be of less value than the price paid for it, the loss falls upon the purchaser or discounter If a profit or gain is made upon the transaction, it belongs wholly and exclusively to the discounter or purchaser'

The court in De Villiers took Vice-Chancellor Bacon's comments further by comparing discounting with a loan As has been stated, a discounter becomes the owner of the note and he can deal with it in any manner that he wishes However, if the transaction was one of a loan of money against security of a bill or note, the discounter would not be able to deal with the instrument as he wished Accordingly, the court held that the discounting of the note was not in substance a loan of money The case is thus clear authority that, in the case of a genuine discounting, the relationship between the discounter of a promissory note and the person selling it for payment is one of purchaser and seller and not lender and borrower"

In Moser v Meiring[10] the defendant made a promissory note in favour of one Humphreys The note was an accommodation note Humphreys then discounted the note with the plaintiff The plaintiff successfully sued on the note One of the defences raised by the defendant was that there was a loan of

d 30

Consideration = R1 000 000 - [R1 000 000 x (8,5/100) x (30/365)]

= R993 013,80

2.3 CASE LAW ON THE MEANING OF DISCOUNTING

The courts have considered the meaning of discount profits in the context of the Usury Act 23 of 1908 which was superseded by the Usury Act 37 of 1926 and the Usury Act 73 of 1968 as amended

In De Villiers v Rous,[7] the court considered whether the discounting of a note took place under circumstances which were substantially those of moneylending The defendant in this case was the maker of a promissory note in favour of Coates The note was endorsed and discounted by Coates with the plaintiff The defendant denied that the plaintiff was the bona fide holder for value of the note and that the plaintiff's acquisition of the note was tainted with fraud The plaintiff claimed and the court found that he had no knowledge of the underlying transaction between the defendant and Coates and that he had discounted the bill in the ordinary course of his business Thus, he was the bona fide holder of the note The court reviewed the early English authorities on the meaning of the discounting of a bill of exchange and found that the judges referred to the transaction as one of purchase Of particular relevance is a passage from the judgment of Vice-Chancellor Bacon in London Financial Association v Kelk "

[(8,1/100) x 1 000 000]

R24 424,65

If the cost were to be quoted as an accrual discount rate, it would be calculated as follows

(24 424,65/1 000 000) x (365/90) x 100 = 9,906%

A banker's acceptance may be negotiated in the secondary market. If it is payable to bearer, it is transferable by delivery. If it is payable to order, it is transferable by endorsement in blank by the holder and completed by delivery. A person purchasing a banker's acceptance acquires it at a discount on its face value and will normally make a profit on its sale or redemption.[6]

The consideration payable is calculated as follows

Consideration = $N - [Nx (^{i}/100) x (^{d}/365)]$

Where N = nominal amount

i = percentage discount rate per annum

d = outstanding days

Thus, assume

N R1 000 000

i 8,5

and Land Bank bills ' The operation of such instruments may be illustrated by considering a banker's acceptance

A banker's acceptance is an unconditional order in writing addressed by a drawer to a bank which is the drawee The bank signs the bill and thereby becomes the acceptor In terms of the bill the bank is required to pay at a fixed or determinable future time a sum certain in money to, or to the order of, the drawer A banker's acceptance is issued in order to enable the drawer to obtain short-term finance Thus, the drawer endorses the banker's acceptance in blank so that it is made payable to bearer Normally, it is discounted in the market by the bank The net proceeds from the sale of the banker's acceptance are paid to the drawer The accepting bank is required to pay the bill at maturity and, at the outset, requires the drawer to comply with certain terms and conditions One of these terms is that the drawer will place the bank in funds when the bill matures '

The cost of issuing a banker's acceptance is illustrated by the example set out below

Nominal value	R1 000 000
Discount rate	8,00% per annum
Period of bill	90 days
Bank charges	1,5% per annum of nominal value
Stamp duty	10 cents for every R100
Cost	[R1 000 000 x (90/365) x (1,5+8,0)/100] +

In these circumstances, the maturity value is calculated as follows

MV = R1 000 000 x [1+(^{365}/365) x (^{11}/100)]

= R1 110 000

When the interest on an NCD is payable at maturity, the proceeds on sale will vary depending upon the yield at the time of sale. The yield may be greater or less than the stipulated interest, depending upon fluctuations in the interest rate and the period to maturity. The sale proceeds are determined by the following formula

Proceeds = MV/[(1+^{d}/365) x ^{i}/100]

Where

MV = maturity value

d = number of days outstanding

i = required percentage yield per annum

Thus, assume the following

MV = R1 110 000

d = 100

i = 10

Proceeds = R1 110 000/[1+(^{100}/365) x (^{10}/100)]

R1 080 400

Short-term credit instruments include, for example, banker's acceptances, trade bills, promissory notes, treasury bills, capital project bills, bridging bonds

The details concerning the issue and negotiation of these types of bonds can be illustrated by examining a negotiable certificate of deposit, or NCD in its abbreviated form An NCD is a fixed deposit receipt issued by a bank or building society and may be negotiated in the secondary market which exists for NCDs ' It constitutes an undertaking by the issuing institution to pay the amount of the deposit to the holder of the certificate on maturity date In addition, the institution undertakes to pay interest at a specified annual rate and at specified dates Thus an NCD issued for a period in excess of one year may specify that interest is payable six monthly in arrears NCDs are normally issued in bearer form, in which event they are transferable by delivery alone

The maturity value of an NCD is determined by the following formula -

MV = I x [1+(d/365) x (r/100)]

Where

MV = maturity value

I = amount invested

D = number of days

r = percentage rate of interest per annum

Thus, if one takes a very simple example, assume the following

I = k1 000 000

d = 365

r = 11

2.2 DISCOUNTING

The discounting of a bill, note or bond may take place in a number of different circumstances

A deep discount bond bearing no interest may be issued at a substantial discount on its face value. The redemption date is normally a number of years after the date of issue. The person who acquires the bond will receive no income in respect of the instrument prior to its sale or redemption. When the holder of the instrument sells or redeems it, the proceeds on sale or redemption will generally exceed the cost of acquiring it.[1] It is this profit which is referred to as a discount profit

A long-term interest bearing bond may be acquired at a discount on its face value. The bond is normally issued at its face value and bears a fixed rate of interest. The capital value of the bond may vary, depending upon prevailing interest rates in the money market. If the capital value decreases and the bond is sold, the person acquiring it will normally do so at a discount on its face value.[2]

Examples of long-term bonds are long-term Government stock, municipal stock, stock issued by public corporations such as Eskom and stock issued by public utilities such as the Post Office, negotiable certificates of deposit, South African Reserve Bank debentures and Land Bank debentures

2 NATURE OF A DISCOUNT

2.1 INTRODUCTION

An examination of the nature of a discount is essential to an understanding of the taxation of discounting transactions in South African law. The reason for this is that the nature of a discount affects its tax treatment. If a discount is regarded as a loan, the taxation consequences of discounting will be different from those where a discount is regarded as the purchase and sale of a financial instrument.

Accordingly, this chapter deals with the nature of a discount in South Africa. Various types of discounting transactions and financial instruments are discussed. This is followed by an examination of the case law on the meaning of discounting. The principles arising from these cases are analysed in order to determine the meaning of discount.

FOOTNOTES

1 See H B Falkena L J Fouri. & W J Kok The Mechanics of the South African Financial System 2 ed (1986) at 202

2 See Falkena, Fourie & Kok at 194-236

3 See sch 9 and s 36 of the Finance Act of 1984 and sch 11 and s 46 of the Finance Act of 1985

4 58 of 1962

the meaning of receipt or accrual in the context of discounting transactions, the nature of the proceeds, particularly the issue whether the proceeds are of a capital or revenue nature as well as the South African rules of source that are applicable to discounting transactions. Section 24J of the Income Tax Act was recently promulgated. It contains important changes to the taxation of discounting transactions. These changes will be examined in detail. For comparative purposes there is an examination of the treatment of profits and gains arising out of discounting transactions in the United Kingdom.

The other aspect of discounting transactions which is discussed is the deductibility of expenditure incurred in such transactions. This involves an examination of the general deduction formula contained in ss 11(*a*), 11(*h*) and 23(*g*) of the Income Tax Act and the effect of the trading stock provision contained in s 22 of the Income Tax Act. In examining these provisions, particular attention is paid to the requirement that in order to be deductible, the expenditure must be incurred for the purposes of a taxpayer's trade. The approach of the South African courts to this question is discussed. In order to analyse the approach of the South African courts, it is necessary to refer extensively to authorities in the United Kingdom. There is a detailed discussion of the provisions of s 24J insofar as they affect the deductibility of discounting expenses. Finally there is discussion on the tax treatment in the United Kingdom of the deduction of expenditure incurred in discounting transactions.

Considering these types of transactions, there are two main aspects that require examination

First is the question whether any proceeds are taxable In the case of a financial instrument such as a promissory note being issued at a discount, the person to whom the instrument is issued will receive its face value at maturity When a financial instrument is acquired at a discount on its face value and is subsequently sold, the seller of the instrument will make a profit on its sale In both types of transactions the issue is whether the net proceeds on sale or redemption of the instrument are taxable, and at what stage the proceeds are taxable

Second, is the question whether any expenditure incurred in the production of income is deductible, and, if so, at what stage it is deductible If an instrument such as a promissory note is issued at a discount on its face value, the issuer will be obliged to pay its face value to the holder on maturity The original issue discount will constitute an expense incurred by the issuer In the case of an instrument purchased for resale, its cost price will be expenditure incurred by the holder

In order to examine the first aspect, namely, whether any discounting receipts are taxable, it is necessary to examine the definition of gross income in s 1 of the Income Tax Act [1] Thus there is full discussion on the nature of a discount,

the parties involved in issuing these types of instruments at a discount and their subsequent trading. The principles discussed apply to the different types of instruments.

There is no formal definition of a deep discount bond in South African law. Such bonds are specifically defined in United Kingdom legislation which has been enacted to deal with the taxation of transactions relating to such bonds.[3] Essentially, a deep discount bond is a form of a post-dated promissory note that has been issued at a discount which is equal to or greater than a stipulated discount rate.

Having regard to the various types of financial instruments relating to discounting, there are two basic types of discounting transactions that are examined.

The first is that in which a person issues a post-dated instrument such as a promissory note at a discount on its face value. The person to whom it is issued holds the instrument until its maturity date. The holder redeems the instrument on due date and is paid the face value by the issuer or maker of the instrument.

The second transaction involves a person acquiring a financial instrument such as a promissory note at a discount on its face value. He subsequently disposes of it at a profit.

65. W B Riley & A H Montgomery 'The Tax Reform Act of 1984 and Market Discount Bonds' (1986) 39 (1) National Tax Journal 79 See also Fletcher v Bank of the United States 104 US 271 (1881) Changes were effected as a result of the Deficit Reduction Act of 1984

21 For a full discussion of these issues, see J D Falconbridge Banking and Bills of Exchange 6 ed (1956) at 120-3, M Megrah & F R Ryder Paget's Law of Banking 8 ed (1972) at 508-9

22 See Falkena, Fourie & Kok at 203-7

23 ibid. DV Cowan & L Gerring Cowan The Law of Negotiable Instruments in South Africa 5 ed I (1985) at 170-87 A 'liquid asset' is defined in s1(1) of the Banks Act 9 of 1993 A liquid bill is one in which the underlying transaction is self-liquidating This type of bill includes a bill to finance a trading transaction connected with the movement of goods Non-liquid bills are generally those drawn for accommodation finance

24 ITC 1587 (1995) 57 SATC 97 at 102-3, ITC 1588 (1995) 57 SATC 148

11 See P Gane The Selected Voet being the Commentary on the Pandects (Paris Edition of 1829) by Johannes Voet (1647 - 1713) and the Supplement to that Work by Johannes Van Der Linden (1756 - 1835) Vol 2 Durban Butterworth & Co (Africa) Ltd 1955 at 12 1 1

12 1916 CPD 295

13 1931 OPD 74

14 1962 (2) SA 58 (W) See also New York Shipping Co Ltd v EMMI Equipment Ltd 1968 (1) SA 355 (SWA) and Engar & others v Omar Salem Esaa Trust 1970 (1) SA 77 (N)

15 Tucker v Ginsberg at 62

16 at 58-60

17 at 65

18 at 63

19 This is terminology used to indicate the earning of discount to maturity from an original issue It also includes the sale of the bill prior to maturity

20 See Deputy v Du Pont 60 SCt 363 (1939), United States v Midland-Ross Corporation 381 US 54 (1965), M Anak, L Goodman and A Silver 'Premium and discount securities relative tax advantage under the Deficit Reduction Act of 1984' (1986) 39 (1) National Tax Journal

FOOTNOTES

1 See F R Malan assisted by C R de Beer Bills of Exchange, Cheques and Promissory Notes in South African Law (1983) at 4

2 See Malan at 152. H B Falkena, L J Fourie & W J Kok The Mechanics of the South African Financial System 2 ed (1986) at 211-29

3 See Falkena, Fourie & Kok at 229-32 The learned authors explain at 229-31 the distinction between primary and secondary markets The primary market is the market for the new issues of securities The secondary market is the market for the exchange of previously issued financial securities

4 See Malan at 4

5 See Falkena, Fourie & Kok at 203-7

6 See Falkena, Fourie & Kok at 203-4

7 1916 CPD 295

8 (1879) 26 LR 107 (Ch D)

9 See Benjamin v Downes 1928 PDL 311 at 314

10 1931 OPD 74

2.5 CONCLUSION

Where A issues a note to B at a discount on its face value, the transaction is, in substance, one of loan. Thus B is treated as having lent A the consideration paid by him. When the note is redeemed by A at the maturity date, B receives its face value. The difference between the consideration paid by B for the note and its face value is treated as interest.

On the other hand, where B negotiates the bill or note to C, the transaction between B and C is treated as one of purchase and sale. Thus, any profit made by C where he either resells or redeems the bill or note is treated as a profit arising from the disposal of the bill or note and not interest.

It therefore follows that the discounting of an NCD in the secondary market constitutes a purchase and sale. The issuing of a banker's acceptance being a non-liquid bill is a form of accommodation finance involving the drawer and the accepting bank. The initial negotiation of the banker's acceptance by the drawer to the discount house is a transaction of loan. Subsequent negotiations of the bill constitute transactions of purchase and sale. In the case of a deep discount bond, the issue of the bond is a loan whilst subsequent negotiations of the bond are purchases and sales. This approach has been adopted in two recent special court cases.[4]

accepting bank in the case of a non-liquid bill is a form of accommodation finance.[4] The drawer is securing the accommodation signature of the accepting bank to the bill.

Assume A draws a banker's acceptance and the bank, B, accepts it. It is then negotiated to C, normally a discount house, which then sells it to D. B, on behalf of A, receives the face value of the bill less the issue costs from C. The transaction between A and C is one of loan. If C were to hold the bill to maturity it would be paid the face value of the bill by B who would recover the funds from A. The negotiation of the bill from C to D would constitute a purchase and sale.

A deep discount bond bearing no interest is generally issued at a discount on its face value. Its redemption date is normally a number of years after its date of issue. Where A issues a deep discount bond to B who holds it until maturity, the transaction is, in effect, a loan by B to A of the purchase consideration of the bond. The reason for this is that as the principals involved, namely A and B, are aware that the underlying transaction is a loan, on the authority of Tucker the transaction would be treated as a loan. However, if B is a financial institution and negotiates the bond to C, the transaction between B and C is one of sale.

is one of purchase and sale This would apply where the payee subsequently endorses the note to a third party In this situation the transaction could be regarded as one of purchase and sale

The second transaction in the above example involves B's negotiating the bill which he acquires for R85 to C for R92 The third transaction takes effect at the maturity date when C presents the bill for payment and receives R100 from A There is no difference in principle between these two transactions as far as their nature is concerned

A discounting of this nature is, in effect, a sale of a claim against a third party There is an implied guarantee by the seller that payment of the claim will be made at the maturity date Where money is lent to a person, the borrower is obliged to repay the capital on the basis agreed upon with the lender If property is transferred to the lender as security for the loan, the borrower is entitled to reclaim the property once the capital and outstanding interest have been paid by him Where B acquires a bill for R85 and sells it to C for R92, C is not entitled to claim repayment ..om B of the R92 paid by him If the bill is dishonoured when C presents it for payment at the maturity date then C, as holder in due course, will have a claim for R100 against the maker He will also have a claim for damages against B His claim against B will be similar to a claim for breach of warranty and will not be a claim for the repayment of a loan Whilst the bill is held by C, he is the owner of it B will not have any right to redeem it Any profit or loss made by C in respect of the bill is for his

issues a note for R100 and negotiates it to B for R85 the transaction is, in substance, a loan by B to A of R85. Effectively, a distinction is drawn between the issue of a note at a discount and the subsequent discounting of an existing bill or note. This approach is similar to that which was adopted in the past in the United States where it was held that so-called earned original issue discount[17] served the same function as interest, namely, compensation for the use of money.[18]

On the other hand, it could be argued that, on the authority of London Financial Association and De Villiers, the transaction is one of purchase and sale. The reason is that the person acquiring the bill or note becomes the owner of it. He can deal with it as he wishes. Any profit or loss on the sale of the bill or note will be for his own account. If the contract was a loan with the bill or note being issued as security for it, the acquirer would not be entitled to deal with the bill or note as he wished.

There is no clear authority for either argument. It is, however, submitted that where A issues a post-dated promissory note and negotiates it to B, B is aware that the underlying transaction between them is one of loan. B is advancing money to A, who is issuing a note to him. On the authority of Tucker, the substance of the transaction is one of loan and the transaction should be treated as a loan. Thus, if A issues a bill to B at a discount on its face value, the relationship between the parties is that of borrower and lender. The reasoning of De Villiers can only apply where the substance of the transaction

The South African cases on discounting do not specifically deal with this question In De Villiers and Moser the courts considered a situation similar to that of C in the above example In both these cases the plaintiffs had acquired bills at a discount and had presented them to the makers for payment

The position in Tucker is not so clear The initial set of bills constituted accommodation bills Thereafter they were replaced by promissory notes In addition, the plaintiff discounted a further promissory note for the defendant Clearly the making of the initial promissory notes by the defendant and the making of a further promissory note by the defendant and the discounting of it with the plaintiff constitute transactions which equate with those between A and B in the above example As far as the accommodation bills are concerned, if one were to equate the facts of the case with the above example, the position would be similar to A's securing the accommodation signature of a third party to a bill and then negotiating it to B who would have knowledge of the accommodation The court found, on a balance of probabilities, that B had lent A money The court thus found that, whilst there is a clear distinction between the discounting of a bill and the lending of money on the security of it, one should have regard to the substance of the transaction between the parties In this particular case the court held that, in substance, the transactions between the parties were probably those of moneylending

It could therefore be argued, on the authority of Tucker, that one should have regard to the substance of the transaction between the parties Thus, where A

2.4 MEANING OF DISCOUNTING

There are a number of situations of which one must take account when considering the meaning of discounting. In order to examine each situation, it is appropriate to consider an example. Assume A issues a note with a face value of R100 and a due date of 365 days later. B purchases the note from A for R85. B subsequently sells the note to C for R92. C holds the note until due date when he presents it for payment and receives R100 from A.

The first transaction involves A in issuing the note for R100 and negotiating it to B for R85. B has the option of holding the note until maturity or of negotiating it to C prior to maturity. Where B negotiates the note to C, the transaction is, in principle, similar to a banker's acceptance. B is fulfilling a role similar to that of an accepting bank. The difference is that, in the example, when B negotiates the note, the holder in due course will have a right of recourse in the first instance against A. Thereafter he will have a right of recourse against B as an endorser of the note. In the case of a banker's acceptance the accepting bank is normally required to pay the bill at maturity.

The question arises whether the transaction between A and B in the example is one of purchase and sale or loan. The issue would be of particular relevance were B to hold the note until maturity and present it to A for payment on due date.

The court examined the position of an accommodation bill. Where A secures the accommodation signature of B to a note for R100 payable to A after 90 days and A endorses the note to C for R90, then effectively the transaction is a loan by C to A. If C is aware of the accommodation and that A is the principal debtor, the discount may be regarded as a loan by C to A.[18]

The importance of the decision in Tucker can be summarised thus.

(i) It confirmed the decision of the courts in De Villiers and Moser. The court accepted that there was a clear distinction between discounting and lending. It should be noted that in drawing this distinction, and in giving examples, the court referred mainly to one type of discounting, namely, the negotiation of a bill by a holder at a discount on its face value. It did not specifically refer to the situation of the maker of the bill or note.

(ii) The court emphasised the importance of determining the substance of a transaction when deciding whether it is one of discounting or loan. This is clear from the court's analysis of the position of an accommodation bill. In the example given above, where A has secured the accommodation signature of B to a note and then endorses the note to C, the transaction is one of loan where C is aware of the accommodation.

In Tucker the court made the point that the object of both discounting a bill and lending money on the security of it is the same. The object is to provide the one party with ready money. However, the nature of the two transactions is fundamentally different.[15]

The facts of the case were fairly complicated. The defendant arranged for certain promissory notes to be drawn by a company in which he was interested. They were probably drawn in favour of one of the endorsers and subsequently endorsed by a number of persons. In each case the defendant was the last endorser and the notes were discounted by the plaintiff. In all cases but one the proceeds of the discounting transaction were paid to the defendant. In effect the defendant argued that the notes were all made and endorsed to accommodate him as he wished to raise money by doing so. He argued further that the plaintiff was aware of this fact and that the transaction was one of loan. When the promissory notes fell due for payment they were not met. The notes were renewed from time to time and the defendant paid the interest for the extension of time for payment. There was a period when the notes remained unpaid and unrenewed. Thereafter the defendant's indebtedness was replaced with further promissory notes. During this time the plaintiff discounted a further promissory note for the defendant. The notes were then renewed further and certain of them were paid by the defendant.[16] The court found, inter alia, that the probabilities favoured the defendant's succeeding in proving that the transactions were, in substance, moneylending transactions.[17]

money as between the plaintiff and Humphreys, and that the loan did not comply with certain requirements laid down in the Usury Act. The court found that there was no loan between the plaintiff and Humphreys. However, the court adopted a different approach to the distinction between discounting and lending. A mutuum or loan for consumption is a contract by which a fungible is delivered to another person who is obliged to return a thing of the same kind, quality and quantity.[11]

Thus in a contract of loan a sum of money is delivered to a person who undertakes to repay an equal sum. Where a payee of a promissory note discounts it for value to another person, the holder of the note will look to the maker for payment when the note is presented for payment. If there is no agreement between the payee and the holder in terms of which the holder will repay the sum received by him, the transaction is not a loan. If the holder recovers the amount due in terms of the note from the maker, the note will come to an end. The court thus held that an endorsement of a note is a sale of a debt with a warranty that the debt will be paid by the debtor. The court concluded, accordingly, that the discounting of a promissory note is not a mutuum or loan of money. It may happen that the transaction underlying the discounting is really a loan in which event the situation will be different.

The decisions of De Villiers[12] and Moser[13] were confirmed in Tucker v Ginsberg.[14]

the question of double taxation are open to criticism The approach of Stratford and Beyers JJA certainly has merit

In Isaac v CIR[91] the Appellate Division considered the question whether a person could be liable for super tax twice on the same income Watermeyer CJ stated

> 'I think, bearing in mind that an income tax is fundamentally a tax upon a person's annual profits or gains, that the Income Tax Act should not be read as imposing normal tax or super tax upon a taxpayer twice in respect of the same profits or gains unless the language of the Statute makes it clear that such a result was intended '[92]

He then went on to state that underlying the views expressed by the majority of the members of the court in Delfos was a recognition of this principle[93] Whilst it must be accepted that this principle is part of South African law, the views of the majority of the members of the court in Delfos are open to criticism

The use of the words 'received by or accrued to' in the definition of gross income in s 1 of the Income Tax Act (at that time) is plain The principle enunciated by Watermeyer CJ applies -

'There is, however, a "necessary implication" that the same amount shall not be taxed twice in the hands of the same taxpayer '[39]

This statement is open to possible criticism on the grounds that it is contradictory The criticism could be based on the fact that, if on a literal interpretation of the Income Tax Act, a taxpayer should be taxed twice, it should not be possible to state that the same statute contains an implication that a taxpayer should not be taxed twice [40] However, it would appear that the learned judge was merely discussing the difficulty of interpreting the words in question and the approach that should be adopted Such criticism would therefore appear to misconstrue the approach adopted by the learned judge

The approach of Stratford JA was that if one regarded receipts as an independent basis of taxation, such an interpretation would inevitably result in double taxation In the circumstances, he advocated a restrictive interpretation of the word 'received' whereby it was limited to receipts, which accrued in the year in question [41] Beyers JA also considered that there should be a correlation between receipts and accruals [42]

The approach to the issue of double taxation by Wessels CJ and Curlewis and De Villiers JJA was not uniform Although their decisions on the main issue before the court constituted its majority decision, their approaches to

In Delfos, Wessels CJ recognized the possibility of double taxation, but stated

> 'I do not think that we should make of double taxation a bogbear and alter the plain language of the Legislature to avoid the mere fear of double taxation "If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be," even if it should involve a case of possible double taxation It may well be that if it was sought to tax the taxpayer "twice over in a particular case it may be possible to invoke equitable principles in order to avoid double taxation '[46]

It is not clear how equitable principles could be invoked in order to avoid double taxation Curlewis JA adopted a different approach

> 'Nor can I find any substance in the fear of double taxation if "gross income" be given the meaning which is assigned to it by sec 7(1), not if the Act is administered in a reasonable and practical manner I cannot conceive that any difficulty can arise in regard to double taxation which could not be obviated in practice '[47]

It is difficult to understand how one can, in practice, avoid legal consequences laid out in the Income Tax Act [48] De Villiers JA stated that

Silverglen and that, if an inference is to be drawn, it is only that the same amount cannot be taxed twice and not that receipts are not taxable [42] It is respectfully considered that Silverglen found that as a general rule the Commissioner cannot postpone the assessment of disclosed accruals to a subsequent tax year to tax them as receipts in that subsequent tax year.

It is interesting to note that, prior to Silverglen the Cape Provincial Division considered the Commissioner's right to tax a receipt in Marais v CIR [43] The facts of the case were that the taxpayer, by arrangement with the Commissioner, returned his income and was assessed to tax on a receipts basis During the year of assessment in question, the taxpayer successfully embarked upon a campaign to collect outstanding fees However, by this time the taxpayer's taxable income was subject to excess profits duty as well as normal and super tax He therefore argued that his receipts related to prior year accruals and that the taxpayer's assessments for the previous years should be re-opened in order correctly to reflect the accrual of these outstanding fees for each year in which they had been earned [44] The court considered itself bound by the majority decision in Delfos It stated that the receipts in question fall within the definition of gross income as applied to the relevant year of assessment This was the case irrespective of the date or dates upon which the amounts originally accrued [45]

In considering the validity of the receipts basis of taxation, it is appropriate to examine the approach of the courts to the possibility of double taxation

O'Donovan did not consider that there could be circumstances in which a taxpayer could obtain a receipt prior to an accrual. Generally, the receipt either coincides with or is preceded by an accrual.[46] On the basis of these arguments, O'Donovan submits that it is not possible under the Income Tax Act to tax receipts independently of accruals.[47]

As far as O'Donovan's submission that receipts do not form a separate basis of taxation is concerned, Meyerowitz[48] considers that it reads more into Silverglen than exists and that it contradicts the ratio decidendi of Delfos.[49] It is submitted, with respect, that Meyerowitz's criticism of O'Donovan's proposition is valid. In Delfos the court was unanimous in its view that between 1923 and 1929 the full salary payable to the taxpayer accrued to him in each of the years under consideration. The portion of salary that was not paid to him in each of these years was written off as a bad debt. The majority found that the payment by the company was a windfall and constituted a receipt in 1930. Thus recognition was given to the fact that it is possible to tax receipts separately from accruals.

O'Donovan's further submission that if accruals have been disclosed in a taxpayer's return of income in the year of accrual, they cannot be taxed in the subsequent year of receipt, has also been criticized by Meyerowitz.[50] Meyerowitz[51] indicates that this proposition is not expressly stated in Silverglen. He states that, at best, this can merely be inferred from

3.4 VALIDITY OF THE RECEIPTS BASIS

The question arises whether the case law interpreting the words 'received by or accrued to' in the definition of gross income has eliminated 'receipts' as an independent basis of computing gross income.

In a discussion of Silverglen,[41] O'Donovan states that, as a general rule, accruals must be included in gross income in the year of assessment of the accrual.[42] Where an accrual has been disclosed in a taxpayer's return of income, the Commissioner is obliged to take it into account in that year of assessment. He may not tax it in a subsequent year of assessment.[43]

O'Donovan submits that the decision in Silverglen sets aside the possibility of receipts and accruals being utilized as alternative bases of taxation.[44] He argues that there is no provision in the Income Tax Act that authorizes the Commissioner to tax on a receipts only basis. He argues further that there is no provision in the Income Tax Act that enables the Commissioner to elect to tax a taxpayer in the year of receipt in circumstances in which the taxpayer has failed in a prior year of assessment to disclose the accrual.[45]

It therefore follows that the meaning of 'received' does not include stolen money, because theft does not bestow upon the thief the right to the stolen goods.[22] When a person borrows an asset, it cannot be said that he has received it for the purposes of the definition of gross income, because he is obliged to return it in specie to its owner.[23] At no stage does he become the owner of the assets.[24] Likewise, where a person borrows a sum of money he will not be regarded, for the purposes of the definition of gross income, as having received the money.[25] The reason is that, although he does become the owner of the money, he is obliged to repay a similar amount.[26] It has thus been held that it does not accord with ordinary usage to treat borrowed moneys as a receipt within the meaning of gross income.[27]

If an agent receives money on behalf of his principal[28] or a usufructuary receives the proceeds from the sale of the assets that are subject to his right of usufruct,[29] it cannot be said that there has been a receipt falling within the definition of gross income. The reason is that, in order to constitute such a receipt, the money must have been received by the taxpayer for his own benefit.[30]

With regard to discounting, there is no ambiguity in the meaning of 'receipt' and it does not need to be specifically discussed.

Depending upon the meaning that one attributes to 'accrue', it is possible for the redemption or sale proceeds of a note to accrue at redemption or sale date or for the redemption proceeds to accrue when the holder acquires it [16] The proceeds can be received only on date of redemption or sale at the earliest [17] Thus, in a discounting transaction, a receipt prior to accrual is not possible

3 3 RECEIPT

The ordinary meaning of the word 'to receive' is

> 'To take into one's hand, or into one's possession (something held out or offered by another), to take delivery of (a thing) from another for oneself or for a third party '[18]

As the word 'received' is used in the definition of gross income[19] and since this definition is the basis of the Income Tax Act, it is only in exceptional circumstances that the plainly expressed meaning of the words forming part of the definition can be modified [20]

Thus, apart from excluding from its meaning the taking of delivery f. third party, there is no reason to construe 'received' in the definition of gross income as having any but its ordinary meaning [21]

court postulated the possibility that where an accrual has not been disclosed in the return for the year of accrual, the Commissioner could, under s 76(2) of the Income Tax Act, forego the additional tax payable under that section and include it as gross income in the year of receipt. Alternatively, the Commissioner could assess on the basis of receipts only.[13]

Having established the general principle relating to amounts which have been received by or have accrued to a taxpayer, it is necessary to consider their application to discounting transactions.

The discounting of a security usually involves a person's acquiring a post-dated security such as a promissory note with a face value of, say, R100 at a discount of, say, R5.[14] He will thus acquire the note for R95. Should he hold it until redemption, he will receive the full face value of R100 when the security is redeemed. Should he sell it prior to redemption for, say, R97, he will be entitled to the sale proceeds at the time of the sale, and the new holder who has acquired the note for value will be entitled to the proceeds upon redemption.

The effect of this type of discounting transaction is that, in the context of the definition of gross income in the Income Tax Act,[15] the redemption or sale proceeds of a note will be received by or accrue to the holder who acquired the note at a discount.

The court had to decide whether the sum received in the 1930 year of assessment was taxable in that year, or whether it was taxable over the period from 1923 to 1929, when the full salary accrued to the taxpayer

The majority held that the sum was taxable in the 1930 year of assessment [6] Effectively, the majority decided that accrued amounts deducted as bad debts in previous years are taxable in the year in which they are paid to a taxpayer [7] Whilst accepting that there are two bases of tax, namely, receipts and accruals, the majority did not consider that there was a real danger of double taxation [8] The minority judges, on the other hand, considered that receipts should be limited to receipts accrued in the year of assessment [9]

In SIR v Silverglen Investments (Pty) Ltd [10] the court held that, when the dates of receipt and accrual fall into different years of assessment, the Commissioner does not have the right to select either one or the other year to tax the taxpayer The court made the point that the Income Tax Act required that both receipts and accruals should be disclosed in a taxpayer's return of income and are subject to tax, provided the conditions laid down in the definition of gross income are met [11] Failure to disclose receipts or accruals may result in the levying of penalties and additional tax The court held that these provisions clearly indicate that accruals must be taxed in the year of accrual and that the Commissioner has no right to postpone the assessment of disclosed accruals to a subsequent year of assessment [12] The

position that the issuer of the bond is liable to pay normal tax on the proceeds prior to receipt of the proceeds

3.2 RECEIPT OR ACCRUAL

The definition of gross income specifically refers to an amount which has been received by or has accrued to a taxpayer. The effect of this is that, as a general rule, liability for normal tax arises when there is either a receipt or an accrual.

Where an accrual occurs in a year of assessment prior to that of receipt, the Commissioner is obliged to tax the amount in the year of accrual.[4]

An important case on the meaning of receipt or accrual is CIR v Delfos.[5] The facts were, very briefly, that the taxpayer was entitled to a salary during the years 1923 to 1929. However, because the company that employed him was in a poor financial position, the full amount of his salary was not paid to him during these years. In each year he wrote off the outstanding salary as bad. Thus, over this period his taxable income did not include his outstanding salary. Although he had written off the outstanding salary as bad, the amount was credited to him in the company's books. The company paid the outstanding amount to him in the 1930 year of assessment, and he was assessed on this amount in the year of receipt.

3 RECEIPT OR ACCRUAL

3.1 INTRODUCTION

The definition of gross income in s 1 of the Income Tax Act 58 of 1962 includes the total amount, in cash or otherwise, received by or accrued to or in favour of any person during a year or period of assessment.[1] In this chapter there is an examination of the meaning of receipt and accrual in the context of the definition of gross income, and the application of this meaning to discounting transactions.

When a post-dated promissory note is issued at a discount on its face value, the redemption proceeds may accrue to the holder of the note either before or at the same time as the receipt. The meaning of accrual in discounting transactions is crucial when considering receipts and accruals in the context of the definition of gross income. This is particularly relevant in relation to deep discount bonds. There used to be uncertainty as to the meaning of accrue. One school of though was of the opinion that 'accrue' should mean 'due and payable', whilst the other school of thought considered that it should mean 'entitled to'. The Appellate Division has now held it to mean 'entitled to'.[2] The effect of this is that when a person issues a bond with a face value of R100 for R25 with a redemption date five years after the date of issue, the redemption proceeds of R100 will accrue to the holder of the bond only on the date that it is issued. This has created the unfortunate

W. he court's approach to this issue may have some merit, the fact is that the provision contained the words 'due and payable' This is more consistent with an interpretation of accrue as meaning due and payable

The court also referred to the reference by Stratford JA in Delfos to the provision in the Income Tax Act dealing with bad debts [15] The court dismissed the view of Stratford JA that a debt could only be considered bad when it had become payable [16] The court's approach to this issue is open to criticism First, the court gave no reason or authority for its holding that the view that Stratford JA adopted was unrealistic Second, under normal circumstances a creditor will only consider whether a debt is bad when it claims the debt This should be when the debt is payable [17]

Counsel for the taxpayer also argued that, if the Lategan principle were applied, debts due to the taxpayer would be subject to a deduction for bad or doubtful debts, whereas debts owing but not due would not be deductible [18] The court resolved the issue by attributing a different meaning to 'due' It held that 'due' in s 11(i) and (j) means 'owing' [19] With respect, simply to change the meaning of words in an Act to suit one's viewpoint is not the correct approach The cardinal rule of interpretation is that the literal meaning of the word must be applied [20] In s 7(1) 'due' clearly means 'due' and there should be no reason to interpret it as meaning 'owing'

The valuation of a right, which already has a face value, in the manner discussed does not appear to be justified in the Income Tax Act If this proposition is accepted it is not clear what factors should be taken into account in valuing the debt Where should one draw the line? For example, could one take into account the creditworthiness of the debtor or, where the debt is denominated in a foreign currency, its value, taking into account projected exchange fluctuations?

The second criticism was that s 7(1) of the Income Tax Act[111] seems to envisage a meaning of accrual as being 'due and payable' The court considered that this point also had no merit The court's reasoning was that the legislature dealt with postulated factual situations, one of which was where income remained due and payable Therefore, this did not justify the conclusion that the test of an accrual is that income is due and payable.[112]

The court's dismissal of this criticism is not persuasive If 'accrual' meant 'entitled to', there would be no need for s 7(1)

The court referred to a further point raised by De Villiers JA in Delfos This was that the provision in the Income Tax Act at that time included in gross income amounts due and payable under a contract of service tended to support an interpretation of accrue to mean due and payable.[113] The impact lay in the fact that amounts due related to a contract of service.[114]

The court considered the reasoning supporting the second proposition as being incontestable. It is that where a taxpayer has acquired any right of a non-capital nature during the tax year, and where a money value can be attached to that right, such right forms part of the taxpayer's gross income. This applies irrespective of when the right is enforceable. If it is not immediately enforceable its value is affected.[196]

It is submitted that the reasoning used to support the second proposition could also apply if 'accrual' meant 'due and payable'.[196] The right should form part of gross income when it becomes due and payable. At that stage it should be calculated at its face value. Adjustments to the face value may be made by applying the provisions of the Income Tax Act dealing with bad and doubtful debts.[197]

The court examined the criticisms of the judgment in Lategan.[198]

The first criticism was that there is no basis in the Income Tax Act for a reduction in the face value of a debt apart from the provisions covering bad and doubtful debts. The court considered that there was no merit in this point.[199]

The court considered that the Lategan principle does not purport to allow the taxpayer to deduct a further amount - it simply defines the extent of the gross income. Permissible deductions are made from the gross income.[200]

During the tax year in question the taxpayer sold goods amounting to approximately R1,3 million under the scheme At the end of the tax year instalments still outstanding but not yet payable amounted to R341 281 The Commissioner included this amount in the taxpayer's taxable income, subject to a deduction of a doubtful debt allowance of R7 702 [98]

The taxpayer argued that the outstanding instalments had not been received by or accrued to or in its favour as envisaged in the meaning of gross income in s 1 of the Income Tax Act Alternatively, the taxpayer argued that the unpaid instalments should not have been included in its gross income at their face value but at their present value [99]

The Special Court held that the outstanding instalments had accrued to the taxpayer and that the outstanding debts had to be valued at their market value [100] The Special Court considered itself bound by Lateegan [101]

In considering the meaning of the words 'accrued to or in favour of' the court considered the validity of the two main propositions in Lateegan [102]

The first is that income is not limited to an actual amount of cash, but includes every form of property As has been stated, the proposition is clearly correct [103] The second proposition is that 'accrual' means to become entitled to the amount in question [104]

The comments of the court in Delfos on the meaning of accrue were made obiter [92] In Hersov's Estate v CIR Centlivres CJ stated that it could not be said that Lategan had been accepted in Delfos as correctly laying down the law [93] Centlivres CJ was of the opinion that accrue means due and payable [94]

Subsequently there have been a number of cases that have referred to the differing interpretations of accrue, but which have not determined its meaning [95] In the Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa there is support for the view that accrue should mean to become entitled to There is, however, no discussion on the question of the valuation of amounts which have accrued [96]

The question of the meaning of accrue was finally determined in the Appellate Division in CIR v People's Stores (Walvis Bay) (Pty) Ltd [97] The facts of the case were, briefly, that the taxpayer carried on business as a retailer It sold goods to customers for cash and on credit Most of its credit sales were under its so-called six months to pay revolving credit scheme In terms of the scheme, the amount chargeable to a customer's account was payable in six equal monthly instalments At the end of each month a statement of account was sent to each customer The statement reflected the amount of the next instalment due by the customer

In CIR v Delfos two of the judges agreed with the interpretation in Lategan of the meaning of accrue, whilst two held the meaning of accrue to be due and payable

De Villiers and Stratford JJA were of the opinion that accrue means due and payable[86] They both relied on various provisions in the Income Tax Act in order to substantiate their views[87]

They relied on the current equivalent of s 7(1) to support their interpretation of the meaning of accrue[88] In addition, De Villiers JA referred to a provision in the Income Tax Act which is no longer contained in the current Act[89] In terms of this provision, gross income included-

> 'any amount so received or accrued in respect of services rendered, whether due and payable under a contract of service or not'

Furthermore, Stratford JA considered that his interpretation of accrue was supported by the section in the Income Tax Act dealing with the provision for the deduction of bad debts[90] He stated

> 'A bad debt cannot, generally speaking, be estimated as bad until it has become payable'[91]

The main difficulty facing the court in Lategan was the effect of s 21(2)(*e*) of the Income Tax (Consolidation) Act 41 of 1917. This section prohibited the deduction of debts owed to a taxpayer. It supported the view that unpaid debts should be included in gross income at their face value. Whilst this section has been omitted from subsequent Income Tax Acts, the position appears to be the same, namely, that debts are included in gross income at their face value. In terms of ss 11(*i*) and (*j*) of the Income Tax Act 58 of 1962 deductions may be claimed for, respectively, bad debts written off and a provision for doubtful debts. Thus s 11(*i*) and (*j*) provides, in effect, a mechanism for valuing debts. However, it is important that the face value of the debts is taken into account in gross income. In other words, the only provisions in the Income Tax Act which provide for a reduction in the face value of a debt are the allowances for bad or doubtful debts.[83]

A further argument against the decision in Lategan is the wording and effect of s 7(1) of the Income Tax Act.[84] Section 7(1) deems income to have accrued, notwithstanding certain events. One of these is where income has not been actually paid over to the taxpayer but remains due and payable.[85]

It is submitted that this wording accords more with an interpretation of 'accrue as being 'due and payable' rather than 'to become entitled to'

It is interesting to note that in Lategan the special court relied on the fact that the full purchase price had been credited in account [74] However, the Cape Provincial Division attached no weight to this factor [75]

The decision in Lategan is open to criticism on a number of grounds

The court held that the value of the debt should be included in the appellant's gross income as it had already accrued to the appellant, and that accrue means to which a person has become entitled [76] In so doing, it followed the approach previously adopted by the Special Court [77] In addition, the court decided that the debt should be included in the appellant's gross income at its value at the end of the year of assessment in question [78] Both these interpretations are questionable

The court acknowledged that there were difficulties in its approach [79] It distinguished St Lucia Usines & Estates Co Ltd v St Lucia (Colonial Treasurer)[80] and certain Australian cases on the ground that the Acts upon which those cases were decided differed from the South African Income Tax Act [81]

St Lucia Usines was concerned with the words 'income arising or accruing' and accordingly the court in Lategan[82] was, with respect, correct in distinguishing this case

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St Lucia Usines was concerned with the words 'income arising or accruing' and accordingly the court in Lategan[82] was, with respect, correct in distinguishing this case

There have been a number of cases which have considered the meaning of 'accrue' As its meaning is not clear a detailed examination of the case law is necessary In addition, legislation has been passed which affects the question of accrual This legislation is also considered

In Lategan v CIR[61] the appellant was a wine farmer In May 1920 he sold the wine he had made during the year of assessment ending 30 June 1920 for £5 924 Of this sum, £3 500 was payable in the year of assessment, and the balance was payable in the following year of assessment. The Commissioner claimed that the full purchase price should have been included in the appellant's income for the year of assessment ending 30 June 1920 The appellant argued that the outstanding instalments should have been excluded from his income in that year

Watermeyer J who delivered the judgment of the court, held that accrue means 'to which he has become entitled'[64] He held further that the appellant's income included not only cash which had been received by or had accrued to him, but the value of any other form of property which he had received or which had accrued to him[65] The outstanding instalments represented a right to claim payment of a debt in the future This right had vested in the appellant and had accrued to him in the year of assessment Accordingly, Watermeyer J held that the value of this right had to be included in the appellant's gross income for income tax purposes The debt

It is clear that in considering the question of double taxation the Appellate Division has regarded receipts as an independent basis of taxation

It is, therefore, clear that receipts exist independently of accruals in computing gross income However, in view of the cases which have established that a receipt should be for the benefit of the recipient in order to fall within the definition of gross income, there will seldom be a receipt prior to an accrual It is submitted that, in order to avoid the possibility of double taxation, receipts should be correlated to accruals and interpreted restrictively Thus both O'Donovan and Meyerowitz are correct in concluding that the 'receipts basis' of tax is not appropriate to our system of tax, which has discarded the concept of profits and gains as its basis

3.5 ACCRUAL

The date of accrual is an important factor when considering the taxation of discounting transactions, particularly deep discount bonds The reason is that, for example, in the case of deep discount bonds, a number of years may elapse between the date of issue of the bond and its redemption.[62] If the person who acquires the bond at a discount is taxable on the redemption proceeds, one must determine when the proceeds accrue to him

'unless the language of the Statute makes it clear that such a result was intended' [76]

This problem could have been overcome if receipts were interpreted restrictively as set out by the minority of the members of the court in Delfos

The principle above enunciated by Watermeyer CJ in Isaacs was affirmed by the Appellate Division in People's Stores [77] Hefer JA stated

'There is a possibility of the same income being taxed twice even in cases where a debt, payable during one year, is paid during the next or a later one The real answer to the submission is, however, that the possibility of double taxation is more imaginary than real since there is, what has been referred to as, a "necessary implication" that an amount which has been taxed as an accrual or receipt, cannot again be taxed when it is received or accrued' [78]

It is unfortunate that the Appellate Division in People's Stores simply affirmed the view of De Villiers JA in Delfos [79] As has been stated above,[80] this approach is contradictory It would have been preferable to interpret the word 'received' restrictively by limiting it to receipts, which accrued in the year in question [81]

argument can be advanced to the effect that the holder of a post-dated bill, note or bond only becomes entitled to the discount when he presents the instrument for payment in the proper manner

3 6 SECTION 24J

As has been indicated, further legislation has recently been introduced in order to regulate the taxation of financial instruments such as deep discount bonds The legislation is contained in a new s 24J of the Income Tax Act It was enacted in terms of s 21 of the Income Tax Act 21 of 1995 and amended in s 14 of the Income Tax Act 36 of 1996 Section 21(2) of Act 21 of 1995 sets out the application of the new section Section 24J applies to three broad circumstances The first is to any instrument issued after 15 March 1995 In these circumstances, the instrument is deemed to have come into operation on 16 March 1995 and s 24J applies to any instrument issued on or after that date The second is to any instrument issued on or before 15 March 1995 where, after that date, either the term is extended or the terms and conditions are materially varied In these circumstances, s 24J is deemed to have come into operation from the date of such extension or variation in relation to that instrument The third is to any transfer on or after 19 July 1995 of any instrument issued on or before 15 March 1995 In these circumstances, s 24J applies to any instrument transferred on or after that date with effect from the date of transfer It is therefore clear that, based on the amending legislation brought into effect by s 21 of the

example, B would not be obliged to pay A the face value if A did not present the note for payment

In view of this, it could possibly be argued that A only becomes entitled to the maturity value of the note on due date when B fulfils his obligation to pay pari passu with A's presenting the note for payment This argument could be criticised on the basis that it gives too broad a meaning to 'entitled to'

On the other hand, it could be argued that, on the authority of ITC 76, A has acquired a vested right which he could realize prior to maturity date by discounting the note [145] However, it should be appreciated that the court made its comments obiter dicta and did not consider the situation regarding reciprocal obligations. Its authority is therefore limited

It was arguable that the position prior to the enactment of further legislation was therefore, that, when a post-dated bill, note or bond is issued prior to the date when further legislation is effective, it can be argued that the holder will include in gross income the face value of the instrument This is inequitable on two grounds First, the holder is taxable at a stage when he does not have the cash to pay the tax Second, the value of the right to the redemption proceeds does not take into account the effect of inflation and the consequent decreasing value of the proceeds On the other hand, on the basis of reciprocal obligations a more persuasive

passu or indicated that he is willing to perform at a later date [141] On the other hand, it should be noted that the mere fact that a contract specifies that the obligations are to be performed on the same day does not necessarily mean that the parties intended them to be reciprocal [142]

Where B issues A with a post-dated promissory note at a discount on its face value, the question which arises is whether the discount accrues to A at the date of issue In this regard, the proviso which was added to the definition of gross income refers to the situation in which the taxpayer has become entitled to an amount which is payable in a subsequent year of assessment [143] Thus, both the interpretation of 'accrued' in People's Stores and the use of the word 'entitled' in the new proviso to the definition of gross income indicate that the test of entitlement must be applied in determining whether the discount accrues to A at the date of issue of the note

In considering this matter in the context of reciprocal obligations, one must examine the obligations of the parties on due date in order to ascertain whether these affect A's entitlement to the discount at the date of issue When the note matures, A must present it for payment [144] and, when he does so, B must effect payment to A of the face value on the note Clearly, on the basis of the cases discussed above, the presentation of a note for payment on due date constitutes a reciprocal obligation Thus, for

Reciprocal obligations exist in various types of transactions For example, in the case of a purchase and sale for cash, the article sold must be delivered pari passu with the payment of the purchase price [135] In the case of a mortgage, the mortgagor is obliged to settle the amount outstanding on the due date and the mortgagor is obliged to discharge and cancel the mortgage bond pari passu with such payment by the mortgagor [136]

This principle applies where a person's right to performance is conditional on his re-performance of a reciprocal obligation [137] There must be a relationship between the one party's obligation to perform and the performance due by the other party The relationship should indicate that one obligation was undertaken in exchange for the performance of the other The circumstances should be such that the obligations are not consecutive [138] There should, therefore, be a connection between the performance of the one party and the other's counter-performance [139] Generally, where reciprocal obligations exist, the one party is entitled to insist that the other party's reciprocal obligations be discharged pari passu [140]

This situation should be distinguished from that in which the obligations need not be performed pari passu, but consecutively Where consecutive obligations exist, the party who must perform is not entitled to withhold performance because the other party has not tendered performance pari

enjoyment be postponed until the happening of some certain future event '[110]

Where B issues A with, for example, a post-dated promissory note, a contractual relationship between the parties is established It is necessary also to consider whether this relationship might affect the nature of the rights acquired by A In a contract of sale, reciprocal obligations are created Where there is a cash sale, the seller is obliged to deliver the goods and the purchaser is obliged to pay the purchase price in cash upon delivery[111] Thus, 'in a bilateral contract certain obligations may be reciprocal in the sense that the performance of the one may be conditional upon the performance, or tender of performance, of the other This reciprocity may itself be bilateral in the sense that the performance, or tender of performance, of them represent concurrent conditions that is, each is conditional upon the other'[112]

The general principle relating to reciprocal obligations was discussed in the Appellate Division in Hauman v Nortje[113] This principle was stated by Lord De Villiers CJ as follows

'The general principle applicable to all bilateral contracts undoubtedly is that one party cannot, in the absence of any special agreement, call upon the other party to perform his contract without himself having performed or being ready to perform his part of the contract '[114]

Income Tax Act, and assuming that there is an immediate entitlement and accrual in A's hands, the sum of R100 will immediately accrue to A at the date of acquisition

Undoubtedly the effect of Lategan and People's Stores, as read with the above interpretation of the proviso to the definition of gross income in the Income Tax Act leads to an inequitable result from the point of view of the bondholder in the circumstances set out above If normal tax is payable on redemption proceeds, it should be payable at a stage when funds from the redemption of the bond are available This situation would have applied had the Appellate Division held 'accrue' to mean 'due and payable'

It could be argued that, when B issues A with a bill, note or bond with a face value of, say, R100 for R25 and a redemption date five years thereafter, there is no accrual to A until the redemption date The argument is based on the fact that, in order for there to be an accrual in the sense of an entitlement, A would have to acquire an unconditional right to the R100 [126] Thus, in the case of a negotiable instrument such as a deep discount bond, A would only acquire an unconditional right to the bond at the date of redemption

Before analysing the nature of the rights acquired by A, it is necessary to distinguish vested or unconditional rights and contingent rights [127]

income prior to redemption. At the date of redemption there would be no further accrual. Accrual took place at date of acquisition. It could possibly be argued that a further amount should be included in the holder's gross income as it had been received by him. However, accrual of the debt would have taken place at date of acquisition. It was valued at its present value. Therefore, a further receipt would constitute double taxation.

Therefore, on the authority of Lategan and People's Stores, one could argue that the holder should not have been taxable on any part of the face value of the instrument at redemption date.

However, assuming there is an accrual at the date of acquisition, the proviso to the definition of gross income in the Income Tax Act has the effect of deeming the full redemption proceeds of the bond to have accrued to the holder at the date of acquisition.

Thus, assume that A lends B R100 for a period of five years and that interest is chargeable at a simple interest rate of 15% per annum. In this situation A will include R15 in his gross income in each year which the capital remains outstanding. If B were to issue A with a deep discount bond with a face value of R100 for R25, the situation will be different. A will immediately pay B the sum of R25. On redemption date B will pay A the sum of R100. Applying the principles laid down in Lategan, and People's Stores and the proviso to the definition of gross income in the

due and payable after, say, ten years, then on the date of acquisition, the nominal value of the debt will be deemed to have accrued to the person. This will apply notwithstanding the fact that, at the date of acquisition, taking into account the effect of inflation on the value of the debt, the value of the right may be considerably less than the face value of the debt.

On the basis of the decisions in Lategan and People's Stores, if a deep discount bond is acquired at a discount and the bond is redeemable after five years, it can be argued that the full redemption proceeds of the bond accrue to the person who acquires it at the date of its acquisition.

In the absence of the proviso to the definition of gross income deeming the face value of a debt to have accrued to a taxpayer in circumstances set out above, it could be argued that the redemption proceeds of a deep discount bond, in effect, constitute a debt and the value of the debt should be included in the holder's gross income in each year of assessment prior to redemption of the bond. In each year the debt could be valued at its present value. Effectively, the holder could have had annual accruals to include in his gross income.

On the other hand, it could be argued that accrual took place when the bond was acquired by the holder. At that stage, the debt would have been valued at its present value. As no subsequent accruals took place, there should therefore be no further amounts included in the holder's gross

'Provided that where during any year of assessment the taxpayer has become entitled to any amount which is payable on a date or dates falling after the last day of such year, there shall be deemed to have accrued to him during such year -

(*a*) if the taxpayer has on or before 23 May 1990 submitted a return of income drawn on the basis that the present value of such amount has accrued to him during such year, the present value of such amount; or

(*b*) in any other case, such amount

Provided further that where the provision of paragraph (*a*) of the first proviso is applicable, there shall be deemed to have accrued to the taxpayer during any subsequent year of assessment in which he receives such amount or any portion thereof, a sum equal to the difference between such amount or portion thereof and the present value of such amount or portion thereof so deemed to have accrued to him during the firstmentioned year of assessment '

The proviso has retroactive effect in circumstances in which the transitional provision does not apply In addition, the combination of the decision in People's Stores and the enacting of the proviso to the definition of gross income has had the effect of creating a most unfortunate situation If a person acquires a right to a claim against a third party and such right is only

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There is another argument against the interpretation of accrue as meaning 'entitled to' which is not referred to in the judgment in People's Stores Section 24 relates to any agreement with another person in respect of any property whereby the ownership of the property passes from the taxpayer to the other person upon or after receipt by the taxpayer of the whole or a portion of the sale price. In these circumstances the whole of the sale price is deemed to have accrued to the taxpayer on the date on which he entered into the agreement.[121] The Commissioner is authorized to grant the taxpayer a special allowance.[122] The interpretation of accrue as meaning 'entitled to' creates an anomaly insofar as s 24 is concerned. If accrue means that to which a taxpayer is entitled, accrual would take place when the taxpayer signs the contract of sale. There would be no need for the deeming provision in s 24.[123]

It is unfortunate that the Appellate Division interpreted 'accrued to' as meaning 'to be entitled'. As it is a decision of the highest court in the country it must be accepted that this interpretation is now the law and that the dispute as to the meaning of 'accrued to' has now been finally resolved.[124]

The legislature then proceeded to act with seemingly undue haste to create an imbalance in the effect of the court's decision. A proviso was added to the definition of gross income in s 1 of the Income Tax Act.[125]

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instrument during the period from acquisition to date of transfer or redemption of the instrument by the holder [170]

An example of the calculation of such a gain where the holder did not apply an alternative method is given in the Explanatory Memorandum [171] In the example a dealer in financial instruments purchases an instrument for R920 000 on 31 July 1995 The instrument is redeemed for R1 000 000 two years later The instrument bears an annual coupon rate of 10% payable at the end of July The taxpayer sells the instrument on 20 September 1996 for R981 000 The cash flows are set out in the table below

Date	R
31 July 1995	(920 000)
31 July 1996	100 000
31 July 1997	1 100 000
	280 000

The yield to maturity is 14,91564% assuming an annual accrual period

Section 24J(3A) covers the situation in which a person holds an income instrument which was issued on or before 15 March 1995 and was unredeemed on 14 March 1995. In this situation s 24J applies to all accrual periods from the date of the holder's acquisition of the instrument until 15 March 1995. The excess of all accrual amounts over any interest received by or accrued to the holder during this period in respect of the instrument is deemed to have accrued to the holder in the year of assessment in which he transfers or redeems it. This provision does not apply in the case in which, prior to 3 July 1996, the holder has been assessed to tax in respect of interest relating to the instrument.

Where a holder makes a profit on the sale or redemption of an instrument, the adjusted gain is deemed to have accrued to him in the year of assessment.[69] The adjusted gain from the holder's perspective is calculated by adding the transfer or redemption proceeds to any payments in respect of the instrument received by the holder in the relevant accrual period. There is deducted from this sum, where the holder did not apply the alternative method, the adjusted initial amount relating to the instrument and any payments made by the holder in terms of the instrument by the holder during the accrual period. Where the holder applied an alternative method in relation to the instrument, there is deducted from this sum the initial amount, all amounts determined in accordance with the alternative method used and any payments made by the holder in terms of the

Based on these cash flows, the accruals to the holder in terms of s 24J are set out in the table below

Tax year	Period	AIM (R)	Note	Yield	Accrual (R)
1995/6	30 Jun 1996	8 800 000	1	0,0650308	572 271
1996/7	31 Dec 1996	9 372 271	2	0,0650308	589 977
1996/7	30 Jun 1997	9 962 248	3	0,0650308	608 834
1997/8	31 Dec 1997	9 571 082	4	0,0650308	628 918

Notes

1 R8 800 000

2 R8 800 000 + R572 271 - R[illegible]

3 R8 800 000 + R1 162 248 - R[illegible]

4 R8 800 000 + R1 771 082 - R[illegible]

Explanatory Memorandum three alternative methods are referred to These are those based on the weighted outstanding capital and interest and on a straight-line spreading of interest and that calculated by applying the rate and instalments in terms of the relevant agreement [167]

An example on the accrual of interest is given in the Explanatory Memorandum which will be discussed as it gives one a better understanding of the application of the formula contained in s 24J [168] In the example the taxpayer acquires a two-year financial instrument at a discount of R1 200 000 Interest at 3% of the face value is receivable at six-monthly intervals The yield to maturity assuming a six-monthly accrual period is 6,50308% per period It is assumed that the taxpayer has a financial year end 30 June The cash flows relating to the financial instrument are set out in the table below

Month	R
31 December .995	(8 800 000)
30 June 1996	300 000
31 December 1996	300 000
30 June 1997	300 000
31 December 1997	10 300 000
	2 400 000

instrument must be issued or acquired at a discount or premium, or it should bear deferred interest. In the case of any company, an income instrument means any instrument [163]. Examples of income instruments held by persons other than companies that are given in the Explanatory Memorandum are savings and call accounts, fixed deposits not exceeding one year and fixed deposits exceeding one year where the interest is set at a fixed rate and is paid annually [164].

Having considered the issues arising from the formula, it is now necessary to consider the application of the formula to the holder of an instrument. There is deemed to have accrued to the holder an amount of interest. There are two bases for calculating the interest that is deemed to have accrued to the holder. The first basis is to determine the sum of the accrual amounts in respect of all accrual periods falling within the year of assessment. This applies not only to complete accrual periods, but also to any part of an accrual period falling in the year of assessment. The accrual amounts are determined by applying the formula. The second basis is to calculate the interest by applying an alternative method [165]. The meaning of alternative method is defined. It is a method of calculating interest in relation to any class of instrument. It must, however, conform with generally accepted accounting practice, be consistently applied in respect of all instruments for all financial reporting purposes and the result in respect of the accrual of income and the incurring of expenditure should not differ materially from that resulting from an application of the formula [166]. In the

with some justification that certain types of short-term redeemable preference shares should be included in the definition of instrument as such types of shares have certain rights that are similar to those relating to certain types of bonds. Conversely, bonds which are convertible into shares are covered by the legislation. The values of these types of bonds vary in relation to the price of the associated shares. It could, therefore, be argued that these types of bonds should not be covered by this legislation as they are similar to the associated shares and should not be treated differently. A similar argument could be advanced in respect of bonds which are linked to an official price index. It is submitted that the definition of instrument does not include derivatives such as options, warrants and futures. The reason for this is that an instrument is defined as any form of interest-bearing arrangement. It is submitted that derivatives do not constitute interest-bearing arrangements. For example, an option in a financial instrument is a right to buy or sell the instrument at a certain price within a defined period. It clearly does not constitute an interest-bearing arrangement.

Having examined the definition of an instrument, it is now possible to consider the meaning of an income instrument. It will be recalled that the formula in terms of s 24J only applies to a holder of an instrument where the instrument involved is an income instrument. An income instrument in the case of any person other than a company is an instrument where its term will or it is likely will exceed a period of one year. In addition, the

accrual periods and any other payments made by the holder in previous accrual periods less any payments received by him in respect of the instrument [59]

The fourth issue relates to the type of instrument covered by the formula. When considering the position of a non-corporate holder, the formula only applies to income instruments.[60] An income instrument is defined as a certain type of instrument. Before examining the type of instrument, it is necessary to establish the meaning of an instrument. The definition is a general one with certain inclusions and certain exclusions. The general definition covers any form of interest-bearing arrangement.[61] The instrument must have been issued after 15 March 1995, or on or before that date and transferred on or after 19 July 1995, or, insofar as it relates to its holder, issued on or before 15 March and unredeemed on 14 March 1995. An instrument includes stocks, bonds, debentures, bills, promissory notes, certificates and similar arrangements. It includes various forms of bank deposits and loans as well as repurchase and resale agreements. Where there is a right to receive interest or an obligation to pay interest in terms of such an instrument and the right or obligation is acquired or disposed of, the acquisition or disposal will also constitute an instrument. There is excluded from the definition of instrument a lease agreement and any agreement in which the holder qualifies for an allowance under s 24(2) of the Income Tax Act.[62] It should be noted that the definition of an instrument does not include a share. It could be argued

There are certain circumstances in which the yield to maturity should be recalculated or redetermined. Where the instrument is linked to a variable rate of interest, the rate of compound interest is calculated in respect of the rate applicable when the compound interest is calculated. This rate applies in calculating amounts receivable after the date when the calculation is made.[153] If the variable rate changes, the rate of compound interest must be redetermined. In redetermining the rate of compound interest, reference must be made to the adjusted initial amount at the end of the previous accrual period or year of assessment. In addition, the variable rate at the date of redetermination must be used.[154] The Explanatory Memorandum gives, as an example of such an instrument, one that is linked to a commercial bank's prime rate or the consumer price index.[155] Where the terms and conditions of an instrument are varied and this results in a change in the rate of compound interest relating to the instrument, the compound interest must be redetermined. Where there is a variation or alteration of the rights or interests of a holder in respect of the instrument, the rate of compound interest relating to the instrument must be redetermined.[157] An example given in the Explanatory Memorandum is where the terms of the instrument provide for an early repayment of a portion of the debt.[158]

The third issue arising from the formula is the meaning of the adjusted initial amount. Insofar as a holder is concerned, it is the sum of the issue or transfer price, as the case may be, the accrual amounts from previous

This formula raises a number of issues which must be clarified at the outset. First, it is clear that accrual is determined for an accrual period. The accrual periods applicable to a financial instrument must be applied consistently until the maturity of the instrument. There are two possible bases for determining such periods, and in both cases the period may not exceed 12 months. One is where the instrument provides for regular payments at equal intervals. The accrual period will be the period between such payments.[150] The other is the period elected by the holder or issuer, as the case may be. It is not clear what the position is where the issuer and holder elect different periods. The use of the word 'or' seems to indicate that it is not possible for the parties to elect different periods. The section does not appear to provide for the resolution of a dispute on this issue between the parties. It would be appropriate for the South African Revenue Service to issue a practice note on this point. The practice note could indicate that the parties should elect the period in writing, failing which, the period will be treated as being 12 months.

Second, the yield to maturity is comprehensively defined. It is the rate of compound interest in each accrual period at which the present value of all amounts receivable under the instrument by the holder equals the issue or transfer price, as the case may be.[151] A holder is defined as any person who has become entitled to any income under the instrument. If the instrument provides that any interest is payable, the person who is entitled to receive payment is also regarded as a holder.[152]

In order to consider the effect of s 24J in the context of financial discounting transactions, it is necessary to review the type of transaction involved. A financial discounting transaction normally involves a person issuing a bill, note or bond at a discount on its face value. The instrument is redeemable at a future date. A further type of transaction involves the subsequent sale or redemption of the instrument. When considering the question of accrual in a financial discounting transaction, one is concerned with the position of the person in whose hands there will be a receipt or accrual. In the context of the transactions described above, there will be a receipt or accrual in the hands of the person to whom the instrument is issued and any subsequent holder of the instrument. The receipt or accrual will normally arise by virtue of the fact that the instrument will be sold or redeemed.

The provisions of s 24J are fairly complicated. Essentially, s 24J regulates, inter alia, the calculation and accrual of interest. Interest is defined as including the gross amount of interest, related finance charges, discount or premium receivable as a result of a financial arrangement.[13] The amount which accrues to the holder of a financial instrument in an accrual period is determined by multiplying the yield to maturity by the adjusted initial amount.[14]

accounted for on the date of the instrument's transfer or maturity, whichever is the earlier

It is therefore important to understand the position of accrual relating to financial discounting transactions both prior to and after the introduction of s 24J It should also be appreciated that s 24J not only applies to the accrual of income but also to the incurral of expenditure In this section consideration will only be given to the question of accrual of income. The issue of the incurral of expenditure will be discussed in chapter 8 below.

The reasons for the enactment of s 24J are set out in the Explanatory Memorandum on the Income Tax Bill, 1995 It is pointed out that the issuing of financial instruments at a discount and the structuring of contracts to provide for the deferral of interest and finance charges had become popular, particularly in the context of tax planning Thus, for example, the holders of financial instruments issued at a discount argued that the discount or deferred interest only accrued to them at the maturity of the instrument. The Minister of Finance proposed in his budget speech in 1995 that legislation would be introduced in terms of which an accrual basis would be recognized. Thus, interest, discounts and premiums would accrue on a day-to-day basis for tax purposes [146] Section 24J is the result of these pronouncements The Explanatory Memorandum emphasizes that s 24J does not interfere with general tax principles such as source or the capital or revenue nature of such profits [147]

Income Tax Act 21 of 1995 and apart from the circumstances set out above, s 24J did not affect instruments issued on or before 15 March 1995. However, in his budget speech of 1996, the Minister of Finance announced a further amendment to these transitional provisions. Details of these amendments are contained in section 5.3.1.5 of the Budget Review issued by the Department of Finance on 13 March 1996. The amendment which was proposed applied s 24J to all instruments issued on or before 15 March 1995 and which were unredeemed on 14 March 1996. This amendment was effected by s 14(1)(*d*) of Act No of 1996. Thus s 24J applies to instruments which were excluded from s 24J by virtue of the fact that they were issued on or before 15 March 1995 and had not been varied or transferred after that date. Section 24J does not apply to instruments which had been issued on or before 15 March 1995 and which had not been varied or transferred after that date and which were no longer in existence on 13 March 1996. The application of retrospective legislation to these instruments is unfortunate and government should be discouraged from continuing this practice.

Special provisions will apply to instruments which are brought into the scope of s 24J by virtue of the changes announced in the minister's budget speech of 1996. The difference between all amounts which have accrued for tax purposes and the amount which would have accrued until 13 March 1996, had the proposed measures been applicable, will, for tax purposes, be

The first issue is whether one basis of calculation is acceptable in some circumstances and not acceptable in other circumstances. If one has regard to the example above, the straight-line basis of valuation was not acceptable to the Commissioner at the year end as discussed in the Explanatory Memorandum. In the example given in the Explanatory Memorandum, the year ended at the end of the third month. At that stage the variation with the yield to maturity basis was -10%. If the year had ended at the end of the first month, the variation would have been -60%. The question arises whether, in these circumstances, the straight-line basis would have been acceptable. In this regard, it should be noted that, in the example given in the Explanatory Memorandum, the weighted capital method was acceptable to the Commissioner. At the end of the third month the variance of the weighted capital method was 45%.

The second issue follows on from the first issue. If one has regard to the weighted capital method in the above example, it will be noted that, apart from the last month, the variation was between 25% and 45%. Clearly if 45% was acceptable to the Commissioner, the lower percentage variations were also acceptable. However, it is not clear how high the percentage variation should be before it becomes unacceptable.

The points raised in the two issues discussed above are reinforced when one considers a further example. Assume that a 15-year bond is issued

It is stated in the Explanatory Memorandum that the weighted capital method and the calculation by applying the rate and instalments in terms of the agreement are acceptable as methods of calculation. However, it is also stated that the straight-line method of calculation is not acceptable.[84] The authority for this statement is, presumably, contained in the definition of the alternative method in s 24J(1) of the Income Tax Act. Paragraph (c) of the definition stipulates that the method should achieve a result in relation to the timing of the accrual and the incurral of interest that does not differ significantly from the yield to maturity basis of calculation. It is respectfully submitted that this definition is not sufficiently clear. Paragraph (c) of the definition of alternative method stipulates that the result of an application of an alternative method should not 'differ significantly' from that achieved by applying the yield to maturity basis of valuation. It is not clear as to what would constitute a significant difference. In the example set out above, which is given in the Explanatory Memorandum, it will be noted that, apart from the sixth month, the cumulative percentage variation with the yield to maturity basis of calculation varied from -60% to -109%. On the basis of the comments in the Explanatory Memorandum, the straight-line basis is not acceptable to the South African Revenue Service. In the opinion of the Commissioner, these percentage variations clearly constitute significant differences to the results achieved by applying the yield to maturity basis of valuation. This raises two issues.

The table below sets out the monthly variations of the different methods of calculation with the yield to maturity basis

Month	Actual	Weighted capital	Straight-line
1	0	17	-41
2	0	15	-36
3	0	12	-30
4	0	9	-22
5	0	5	-12
6	0	0	0

The variations as percentages of the total interest are as follows

Month	Actual	Weighted capital	Straight-line
1	0	25	-60
2	0	40	-96
3	0	45	-109
4	0	40	-98
5	0	25	-61
6	0	0	0

Month	Monthly accrual	Cumulative accrual
1	86.34	86.34
2	86.34	172.69
3	86.34	259.03
4	86.34	345.38
5	86.34	431.72
6	86.34	518.07
	518.07	518.07

The actual interest calculation and the calculation based on the yield to maturity have the same results. The table below sets out the detailed accruals based on these methods

Month	Payment	Interest/Accrual
1	1753	146
2	1753	123
3	1753	99
4	1753	75
5	1753	50
6	1753	25
	10518	518

The accruals are, therefore, as follows

Month	Cumulative accrual	Monthly accrual
1	171	171
2	309	138
3	413	104
4	483	70
5	518	35
6	518	0
	518	518

The straight-line method of calculating the accruals involves an equal allocation of the interest over the period involved. The table below sets out the monthly accruals in the above example

In considering this table, it is appropriate to examine the alternative methods of calculating the accruals in more detail

The weighted capital method of calculation is an application of the following formula

$$\frac{\text{Total interest x monthly balances}}{\text{Total monthly balances}}$$

The detailed calculation is as follows

Month	Capital	Payment	Interest	Balance
1	10000	1753	146	8393
2	8393	1753	123	6762
3	6762	1753	99	5109
4	5107	1753	75	3431
5	3428	1753	50	1728
6	1728	1753	25	0

Based on the above figures, the total interest for the period is R518, and the total of the outstanding balances at the end of each month is R25 424

The Explanatory Memorandum contains a discussion and example on the alternative methods of reflecting the spread of interest for accounting purposes [18] In the example, it is assumed that the taxpayer borrows the sum of R10 000 on 31 May 1995 at an interest rate of 17,55% per annum The loan agreement provides that the loan is repayable within six months by way of monthly instalments of R1 753 The taxpayer's financial year end is 31 August The interest payable over the period of the loan is R518 The calculation of the interest using various methods of calculation are set out in the table below

Method	1995 Year (R)	1996 Year (R)
(a) Weighted capital	412,90	105,10
Difference to YtM	45,03	(45,03)
Difference as % of interest	8,7%	(8,7%)
(b) Straight-line	259,00	259,00
Difference to YtM	(108,87)	108,87
Difference as % of interest	(21,0%)	21,0%
(c) Calculated	367,90	150,10
Difference to YtM	0,03	(0,03)
Difference as % of interest	0,0%	0,0%
(d) Yield to maturity (YtM)	367,87	150,13

will apply in determining the market value of the instruments. The election shall not take effect unless the Commissioner has, subject to any conditions that he might impose, approved of the methodology and the manner in which the market value of the instruments is taken into account in determining the company's taxable income. The election will be binding on the company in respect of all such instruments during the year of assessment in which the election takes effect and in all subsequent years of assessment.[179] Where the company has made such an election any instrument to which the election applies will be so dealt with until the instrument is either sold or redeemed.[180] The Commissioner may withdraw his approval if it was obtained by fraud or as a result of a misrepresentation or failure to disclose a material fact by the company. The Commissioner must, of course, be satisfied that, having regard to the full facts, the approval should not have been granted.[181] Where a company no longer complies with the provisions of s 24J(9) the approval granted by the Commissioner is deemed to have been withdrawn with effect from such year of assessment. An adjustment must be made to the company's taxable income in respect of all such instruments held and not disposed of or not redeemed by it at the end of such year of assessment. It is necessary to take into account interest which would have been taken into account had these provisions not have been applicable in prior years of assessment. In addition, account must be taken of any income included in the company's gross income in prior years of assessment.[182]

Notes

1 R500 000 x 0,15 - (R500 000 x 0,15 x 1/12)

2 ((R500 000 + R75 000) x 0,15) + R6 250

3 (R500 000 + R161 250 - R161 250) x 0,15

4 (R500 000 + R236 250 - R161 250) x 0,15

5 (R500 000 + R322 500 - R161 250) x 0,15

The total accrual is, therefore, R421 687

Where there is more than one holder of an instrument, one must exclude all amounts receivable by other holders of the instrument when calculating the accrual amount of the holder [176] Where the holder of an instrument is entitled to any interest in terms of the instrument and, at the same time, is also liable to pay interest in terms of the instrument, he will not be a holder and issuer of the instrument at the same time If the interest receivable by him exceeds the interest payable by him, he will be regarded as the holder of the instrument Conversely, if the interest payable by him exceeds the interest receivable by him in respect of the instrument, he will be regarded as the issuer [176].

A company whose business consists of dealing in instruments may elect a different basis for it to be taxed on its interest [177] The basis on which the company will be taxed will be to apply a market valuation in respect of the instruments [178] The company must make the election in writing and must submit a statement setting out in detail the methodology that the company

Month	R
28 February 1995	(500 000)
29 February 1996	0
28 February 1997	161 250
28 February 1998	0
28 February 1999	0
29 February 2000	760 437
	421 687

The yield to maturity is 15% per accrual period, assuming an annual accrual period

The accruals are set out in the table below

Year end	Accrual (R)	Note
29 February 1996	68 750	1
28 February 1997	92 500	2
28 February 1998	75 000	3
28 February 1999	86 250	4
29 February 2000	99 187	5

are materially altered after that date the instrument is deemed to have been issued after that date In these circumstances, the provisions of s 24J apply to the instrument from the date of the extension or variation of the instrument [12] An example of an extension of a term is given in the Explanatory Memorandum [13] The importance of this provision has mostly fallen away with the minister's announcement in the budget speech of 1996 with regard to the introduction of retroactive legislation concerning the commencement of the application of s 24J and the enactment of s 14 of the Income Tax Act 36 of 1996 [14] Section 24J(5A) provides that any amount which has been deemed to have accrued to a person in terms of s 24J shall not be included in the income of that person more than once as a result of an application of s 24J

In the example, it is assumed that the taxpayer lends R500 000 to another person The loan is in terms of an agreement entered into on 28 February 1995, and the capital bears interest at an annual rate of 15% The interest is to be capitalized and the capital and interest are repayable on 28 February 1997 The parties agree on 31 March 1995 to extend the repayment date to 29 February 2000, but the accrued interest will still be payable on 28 February 1997 The taxpayer's financial year end is at the end of February of each year The taxpayer's cash flows are set out in the table below

The adjusted gain is calculated in the table set out below

Period	Accrual (R)	Note	AIM (R)	Note	Gain	Note
31 Jul 1996	137 724	1	957 224	3		
20 Sep 1996	19 558	2			4 218	4

Notes

1 R920 000 x 0,1491564

2 R957 224 x 0,1491564 x 30/365

3 R920 000 + R137 224 - R100 000

4 R981 000 - R957 224 - R19 558

The adjusted gain in the example is R4 218

Any interest actually received by a person in terms of an instrument is not included in that person's gross income where s 24J applies. Thus, where interest is deemed to have accrued to the holder of an instrument in terms of s 24J(3), the holder is not also taxable on the interest actually received by him in terms of the instrument.[17] Where the term of an instrument issued on or before 15 March 1995 is extended or its terms or conditions

fit to burden their assessors with these complicated provisions. It would have been more appropriate to apply the provisions of s 24J to companies and individuals with large holdings of income instruments. Thus, s 24J should not apply to holders of income instruments below a certain value. This would have the effect of reducing the number of taxpayers affected by s 24J.

If one applies the analysis of the financial effects of the yield to maturity return to s 24J, it is clear that in the case of a zero coupon bond, the effect of this basis of yield is that the yield is in fact greater than the nominal yield. It is the revised yield to maturity. The effect of taxing discounts on the basis of the yield to maturity is more punitive than a simple interest basis such as the simple yield to maturity basis which is the same as the internal rate of return.

The other problem with s 24J insofar as it affects discounts, particularly zero coupon bonds, is that income tax is payable during the life of the bond whereas the notional income in respect of which the tax is payable is only received when the bond matures. In other words, tax is payable in respect of gross income which has not yet been received. Thus, as stated above, the effect of s 24J on zero coupon bonds is to make them less attractive to investors who are subject to normal tax. This will, presumably, discourage the issue of such bonds unless other factors outweigh these fiscal disadvantages.

However, the wording of the legislation is not clear, particularly with regard to when one can apply alternative bases of calculation, and when an alternative basis of calculation is acceptable. Section 24J applies to income instruments as defined. It does not apply to shares. It is arguable whether this limitation is appropriate. In this regard, it is arguable that certain types of redeemable preference shares should be included in s 24J and that certain types of equity linked bonds should be excluded from this section. The provisions contained in s 24J would not inhibit the development of a strips market in gilts. A strips market enables the rights to interest payments to be traded separately from the underlying gilt or bond.[91] The reason for this is that the calculation of the accrued amount automatically takes into account the fact whether or not interest is paid. In addition, if an instrument is acquired without rights to interest, it will be acquired at a discount or its redemption price. In this event, the calculation of the accrual will take into account the fact of the acquisition at a discount.

The application of s 24J to individuals is questionable. The legislation is complicated and it is submitted that it should apply to companies and to individuals with substantial interest and trading profits arising from holding income instruments. The reasons for this submission are that individuals will have to avail themselves of professional assistance in calculating their accruals and assessors at the Department of Inland Revenue will be required to have detailed knowledge of these provisions. As it has been reported by the Katz Commission that there is a skills crisis at the department, it is not clear why the South African Revenue Service has seen

this proviso is that where a taxpayer has become entitled to an amount which is payable on a date falling after the end of the year of assessment in question, such amount is deemed to have accrued to him in such year of assessment. The entitlement test applies to both the meaning of accrue and the aforesaid proviso.

In determining whether the maturity value accrues to the holder of a post-dated bill, note or bond at the date of its issue, one must ascertain when the holder becomes entitled to such proceeds.

On the basis of reciprocal obligations, a strong argument can be advanced to the effect that the holder only becomes entitled to the maturity value when the instrument is presented for payment on due date in the proper manner.

In 1995, s 24J was enacted. It provides for the taxation of income and expenses arising from the issue and trading of financial instruments at a discount on their face values. The legislation deals primarily with the timing of the incurral and accrual of such expenditure and income. The legislation provides for the income to be spread over the period from the date of acquisition of the instrument to the date of disposal or maturity of the instrument. This is achieved by applying the yield to maturity basis of calculation over the term of the instrument. The legislation permits the application of alternative bases of calculation of the accrual of the income

development in South Africa of a strips market in gilts A strip takes place where a bond is separated into its capital element and an interest-only instrument The former instrument is referred to as a zero coupon bond whilst the latter is referred to as a strip A strip is an American acronym from Separate Trading of Registered Interest and Principal of Securities The reason why s 24J would not inhibit the development of a strips market is that the calculation of an accrued amount takes into account the fact whether or not interest has been paid [89]

3 7 CONCLUSION

The Income Tax Act provides, inter alia, for receipts and accruals to be included in the gross income of a taxpayer [90] In the case of discounting transactions it is unlikely that a person would obtain a receipt prior to an accrual Thus, from the point of view of discounting transactions, the receipts basis of taxation is not of great importance However, the meaning of accrual is important in determining the time when an accrual takes place in a discounting transaction The meaning of accrual has now been settled 'Accrue' means 'entitled to' The decision was made in People's Stores, and, whilst it is open to criticism, it must be accepted as a binding decision correctly reflecting the position in South African law

The legislature added a proviso to the definition of gross income in s 1 of the Income Tax Act Apart from the transitional provisions, the effect of

Year	Year-end value	Accretion	Tax	After-tax cash
0	29459			-29459
1	33288	3830	1723	-1723
2	37616	4328	1947	-1947
3	42506	4890	2201	-2201
4	48032	5526	2487	-2487
5	54276	6244	2810	-2810
6	61332	7056	3175	-3175
7	69305	7973	3588	-3588
8	78315	9010	4054	-4054
9	88496	10181	4581	-4581
10	100000	11504	5177	94823
Total		70541	31744	38798
YtM				
Pre-tax	13%			
After tax	7%			

It is clear from this table that, in the case of a conventional bond, the effect of the investor's being able to reinvest the interest payments during the term of the bond is that the revised yield to maturity becomes 9%. This is an increase on the 7% yield achieved by the zero coupon bond. In the circumstances, the effect of s 24J on zero coupon bonds is to make them less attractive to tax paying investors. This will, presumably, discourage the issue of such bonds unless other factors outweigh these disadvantages [88]

Having considered the effects of s 24J on the issue of various types of financial instruments, it is clear that s 24J would not inhibit the

It is clear from this table that, assuming an income tax rate of 45%, a pre-tax yield to maturity of 13% is reduced to an after-tax return of 7%. This is a substantial reduction in the investment return of a zero coupon bond. The question which then arises is what is the difference between the returns of a zero coupon bond and those of a conventional coupon bond? The main difference between these two types of bonds is that in the case of the conventional bond interest coupons are payable during the life of the bond. Therefore, in the case of a conventional bond the investor is able to reinvest his interest earned by him during the term of the bond. In the case of a zero coupon bond, the returns assume a reinvestment of the accruals. The problem is, however, that tax is payable during the life of the bond and there is no cash generated from the bond prior to maturity to fund these tax payments. The following table illustrates the effects of taxation in respect of a conventional bond based on similar assumptions, where appropriate, to those in the table above.

CONVENTIONAL BONDS- TAX	
Assumptions:	
No. of years	10
YTM	13%
Tax rate	45%
Cost	29459
Maturity proceeds	100000

adverse affect on the after-tax returns of the investment The effects of tax are set out in the following table

CONVENTIONAL BONDS- TAX	
Assumptions:	
No of years	10
YtM	13%
Tax rate	45%
Cost	29459
Maturity proceeds	100000

Year	Year-end value	Accretion	Tax	After-tax cash
0	29459			-29459
1	33288	3830	1723	-1723
2	37616	4328	1947	-1947
3	42506	4890	2201	-2201
4	48032	5526	2487	-2487
5	54276	6244	2810	-2810
6	61332	7056	3175	-3175
7	69305	7973	3588	-3588
8	78315	9010	4054	-4054
9	88496	10181	4581	-4581
10	100000	11504	5177	94823
Total		70541	31744	38798
YtM				
Pre-tax	13%			
After tax	7%			

reinvested at the same rate Obviously the market value of the bond will vary for a number of reasons One of them is the variation in the interest rates during the duration of the bond One of the reasons why a zero coupon bond is more price volatile than a conventional coupon bond is that there is no flexibility for reinvestment of interest during the life of the bond It is assumed in the above example that the notional interest is reinvested at 10% per annum Thus, if interest rates increase, it is not possible to reinvest the notional interest at the higher rates In the case of a conventional coupon bond, the interest received during the duration of the bond can be reinvested at the higher rates [187]

If one applies the analysis of the financial effects of the yield to maturity return to s 24J, it is clear that in the case of a zero coupon bond, the effect of this basis of yield is that the yield is in fact greater than the nominal yield It is the revised yield to maturity In other words, the effect of taxing discounts on the basis of the yield to maturity is more punitive than a simple interest basis such as the simple yield to maturity basis which is the same as the internal rate of return

The other problem with s 24J insofar as it affects discounts, particularly zero coupon bonds, is that income tax is payable during the life of the bond whereas the notional income in respect of which the tax is payable is only received when the bond matures In other words, tax is payable in respect of gross income which has not yet been received This has an extremely

Finally, it is necessary briefly to discuss the concept of yield to maturity Yield to maturity has a specific definition in terms of s 24J(1) This definition is an adaptation of the financial meaning of yield to maturity The yield to maturity is generally defined as the interest rate that equates the expected or scheduled cash inflows from an investment to the initial cash outlays The cash inflows normally constitute interest receipts and the proceeds from the disposal of the investment The cash outlays are usually represented by the cash investment [184] This process of equating the initial investment to the future cash flows means that one must discount the future cash flows to the present using the yield to maturity as the discount factor No reinvestment of cash flows is taken into account If reinvestment is taken into consideration, the return is increased This increased return is called the revised yield to maturity [185] In the case of a zero coupon bond, no cash is received by the holder until maturity The only cash flows are the initial investment which is a negative cash flow, and the proceeds received at maturity which is a positive cash flow Thus, for example, assume an initial investment of R1 000 that matures after 30 years If interest is compounded at 10% per annum, the investment will be R17 449 at maturity In order to achieve this return, one could purchase a bond for R1 000 which has an annual coupon of R100 If the interest were reinvested at a rate of 10% per annum, the return would be the same, namely, R17 449 The revised yield to maturity is 19,13% per annum Therefore it is clear that a zero coupon bond with a yield to maturity of 10% per annum assumes that notional interest of 10% per annum is

It is clear from the second example that annual variations to the yield to maturity of the annual accruals applying the weighted capital method of valuation are greater than the variations applying the straight-line basis of valuation. This raises the question whether the straight-line basis of valuation is acceptable in this situation. It is submitted that, applying the second example, it would be difficult to argue that the straight-line basis of valuation is not acceptable. This raises the issue whether a basis of valuation should be acceptable in certain circumstances and not acceptable in other circumstances. It is submitted that it is not desirable for a basis of valuation only to be acceptable in certain circumstances as this leads to uncertainty. A basis of valuation should either be acceptable or not. It is submitted that there is no valid reason why the straight-line basis of valuation should not be acceptable in all circumstances, and the legislation should be changed accordingly.

In the circumstances, it is submitted that the definition of alternative method in s 24J(1) of the Income Tax Act should specify the extent to which the result of an application of an alternative method may vary from that achieved by an application of the yield to maturity basis before such alternative method becomes unacceptable. In addition, the section should also clarify whether one method may be acceptable in certain circumstances and not in others.

The following table illustrates the percentage of total interest of the variations of the different methods of calculation with the yield to maturity basis of calculation

Year	Actual	Weighted capital	Straight-line
1	0	0,46	0,24
2	0	0,47	0,22
3	0	0,47	0,20
4	0	0,48	0,17
5	0	0,48	0,15
6	0	0,49	0,12
7	0	0,49	0,08
8	0	0,50	0,04
9	0	0,51	0,00
10	0	0,52	-0,05
11	0	0,53	-0,10
12	0	0,54	-0,16
13	0	0,55	-0,23
14	0	0,57	-0,30
15	0	-7,05	-0,38

The issue price is R9 million and the redemption price is R10 million. The annual coupon rate is 10%. The accruals are set out in the table below

Year	Amount (Rands)	Yield to m. turity	Actual	Straight-line	Weighted capital
0	9000000				
1	1000000	1028097	1028097	1066667	1102125
2	1000000	1031307	1031307	1066667	1105946
3	1000000	1034883	1034883	1066667	1110205
4	1000000	1038868	1038868	1066667	1114950
5	1000000	1043308	1043308	1066667	1120237
6	1000000	1048255	1048255	1066667	1126127
7	1000000	1053767	1053767	1066667	1132691
8	1000000	1059909	1059909	1066667	1140005
9	1000000	1066753	1066753	1066667	1148154
10	1000000	1074378	1074378	1066667	1157233
11	1000000	1082874	1082874	1066667	1167351
12	1000000	1092341	1092341	1066667	1178623
13	1000000	1102890	1102890	1066667	1191184
14	1000000	1114643	1114643	1066667	1205179
15	11000000	1127739	1127739	1066667	1

104 See Ochberg v CIR and Lace Proprietary Mines Ltd v CIR

105 CIR v People's Stores (Walvis Bay) (Pty) Ltd at 22

106 This applies for the reasons set out above

107 s 11(*i*) and (*j*) of the Income Tax Act 58 of 1962

108 CIR v People's Stores (Walvis Bay) (Pty) Ltd at 21-4

109 at 22

110 See Lategan v CIR

111 Section 7(1) is identical to s 8 of the Income Tax Act 40 of 1925

112 CIR v People's Stores (Walvis Bay) (Pty) Ltd at 22-3

113 See CIR v People's Stores (Walvis Bay) (Pty) Ltd at 23 De Villiers JA was referring to s 7(b) of the Income Tax Act 40 of 1925

114 See CIR v People's Stores (Walvis Bay) (Pty) Ltd at 23

115 ibid

116 ibid

117 See C Divaris & M L Stein Silke on South African Income Tax 11 memorial ed 1 (1989) at 8-78

118 CIR v People's Stores (Walvis Bay) (Pty) Ltd at 23-4

94 ibid

95 See, for example, CIR v Pistorius (1942) 12 SATC 11 at 15, Challenor's Estate v CIR (1960) 23 SATC 108 at 117, Rishworth v SIR (1964) 26 SATC 275 at 281, ITC 1068 (1965) 27 SATC 141 at 144, Mooi v SIR (1972) 34 SATC 1 at 10 It should be noted that in Ochberg v CIR (1933) 6 SATC 1 at 7 Watermeyer J reaffirmed his opinion expressed in Lategan v CIR and that certain special court decisions followed the decision in Lategan v CIR on the basis of stare decisis See, for example, ITC 268 (1933) 7 SATC 159, ITC 437 (1939) 10 SATC 456, and ITC 563 (1944) 13 SATC 319

96 RP 34/1987 para 9 7 and 9 9 at 170

97 (1990) 52 SATC 1

98 at 18

99 at 18

100 at 18

101 at 19

102 at 20-4

103 at 21

82 Lategan v CIR at 21

83 See CIR v People's Stores (Walvis Bay) (Pty) Ltd at 22

84 58 of 1962 This section is identical to s 8 of the Income Tax Act 40 of 1925 which was considered by Watermeyer J in Lategan v CIR

85 This is consistent with the use of the words 'due and payable' in s 7(1)

86 CIR v Delfos at 108 and 111

87 ibid The court was considering the provisions contained in the Income Tax Act 40 of 1925

88 CIR v Delfos at 108 and 111 Section 8 of the Income Tax Act 40 of 1925 was considered by the learned judges

89 s 7(*b*) of the Income Tax Act 40 of 1925

90 CIR v Delfos at 108 Stratford JA referred to s 11(2)(g) of the Income Tax Act 40 of 1925 which is the equivalent of s 11(*i*) of the present Income Tax Act 58 of 1962

91 CIR v Delfos at 108

92 Herson's Estate v CIR (1957) 21 SATC 106 at 119

93 Herson's Estate v CIR at 119

68 See Lategan v CIR at 19-20. CIR v People's Stores (Walvis Bay) (Pty) Ltd at 21

69 See CIR v People's Stores (Walvis Bay) (Pty) Ltd at 21

70 See Ochberg v CIR and Lace Proprietary Mines Ltd v CIR

71 See Mooi v SIR

72 Lategan v CIR at 21

73 See D Meyerowitz & E Spiro Meyerowitz and Spiro on Income Tax (1995) at para 151A

74 See C J Ingram The Law of Income Tax in South Africa (1933) at 32. and the judgment of Ingram J in ITC 563 (1944) 13 SATC 319

75 See Lategan v CIR

76 at 21

77 See ITC 16 (1924) 1 SATC 124

78 Lategan v CIR at 21

79 ibid

80 1924 AC 508

81 The Income Tax (Consolidation) Act 41 of 1917

56 ibid

57 (1990) 52 SATC 1

58 at 24

59 CIR v Delfos at 112

60 See n 50 above

61 ibid

62 See, for example, the meaning of a deep discount security in the United Kingdom in para 1 of sch 4 to the Income and Corporation Taxes Act of 1988

63 (1926) 2 SATC 16

64 at 20

65 ibid

66 at 21

67 See Lategan v CIR at 19-20, CIR v People's Stores (Walvis Bay) (Pty) Ltd at 21, Ochberg v CIR (1931) 5 SATC 93, Lace Proprietary Mines Ltd v CIR (1938) 9 SATC 347, Mocé v SIR (1972) 34 SATC.

44 at 152-3

45 at 156 See also Maguire v COT (1966) 28 SATC 146, 1966 (3) SA 418 (RAD)

46 CIR v Delfos at 102-3

47 at 107-8

48 See Meyerowitz at 226

49 CIR v Delfos at 112

50 Meyerowitz at 226 See also the comment at Stratford JA in CIR v Delfos at 116

51 CIR v Delfos at 116

52 at 117, Meyerowitz at 226

53 (1949) 16 SATC 258

54 at 266 It should be noted that Watermeyer CJ went on to state that he did not use the term 'double taxation' because of the different meanings that could be given to it The reference in this discussion to double taxation refers to gross income which can be subject to normal tax in a taxpayer's hands twice - when it accrues to him and when he receives it at a later stage

55 Isaacs v CIR at 266

32 See B O'Donovan 'Receipts, Accruals and Double Taxation' (1969) 86 SALJ 274

33 at 277

34 at 277-9

35 at 278

36 at 278-9

37 at 279

38 D Meyerowitz 'Are Income Receipts Taxable?' (1971) 20 The Taxpayer 225 at 228

39 (1939) 6 SATC 93 In addition, Meyerowitz at 228 points out that SIR v Silvergden Investments (Pty) Ltd did not purport to overrule the ratio decidendi in CIR v Delfos

40 (1971) 20 The Taxpayer 225 at 228

41 ibid

42 ibid Meyerowitz points out that the court refrained from deciding against the Commissioner's right to tax the receipt of an amount which had not previously been taxed as an accrual as it would have had to overrule the ratio decidendi in CIR v Delfos

43 1943 CPD 150

32 See B O'Donovan 'Receipts, Accruals and Double Taxation' (1969) 86 SALJ 274

33 at 277

34 at 277-9

35 at 278

36 at 278-9

37 at 279

38 D Meyerowitz 'Are Income Receipts Taxable?' (1971) 20 The Taxpayer 225 at 228

39 (1939) 6 SATC 93 In addition, Meyerowitz at 228 points out that SIR v Silverglen Investments (Pty) Ltd did not purport to overrule the ratio decidendi in CIR v Delfos

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41 ibid

42 ibid Meyerowitz points out that the court refrained from deciding against the Commissioner's right to tax the receipt of an amount which had not previously been taxed as an accrual as it would have had to overrule the ratio decidendi in CIR v Delfos

43 1943 CPD 150

legislature However, in the case of the definition of gross income in s 1 of the Income Tax Act, this can be done only in exceptional circumstances

21 See COT v G at 162

22 ibid It is considered, with respect, that the reference at 162 to the English case of Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd 1963 AC 1 is not directly in point because that case considered a different statute

23 See CIR v Genn & Co (Pty) Ltd (1959) 20 SATC 113

24 CIR v Genn & Co (Pty) Ltd at 122

25 at 123

26 ibid

27 ibid

28 ibid

29 See Geldenhuys v CIR (1947) 14 SATC 419

30 See Geldenhuys v CIR at 431

31 (1969) 30 SATC 199

to the maturity date or when it is redeemed at redemption date The meaning of 'receive' is discussed in section 3 3 below

18 This meaning is taken from H W Fowler and F G Fowler The Concise Oxford Dictionary of Current English 5 ed 1966 and is quoted with approval in CQT v G (1981) 43 SATC 159 at 161

19 See s 1 s v 'gross income'

20 See the comments of Wessels CJ in CIR v Delfos At 101-2 he quoted with approval the dictum of Lord Cairns in Partington v Attorney-General (1869) 4 LR 100 (HL) at 122 and accepted in CIR v George Forest Timber Co (1924) 1 SATC 20 at 29 The passage which he quoted was

> 'As I understand the principle of all fiscal taxation it is this if the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be '

Wessels CJ went on to state at 102 that the rule is not absolute and that a section can be given a meaning narrower or wider than its apparent meaning In so doing, the whole statute must be taken into account in order to arrive at the true intention of the

8 Wessels CJ considered in CIR v Delfos at 103 that it might be possible to invoke equitable principles in order to avoid double taxation Curlewis JA at 108 did not foresee a danger of double taxation and De Villiers JA stated at 110 that there was a necessary implication that the same amount could not be taxed twice in the hands of the same taxpayer

9 See the judgments of Stratford JA at 108 and Beyers JA at 113

10 (1969) 30 SATC 199 at 207

11 at 208

12 ibid

13 ibid

14 See, for example, H B Falkena, L J Fourie & W J Kok The Mechanics of the South African Financial System 2 ed (1989) at 209-10

15 See s 1 s v 'gross income'

16 See Lategan v CIR See also CIR v Delfos and CIR v People's Stores (Walvis Bay) (Pty) Ltd This issue is discussed in section 3 5 below

17 The reason for this is that, in a discounting transaction, the holder of the note will only receive an amount when the note is sold prior

FOOTNOTES

1 See s 1 of the Income Tax Act 58 of 1962 s v 'gross income'

2 See Lategan v CIR (1926) 2 SATC 16, 1926 CPD 203, and CIR v People's Stores (Walvis Bay) (Pty) Ltd (1990) 52 SATC 1, 1990 (2) (SA) 353 (A)

3 There are, of course, exceptions For example, in terms of s 7A(1) and (2) of the Income Tax Act an antedated salary or pension is deemed in certain circumstances to have been received by or accrued to the recipient over a specified period These exceptions are not relevant in considering the taxation of discounting transactions

4 See SIR v Silverglen Investments (Pty) Ltd (1969) 30 SATC 199, 1969 (1) SA 365 (A) The Commissioner referred to is the Commissioner for Inland Revenue

5 (1933) 6 SATC 93, 1933 AD 242

6 at 94-100 and 111-13

7 CIR v Delfos at 103 and 108

The earliest Appellate Division decision is that of COT v William Dunn & Co Ltd.[10] This case was decided under the Income Tax Act 28 of 1914, which was based on the English concept of profits and gains rather than receipts and accruals

The facts were that the taxpayer was a company registered and carrying on business in England The taxpayer acted as an agent for three South African firms In terms of its agreements with these firms, the taxpayer purchased, in its own name, goods requisitioned by the South African principals It then invoiced and shipped the articles, debiting the principal concerned with costs, freight charges and commission, together with interest at 5% on the balance due from time to time [11]

The issue before the court was whether this interest was received by or accrued to the taxpayer from a South African source The court held that the interest had not been received from any source within South Africa, but was the result of the employment in England of the taxpayer's own capital in its own business [12]

The Attorney-General, on behalf of the Commissioner, argued that the source of the interest was the employment of capital In other words, the source of profits is the place where the capital which produces the profits is employed The court agreed that this was the correct test [13] The Attorney-General

authority on this issue and it can be argued both that the transaction between A and B is one of purchase and sale and it is a loan.[4] The stronger argument is that, on the authority of Tucker v Ginsberg,[5] the transaction is one of loan.[6]

Thus, where A issues a bill, note or bond to B at a discount on its face value the transaction is one of loan. However, if B negotiates the bill to C the transaction is one of sale.

4.3 APPROACH TO SOURCE

In order to determine whether an amount has been received by or has accrued to a person from a source within South Africa two problems need to be resolved as far as actual source[7] is concerned.

The first is to ascertain the source from which the amount has been received or accrued. Once the source has been identified, the second problem arises, namely, to locate it in order to decide whether it is within South Africa.[8]

4.4 DEVELOPMENT OF THE TESTS TO BE APPLIED IN DETERMINING THE MEANING AND LOCATION OF SOURCE

The tests to be applied in determining the meaning of location of source have been developed in a number of Appellate Division and Privy Council decisions, which will be examined in detail.

should be applied in determining source in both cases However, in practice, the source of a discounting profit arising as a result of the issue of a bill, note or bond at a discount will be its originating cause, which will be the provision of credit

4.2 NATURE OF A DISCOUNT

Discount means the deduction made from the face value of a bill of exchange or promissory note by a person who is giving value for it before it is due [2]

The nature of a discount has been discussed in chapter 2 Whilst the South African courts have not considered, in an income tax context, the question whether discount profits are similar to interest, they have considered this issue in the context of the Usury Act 23 of 1926 and the Usury Act 73 of 1968 [3] It has been held that discounting is not lending and that therefore the discounting of a note should not be regarded in substance as a loan of money [4]

This conclusion accords with the situation where, for example, A acquires for R94 a bill, note or bond with a face value of R100 and subsequently disposes of it for, say, R98 The position is more difficult where, for example, A is issued with a bill, note or bond with a face value of R100 He pays R94 to the issuer of the instrument and, on due date, is paid R100 There is no clear

4 SOURCE

4.1 INTRODUCTION

The definition of gross income in s 1 of the Income Tax Act[1] includes, inter alia, receipts or accruals from sources within, or deemed to be within, South Africa. Thus, if a receipt or accrual is not from a South African source, it will not be subject to normal tax in South Africa.

In this chapter there is an examination of the rules of source insofar as they relate to receipts or accruals from discounting transactions.

The meaning of a discount is discussed. From this it is apparent that the issue of a bill, note or bond at a discount on its face value is a transaction of loan. However, the subsequent negotiation of a bill, note or bond is regarded as a transaction of purchase and sale.

An examination of the development of the tests to be applied in determining the meaning and location of source follows. The tests applied by the courts have not always been clear or consistent.

As far as the source of a discounting profit is concerned, it is necessary to distinguish between profits arising from the issue of a bill, note or bond, and those arising from its subsequent negotiation. The employment of capital test

189 Inland Revenue The Taxation of Gilts and Bonds, a consultative document issued on 25 May 1995 at 8 and R Koch The Financial Times A-Z of Management and Finance 1995 at 360

190 s 1 s v 'gross income'

191 Inland Revenue The Taxation of Gilts and Bonds, a consultative document issued on 25 May 1995 at 8

179 s 24J(9)(h) Note that the stipulation that the election is binding on the company is subject to two provisions, namely s 24J(9)(e) and (f) These provisions are discussed below

180 s 24J(9)(d) This section is also subject to s 24J(9)(e) and (f)

181 s 24J(9)(e)

182 s 24J(9)(f)

183 Explanatory Memorandum on the Income Tax Bill, 1995 at 17-18

184 Explanatory Memorandum on the Income Tax Bill, 1995 at 18

185 L R Rosen Investing in Zero Coupon Bonds (1986) at 17 Generally, see S Homer and M L Leibowitz Inside the Yield Book 1972

186 Rosen at 17

187 Rosen at 19-20

188 It is interesting to note that in the examples given by Rosen at 42-6 if one assumes a tax rate of 50%, the pre-tax yield of a zero coupon bond will be 13% and the after-tax yield will be 6,5% In the case of a conventional bond, the after-tax yield will increase to 10,3%

170 s 24J(1)

171 Explanatory Memorandum on the Income Tax Bill, 1995 at 13-14

172 s 24J(5)

173 s 24J(6)

174 Explanatory Memorandum on the Income Tax Bill, 1995 at 14-15

175 s 24J(7)(*a*)

176 s 24J(8).

177 s 24J(9)(*a*) This section also applies where a company is short selling instruments. Short selling is defined in s 24J(1) as the sale of any instrument by a person who is not the owner of the instrument. However, the person has an obligation to deliver such an instrument at a future date.

178 s 24J(9)(*c*). The market value must be determined in accordance with commercially accepted practice and must be applied consistently by the company for the purposes of financial reporting to the company's shareholders.

162 s 24J(1) s v 'instrument' The definition contains more detail It is, however, beyond the scope of this thesis to examine it in more detail

163 s 24J(1) s v 'income instrument' The definition of deferred interest contains two requirements First, interest which is not receivable within one year from the date of the start of the accrual period In determining whether interest is deferred, the interest rate must be calculated in respect of any accrual period by applying a constant rate of interest over the term of the instrument Second, deferred interest includes interest receivable where such interest is not calculated by applying a constant interest rate throughout the term of the instrument

164 Explanatory Memorandum on the Income Tax Bill, 1995 at 8

165 s 24J(3)

166 s 24J(1) s v 'alternative method'

167 Explanatory Memorandum on the Income Tax Bill, 1995 at 17 These methods will be discussed in more detail when considering various examples

168 Explanatory Memorandum on the Income Tax Bill, 1995 at 13

169 s 24J(4)

152 s 24J(1) s v 'holder'

153 s 24J(1) s v 'yield to maturity'

154 ibid The meaning of 'adjusted initial amount' is defined in s 24J(1) In the context of a holder, it is the sum of the initial amount, the accrual amounts in respect of previous accrual periods and any payments made by the holder in any previous accrual periods, less any payment received by the holder in any previous accrual period in respect of the instrument

155 Explanatory Memorandum on the Income Tax Bill, 1995 at 9

156 s 24J(1) s v 'yield to maturity' The rate of interest must be redetermined with reference to the appropriate adjusted initial amount prior to the variation

157 s 24J(1) s v 'yield to maturity'

158 Explanatory Memorandum on the Income Tax Bill, 1995 at 10

159 s 24J(1) s v 'adjusted initial amount'

160 s 24J(1) and (3)

161 s 24J(1) s v 'instrument' The instrument does not have to be in writing

140 SA Crushers (Pty) Ltd v Ramdass 1951 (2) SA 543 (N) at 546

141 SA Crushers (Pty) Ltd v Ramdass. Arnold v Viljoen. Kamaludin v Gihwala 1956 (2) SA 323 (C) at 326

142 Strydom v Van Rensburg 1949 (3) SA 465 (T) at 467

143 See n 125 above

144 For example, the note must be presented for payment by and to the proper person, at the proper time and place and in the proper manner See D V Cowan & L Gering Cowen The Law of Negotiable Instruments in South Africa 4 ed (1966) at 305-11

145 ITC 76 (1927) 3 SATC 68

146 See Explanatory Memorandum on the Income Tax Bill, 1995 at 7

147 ibid

148 s 24J(1) s v 'interest' This applies irrespective of whether the interest is determined at a fixed or variable rate or whether it is receivable as a lump sum or in unequal instalments

149 s 24J(1) s v 'accrual amount'

150 s 24J(1) s v 'accrual period'

151 s 24J(1) s v 'yield to maturity'

129 ibid

130 (1977) 39 SATC 95 at 112

131 Crispette & Candy Co. Ltd v Oscar Michaelis NO and Leipold Alexander Michaelis NO 1947 (4) SA 521 (A) at 537

132 ESE Financial Services (Pty) Ltd v Cramer 1973 (2) SA 805 (C) at 808-9, Crispette & Candy Co. Ltd v Oscar Michaelis NO and Leipold Alexander Michaelis NO at 537

133 1914 AD 293

134 at 296. It should be noted that there are exceptions to this general principle, some of which were discussed in this case. It is, however, beyond the scope of this thesis to discuss them.

135 Breytenbach v Van Wijk 1923 AD 541, ESE Financial Services (Pty) Ltd v Cramer

136 Nulliah v Harper 1929 AD 141 at 151

137 Arnold v Villiers 1954 (3) SA 322 (C) at 331

138 Myburgh v Central Motor Works 1968 (4) SA 865 (T), Anastasopoulos v Geldenhuis 1970 (2) SA 631 (N) at 656, ESE Financial Services (Pty) Ltd v Cramer at 809

139 Myburgh v Central Motor Works

119 CIR v People's Stores (Walvis Bay) (Pty) Ltd at 23

120 See Partington v Attorney-General (1869) 4 LR 100 (HL). CIR v George Forest Timber Co. (1924) 1 SATC 20

121 See s 24(1) of the Income Tax Act 58 of 1962

122 See s 24(2) of the Income Tax Act 58 of 1962

123 See 'The Meaning of Accrue and the Valuation of a Debt Payable in the Future' (1990) 39 The Taxpayer 61 at 63. J Silke 'The Lategan Principle Confirmed' (1990) 28 ITR 157 at 166-7

124 For a general discussion on CIR v People's Stores (Walvis Bay) (Pty) Ltd. see the articles referred to supra in note 123 above and H Vorster 'Instalment Sales Lategan Revisited' (1987) 2 SAJJ 64. 'When is There an Accrual' (1989) 38 The Taxpayer 201. 'Accruals and their Valuations' (1990) 39 The Taxpayer 81.

125 The proviso was inserted by s 2(1)(*a*) of Income Tax Act of 1990, effective as from 1 July 1962 and applicable in respect of all amounts accrued on or after that date

126 See Lategan v CIR and CIR v People's Stores (Walvis Bay) (Pty) Ltd

127 See Silke at 162-3

128 (1927) 3 SATC 68 at 70

discussed whether, even if this contract was concluded outside New South Wales, the source of the income was outside the state [69]

Isaacs J did not accept the argument of the Commissioner. The argument was based on the proposition that the payment was made in terms of the first contract as part payment for concentrates to be delivered. Thus, the source of the income was the concentrates produced in New South Wales, and Isaacs J regarded the initial basis of the payment as provisional. This basis disappeared when the second contract was concluded [70]

The parties accepted that the operations carried on in New South Wales constituted an essential part of the company's benefits. Thus, the company's business was carried on partly within and partly outside New South Wales. The first contract was made as part of the company's business. When the purchaser of the concentrates committed a breach of the first contract, the company obtained damages for this breach. This was recorded in the second contract. Isaacs J found that if the first contract was entered into as part of the company's business which it carried on partly in New South Wales, then the income arising from the contract was derived wholly or partly from that source [71]

Isaacs J. followed Lovell & Christmas Ltd v COT,[72] and held that a trade or business is carried on where contracts are habitually made. The court held that the company carried on business in New South Wales and was taxable on its

compensation for breaks of the first contract? The latter right would have come into existence in England where the parties entered into the first contract."[1]

Griffith CJ adopted an approach to the determination of source which was subsequently applied in South Africa. This was first to determine the source from which income was derived. Thereafter, one had to locate the source.[42]

Griffith CJ held that where a person carries on the business of dealing with natural products either to prepare them for use or extract from them other products, and then sells the ultimate product, any income arising from the contracts of disposal has its source, at least partly, in the business undertaking. In another sense, source may be the capital embarked in the undertaking. He held that the source was the company's business undertaking.[43]

In his judgment, Isaacs J discussed Kirk in some detail.[44] He concluded that if the first contract had been carried out and not cancelled, the principles laid down in Kirk would have been applicable. Thus, some of the monies paid in terms of the first contract would have been taxable. Kirk was not authority for the proposition that all of the monies paid were from a source in New South Wales."[1]

The lower court found that, on the basis of the second contract, the monies paid to the company constituted damages for breach of contract.[45] Isaacs J

Wales. The contract provided for advance payments and the balance relating to each delivery to be effected upon delivery.

The company received an advance payment and, prior to any delivery being made, the contract was cancelled by mutual agreement. In terms of the cancellation agreement the company retained the advance payment received.[60]

The court had to consider whether the advance payment was from a source within New South Wales and, therefore, taxable in that state.[61]

In terms of the Income Tax (Management) Act of 1912 the term income was defined as meaning income which was derived from any source in the State.[62]

The arguments before the court revolved around the two contracts. The first contract related to the original sale of the concentrates. The second related to the cancellation of the first contract. The arguments concerning the first contract covered the question whether any profit arising from it was derived from a source within New South Wales.

There was an interesting issue raised in argument on the effect of the second contract. This was whether the second contract changed the character of the payment under the first contract. In other words, did the source of the payment to the company arise from the sale of concentrates derived from New South Wales, or was it the equivalent of the company's personal right to

to it from any profession, trade, employment or vocation carried on in New South Wales, from lands of the Crown held under lease or from any other source "[44]

Their Lordships found that there were four processes in earning or producing the income, namely the extraction, manufacturing, sale and receipt of the sale proceeds. It held that the first two processes fell within s 15 and answered in the affirmative the question whether the company had any income falling within the meaning of the Land and Income Tax Assessment Act of 1895.[45]

It should be appreciated that the Privy Council was merely required to answer two questions. First, whether the companies involved had any means in the year of assessment within the meaning of the Land and Income Tax Assessment Act of 1895. Second, whether the companies were liable to taxation under that Act and the Income Tax Joint Act of 1895.[46] Their Lordships answered both questions in the affirmative.[47] They were not called upon to answer whether the companies were only liable to New South Wales income tax on the profits arising from the processes carried on in that state.[48]

In COT for New South Wales v Meeks[49] the company was registered in England and carried on its practical operations of mining, treating and smelting ore in New South Wales. The company, through its London agents, entered into a written contract in England with an English company for the sale to it of slimes concentrates. Delivery was to be made to the purchasers in New South

A further argument put forward by the taxpayer was that Mrs Millin's business was carried on partly in South Africa and partly in England. Thus the taxpayer should only have been taxed upon the portion of the income that was earned in South Africa [48]

The court did not consider that there was a basis for apportionment as the whole source of the royalties was in South Africa [49] In deciding that there was only one source of the royalties, the court referred to certain Privy Council and Australian cases, which will be discussed below [50]

The first case was that of COT v Kirk.[51] The case involved appeals from two judgments of the Supreme Court on special cases stated. In each case a company was formed and incorporated according to the laws of Victoria where it had its head office and board of directors. It carried on the business of mining on leasehold land held from the Crown. The land was situated in New South Wales. A certain portion of the crude oil was sold in New South Wales, but the greater part was treated and sold outside that state. No contracts of sale were made in New South Wales [52] The Privy Council had to decide whether the company had any income within the meaning of the New South Wales Land and Income Tax Assessment Act of 1895 and was accordingly liable to taxation under the provisions of that Act and the Income Tax Joint Act of 1895. The Privy Council had to decide whether s 15(1), (3) or (4) of the Land and Income Tax Assessment Act of 1895 applied [53] To do so it had to be satisfied that, effectively, the companies had income arising or accruing

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The court did not agree with the application of the deeming provision as it related to services, work or labour. The court drew a distinction between paying a person for his labour and purchasing an article which he has made using his skills and labour. The court found that Mrs Millin received her royalties for the right to publish her novel and not for her labour. Thus, the deeming provision did not apply to Mrs Millin's income [44]

The main issue before the court was whether the royalties received by Mrs Millin were from a source within South Africa [45]

The taxpayer's main argument was that the royalties accrued from an English source. The argument was based on the fact that when Mrs Millin wrote a novel she produced a capital asset. This asset was the copyright relating to the novel. The copyright remained her property. She granted her publishers a licence to publish the novel, and the royalties which she received therefrom related to her capital asset. Thus, the source of her income was the place where her capital was employed, namely, London. The court did not accept that the copyright relating to Mrs Millin's novel was a capital asset [46]

The court held that Mrs Millin's business of writing novels was based, not upon capital, but upon her wits and labour. It was the exercise of her wits and labour that produced her income [47]

form of royalties The profits accrued to her from a South African source as she carried on her trade in South Africa [38]

The court accepted that Mrs Millin carried on a trade within the meaning envisaged in the Income Tax Act Her trade consisted not only of the production of works of fiction, but also the publishing and selling of the novels In other words she was dealing with her copyright [39]

The judge in the lower court found on these facts that there was substance for the argument that as part of her business was carried on outside South Africa, her income was not derived from a South African source [40] He did not make a definite finding on this point as he found that Mrs Millin's income was deemed to have accrued from a source within South Africa The deeming provision which he held applied was that relating to services rendered or work or labour done by a person in the carrying on in South Africa of a trade [41]

The approach of the learned judge in the lower court did not find favour in the Appellate Division [42]

The court did not agree with the point that, if part of Mrs Millin's business was carried on overseas, her income was not derived from a South African source The court's reason was that if any of Mrs Millin's income was earned in South Africa, then to that extent it would be regarded as having arisen from a South African source [43]

' "source" denoted origin, not location, and capital which produced profit was located where it was employed' [44]

It is interesting to note that, insofar as the shares in the companies which had been involved in mining operations in South West Africa were concerned, the court considered it significant that the companies in question had ceased operations prior to the taxpayer's acquiring the shares. Thus, the court found that the taxpayer took over the shares in order to obtain the money to which they related. Therefore the resulting profit arose from the taxpayer's employment of capital in South Africa and not from a business or service.[45]

In Millin v CIR[46] the facts were that Mrs Millin, the wife of the appellant, received income in the form of royalties from her publishers in respect of works of fiction written by her in South Africa. The works were printed and published in England and the United States of America. The royalties were payable to Mrs Millin in terms of contracts entered into by her with her publishers, and were remitted to her through her London agents.[47] The main question before the court was whether the royalties received by Mrs Millin from her publishers in England were from a source within or deemed to be within South Africa.[48]

The Commissioner argued that Mrs Millin carried on a trade in South Africa. Her trade was writing works of fiction for profit. She received profits in the

taxpayer also included small shareholdings in mining companies in South Africa. These were amounts due to shareholders of the companies which were in the hands of the Custodian of Enemy Property representing mostly part dividends declared but not distributed during the war period and proceeds from the realization of surplus assets. The interests of Dr Lubbert were taken over by the taxpayer at less than half their market value.[25] The court was called upon to decide, inter alia, two issues. The first was whether the excess received in respect of the liquidated shares over the amount at which they had been acquired was from a South African source.[26] The second was whether the profits on the sale of shares effected in Germany were from a South African source.[27]

The court found that, on both issues, the receipts were from sources within South Africa.[28] It held that, generally, the source of income is the location of the business capital or service which produces the income.[29] Source denotes origin, not location.[30] Thus the capital which produces the profit is located where it is employed.[31]

It is submitted that this case was important for two main reasons. First, it followed Dunn by applying the employment of capital test.[32] This is, perhaps, not surprising as one of the two judgments was delivered by Innes CJ who delivered the judgment in Dunn. Second, it refined the test for determining source by distinguishing clearly between origin and location. Innes CJ stated -

ordinary sense of the word Accordingly, the court upheld the company's claim [18]

The court in Dunn[19] went on to state that the facts under consideration were stronger than those in Reid's Brewery.[20] In Reid's Brewery, some of the transactions constituted temporary loans, whereas in Dunn the relationship of lender and borrower never came into existence.[21]

The court found that in order to determine where the capital was employed to earn the profits one must ascertain the source from which the profits were derived [22] The court held that the source was the taxpayer's English business.[23]

This case is important because it was the first Appellate Division decision to establish the employment of capital test in order to determine source It is submitted that the court's judgment provided a sound basis for the development of the approaches adopted to ascertaining sources of income in South Africa

In Overseas Trust Corporation Ltd v CIR[24] the facts were that the taxpayer had been formed to take over certain interests held by a Dr Lubbert It was registered in both South Africa and South West Africa The interests transferred to the taxpayer consisted of shares and debentures in mining companies in South West Africa, a number of which were in liquidation, and the share capital had already been repaid The interest transferred to the

argued further that the transactions between the taxpayer and the South African firms were loans. The goods which were sent to South Africa represented the money lent and, therefore, the taxpayer's capital was employed in South Africa.[14] The court held that, as a commission agent for the South African firms, the taxpayer had agreed to purchase, invoice and ship the goods, and to pay the costs, insurance and freight. As it used its capital for that purpose, it employed it in its own business and did not lend it to the South African firms.[15]

The court relied on the authority of Reid's Brewery Co. v. Male.[16] In this case the company carried on the trade of brewers, and, in addition, the business of bankers and money lenders, which business was customary for manufacturing brewers. The company was assessed to income tax on its profits from trade and sought to deduct bad debts in respect of loans to customers made as part of its money-lending business.[17]

The issue before the court was whether the money used or expended in the money-lending business was to be treated as capital. If it was capital invested, then no deduction could be made in respect of the bad debts. The court found that the money so dealt with was not capital invested. The reasons for this finding were that no loan was made by way of a permanent investment, the money used in the money-lending business was capital used by the company for its working capital, thus money employed in the money-lending business was money used and it was out of capital, but it was not invested in the

The facts were that the taxpayer was a holding company incorporated in the United Kingdom It did not carry on business nor own any capital within South Africa It held shares in various trading companies in England and throughout the British Empire It was closely associated with a Dutch holding company which held shares in trading companies carrying on business outside the British Empire One of these subsidiaries was a Dutch company, Mavibel Agreements were entered into between the taxpayer, Mavibel and a trustee company the effect of which was that the taxpayer sold and transferred to Mavibel shares held by it In addition it ceded to Mavibel debts owed to it In consideration of the transfers and cessions, Mavibel paid a certain amount of cash and the balance remained outstanding on an interest-bearing loan account As security for the loan, Mavibel transferred to or deposited with the trustee shares owned by it and shares owned by one of its subsidiary companies If Mavibel failed to fulfil its obligations under the agreement, the trustee would hold the shares for the taxpayer and the loan would be extinguished Subsequently a South African company was formed and acquired from Mavibel and its subsidiary company their entire interest in the shares held by the trustee as security It provided that future payments to be made by the South African company were to be made at the taxpayer's registered office in England by sterling cheque None of these agreements was entered into in South Africa They were assented to by the relevant South African government department Interest due by the South African company was paid out of income arising from certain shares held by the trustee as security [12] The Commissioner claimed that this interest was taxable in South Africa [13] The issue before the court was whether

legislature divided income into that from personal exertion and that from property. In doing so, he considered that the language indicated that the legislature regarded these as representing the two general sources of income.

He stated:

> "The legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact."[130]

It is clear that Isaacs J was considering which of the two general sources of income applied to the income in question and whether such income was derived from an Australian source. Although the wording of the Australian legislation differs from the relevant provisions of the South African Income Tax Act, it is sufficiently similar to render Nathan persuasive in South African courts.

CIR v Lever Bros & Unilever Ltd[131] is, perhaps, the most important decision by the South African courts on source in that it crystallized the approach to be adopted by the courts in determining the source of income.

monies to the South African firms and the goods which were sent to South Africa represented the money lent. Accordingly it argued that the taxpayer's capital was employed in South Africa.[124] The court found that the taxpayer employed the capital in its own business and did not lend it to the South African firms.[125] The court's reliance on Reid's Brewery[126] indicates that it considered the approach to be adopted in determining where capital is employed in a business is, first, to determine the business in which the capital is employed. Thereafter it must be established how the money is utilized in the business. If the money is utilized in the profit-making activities of the business, the source of the income remains the capital employed in it.

On the other hand, if the money is capital invested, the place where the capital is employed may change. Thus, in Reid's Brewery, the money was utilised in the company's money-lending business and was not invested as capital elsewhere.[127] Therefore, applying the employment of capital test to the facts in Rhodesian Metals, it is clear that the capital was employed by Rhodesian Metals in its business in Southern Rhodesia.

Finally, it is interesting to note that Lord Atkin applied the practical man test because, having questioned the value of decisions of foreign courts in certain circumstances, he applied a test which apparently originated from an Australian decision.[128] In Nathan v FCOT[129] Isaacs J, who delivered the judgment of the court, had to decide whether income was derived directly or indirectly by the taxpayer from sources within Australia. He stated that the

was similar to that in the Income Tax Act and is, therefore, persuasive [116] In Meeks the court considered a later Australian taxing Act in which income was defined as meaning income which was derived from any source in the state [117] The court held that the source of the income was, at least partly, the business undertaking and followed Lovell & Christmas to determine that the business was carried on where the contracts were habitually made [118] Clearly Meeks is also of persuasive value Sulley[119] and Grainger[120] were concerned with the United Kingdom taxing legislation and are, accordingly, also persuasive in determining what constitutes a business and where such business is carried on Lovell & Christmas dealt with a New Zealand taxing Act which was similar to the United Kingdom taxing Acts It is, therefore, of similar value to Sulley and Grainger The criterion of the determination of the essence of a business is important in understanding the earlier South African decisions

Lord Atkin was uncertain about the meaning of employment of capital, whether it meant the place of purchase, or whether it was represented by the stock and moved to the place of sale, or whether it could be used only as a test of source where the purchase and sale were effected at the same place [121] In Dunn the Attorney-General in argument raised a similar point [122] It will be recalled that, in Dunn, the taxpayer was an English company carrying on business in England Acting as a commission agent for South African firms, it purchased, invoiced and shipped goods, and paid the costs, insurance and freight It earned interest on the balance due by the South African firms from time to time [123] The Attorney-General argued that the taxpayer had loaned

In his comments on the value of the decision of foreign courts, Lord Atkin referred to the charging words of the English statute which covered, inter alia, annual profits or gains from any trade exercised within the United Kingdom [109]

In Dunn[110] the court was concerned with the Income Tax Act 28 of 1914 which was based on the English concept of profits and gains The court applied the test of employment of capital in determining the source of income [111]

The English authority relied upon by the court did not relate directly to source of income, but to what constituted capital invested Although Overseas Trust[112] was concerned with the Income Tax (Consolidation) Act 41 of 1917 it followed Dunn It went further in that it held that the source of income is the location of the business capital or service which produces the income It also held that source denotes origin, not location [113] In Millin the court, following both Dunn and Overseas Trust, held that it was the exercise of her wits and labour that produced Mrs Millin's income In considering whether there was only one source or more than one source to establish a basis for apportionment, the court considered decisions of various overseas courts [114] In view of Lord Atkin's comments, it is appropriate to examine the value of these decisions

Kirk[115] was concerned with a New South Wales taxing Act The wording of the legislation insofar as it applied to the source of the manufacturing proce

Villiers JA. In applying the employment of capital test, he held that the capital was employed in London. He found that the claims did not contribute towards the profit. The transaction was a financial one which took place in London. He emphasized the importance, in a case like this, of the place of conclusion of the contract of sale. This was so because the contract of purchase and sale in London formed the essence of the business and constituted the source of the profit [106] Finally, De Villiers JA applied the practical man test to reaffirm his decision [107]

In the Privy Council, Lord Atkin referred to various English, Australian, New Zealand and South African decisions and stated that no criticisms could be made of them. He pointed out that decisions on the wording of one statute are seldom of value in deciding on different words of another statute. He questioned the employment of capital test. He was not sure whether it meant the place where a taxpayer purchases stock which is profitably sold elsewhere or the place where the stock representing the capital is sold or whether it can be applied only where purchases and sales take place in the same place. He then applied the practical man test and reaffirmed the majority decision of the Appellate Division [108]

During the course of liquidation the whole of its undertaking was sold to St Swithin's as a going concern at a substantial profit. One of the issues was whether the income was derived from a source within Southern Rhodesia.[100]

In a majority decision, the Appellate Division held that the income was from a Southern Rhodesian source.[101] Counsel for Rhodesian Metals argued that the buying and selling of the claims constituted the dominant factor in the making of the profit and these took place in England.[102] Counsel for the Commissioner, on the other hand, argued that the income resulted from the employment of capital in Southern Rhodesia. Thus, if Rhodesian Metals carried on business in London, the profit did not result from the investment of capital in the business there. It resulted from the investment in Southern Rhodesia by the business.[103]

Stratford CJ held that Rhodesian Metals made a fortunate purchase of claims in Southern Rhodesia by employing its capital there and that, accordingly, the profit was made by the productive employment of its capital in Southern Rhodesia.[104] Tindall JA also applied the employment of capital test. He considered that the dominant factor in and the true origin of the profits was the value of the claims. Rhodesian Metals bought and developed the claims and thereafter sold them at a profit. In doing so, it employed its capital in Southern Rhodesia. In addition he held that the English cases, such as Ginsburger and Lovell & Christmas did not apply because of the different wording of the United Kingdom statute.[105] The dissenting judgment was delivered by De

Liquidator, Rhodesian Metals Ltd v COT, Southern Rhodesia[97] was heard in both the Appellate Division of the Supreme Court in South Africa[98] and the Privy Council[99] Both these decisions will be discussed. The facts were that in 1934 Aldworth and Sauerman held 300 tungsten claims, known as the Sequel Mine, in Southern Rhodesia. Bayliss acted as agent in Southern Rhodesia for Davis, a director of companies in London. Acting as agent, Bayliss obtained an option from Aldworth and Sauerman. In terms of the agreement, Davis had the right to develop the claims and to buy them for £38 000 cash and 12% of the share capital of a company to be formed to acquire or work the claims. In addition, Davis had the option to buy the 12 per cent shareholding from Aldworth and Sauerman at the price at which they might offer the claims to a third party and provided that Davis had a right of first refusal to acquire any other tungsten claims acquired by Aldworth and Sauerman. In 1935 Davis pegged further claims in the same locality, and then promoted the flotation of two companies in Southern Rhodesia. The two companies were St Swithin's and Rhodesian Metals.

Davis held 1 600 of the issued shares of Rhodesian Metals and 6 400 shares were held by a nominee company. Davis then sold 420 claims to St Swithin's, and Aldworth and Sauerman sold to the same company the Sequel Mine claims for cash and shares. Davis then sold 1 010 claims to Rhodesian Metals. Within three months of this sale, Rhodesian Metals went into voluntary liquidation.

Whilst the court in Millin was correct in its view of the judgment in Kirk it did not satisfactorily reconcile the judgment in that case with that in Lovell & Christmas. In this regard, the judgment of Isaacs J in Meeks[91] provides a suitable basis for reconciling the different decisions. In Grainger & Son v Gough[92] it was held that a trade or business was carried on at the place where the contracts which form the essence of the trade or business are habitually made. Thus it is important to establish the essence of a business. Where an antecedent operation is preparatory only to the business and does not form part of its essence, it is not taken into account in determining where the business is carried on for income tax purposes.[93] In Kirk[94] the initial processes of extraction and manufacture clearly formed part of the essence of the taxpayer's business.

In Lovell & Christmas the essence of the taxpayer's business was the selling of goods on commission in London and the earlier arrangements entered into in New Zealand were merely preparatory to the essence of the business.[95]

Applying this criterion to Millin it is clear that the court regarded the essence of Mrs Millin's business as the exercise of her wits and labour and the contract with her publishers was merely ancillary. Accordingly, as the essence of her business was carried on in South Africa, there was no basis for apportionment.[96]

decided cases was that where a trade or business ordinarily consists in making certain types of contracts and in carrying them into operation to make a profit, the trade or business is carried on at the place where the contracts are habitually made. The court held that the decisions did not provide authority for going back further than the business from which the profits are directly derived, and the contracts which form the essence of that business.[87] The court held further that in the case in question the business which yielded the profit was the business of selling goods in London and that the profits were not, therefore, taxable in New Zealand.[88]

In Millin[89] the court did not consider that there was a basis for apportionment as the royalties were received wholly from a South African source. The appellant argued that Mrs Millin produced a capital asset when she wrote a book. The asset was the copyright of her book. She retained the copyright when she entered into a contract with her publishers to publish the book. The court held that it was by the exercise of her wits and labour that she produced her income.[90] On the authority of Kirk,[91] it could be argued that there were a number of processes in the earning of Mrs Millin's income and that, accordingly, there was a basis for apportionment of her income. The court was, however, in agreement with the view that in Kirk it was not decided that some portion of the income is taxable in the place where any process in the earning of profits is carried on. This was the reasoning used by the court in Millin to reconcile the decisions in Kirk and Lovell & Christmas.[92]

court had to determine two questions. The first was whether the French principal exercised any trade, employment or occupation within the United Kingdom and, second, if so, whether he was liable to be assessed to income tax in the name of the appellants who were his agents.[82] The House of Lords found in a majority decision that all the appellants did in the United Kingdom on behalf of the French principal was to canvass for orders, to transmit to the principal those orders when they were obtained, and in some cases to receive payment on the principal's behalf. Accordingly the majority held that the French principal did not exercise a trade within the United Kingdom as the contracts were concluded in France.[83]

In Lovell & Christmas Ltd v CQT[84] the company carried on, in London, the business of provision commission agents. The company sold dairy produce on commission on behalf of producers all over the world.

As part of its business, the company had an employee in New Zealand. Each year it sent from London one of its employees who, together with its New Zealand employee, attended meetings of various butter and cheese factories. The purpose of the meetings was to persuade the directors to consign their season's output to the company to be sold in London on commission. The company was prepared to make advances against produce. The court had to decide whether the business from which the profits had been derived was a business carried on in New Zealand so as to bring the profits within the scope of the New Zealand taxing Act. One rule which the court deduced from the

income It could, however, possibly establish a case for apportionment and in this respect the onus was on it to do so [73]

Whilst the court in Millin[74] referred to Lovell & Christmas[75] it did not refer to certain English authorities germane to an understanding of Lovell & Christmas.

In Sulley v The Attorney General[76] the facts were that a firm established in New York habitually bought goods in England and other countries. All goods purchased were sold in America where the profits on the sales accrued. The principal firm in New York had a branch in England which was run by the taxpayer who was a partner in the firm. The other members of the firm were citizens of the United States and not resident in England. The Crown sought to make the taxpayer liable in respect of the profits accruing to the firm generally. The question was whether there was a carrying on or the exercise of a trade in England [77] The court found that a merchant has one principal place in which he may be said to trade and this was where his profits come home to him [78] It held further that the profits of the firm in the United States did not accrue in respect of any trade carried on in England [79] They accrued in respect of the trade carried on in New York where the main business of the firm was conducted [80]

The facts in Grainger & Son v Gough[81] were that the appellants were wine merchants carrying on business in England. They acted as agents for certain purposes for a French wine merchant who carried on business in France. The

generally the business of purchasing and selling credit instruments and usually takes the form of the employment of capital

4.6 LOCATION OF THE SOURCE OF DISCOUNTING PROFITS

There are two situations to consider in locating the source of discounting profits. The first is where A issues a bill, note or bond with a face value of R100 to B for R94 and B holds it to maturity. B will have made a gain of R6. The second situation is where A issues a bill, note or bond with a face value of R100 to B for R94. B negotiates it to C for R96 and C holds it to maturity. C will have made a gain of R4.

In the first situation the source of B's gain is its originating cause. This should be the employment of capital by B. In order to establish where the capital is employed, the business in which the capital is employed must be determined. In this regard, it is important to isolate the dominant cause or essence of the business or activity which produces the gain. Thus activities which do not form part of the essence of the business should not be taken into account. Thereafter, how the money is used in the business should be ascertained. If the money is used in the profit-making activities of the business, the source of the income remains the capital employed in it.

company was obliged to retain in London sums of money to meet its various financial commitments. The company then changed its investment strategy. Instead of depositing surplus funds in an interest bearing account, it adopted the procedure of purchasing short-term United Kingdom government securities with the object of reselling them at a profit. After the company had purchased and paid for the securities in London, they were registered in the name of a nominee in London and retained there until sold. The sale and receipt of the consideration also took place in London.[170] The court found the originating cause to be the activities conducted in London.[171] It held that the company carried on a separate business in London.[172] It further held that if the originating cause of the profits was the employment of capital, the capital was employed in London where the source was located.[173] In addition, on the authority of Lovell & Christmas, the essence of the business was the contracts of purchase and sale and as these were habitually made in London this confirmed the location of the source as being there. The court had difficulty in differentiating the practical man from the theoretical lawyer. However, in applying this test, it held that the ordinary businessman would regard the profits as being from a London source.[174]

Having regard to the various authorities discussed, the approach which should have been adopted by Watermeyer CJ in Lever Bros should be used to determine the meaning of the source of discounting profits. It is thus necessary to determine the originating cause of the profits. The originating cause is

In CIR v Black[166] the taxpayer was a stockbroker who lived and carried on business in South Africa The firm in which the taxpayer was a partner did some business with a firm of London brokers The taxpayer sent a sum of money to the London brokers to enable them to deal on his behalf on the London Stock Exchange

The sum sent by the taxpayer did not cover his purchases It was understood that the London firm would extend credit where necessary The London firm effected the purchases and sales in London where the shares were paid for, held and delivered and where the sale proceeds were received In most cases purchases were made by the London firm only after confirmation by the taxpayer [167] The court found that the taxpayer employed his capital and carried on business in London and that, accordingly, the source of the profits was located in London.[168]

In M Ltd v COT (SR)[169] the company was incorporated in the United Kingdom After many years its management and control was transferred to Northern Rhodesia and then to Southern Rhodesia Its main activity was the carrying on of mining operations Decisions on the sales of its products were made in the Federation, and sales were made through a sales agent in London The agent received offers and would transmit them to the head office in the Federation where they would be accepted The sales agent would receive the sale proceeds and transfer them to the company's financial agent in London These sums were deposited in the company's current account in London The

The approach which should be adopted in order to determine the meaning of the source of the receipt of R6 earned by B is that the source of the receipt is its originating cause. The originating cause of the receipt is the employment of capital by B.

If the criterion laid down by Watermeyer CJ in Lever Bros is applied, the first part of the test will remain the same. Thus, the source of the receipt is its originating cause. However, thereafter the tests differ. Watermeyer CJ held that the originating cause of a receipt is the work that a taxpayer does to earn it. The supply of credit by B would thus be the service which B performs for A. It would be in return for this service that A would pay B the gain of R6. Thus the originating cause or source of the gain received by B would be the provision of credit.

It has already been noted that discounting consists not only of the issue of a bill, note or bond at a discount [104]. Thus, if A issues a bill, note or bond with a face value of R100 to B for R94, B may negotiate it to C for R96. In this situation, the transaction between B and C is one of purchase and sale and not loan.

In Overseas Trust the court held that the source of profit from the sale of shares is the place where the capital is employed.

upon the conclusion of English courts in considering different statutes [159] However, decisions referred to in Nathan had previously been accepted by the Appellate Division [160] Finally, and perhaps most importantly, it held that the source was the debt This clearly conflicts with Dunn and the decision of Watermeyer CJ in Lever Bros

Since there was uncertainty about the meaning and application of the practical man test, it would have been better had the court simply rejected it as a test to determine the source of income On the basis of the judgment of Watermeyer CJ in Lever Bros, the approach of the court should have been to determine the originating cause of the dividends The originating cause should have been the employment of his share capital in the company

4 5 MEANING OF SOURCE OF DISCOUNTING PROFITS

In order to establish the meaning of source of discounting profits, it is necessary to recap on the nature of a discount

Assume A issues B with a bill, note or bond with a face value of R100 and a maturity date of 120 days after date of issue Assume further that B acquires the instrument for R94 and holds it until the maturity date when he presents it for payment In these circumstances the transaction between A and B should be one of loan [161] The gain of R6 earned by B will be in the nature of interest income

objected to the assessment on the ground that nine-tenths of the dividends were derived from a South West African source [154]

Counsel for the taxpayer based his argument mainly on Nathan and an obiter remark of Innes CJ in Overseas Trust The court held that the practical man test had not been accepted by the Appellate Division [155] Lord Atkin 'inclined' to the view that the practical man test was the test to be applied [156] In Lever Bros Watermeyer CJ had some difficulty in accepting the test,[157] while it is not clear why Davis AJA considered himself bound by Lord Atkin's remarks [158]

The court held that Nathan was an unsafe guide for the purpose of interpreting the Income Tax Act because it considered a different statute and a case relied upon by it had subsequently been overruled [159] The court held that the source of the dividends was the shareholding and that a share is situated where it is registered. The court held that once a dividend has been declared, the company is indebted to the shareholder in respect of the dividend Thus, the source of the dividend was the debt [160]

While, with respect, the decision of the court on the source of dividends is correct, the reasons it advanced in arriving at its decision are disappointing The practical man test was in fact, applied by the Privy Council in Rhodesian Metals and although Watermeyer CJ had some difficulty in accepting the test, both he and Davis AJA in Lever Bros[161] found that Nathan could not be relied upon because, inter alia, it dealt with a differently worded statute, and relied

the interest received by the lender is this provision of credit [140] It is submitted that Watermeyer CJ's approach is open to criticism The reason is that he regards the granting of a loan as the provision of a service This is not necessarily the case The correct approach, following Dunn and Overseas Trust, should be to apply the employment of capital test To establish where the capital is employed in a business, the business in which the capital is employed has to be determined How the money is utilized in the business must then be ascertained If it is utilized in the profit-making activities of the business then the source is the capital employed in the business If the money is capital invested, the place where the capital is employed may change

Although the judgment of Watermeyer CJ may be criticized, his approach is accepted as fundamental in determining and locating the source of income, particularly interest income [141]

Boyd v CIR[142] was concerned with determining the source of dividends The taxpayer received dividends in respect of certain shares held by him in a company The company was a public company incorporated in South Africa where it had its registered office and kept its principal share register Its head office was situated in South Africa It was managed and controlled in South Africa and all dividends were declared there by the board of directors The company derived nine-tenths of its income from South West Africa.[143] The issue in the case was whether the Commissioner was correct in taxing the taxpayer on the whole of the dividends which accrued to him The taxpayer

which may be made of his judgment. Having regard to the earlier decisions dealing with source of income particularly Dunn, Overseas Trust, Millin and Rhodesian Metals, it will be noted that the Appellate Division had developed its approach to the question of source. Thus, it had been held that source denotes origin, not location. Source of income is either the place where the capital is employed or where activities are performed.

Watermeyer CJ correctly extended the principle enunciated by Innes CJ in Overseas Trust, in which he held that the source of receipts is the originating cause of their being received as income and not the quarter from whence they come. He then confused the issue by stating that the originating cause of a receipt is the work that a taxpayer does to earn it.[146] This is confusing because it implies that there must always be an activity that a taxpayer does to earn the income. This is not necessarily so. Capital may be employed and this may result in a source of income. In this situation, the activity of the taxpayer is not relevant in the determination of the source of the income. Thus, the point made by Schreiner JA that it is not necessary for every source of income to involve the activity of the taxpayer, is, with respect, valid.[147]

In the case of the source of interest on a loan of money, Watermeyer CJ stated that a lender either grants credit to a borrower or transfers to the borrower certain rights of obtaining credit. He held that this supply of credit is the service which the lender performs for the borrower and it is in return for this service that the borrower pays interest. Thus the originating cause or source of

the latter situation, interest is the fruit of the money lent and it comes from where the money is situated. It does not matter where the contract was made or the interest payable [145]

Accordingly, he found that the source of the interest was the debt. He held that the source of the interest was located at the place where the debt was recoverable. This place was the residence of the debtor [146]

Watermeyer CJ did not accept that the source of interest is the debt resulting from the loan of money. He compared a loan at interest with a letting of property. In each case one party gives another party the use of property in return for periodical income payments. The difference is that in a lease of property ownership of the property remains with the owner and the property must be returned to the owner at the end of the lease. A loan, on the other hand, is a mutuum. The borrower is not obliged to repay the same money to the lender when the loan is repaid. He is obliged to repay only the same amount of capital lent. This difference is not material to Watermeyer CJ's analogy. He stated that if the source of the interest is the debt, it follows that the obligation on the lessee to redeliver the leased property is the source of rental. As this conclusion is clearly not correct, Watermeyer CJ dismissed the argument that the debt is the source of interest [147]

Although Watermeyer CJ's argument against a debt being the source of interest on it has, with respect, considerable merit, there are certain criticisms

rights, or a combination of these. It therefore follows that where a source of income is property, there is not necessarily an activity of a taxpayer involved in the source. It should be appreciated when a person derives income from rent, dividends or interest it is the income itself and not its source that is in issue.[142]

Schreiner JA went on to state that where a source of income is a combination of a taxpayer's activities and property over which he has rights in which, for example, goods are manufactured or bought and subsequently sold, the profits of the taxpayer are regarded as arising from the carrying on of a business. He cautioned that care should be taken to maintain the distinction between income derived from the carrying on of a business and income derived from property over which a taxpayer has rights. Thus, if income is derived from property over which a taxpayer has certain rights, the place of the taxpayer's business is not relevant. It is, therefore, possible for a person to carry on business in one country and to derive income from his property in another country.[143] He argued that Dunn did not contradict this statement as Innes CJ held that the capital was employed by the company in its own business. The capital was not lent to the South African firms and there was no relationship of borrower and lender. Thus, the interest was treated as a part of the company's business charges in carrying out its agency business in England and was not a return on an investment.[144]

Schreiner JA then dealt with the situation of interest on a loan investment. He drew a distinction between a trade debt and an investment by way of loan. In

aware of any decision which laid down clearly what would be the governing consideration [137] He found that the interest was not from a source within South Africa [138] He then stated that, although he had some difficulty in differentiating a practical man from a theoretical lawyer, a practical man would not regard the interest as being from a South African source [139]

The approach of Watermeyer CJ in locating the source is not substantially different, in principle, from Kirk, Meeks, Lovell & Christmas, Sulley and Grainger The originating cause of the income should be determined Where there is more than one cause, the dominant cause should be ascertained [140] This equates with the essence of the business or activity which produces the income Thus, to locate the source, activities which do not form part of the essence of the business or activity should be taken into account Where this essence is located in more than one country, the case law does not assist in establishing how it should be apportioned

In Lever Bros Davis AJA, who together with Watermeyer CJ formed the majority, applied the practical man test as he felt bound to apply the test applied by Lord Atkin in Rhodesian Metals [141] In doing so, he had little doubt that the practical man would say that the source of the taxpayer's income was the provision by it of assets in America and the giving of credit in England

Schreiner JA in a minority judgment, argued that, generally, a source of income is either a taxpayer's personal activity or property over which he has

the interest was from a South African source. In a majority decision, the court held that the interest was not from a source within South Africa.[114]

Watermeyer CJ held that the source of receipts is the originating cause of their being received as income and not the quarter from whence they have come. The originating cause of a receipt is the work that a taxpayer does to earn it. The work he does may be a business, enterprise or activity and may take the form of personal exertion or employment of capital. Capital may be employed to earn income or it may be let to another person. He pointed out that the work may be a combination of these.[115]

This approach by Watermeyer CJ has become the basic approach adopted by courts to establish the meaning of the source of income. In formulating his approach, Watermeyer CJ developed the principles that had been propounded mainly in Dunn, Overseas Trust and Millin. His judgment on the principles relating to the general meaning of source is, on the whole, an extension of these principles. He held that, as far as interest is concerned, its originating cause or source is the provision of credit. This conclusion is not necessarily correct and will be discussed below.[116]

In locating the source, the learned judge referred to earlier decisions of the Appellate Division, Privy Council and Australian courts and stated that a source of a receipt may be located partly in one country and partly in another. This would depend upon the circumstances of the case. He was not, however,

96 See Millin v CIR (1928) 3 SATC 170

97 (1938) 9 SATC 363 and (1940) 11 SATC 244

98 (1938) 9 SATC 363

99 (1940) 11 SATC 244

100 (1938) 9 SATC 363 at 371–4

101 at 365-79

102 at 378

103 ibid

104 at 371

105 at 376-7

106 at 378-9

107 at 379

108 (1940) 11 SATC 244 at 248-50

109 at 249

110 (1918) 32 SATC 33

111 at 36

112 (1926) 2 SATC 71

79 ibid

80 ibid

81 1896 AC 325

82 at 332-3

83 at 332-47

84 1908 AC 46

85 at 50-2

86 at 52-3

87 (1928) 3 SATC 170

88 at 175

89 1900 AC 588

90 See Millin v CIR at 177

91 (1915) 19 CLR 568

92 1896 AC 325

93 Lovell & Christmas Ltd v COT at 52-3

94 COT v Kirk 1900 AC 588

95 See Lovell & Christmas Ltd v COT at 46

64 at 579

65 ibid

66 at 581-3

67 at 583

68 at 584

69 ibid

70 at 584-5

71 at 586-7

72 1908 AC 46

73 CQT for New South Wales v. Meeks at 580, 589 and 592 See, however, Mount Morgan Gold Mining Co v CIT, Queensland (1923) 33 CLR 76

74 (1928) 3 SATC 17 at 179

75 1908 AC 46

76 1860 157 ER 1364

77 at 1366-7

78 at 1367

52 at 590

53 at 591

54 It should be noted that s 15(3) referred, inter alia, to income derived from lands of the Crown The court held that no special meaning attached to the word 'derived' and treated it as synonymous with arising or accruing See COT v Kirk at 591

55 at 592-3 Lord Davey was careful to point out that the question was whether the company had any income taxable in New South Wales, and not whether all the income arising from the contracts was taxable in the state See also Solomon CJ in Millin v CIR and Isaacs J in COT for New South Wales v Meeks (1915) 19 CLR 568

56 COT v Kirk at 595

57 at 594

58 See Millin v CIR at 177

59 (1915) 19 CLR 565

60 at 577-8

61 ibid

62 ibid

63 at 581

37 at 172

38 ibid

39 ibid

40 at 172-3

41 at 173 The deeming provision to which he referred was s 9(1)(*b*) of the Income Tax Act 40 of 1925 The equivalent section in the current Income Tax Act 58 of 1962 is s 9(1)(*d*)

42 Millin v CIR at 172-4

43 at 172-3

44 at 173-4

45 at 174

46 at 174-5

47 at 174

48 at 175

49 ibid

50 at 176-80

51 1900 AC 588

20 (1891) 2 QB 1

21 CIT v William Dunn & Co Ltd at 36-7

22 at 37

23 ibid

24 (1926) 2 SATC 71

25 at 73-4

26 at 74

27 ibid

28 at 76-7 and 79-80

29 at 76

30 ibid

31 ibid

32 at 76 and 79

33 at 76

34 at 76 and 79

35 (1928) 3 SATC 170

36 at 170-2

7 In Tucker v Cousbery at 62-3 it is clear that the substance of the transaction must always be examined. Thus, in the example at 63, if A secures the accommodation signatures of B to a note and A endorses the note to a third party who knows of the accommodation, the third party knows that A is the principal debtor and the discount may be regarded as effectively a loan to A

8 Actual source is used in order to differentiate it from deemed source

9 CIR v Lever Bros & Unilever Ltd (1946) 14 SATC 1

10 (1918) 32 SATC 33

11 CQT v William Dunn & Co Ltd at 35-6

12 at 37

13 at 36

14 ibid

15 at 36-7

16 (1891) 2 QB 1

17 at 8

18 at 8-11

19 (1918) 32 SATC 33

FOOTNOTES

1 58 of 1962

2 See the definition of 'discount' in H W Fowler & F G Fowler The Concise Oxford Dictionary of Current English 5 ed (1964) See also Torrens v IRC 18 TC 262 at 267. For a discussion on banker's acceptances and how the discount is established, see H B Falkena, L J Fourie & W J Kok The Mechanics of the South African Financial System (1986) 2 ed at 203-7, D V Cowen & L Gering Cowen The Law of Negotiable Instruments in South Africa 5 ed (1985) at 170-87

3 See De Villiers v Ross 1916 CPD 295, Tucker v Ginsberg 1962 (2) SA 58 (W) and Ingar & others v Omar Salem Esau Trust 1970 (1) SA 77 (N) For a general discussion on the discounting of bills, see N Willis Banking in South African Law (1981) at 143-6, Cowen & Gering at 170-87, Falkena, Fourie & Kok at 200-40

4 De Villiers v Ross, Moser v Meiring 1931 OPD 74 and Tucker v Ginsberg

5 This issue has been discussed fully in chapter 2

6 1962 (2) SA 58 (W)

Applying the employment of capital test, it is first necessary to establish the business in which the capital is employed In doing so, one should isolate the dominant cause or essence of the business or activity and ignore its activities Thereafter, it is necessary to determine how the capital is used in the business If it is used in the business's main activities, the source is the place where the business is carried on If the business is carried on in more than one place, it may be necessary to apportion the source of income If the capital constitutes surplus funds which are used to acquire an instrument, the source of the profit will be the place where the surplus funds were used to acquire it

Applying the provision of capital test in practice in the case of an original issue discount, the originating cause is the supply of credit This involves a factual enquiry

In applying these tests, it is possible for a South African taxpayer to earn profits from discounting transactions outside South Africa which are not regarded as being derived from a South African source It is also possible for such profits to be apportioned between South African and non-South African sources in certain circumstances Where a person resident outside South Africa is engaged in the business of purchasing and selling credit instruments in South Africa, the profits so derived therefrom may well be from a South African source

4.7 CONCLUSION

The courts have developed tests to be applied in determining the meaning and location of the source of receipts and accruals from discounting transactions

An examination of the decisions of the courts concerning the meaning of source indicates that the approach to the courts has not always been consistent

The source of a profit arising from an original issue discount is its originating cause As this profit is akin to interest, the originating cause should be determined by applying the employment of capital test However, in practice the employment of capital test is no applied In this situation the courts will regard the originating cause as the provision of credit The profit arising from the purchase and sale of credit instruments is not treated as interest, but as a profit arising from carrying on such activities In these circumstances the originating cause of the profit will be the employment of capital

The location of the source of discounting profit may differ if one applies the employment of capital test and the provision of capital test, the letter test applying in practice in the case of a profit arising from an original issue discount

The source of discounting profits made by C will be the place where the capital is utilized to earn the profits. If instruments are purchased and sold in one country, as part of a business carried on there, the source should be located in that country.

In both the situations discussed above, it is important to determine that the essence of the business is carried on in the one country only. If, on the facts, it is found that the essence of the business is carried on in more than one country, for example, where the trading takes place in two countries, the onus will be upon the taxpayer to establish a basis for apportionment. In this regard, s 30 of the Income Tax Act[79] provides for apportionment on the basis of the ratio that the taxpayer's assets within South Africa bear to his total assets. It is, however, provided that if accounts satisfactory to the Commissioner are furnished, the Commissioner or the taxpayer may claim that the actual taxable income derived from South African sources, or losses incurred from within South Africa, should be assessed on a different basis.

In other words, if B is carrying on a business of making discounting profits from the acquisition and disposal of bills, note or bonds all the activities which form part of the essence of the business must be determined. The place where these activities are carried on will be the place where the business is carried on. If these activities are conducted in more than one place, it may be necessary to apportion the source of income.

On the other hand, if the money is capital invested, the place where the capital is employed may change. In other words, if B is carrying on a manufacturing business and he uses his surplus funds to acquire a bill, note or bond from A at a discount on its face value, the source of the gain made on redemption of the instrument will not necessarily be the place where he is carrying on his manufacturing business. The source of the gain should be the place where he employed his surplus funds in acquiring the instrument from A.

However, the test laid down by Watermeyer CJ in Lever Bros changes the position. The source of B's gain is the originating cause. The originating cause is the supply of credit by B, and its location involves a factual enquiry.

The second situation concerns the source of discounting profits of C as a result of the purchase and sale of a bill, note or bond. The originating cause will generally be the business of purchasing and selling financial instruments and will take the form of the employment of capital.

In order to prove that a receipt is of a capital nature, a taxpayer may do so either directly or indirectly. Indirect proof may be established by inference from the fact that the receipts are not of a revenue nature.[12] Apart from determining the nature of receipts arising from fortuitous gains, the indirect approach does not appear to offer any advantage over the direct approach.[13] Where a taxpayer follows the indirect approach he must establish facts from which it can properly be inferred that the relevant receipts are not of a revenue nature.[14]

The phrase 'an operation of business in carrying out a scheme for profit-making' was refined in Natal Estates[15] and Elandsheuwel.[16] A distinction is drawn between the carrying on of a business and the pursuance of a profit-making scheme. A series of transactions is indicative of the carrying on of a business. However, no matter how many transactions have taken place, the receipts will only be of a revenue nature if the business is carried on in order to make a profit.[17]

In deciding whether or not a gain is made as part of a profit-making scheme, the courts take into account all relevant circumstances.[18] It should be appreciated that, essentially, the question must be decided upon the facts of each case.[19] No single circumstance is of decisive pre-eminence.[20]

must be had to the purpose of the acquisition and holding [22] The essence of fixed capital is its permanency [23] In other words, assets will be regarded as fixed capital where they will only be disposed of in an unexpected event or if special circumstances have supervened in order to warrant or induce the disposal [24]

The distinction between fixed and floating or circulating capital derived from writers on political economy [25] It should be appreciated that the labelling of capital in either of these categories does not mean that the nature of the asset concerned cannot change Thus, it is possible for fixed capital to become circulating capital and vice versa The assignment of an asset into one of these categories is not dependent on the type of asset For example, land can constitute either fixed or circulating capital [26]

It is not possible for an asset to be both non-capital and non-income at the same time [27] Thus, if a taxpayer fails to establish on a balance of probabilities that the profit on the sale of an asset is of a capital nature, it will be treated as revenue profit [28]

Where a single transaction is involved, the enquiry is normally limited to either a capital realization or a profit-making scheme [29] It therefore follows that where a series of transactions is involved, the enquiry is whether the receipts are as a result of the carrying on of a business [30] In carrying out this enquiry, the emphasis is on the taxpayer's actual operations [31]

the ordinary sense, it appeared to be a return for the risk he ran and was thus of a revenue nature [16]

As these cases do not canvass all the relevant issues, one must examine the general principles that have evolved through various court decisions

5.3.2 General Approach

The courts have adopted the dictum in California Copper Syndicate that a gain made from an operation of a business in carrying out a scheme for profit-making is of a revenue nature [17] Where a taxpayer disposes of some of his assets for a profit, the enquiry is whether the profit resulted from the realization of capital at an enhanced value or from the productive use of capital employed to earn it In the former case the profit will be treated as being of a capital nature whilst in the latter case it will be treated as being of a revenue nature [18] It should be appreciated that the owner of an asset is entitled to realize it to best advantage If he does so, this will not, by itself, alter what is capital invested into a trade or business for earning profits [19] However, if the taxpayer holds an asset as an investment of capital, its realization would constitute merely a conversion of the capital asset for cash This cash would then be held as capital and not revenue [20] Where an asset is held as stock-in-trade or as part of a taxpayer's floating capital, it is treated as a revenue asset Floating capital is capital which is not turned to account by holding it but by disposing of it [21] Where an asset is held as fixed capital it is treated as being of a capital nature In order to determine the nature of the asset held, regard

definition of gross income in s 1 of the Income Tax Act insofar as it applies to transactions in certain types of credit instruments which are issued at a discount and of which special reference is made Usually the views of a government department on the meaning of a statute administered by it are not admissible in interpreting the statute [11] There is authority for the proposition that where legislation is founded on a continuous practice, and repeats the words upon which the practice is founded, the practice may be used as an aid in the construction of that statute [12] However, the practice note does not represent a practice upon which the definition of gross income was founded [13] Accordingly, it is not admissible in interpreting the definition of gross income in s 1 of the Income Tax Act It follows that in deciding upon the taxation of transactions in credit instruments, the courts are not bound by the practice note

5 3 GENERAL PRINCIPLES ENUNCIATED BY THE COURTS

5 3 1 Premiums on Loans

There are only two South African cases that have dealt with the taxation of premiums on loans In ITC 244[14] the taxpayer accepted that the premium was taxable and the court merely examined the source of the premium In ITC 416[15] the court found, first, that the company which had paid the premium had treated it as a revenue expense, and, second, that the taxpayer had not discharged the onus of showing that the premium was of a capital nature Thus the court held that although the premium was not a return of interest in

The Commissioner for Inland Revenue has issued a practice note which sets out his practice concerning the taxation of certain transactions in specified types of credit instruments. It is called Practice Note 2 dated 6 May 1985 and covers transactions in credit instruments which are issued at a discount. It provides, inter alia, that profits or gains derived by holders of banker's acceptances, treasury bills and Land Bank bills on their sale, other disposal or redemption constitute taxable income in the hands of the holders who have disposed of them.

The purpose of the practice note is obviously to set out the Commissioner's practice in dealing with these types of profits or gains and thus is indicative of his prevailing practice.[10] Section 102 of the Income Tax Act prohibits the Commissioner from authorizing a refund of tax paid in respect of an assessment accepted by the taxpayer and made in accordance with the practice generally prevailing at the date of that assessment. On the other hand the Commissioner may not raise an additional assessment under s 79 of the Income Tax Act in respect of an amount which was, according to general practice prevailing at the date of the original assessment, not assessed or fully assessed to tax.

The practice note indicates not only the Commissioner's prevailing practice, but, in effect, is the Commissioner's interpretation of the meaning of the

difference in principle between receipts arising out of transactions involving land and shares, and discounting transactions

In this chapter there is an examination of the nature of receipts or accruals arising from discounting transactions in order to establish whether they are of a capital or revenue nature

There are two types of discounting transactions which are taken into account The first is that in which A issues a post-dated bill, note or bond to B at a discount on its face value If the bill, note or bond has a face value of R100 and is issued to B for R94 and B holds it until maturity, he will be paid by A the sum of R100 B will thus have made a gross profit of R6 on the transaction The second type of transaction is that in which B purchases a post-dated bill, note or bond at a discount on its face value and sells it at a profit prior to maturity For example, if B purchases for R94 a post-dated bill, note or bond with a face value of R100 and sells it to C for R96, he will have made a gross profit of R2 on the transaction

In this chapter both these types of transactions will be examined to ascertain whether the proceeds received or accrued in respect of them are of a capital or revenue nature In so doing, it is clear that there is no difference, in principle, between the two types of transactions insofar as the nature of their proceeds are concerned Thus, both types of transactions are considered together

5 NATURE OF THE PROCEEDS

5.1 INTRODUCTION

The definition of gross income in s 1 of the Income Tax Act[1] includes, inter alia, receipts or accruals not of a capital nature. Thus, capital receipts or accruals are not included in the definition and so are not subject to normal tax.

Capital is used in contrast to income in its economic sense.[2] The Income Tax Act contains no definition of capital. It is difficult to define capital and income in an income tax context unless one does so in relation to one another.[3] Thus, in determining the economic meaning of capital and income, the one excludes the other.[4]

The tests which have been used by the courts in order to determine whether a receipt is of a capital nature are neither prescriptive nor comprehensive.[5] They are simply guidelines used by the courts.[6] Each case must, ultimately, be determined on its own facts.[7] Whichever guidelines are followed, one should not be led to a result that is contrary to sound commercial and good sense.[8]

In determining whether receipts are of a capital or revenue nature, the same principles apply when one is considering transactions involving land and transactions involving shares.[9] Likewise, it is submitted that there is no

174 at 36

175 58 of 1962

157 at 373

158 at 374

159 at 376

160 at 376-8

161 (1946) 14 SATC 1 at 16 and 23-4

162 See Boyd v CIR at 373-6

163 See Milliny CIR at 177-80

164 See section 4 2 above

165 ibid

166 (1957) 21 SATC 226

167 at 230-2

168 at 235

169 (1958) 22 SATC 27

170 at 28-30

171 at 34

172 at 35

173 at 35-6

141 (1940) 11 SATC 244 at 249-50

142 CIR v Lever Bros & Unilever Ltd at 16-19

143 at 18

144 at 19

145 ibid

146 at 23

147 at 9

148 at 8-9

149 at 17

150 at 8-10

151 See D Meyerowitz & E Spiro Meyerowitz and Spiro on Income Tax (1995) at para 204

152 (1951) 17 SATC 366

153 at 370-1

154 at 371

155 at 374

156 at 372-4

128 See Boyd v CIR (1951) 17 SATC 366 at 372. Lord Atkin applied the practical man test in Liquidator, Rhodesian Metals Ltd v COT, Southern Rhodesia at 249-50

129 (1918) 25 CLR 183

130 at 189-90

131 (1946) 14 SATC 1

132 at 3-7

133 at 7

134 at 2-24

135 at 8-9. This approach was followed in CIR v Epstein (1945) 19 SATC 221 at 231-2, 1954 (3) SA 689 (A) at 698, Essential Steroln Products (Pty) Ltd v CIR 1993 (4) SA 859 (A) and ITC 1585 (1995) 57 SATC 81 at 87

136 at 9-10

137 at 10-13

138 at 14

139 at 16

140 See E B Broomberg Tax Strategy 2 ed (1983) at 154

113 at 76

114 Millin v CIR at 174-5

115 1900 AC 588.

116 Section 15(4) of the New South Wales Land and Income Tax Assessment Act of 1895 covered income arising or accruing from any other source. See Kirk v CQT at 591

117 COT for New South Wales v Meeks at 578

118 Lovell & Christmas Ltd v COT at 52-3.

119 (1860) 157 ER 1364

120 1896 AC 325

121 (1940) 11 SATC 244 at 249

122 COT v William Dunn & Co Ltd at 36

123 at 35-6

124 at 36

125 at 37.

126 (1891) 2 QB 1

127 Reid's Brewery Co v Male at 8-11

taxpayer's intention in selling the asset may well be different from his intention when he acquired it [125]

5.3.6.4 Sale of the Asset

The next test is the reason and circumstances surrounding the sale of the asset [126] If the bill, note or bond is not sold, but held to maturity, this fact on its own is unlikely to indicate any change in intention by a taxpayer However, if the taxpayer sells the instrument prior to maturity it is necessary to examine the reasons for the sale The reasons for sale could include, for example, disruption of a partnership where the instrument is held by the partnership,[127] ill health[128] or a change in the domestic circumstances of the taxpayer,[129] anticipated adverse economic conditions,[130] pressure from creditors,[131] a sale to get a better return on capital,[132] a sale to realize cash to assist the taxpayer's family,[133] a sale by a syndicate or group of investors in which the taxpayer is a minor member,[134] a sale as a result of an unsatisfactory yield,[135] or the sale of an inherited asset where the asset is not sold as part of a business or in the course of a scheme of profit-making [136]

Where a taxpayer has held gold shares, an indication of the fact that proceeds of the sale are of a revenue nature is the fact they were sold when the gold price declined even where shares were paying excellent dividends [137] It should be noted that a forced relinquishment of land indicates that the proceeds are neither of a capital nor income nature [138]

inflation because of a taxpayer's particular experience of rampant inflation, such circumstances could indicate an intention to acquire the instrument as a capital asset [118] Such a capital intention would be strengthened if the assets were acquired with the taxpayer's surplus funds and not out of borrowed money [119] Where the taxpayer acquired an asset for certain collateral advantages, the actual obtaining of such advantages would tend to be a factor substantiating the averment [120]

The test for holding assets such as shares on capital account is whether the taxpayer purchased the assets as long-term investments or as fixed capital [121] It is both rationally and legally possible for one person to acquire similar but separate assets with different purposes For example, an investment company could acquire some shares as part of its trading operations and some shares as part of its investment portfolio [122]

Where a person acquires an asset by way of inheritance, the asset will be treated as a capital asset at date of acquisition unless exceptional circumstances exist [123]

The intention of the taxpayer in acquiring an asset assumes less significance where there is a nova causa interveniens causing a change in intention [124] It should be appreciated that whilst the intention with which an asset is acquired is important, it is not necessarily decisive The reason for this is that the

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Whilst a court will take note of a company's formal acts as factors in determining its intention,[111] this does not mean that a company's intention cannot be determined in any other way than its formal acts.[112]

5.3.6.2 Nature of the Business and the Transaction

The nature of a taxpayer's business and the transaction in question is an important consideration.[113] For example, if the taxpayer is a financial institution which has as one of its objectives the making of profit from discounting, then prima facie it would appear that its discounting profits would be of a revenue nature. Where the taxpayer is a commercial bank which does not deal in shares, this would be a factor indicating that shares were not acquired for resale at a profit.[114] On the other hand, where the taxpayer is an individual building up a portfolio of secure investments, this is a strong indication of an investment rather than a speculative purpose. This situation can be contrasted with an institution purchasing and selling large volumes of shares and other investments in order to improve the position of its financial statements.[115]

5.3.6.3 Mode of Acquisition

The mode of acquisition is one of the most important tests of a taxpayer's intention.[116] In applying this test it is necessary to look at the reason for acquisition and the circumstances under which the asset was acquired.[117] Thus, if a bill, note or bond was acquired as a long-term hedge against

account the taxpayer's activities in relation to the asset up until the decision was made to sell it. An important consideration will be the light that these activities may throw on the taxpayer's ipse dixit concerning intention.[104] In determining a company's intention, evidence of the state of mind or intention of the persons in effective control of the company will be an important factor.[105] Courts will also take into account changes in shareholdings as new shareholders may bring about a change in a company's intention.[106] The evidence of the taxpayer is not necessarily decisive. The courts will test it against the objective facts, the surrounding circumstances and the inherent probabilities of the matter.[107]

Where a taxpayer is a company and its objects provide that it will not deal in assets such as shares or land, this fact will not necessarily mean that the taxpayer can never be held to deal in these assets. This is dependent upon a proper construction being placed upon the taxpayer's actions in relation to the assets. It is possible that a court could conclude that, despite a prohibition in its memorandum, the taxpayer dealt with a particular asset as part of a profit-making scheme.[108] The true test of intention is to have regard to a corporate taxpayer's objects, its acts and the result of its acts.[109]

It should, however, be appreciated that the ipse dixit of those in control is merely a factor that is taken into account in weighing up all the circumstances. It must be tested against objective factors.[110]

In the case of an individual taxpayer, the courts will take account of his ipse dixit where he is found to be credible and his evidence is found to be probable.[89] However, the court will disregard his ipse dixit regarding his intention where it is not supported by his conduct and the surrounding circumstances.[90] It is no use for a taxpayer to profess a contrary intention when it is known that it is not possible to attain such an objective.[91] The courts will often seek some confirmation of the taxpayer's ipse dixit.[92] In the case of a corporate taxpayer the courts will take account not only of the evidence of credible witnesses who were members or officers of the company,[93] but the company's objects,[94] although the South African practice of framing objects in very wide terms may reduce the significance of this factor,[95] statements in its prospectus,[96] statements or evidence of its chairman[97] and public officers,[98] its directors or those in effective control of the company,[99] its establishment and composition[100] and the actualities of the situation.[101]

It should be noted that in ascertaining the intention of a company regard is had, inter alia, to the intention and views of those in effective control of the company.[102] The type of control envisaged in these circumstances is the de facto control of the company. In other words, the persons in effective control are those who carry out the day-to-day activities of the company and the persons through whom the company acts.[103]

The courts will take into account, inter alia, the intention of the taxpayer when the asset was first acquired and when it was sold. They will also take into

authority for the proposition that the management of an investment portfolio causes it to be regarded as floating capital irrespective of the long-term investment intention in compiling the portfolio [82]

5.3.6 **Determining a Taxpayer's Intention**

5.3.6.1 **Taxpayer's Ipse Dixit**

In determining the intention of the taxpayer, the courts consider a number of factors. The taxpayer's ipse dixit regarding his intention is an important factor [83]. The non-acceptance of a taxpayer's ipse dixit does not necessarily create doubt as to his honesty. The reason for this is that human intentions are often interchangeable, unformulated. Ex post facto evidence of such intentions, however honest, is often unreliable and constitutes pure reconstruction [84].

In addition, the courts will objectively review the circumstances in order to establish whether the taxpayer's ipse dixit is borne out by the facts [85]. In this respect, the important factors are the nature of the taxpayer's business, the modes of acquisition and sale of the asset, the period for which the asset was held and the frequency and repetition of similar transactions [86]. In addition to these more important factors, the courts will also examine the circumstances surrounding the transaction in question and any other relevant circumstances [87], including facts leading up to the transaction in question [88].

The business of an investment-dealing company, on the other hand, is to make a profit on shares by either holding or selling them. These are merely alternative methods of dealing in shares in order to make a profit.[77] In this situation, it would be difficult for a company to establish that a particular sale of shares was not part of its ordinary profit-making business.[78]

However, the situation is different where a bank carries on share-dealing ancillary to its banking business. The question whether a share transaction falls within its share-dealing business is a different issue. The intention with which the transaction was entered into will be fundamental, although not decisive in determining the question.[79] If it is not possible to state that one purpose was dominant the taxpayer will have failed to discharge the onus of proving that the asset was held for capital purposes.[80] Where a person buys and sells shares, his intention regarding all transactions is not necessarily the same.[81]

When an option is exercised to acquire an asset which is then sold, the taxpayer's intention must be determined as at the date when the option is acquired.[82]

Cases draw a clear distinction between a dealer or trader and an investor. A taxpayer can hold assets as both an income-producing capital base and as stock-in-trade for sale at a profit. Profits made by such a taxpayer are generally regarded as part of his income. Thus profits derived from the sale of assets held both as capital and as stock-in-trade are taxable.[83] There is no

5.3.5 Primary and Secondary Businesses

Whether an investment company is carrying on a secondary business of share-dealing, is a question of fact to be determined after examining all the circumstances.[66] Where such a secondary purpose is established and the trading profits need to supplement the dividend income, the profits will clearly be of a revenue nature.[67] However, where there is no motivation for profit-making nor to supplement dividend income, the profits will be of a capital nature.[68] Where a taxpayer acquires an asset with a dominant investment intention and a dual or coexisting trading intention, the profit on the sale of the asset will be of a revenue nature.[69] Where a taxpayer acquires and disposes of assets as part of a scheme of profit-making, the receipts arising from the scheme will be of a revenue nature.[70] Thus, if the purpose of a scheme is not profit-making, the receipts should be of a capital nature.[71]

In this regard, contemplation should not be confused with intention. One is solely concerned with his object, aim or actual purpose.[72] Thus, whilst a taxpayer may contemplate the making of profit, his intention may be different.[73]

It is possible for an investment-holding company and an individual to carry on a secondary business of share-dealing. This question is primarily one of fact to be determined by considering all the surrounding circumstances.[74]

whether there was one dominant purpose. Should there have been a dominant purpose, the courts would give effect to it.[50]

Where there are mixed purposes, it may be difficult to determine which purpose is dominant.[51] Intentions may overlap or be so mixed that there is no dominant intention. In these circumstances, the fact that the taxpayer prefers one objective to another does not constitute a dominant intention.[52] The effect of a dual purpose where neither purpose is dominant may result in the taxpayer's failing to discharge the onus of proving that the asset is held as an investment.[53] It should be appreciated that, whilst a taxpayer's main purpose may be to maximize his income from, say, dividends, this does not necessarily mean that such a purpose is dominant. Thus, for example, a taxpayer's main concern may be to maximize dividend income. In doing so, he purchases sound equities with a high dividend yield. At the same time he sells when the opportunity arises, yielding a substantial profit. The intention to sell may be inseparable from the taxpayer's main object but it is not incidental to it.[54] In order for the main purpose to be dominant, the taxpayer needs to show that the object of securing a dividend income occasionally results in a purely incidental change of investment.[55] The fact that shares are purchased with the intention of resale does not necessarily mean that the profit on resale is taxable. There may, for example, simply be a change in the investment portfolio.[56]

income nature to that of a capital nature the taxpayer must show that he has ceased trading in those assets He would have to show that he held and used those assets on a more or less permanent basis [51]

Where a person who owns the shares in a share-trading company dies, and his executors change the company's shareholding to a long-term investment portfolio, the proceeds on sale of the shares will be of a capital nature [52] It is, however, difficult for a taxpayer to establish that, for the purposes of taxation, he has changed from a trader to an investor [53]

Unless some other factor intervenes to show that when the asset was sold it was sold as part of a profit-making scheme, the taxpayer's intention when he acquired the asset is conclusive in determining whether the asset is of a capital or revenue nature [54] The mere decision to sell an asset will not constitute a change of intention sufficient to render the profit on the sale of the asset taxable [55]

5.3.4 *Mixed Intentions*

The intention with which an asset is acquired and any change of intention are important criteria However, these criteria cannot by themselves change the character of the asset and the nature of the profit on sale [56] Not even a dominant purpose will be decisive [57] Thus it must be established whether or not there has been a change of intention [58] However, where a taxpayer does not have a clear intention when acquiring an asset, the enquiry should establish

5.3.3 **Intention**

It is important to ascertain the intention with which an asset is acquired.[41] Thus, where a bank acquired shares and the acquisition was motivated predominantly by the possibility of obtaining collateral advantages such as new business, this factor is indicative of the fact that the shares were not acquired in order to resell at a profit.[42] This intention at acquisition does not necessarily determine the nature of the gain made on realization, the intention may change.[43] The change in intention may be from trader to investor and vice versa.[44]

It should be noted that the intention with which an asset is acquired is important but not necessarily decisive.[45]

The mere change of intention on behalf of the taxpayer does not convert a capital asset to a revenue asset.[46] An additional factor is required. This is that the taxpayer should have begun to carry on a business or a scheme of profit-making or perform acts pursuant to these.[47]

It should be emphasized that the courts have recognized the relevance of a change of intention in holding an asset.[48] A number of cases have dealt with the situation of a possible change in character of an asset from a fixed asset to stock-in-trade.[49] The converse situation can also apply. In other words, one can consider a change in the character of an asset from stock-in-trade to a capital asset.[50] Before the character of an asset can change from that of an

remark of Holmes JA illustrates one of the inequities in not taking inflation into account in the tax system

In view of the fact that the Income Tax Act does not recognize that a principal amount loaned can depreciate in real terms because of the effect of inflation, it is difficult to argue that the increase in the amount repaid at redemption of an index linked loan is of a capital nature

The final situation to examine is that of a deep discount bond Generally such bonds are only redeemable a number of years after the date of issue There is no legislation regulating the taxation of deep discount bonds and one must, therefore, examine the taxation of such bonds taking account of the general principles already discussed

A deep discount bond may be issued at a substantial discount on its face value and be redeemable after a number of years In addition it may yield no interest There is no formal definition of a deep discount bond in South African law Such bonds are specifically defined in United Kingdom legislation [20]

The issue is whether the gain on the sale or redemption of a deep discount bond constitutes a gain made by an operation of business in carrying out a scheme for profit-making If so, the proceeds on sale or redemption are of a revenue nature However, if this was not the case and the bond was held as an

investment of capital and not in carrying out a scheme for profit-making.[103] Factors which could indicate the capital intent could possibly be the investor's ipse dixit as to his intention,[104] the fact that the investor did not previously acquire credit instruments similar to the bill, note or bond[105] and his object was to secure the income return to meet his personal income requirements, the fact that he acquired the instrument as a long term hedge against inflation,[106] his reasons for redeeming or selling the bond if they were valid, such as ill health[107] or pressure from creditors,[108] and if he had held the instrument for a long time.[109] It is thus possible that, in appropriate circumstances, a strong case could be made for showing that the R20 is of a capital nature.

The next situation to discuss is that in which the principal amount loaned or the face value on the bill, note or bond is index linked. The point to consider is whether the increase in the amount repaid at redemption is of a capital or revenue nature in the hands of the lender. As there is no legislation covering this matter, it is necessary to apply general principles.

In Natal Estates Ltd[110] Holmes JA remarked in an obiter dictum that where an owner of property has held it for a number of years and has subsequently changed his intention and held it as trading stock, it is conceivable that the increment in value of the asset whilst held for capital purposes may be regarded as a capital receipt when the property is sold. It is submitted that, as the law currently stands, such increment is clearly of a revenue nature. The

Apart from ITC 416 there is no decision of a court in South Africa on this question. As the R20 represents compensation to the lender for the risk of losing his capital, it is submitted that one approach could be that the enquiry should be based on whether the receipt of R20 is to reimburse the lender for trading profits that he would earn if the capital were not lost, or whether it is to compensate for the possible loss of the capital.[191] Since the lender is receiving a market related interest and the R20 is paid to him to compensate for the possible loss of capital, clearly the R20 cannot constitute reimbursement for trading profits. Therefore, it can be argued that the R20 is of a capital nature. The position is, however, by no means certain.

Another approach could be to regard the R20 as akin to a discounting profit and to apply general principles regarding capital and revenue gains to the receipt in order to ascertain whether it falls within the definition of gross income in s 1 of the Income Tax Act. If the bill, note or bond was a long-term credit instrument similar to Eskom stock, there could be circumstances in which an argument could be put forward to the effect that the R20 is of a capital nature.[192] The weakness of this argument is that, in South Africa, the issue of such an instrument would probably be treated as a loan. Thus, the discounting profit arising from this transaction would be akin to interest. Where the instrument is subsequently sold, it could possibly be argued that the instrument was purchased as a long-term investment. In these circumstances, the profit made by the person purchasing the instrument could be regarded as being of a capital nature if the investor acquired and held the instrument as an

If A lends B R100 on condition that B will pay A R110 after one year, the issue to be determined is whether the R10 profit is of a revenue nature. This type of transaction is similar to the discounting of a banker's acceptance and in fact could take the form of the issue of a post-dated promissory note at a discount on its face value. It is submitted that, applying the criteria set out above, the profit of R10 would probably be held to be of a revenue nature. The main reason for this is that the nature and function of the instrument create a presumption of revenue intent that would be difficult to rebut. An asset held for a short period[197] and yielding no income would probably be regarded prima facie as being held for speculative purposes. The same principle applies in respect of a short-term credit instrument, such as a banker's acceptance, which is purchased and then sold shortly afterwards in circumstances in which a profit is made on the transaction.

The position is more difficult where A lends B R100 at a reasonable commercial rate of interest and it is stipulated that B will pay A R120 at maturity of the loan. This transaction could take the form of the issue of a post-dated promissory note with a face value of R120. The issue price would be R100. Were it established that the R20 had been intended to compensate A for his capital risk, it could be argued that the R20 constitutes a capital receipt. In ITC 416[198] the court held that, inter alia, a premium on a loan represented a return for the lender's risk and that it was, therefore, taxable. The issue does not, however, appear to have been fully canvassed before the court and, in the circumstances, it is submitted that this case is not necessarily authoritative.

character of the taxpayer's conduct regarding the relevant asset. In assessing these factors, the courts will consider whether the taxpayer's conduct constitutes usual and normal conduct in the commercial community.[181] The character of the taxpayer is also a factor which must be taken into account.[182]

Factors which indicate that the taxpayer's profits are of a revenue nature include the situation where, for example, shares are acquired with the intention of selling them if their market value rises without a corresponding increase in dividends,[183] not all assets, such as shares, are acquired for investment,[184] the taxpayer owns an investment portfolio such as shares and constantly reviews the shareholding in order to replace overpriced shares,[185] the scope, nature and scale of the taxpayer's activities indicate that he is carrying on the business of dealing in the assets,[186] and the net profits from share disposals far exceed the dividend income.[187] A person can carry out a profit-making scheme by dealing in shares in companies owning the assets as well as dealing in the assets themselves.[188]

5.4 APPLICATION OF GENERAL PRINCIPLES

Having reviewed the general approach of the courts to the taxation of the net proceeds from the redemption or sale of assets such as bills, notes or bonds, certain specific situations need to be examined.

inference that it is held for speculative purposes. The nature of the taxpayer's activities in relation to the asset is an important factor up to the time that it is sold.[171] The intention with which an asset is held can change. Such change can thus change the character of the asset and convert it from a capital asset to stock-in-trade.[172]

Additional factors include whether the profits from the transaction have been distributed,[173] whether the sale of the asset was a step in the liquidation of a corporate taxpayer,[174] and whether the asset was realized during an economic boom.[175] The fact that a taxpayer did not want to make a profit would not necessarily result in the profit being of a capital nature.[176] If a company or trust is formed for the purpose of realizing capital assets in the hands of its founders, its profits will normally be of a capital nature as if the founders had realized the assets without interposing a trust or company.[177] A further factor is the way an asset is used whilst it is held.[178] Where a taxpayer receives the proceeds from the sale of an asset and the quid pro quo consists of two or more separate elements, if at least one element is of a capital nature and one of a revenue nature, the court may apportion the receipt on an acceptable basis.[179] The relationships between the taxpayer and the party from whom the asset was acquired and the taxpayer and the person to whom it was disposed are also factors which the courts take into account.[180]

The courts consider the tax structure, the tax imperatives and the tax needs of the taxpayer during the relevant period. Also of importance is the quality and

As a general rule, one or two isolated transactions cannot be considered as the carrying on of a business [166] In determining whether it is necessary for there to be continuity in the carrying on of a business, a distinction is drawn between a company and an individual The difference between the tests applied to companies and individuals does not relate to the quality of the taxpayer's intention but to the inference as to intention that may be drawn from an isolated transaction In the case of a company, if its objects include the purchase and sale of assets at a profit, it is possible to infer that an isolated transaction is part of a scheme of profit-making The company's objects will not necessarily be decisive In the case of an individual who acquires and sells an asset for a profit in an isolated transaction, it is necessary to establish his intention in acquiring the asset and whether any factor intervened to change that intention In determining the taxpayer' intention, continuity is a factor that is taken into account [167] Where a single transaction is carried out as part of a profit-making scheme, the net proceeds will be taxable [168]

¶ 3 6 7 Other Factors

There are other factors which indicate a taxpayer's intention in acquiring, holding and realizing an asset The nature[169] and function[170] of the asset may give an indication of a taxpayer's intention Thus, a taxpayer who acquires a banker's acceptance would prima facie be regarded as holding it for the speculative purpose of realizing it for a profit The reason is that a banker's acceptance is a short-term credit instrument which does not yield income other than the discounting profit Therefore its nature and function warrant an

not itself acquired and sold as part of a scheme of profit-making [156] In applying a test or guideline, it is important to have regard to the underlying philosophy and not simply to adhere uncritically to the test or guideline [157] Therefore, the test of permanence should not be too narrowly applied [158] Thus, for example, it was held that an employee share trust was not established as part of a profit-making scheme but in order to secure the future loyalty and goodwill of key employees [159]

5.3.6.6 Frequency of Transactions

The frequency of transactions of a similar nature entered into by the taxpayer may also indicate the taxpayer's intention in holding an asset [160] There is clear authority that no inference that the transaction under consideration is speculative should be drawn from prior speculative transactions [161] In spite of this, there have been cases in which account was taken of prior transactions [162] Where a taxpayer enters into a number of transactions regarding the purchasing and selling of shares this will indicate a scheme of profit-making although not necessarily so If the number of sales proportionate to the total shareholding is large, this will indicate a trading operation [163] Where assets are purchased with borrowed money, this is a factor indicating revenue assets [164]

A taxpayer may be taxable on the profit arising from the sale of an asset in spite of the fact that he is not ordinarily involved in the business of selling such types of assets The relevant factor is not that the transaction is an isolated one The test involves the determination of the taxpayer's intention [165]

the fact that an asset has been held for a long time does not, in itself, imply that it was held for investment purposes [140] It may constitute good business sense for a person to buy an asset with a dual purpose The one purpose would be to obtain income from the asset The other purpose would be to sell the asset for a profit at an opportune time In such a case, the profit will be taxable even if the asset was held for a long time and yielded a good income [141]

An asset is regarded as a capital asset if it was acquired and held with the necessary element of permanence The intention of the taxpayer at the time of acquisition is, therefore, a most important test in determining whether the proceeds on the sale are of a capital or revenue nature [142] The fact that when a taxpayer acquires an asset he foresees the possibility that he might sell it will not, in itself, render the profit on the sale to be of a revenue nature He might, for example, foresee that, with inflation the monetary value of the asset might grow and that it might be sold at a profit [143] If an asset was held for a short time it does not necessarily follow that it was acquired for a profit-making purpose [144]

A further guideline regarding the holding of an asset is that, in order for it to constitute capital, it must be acquired and held with an element of permanency and it must be held with the object that it produces an economic utility for the holder [145] The philosophy behind the requirement of permanence is that it assists in determining the nature of the holding of an asset It helps to distinguish the case where an asset is used in the production of income but is

developing and selling the assets such as land for profit In this regard, the enquiry is -

> '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' [144]

Where a taxpayer has disposed of an asset as a result of a sale under compulsion, this type of sale has the same tax consequences as a voluntary sale [145] If the asset was of a capital nature, the net proceeds on sale will be treated as having a similar nature On the other hand, if the asset sold formed part of the taxpayer's stock-in-trade, the net proceeds will be of a revenue nature [146]

Additional factors which indicate a capital intent when selling property include expropriation of portions of the property rendering the residue too small for profitable development, pressure from the local authority to make the property available for use by the community and the fact that the property was unlikely to yield economic returns [147]

5.3.6.5 **Holding of the Asset**

The period for which an asset was held may give an indication of the taxpayer's intention in holding the asset [148] Holding an asset for a short period is a prima facie indication that the asset was held for speculation [149] However

Further factors which indicate a capital intent in the case of a property owner are where the owner has difficulty in finding tenants for the property in question and where the owner receives an unsolicited offer to purchase the property [139] The taxpayer's modus operandi is important A taxpayer would probably have a revenue intent where he has held assets such as shares or other securities and he has switched out of them from time to time in a rising market knowing that the sales would in all probability be at a profit [140]

Where the taxpayer has subdivided land, one should have regard to the planning extent, duration, nature, degree, organization and marketing operations of the taxpayer In taking these factors into account, one must determine whether the taxpayer's activities indicate that he carried on business or embarked upon a scheme of profit-making [141] South African law has recognized the concept of a realization company formed for the sole purpose of acquiring and realizing an asset [142] A realization company is normally formed in circumstances where a person owns a capital asset such as a piece of land, and wishes to realize the asset He forms the realization company and transfers the land to the company in order to realize it When the land has been sold the realization company is liquidated and its assets distributed to the shareholder The net profits of the realization company will be treated as being of a capital nature unless it is regarded as having carried on a business of trading in the assets concerned [143] In deciding whether the assets of the realization company are of a capital or revenue nature, it is necessary to examine the extent to which the company has involved itself in the process of

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intend to sell them and thereafter did not change its intention and it did not decide to embark on a trade, business or scheme for profit-making by selling the Krugerrands. Accordingly the proceeds from the sales of the Krugerrands were of a capital nature.

The approach adopted by the courts in ITC 1525 and ITC 1526 appears to be slightly different from that adopted by the courts in ITC 1355 and ITC 1379. In ITC 1525 and ITC 1526 the courts paid particular attention to the fact that the taxpayers in question considered that they would realize the Krugerrands at a future date. This can be contrasted with ITC 1543 where a person in effective control did not envisage that the coins would be sold but could be passed on to his children who might one day sell them. The approach adopted by the courts in ITC 1525 and ITC 1526 could possibly be open to criticism on the basis that there is a possibility that an asset held as a long-term capital investment could possibly be sold at some future date. The facts in these cases would certainly appear to indicate that, when the Krugerrands were acquired, the taxpayers involved intended to acquire the coins for long-term investment purposes. It has clearly been established that the mere change of intention on behalf of a taxpayer does not convert a capital asset to a revenue asset. An additional factor is required, namely, that the taxpayer should have begun to carry on a business or a scheme of profit-making or should perform acts pursuant to these. This approach was not adopted in these two cases.

trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is taken into or used as his stock in trade '[240]

The court also took into account the following passage from the judgment of Trollip JA in Elandshauwel

'Of course every decision by an owner to dispose of an asset held as a capital asset does involve a change of intention hitherto his intention has been to retain it as such, now he changes that intention by deciding to dispose of it According to the above mentioned dicta a mere change of intention of that kind does not per se subject any resultant gain to tax, something more is required for that to happen That additional factor is usually something indicating that the disposal is in reality in pursuance of some trade or business or scheme for making profit The intervention of such an additional factor may be indicated by the circumstances surrounding the change of intention or in the way in which it was manifested or carried out '[241]

On the facts, the court was satisfied that there was no change of intention on the part of the taxpayer when the coins were sold Thus, the court concluded that the taxpayer acquired the Krugerrands in question as investment, did not

are in effective control of the company [235] The court went on to state that the frequency of a particular transaction may provide a guideline as to the degree of permanency with which an asset is acquired In addition, a factor which can be taken into account is whether a taxpayer has treated an asset as fixed or circulating capital [236]

The court then referred to ITC 1355, ITC 1379 and ITC 1525 to illustrate the fact that a disposal of Krugerrands should not be treated differently to the disposal of other assets insofar as application of tests is concerned [237]

The court referred to a passage from ITC 1185[238] concerning the weight which a court can attach to a taxpayer's ipse dixit The court took cognisance of A's evidence to the effect that he had acquired the Krugerrands with no intention of resale The court then considered whether the taxpayer changed its intention regarding the Krugerrands which were sold [239] The court then considered whether there had been a change of intention by the taxpayer The court referred to the following passage from John Bell

> 'Moreover, my understanding of the cases that deal with the matter is that the mere change of intent[ion] to dispose of an asset hitherto held as capital does not *per se* subject the resultant profit to tax Something more is required in order to metamorphose the character of the asset and so render its proceeds gross income For example, the taxpayer must already be

the time he did not have sufficient cash to pay for the re-roofing and he did not raise a mortgage bond in view of the interest payments that would have had to have been made The house was owned by B and indirectly belonged to his children The sale of the coins in the second year was because they were not giving the taxpayer income and the gold price was dropping A decision was taken to invest the proceeds from the sale of the coins into shares which would yield an income At that stage the value of the Krugerrands was declining and it was more important for A to ensure that the money was invested in shares which would grow in value [29]

In his evidence, A stressed that he did not envisage that the coins would be sold as he thought they would one day be sold by his children and not by him When he acquired the coins he indicated that he had no intention of reselling them [30]

The court drew attention to the fact that in deciding whether a receipt or accrual is of a capital or revenue nature, one must consider all the facts and circumstances of the particular case There is no single or infallible test [31] The court drew attention to the general principles relating to the distinction between realizing a capital asset and selling an asset in the course of carrying on a business or embarking on a scheme for profit [32] Insofar as intention is concerned, the court drew attention to the fact that where companies are concerned the courts can take cognizance of the intention of the persons who

to increase in value and to take advantage of this at a future date by realizing them. Thus the court found that on the balance of probabilities the proceeds from the sale of the Krugerrands were of a revenue nature and therefore subject to normal tax.[227]

In ITC 1543[228] the taxpayer was a family company, the shares of which were held by a company B, and the shares in B were held by a trust, C. The beneficiaries of the trust were A's children. The taxpayer and B were investment companies established for the ultimate benefit of A's children. The assets of the taxpayer consisted mainly of a portfolio of shares, Krugerrands and loans to two of his children.[229]

The Krugerrands were purchased over a four-year period. A testified that his reasons for purchasing the coins were similar to those for investment in shares, namely, to provide a hedge against inflation. A had no knowledge of gold shares and, in the circumstances, preferred to purchase gold coins. When the taxpayer purchased the coins, it did not need income from the capital. A testified that when the coins were purchased, the taxpayer did not have an intention to resell them. The intention was to keep them for A's children.[230]

After holding the coins for about ten years, approximately half of the coins were sold over a two-year period. A testified that the sale of the coins in the first year was to provide the funds to re-roof the house in which he lived. At

Krugerrands. If the taxpayer's intention was to hold an asset on a more or less permanent basis in order to produce income on its disposal, the proceeds would be of a capital nature.[220] An asset could be held in an unproductive state. However, such an unproductive asset would be a capital asset if it produced an economic utility to the taxpayer.[221] The court stated, however, that the element of permanence is a requisite in determining whether an asset is held as a capital investment.[222]

The court referred to ITC 1355,[223] ITC 1379[224] and ITC 1525.[225] The court found that it was difficult to define the term 'commercial utility' and it was of the opinion that the meaning of the term was dependent on the purpose for which an asset was acquired and held.[226] The court accepted that Krugerrands could have an economic utility if that was the test. In determining the intention of the taxpayer, the court took into account the evidence and state of mind of A who effectively controlled the taxpayer, the taxpayer's memorandum of association, its activities, its policy and the circumstances of the acquisition of the asset, and the manner in which it was dealt with, held and subsequently realized. The court found that the objective facts and the probabilities did not support the taxpayer's ipse dixit to the effect that he kept Krugerrands with a degree of permanence. This cast doubt on A's claim that the taxpayer purchased the Krugerrands with the intention of any degree of permanence. The court accordingly found on the probabilities that the main or dominant intention of the taxpayer was linked to the inherent capacity of the Krugerrands

The taxpayer invested a large portion of the sale proceeds in Krugerrands A regarded this as an ideal method of investment for storing money for his children He wanted to protect the capital as against inflation He never purchased or speculated in shares and he purchased the Krugerrands from a bank as a single investment

A then registered a new company for the purposes of research and development which fell outside the ambit of his restraint contained in the agreement for the sale of the taxpayer's operating companies He utilized some of the cash resources which had been retained from the sale of the operating companies and operated on an overdraft as long as he could so that he would not be obliged to sell the Krugerrands During the next four financial years the taxpayer sold Krugerrands for various purposes The purposes included the settling of A's overdraft, the purchase of properties for A and his family, improvements to his house, and the purchaser of Iscor shares [218]

A's intention in investing in Krugerrands was to provide a store of wealth He was of the opinion that the Krugerrands provided a good investment and enabled him to protect his capital Thus he was able to take steps to guard against inflation In addition he wanted to create wealth for his children [219]

The court emphasized that the taxpayer's intention was virtually decisive in the case in determining the nature of the proceeds from the sale of the

stage should the need arise In the circumstances, he had a profit-making intention and the proceeds were treated as being of a revenue nature [214]

In ITC 1526[215] the taxpayer was a private company that had been incorporated for the sole purpose of operating as an investment company The shareholders of the taxpayer were A, his wife and his children's trust A was the trustee of the trust and effectively controlled it The trust held assets which were eventually to devolve upon A's children

A was a director of the appellant and had been in effective control of its affairs since its incorporation A's background was that he was an electrician who had qualified as a design engineer and subsequently a consulting mechanical and electrical engineer He formed a company which manufactured and sold Teflon products He was involved in research and development of various products which were unique in the processing field in South Africa In addition he acquired a reputation internationally in this field [216]

The taxpayer acquired all the shares in A's operating company which in turn established two subsidiary sale companies In addition a further company was formed to hold the properties from which the business operations were conducted The taxpayer eventually sold its shares in the operating company, its sale subsidiaries, and in the investment company A retained his rights to carry on the business outside Africa [217]

The court drew attention to the distinction between fixed and floating capital which was drawn in ITC 1418 [211] In ITC 1418 it was held that where an asset is held for the purpose of resale at a profit, this does not nec ...ily mean that one must make a profit by virtue of the resale, nor that the motive in purchasing the asset is to make a profit It simply means that the taxpayer treats the asset as part of his floating capital and not part of his fixed capital Thus the acquisition of : asset for the purpose of resale at a profit is simply another way of stating that the asset is held as stock-in-trade [212]

The court concluded that the authorities indicate that fixed capital has the characteristic that either the asset is held on a more or less permanent basis for the purpose of producing income or it should have an economic utility In the case of Krugerrands one is not dealing with an income producing asset nor an asset having an economic utility [213]

The court found that where a taxpayer saves Krugerrands for either commencing a business or his old age, he must envisage that in due course he will sell the asset There was no suggestion that the Krugerrands were for the taxpayer's family or for him to dispose of by way of bequest In the circumstances, the taxpayer must have envisaged realizing the coins in his retirement years The court found on a balance of probabilities that the taxpayer acquired the Krugerrands with the intention of selling them at some

These cases were followed by three recent cases.[206]

In ITC 1525[207] the taxpayer was a reformed alcoholic. Whilst he was being treated for alcoholism he found it difficult to retain a job and to build up a capital reserve. He was advised to acquire Krugerrands with any surplus funds available. Accordingly he purchased Krugerrands over a number of years. After a period of approximately 20 years he started his own business. He sold some of his Krugerrands in order to fund the setting up of the business. At the time when he sold the Krugerrands, he had a fixed deposit which he could have realized in order to capitalize his business. However, he took a gamble in preferring to sell the Krugerrands.

The essence of the taxpayer's case was therefore that, being unable to hold on to a permanent job whilst recovering from alcoholism and because he wanted to spend surplus funds on alcohol, he followed his accountant's advice and purchased Krugerrands. The court found that it must have been the intention that Krugerrands were acquired to provide the taxpayer with funds should he need it at some stage in the future.[208] The court drew attention to the fact that the Krugerrands did not have an income earning capacity or an economic utility.[209] The court found that a Krugerrand does not have an economic utility unless it is worked into jewellery. The only utility that it has is that it can be sold when cash is needed.[210]

investment of capital, the proceeds on sale or redemption would be of a capital nature

The enquiry involves an examination of all relevant circumstances.[202] There are factors which, prima facie, indicate that the holder of a deep discount bond may hold it as part of a profit-making scheme

The nature and function of a deep discount bond indicate a revenue intent as it yields no income other than the discounting profit. It could, thus, be argued that the bond could only have been acquired with the intention of disposing of it at a profit. The fact that a bond may have been held for a long period does not, by itself, indicate a capital intent.[203]

In spite of the prima facie inference of a revenue intent, there could be factors which could indicate a capital intent. In ITC 1355[204] and ITC 1379[205] the taxpayers acquired Krugerrands as a hedge against inflation. The taxpayers had, either personally or through families, experienced the difficulties of rampant inflation in pre-war Europe and had invested in Krugerrands to guard against a devaluation in the purchasing power of their currency. Krugerrands were subsequently sold in order to assist their families. In both cases the courts held that the proceeds on disposal of the Krugerrands were of a capital nature

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41 CIR v Stott at 261-2, Marshall Industrials Ltd v CIR (1951) 17 SATC 178 COT v Levy (1952) 18 SATC 127, CIR v Strathmore Consolidated Investments Ltd (1959) 22 SATC 213, Wilcox v CIR (1960) 24 SATC 1, Greenland Properties (Pty) Ltd v CIR at 156, ITC 1391 (1985) 47 SATC 66 at 72, CIR v Guardian Assurance Co of SA Ltd at 151, , CIR v Malcomess Properties (Isando) (Pty) Ltd at 162, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 372, ITC 1522 (1992) 54 SATC 185, Beren Park Avenue Properties (Pty) Ltd v CIR (1995) 57 SATC 167 at 171, 1995 (2) SA 411

42 SIR v The Trust Bank of Africa Ltd, CIR v Nedbank Ltd (1989) 48 SATC 73

43 CIR v Stott at 261-2, CIR v Lydenburg Platinum Ltd, CIR v Richmond Estates (Pty) Ltd (1956) 20 SATC 355, Natal Estates Ltd v SIR at 217, John Bell & Co. (Pty) Ltd v SIR, CIR v Malcomess Properties (Isando) (Pty) Ltd at 162, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 373

44 New Mines Ltd v CIR (1938) 10 SATC 9, Yates Investments (Pty) Ltd v CIR (1956) 20 SATC 368

45 SIR v The Trust Bank of Africa Ltd at 104, Natal Estates Ltd v SIR at 218

46 John Bell & Co. (Pty) Ltd v SIR at 103, Constantia Heights (Pty) Ltd v SIR (1979) 41 SATC 77 at 94

47 ITC 1417 (1987) 49 SATC 39

28 Onyx Mining & Exploration (Pty) Ltd v Secretary for Finance at 372

29 Elandsheuwel Farming (Edms) Bpk v SBI at 180-1

30 CIR v Pick 'n Pay Employee Share Purchase Trust at 291

31 CIR v Stutt at 257. CIR v Lydenburg Platinum Ltd

32 CIR v Pick 'n Pay Employee Share Purchase Trust at 292. ITC 1450 (1989) 51 SATC 70 at 77. CIR v Lunnon at 9

33 CIR v Pick 'n Pay Employee Share Purchase Trust at 293

34 at 294

35 (1975) 37 SATC 193 at 216

36 (1978) 39 SATC 163 at 180-1

37 CIR v Pick 'n Pay Employee Share Purchase Trust at 280

38 SA Marine Corporation Ltd v CIR (1955) 20 SATC 115. SIR v The Trust Bank of Africa Ltd (1975) 37 SATC 87. Natal Estates Ltd v SIR. Greenland Properties (Pty) Ltd v CIR (1981) 43 SATC 151 at 156. Ony Mining & Exploration (Pty) Ltd v Secretary for Finance at 372

39 SIR v The Trust Bank of Africa Ltd at 108. CIR v Guardian Assurance Co of SA Ltd (1991) 53 SATC 129 at 151

40 CIR v Guardian Assurance Co of SA Ltd at 151

(1956) 20 SATC 375 at 386-8, Lace Proprietary Mines Ltd v CIR (1938) 9 SATC 349 at 356-7

18 COT v Boosyens Estates Ltd, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance (1991) 53 SATC 359 at 372

19 CIR v Stott at 263, John Bell & Co (Pty) Ltd v SIR (1976) 38 SATC 87 at 103, CIR v Malcomess Properties (Isando) (Pty) Ltd (1991) 53 SATC 153 at 162

20 ITC 1185 (1972) 35 SATC 122

21 Elandsheuwel Farming (Edms) Bpk v SBI (1978) 39 SATC 163, ITC 1418 (1987) 49 SATC 42, ITC 1462 (1989) 51 SATC 168 at 172

22 Bloch v SIR (1980) 42 SATC 7 at 13-14

23 SBI v Ayeling (1978) 40 SATC 1 at 17-18

24 Barnato Holdings Ltd v SIR (1978) 40 SATC 75 at 91, CIR v Tod (1983) 45 SATC 1 at 8

25 Estate A G Bourke v CIR (1991) 53 SATC 86 at 94

26 ibid

27 Pyott v CIR, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 372, ITC 1508 (1991) 53 SATC 442 at 447

liability to return their taxable profits from banker's acceptances, treasury bills and Land Bank bills

11 Commissioners for Special Purposes of Income Tax v Pemsel 1891 AC 531 at 590-1 See also S G G Edgar Craies on Statute Law 7 ed (1971) at 132 For the position in South Africa, see, for example, Randfontein Estates Gold Mining Co. v Minister of Finance 1928 WLD 77, which quoted Pemsel with approval, R v Lloyd 1920 AD 474, Ernst v CIR 1954 (1) SA 318 (A), Acting Master, High Court v Estate Mehta 1957 (3) SA 727 (SR) See also 'Practice as an Element in the Interpretation of Taxing Legislation' (1958) 7 TheTaxpayer 4

12 Commissioners for Special Purposes of Income Tax v Pemsel at 591

13 ibid

14 (1932) 6 SATC 372

15 (1938) 10 SATC 261

16 at 264

17 California Copper Syndicate v Inland Revenue (1904) 41 Sc.L.R 691, quoted with approval by Innes CJ in Overseas Trust Corporation Ltd v CIR (1926) 2 SATC 71 See also COT v Booysens Estates Ltd, ITC 1413 (1985) 48 SATC 167, CIR v Stott (1928) 3 SATC 253 at 256-2, CIR v Lydenburg Platinum Ltd (1929) 4 SATC 8 at 16-17, CIR v Strathmore Exploration & Management Ltd

FOOTNOTES

1 58 of 1962

2 CIR v Pick 'n Pay Employee Share Purchase Trust (1992) 54 SATC 271 at 287

3 CIR v Lunnon (1924) 1 SATC 7 at 9, COT v Booysens Estates Ltd (1918) 32 SATC 10 at 25

4 CIR v Visser (1937) 8 SATC 271 at 276, Pyott v CIR (1945) 13 SATC 121 at 126

5 See CIR v Pick 'n Pay Employee Share Purchase Trust at 288

6 at 288

7 Natal Estates Ltd v SIR (1975) 37 SATC 193 at 220

8 ITC 1450 (1989) 51 SATC 70 at 76, quoted with approval in CIR v Pick 'n Pay Employee Share Purchase Trust at 279

9 Deceased Estate v COT (1949) 16 SATC 305, CIR v Pick 'n Pay Employee Share Purchase Trust at 280

10 In 'Departmental Practices' (1985) 34 The Taxpayer 182 at 184 it is stated that the note is not so much a practice note as a warning to taxpayers of their

In the circumstances, it should be appreciated that the determination of the nature of the proceeds on the sale or redemption of a deep discount bond would involve an in-depth examination of the circumstances of the acquisition, holding and sale of the instrument and the testing of these against tests laid down by the courts. In view of the nature of a deep discount bond, it will be difficult for a taxpayer to establish that such an instrument was held as a capital asset.

Section 24J only covers the accrual and incurral of certain defined amounts. It is therefore submitted that it is theoretically possible to argue that if a discounting profit is of a capital nature the annual accruals as determined by s 24J are not taxable in the hands of the investor. However, in practice this is unlikely to be the case. If an investor acquires an instrument as a long-term investment, it will be very difficult for him to prove in the year of acquisition that he acquired the instrument for investment purposes. Many of these factors which indicate whether a receipt is of a capital or revenue nature relate to events which take place after acquisition of the asset. Therefore, the argument to the effect that the provisions of s 24J apply regardless of the nature of the discounting profit is valid even in the situation in which an instrument is sold prior to maturity.

scheme of profit-making. Where a taxpayer has mixed intentions, it would be important to determine his dominant purpose in acquiring and holding the asset.

In determining the taxpayer's intention regard should be had to the business of the taxpayer. In this regard, whilst assistance can be obtained from examining cases dealing with the sale of Krugerrands, it should be appreciated that the various cases dealing with the sale of Krugerrands relate to individuals. In the case of deep discount bonds, it would be more likely that a large institution such as a bank would be involved as the taxpayer. In this regard, the institution could be primarily an investment institution. Whilst the latter could indicate a capital intent in investing in deep discount bonds, regard should be had to whether the institution was carrying on a secondary business of dealing in instruments such as deep discount bonds.

In determining the taxpayer's intention, the courts will take account of the taxpayer's ipse dixit, the nature of the taxpayer's business and the transaction in question, the mode of acquisition of the instrument by the taxpayer, the reason and circumstances for the sale of the asset, the period for which the asset was held and factors which indicated the taxpayer's intention in holding the asset, frequency of the transactions and various other relevant factors. In this regard, the nature and function of a deep discount bond would prima facie indicate a revenue intent.

Finally, where a profit is made on the sale or redemption of a deep discount bond, it would be very difficult to establish that it is of a capital nature and it would, therefore, probably be regarded as being a revenue profit

In determining the nature of the proceeds on the sale or redemption of a deep discount bond, the courts would take into account various tests which have been enunciated over the years In essence, a gain made from an operation of a business in carrying out a scheme of profit-making is of a revenue nature The enquiry is therefore to determine whether a taxpayer in selling or redeeming a deep discount bond was carrying out an operation of a business as part of a profit making scheme Whilst it is difficult to determine whether the proceeds are of a capital or revenue nature, and whilst it is accepted that the inherent nature of a Krugarrand would indicate that the proceeds would be of a revenue nature, nevertheless the courts would need to examine in detail the facts of the case and test them against the tests laid down by the courts in dealing with the capital and revenue nature of sale proceeds

An important factor in determining the nature of the proceeds is to ascertain the taxpayer's intention with which the instrument was acquired It should be appreciated that this intention might change during the holding of the instrument Where an instrument was acquired with a capital intention, the mere change of intent would not convert the asset into a revenue asset and it would need to be shown that the taxpayer had begun to carry on a business or

held for investment purposes Many of these factors relate to events which take place after acquisition of the asset Therefore, the argument to the effect that the provisions of s 24J apply regardless of the nature of the discounting profit is valid except in the situation in which an instrument is sold prior to maturity In the latter circumstance s 24J accruals in years of assessment prior to the sale of the instrument will still remain taxable for the reasons set out above

5 6 CONCLUSION

The tax consequences on the sale or redemption of a bill, note or bond can vary depending upon the type of instrument and the investor's circumstances Generally, the discounting profit on a short-term credit instrument, such as a banker's acceptance, will be of a revenue nature Where a reasonable commercial rate of interest is charged and an additional sum is payable to compensate for the capital risk, or a discounting profit is made on a bond such as Eskom stock, there may be circumstances in which the proceeds will be of a capital nature

Where the principal loaned or the instrument is index linked any profit made on redemption of the loan or instrument is likely to be of a revenue nature

capital or revenue nature of the discounting profit. This matter is referred to in the Explanatory Memorandum on the Income Tax Bill of 1995. However, there is also no reference in s 24J to the fact that any amount which accrues to a taxpayer in terms of the section is taxable. For example, in s 24J(3) certain defined accrual amounts are deemed to have accrued to the holder of an income instrument. There is no provision to the effect that such amounts are taxable. When the instrument is sold or redeemed s 24J(4) applies. In these circumstances any adjusted gain is deemed to have accrued in the year of assessment in which the instrument is sold or redeemed. It has therefore been argued that the distinction between the capital and nature of the discounting profit will only apply when the instrument is sold prior to maturity. In all other circumstances the amount deemed to have accrued in terms of s 24J will be taxable, irrespective of the nature of the discounting profit.

In view of the fact that s 24J only covers the accrual and incurral of certain defined amounts it is submitted that it could be argued on a theoretical basis that s 24J does not affect the nature of the discounting profits. In other words, if the discounting profit is of a capital nature the annual accruals as determined by s 24J would not be taxable in the hands of the investor. However, in practice this is unlikely to be the case. If an investor acquires an instrument as a long-term investment, it will be very difficult for him to prove in the year of acquisition that he acquired the instrument for investment purposes. As has been discussed above, there are many factors that determine whether an asset is

5.5 APPLICATION OF S 24J

It is necessary to consider the application of s 24J to capital discounting profits earned by investors. The type of situation in which this issue could arise would be that in which an investor acquired Eskom stock at a discount on its face value and the investor's intention in acquiring the stock was to hold it as a long-term investment.

It is stated in the Explanatory Memorandum on the Income Tax Bill of 1995 that s 24J will not interfere with general tax principles. The general principles specifically mentioned include the capital or revenue nature of interest accrued or incurred in respect of interest-bearing arrangements.[242] Thus, on the basis of this statement, one could assume that s 24J would not apply to capital discounting profits which accrue to an investor. However, this assumption is not necessarily correct. Prior to the introduction of s 24J a capital discounting profit earned by an investor was not taxable in the investor's hands. It has been argued that the effect of applying s 24J to such capital profits is that such profit is taxable on an annual basis whilst the instrument is held by the investor. It is only when the financial instrument is sold before maturity that there is a distinction between a capital and revenue profit.[243]

In considering this issue, it should be noted that there is no specific reference in s 24J to the fact that it does not affect the general principles relating to the

In addition, whilst the emphasis on permanency and economic utility in ITC 1525 and ITC 1526 is valid, the approach is possibly too narrow. A review of the authorities in the approach adopted and the general principles discussed above indicates clearly that the general approach of the courts is to view the matter on a wider basis and that factors such as permanency and economic utility are merely factors which indicate a taxpayer's intention. There are many other important factors which also need to be taken into consideration and were possibly neglected by the courts.

It is therefore clear that an investment in Krugerrands does have certain similarities to an investment in deep discount bonds. Neither of them yields regular income, both are held for ultimate disposal, and the values of both will vary depending upon a large number of factors such as the price of gold and interest rates. However, Krugerrands differ from deep discount bonds in that they have an intrinsic value and in times of hyper-inflation they would have real value. A deep discount bond, on the other hand, is merely a credit instrument.

It is, therefore, possible that a person could acquire a deep discount bond as a capital asset in circumstances analogous to those in the Krugerrand cases. However, because of the differences between Krugerrands and deep discount bonds, it is considered that it would be very difficult for a person to establish that a deep discount bond was held as a capital asset.

164 ITC 1362 (1981) 44SATC 182 at 186

165 ITC 382 (1937) 9 SATC 439, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 374

166 CIR v Stott at 260

167 Stephan v CIR (1919) 32 SATC 54, CIR v Lydenburg Platinum Ltd at 16-17, ITC 509 (1941) 12 SATC 239, ITC 1244 (1975) 38 SATC 7 at 10, CIR v Pick 'n Pay Employee Share Purchase Trust at 292

168 ITC 598 (1945) 14 SATC 267, ITC 1299 (1980) 42 SATC 45 at 50, ITC 1314 (1980) 42 SATC 205 at 211

169 Rutledge v IRC (1929) 14 TC 490, CIR v Guardian Assurance Co of SA Ltd at 151, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 373.

170 CIR v Goodrick, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance

171 Natal Estates Ltd v CIR at 220. . SIR v Rile Investments (Pty) Ltd at 141

172 John Bell & Co (Pty) Ltd v SIR at 67

173 African Life Investment Corporation (Pty) Ltd v SIR

174 COT v Booysens Estates Ltd

175 ITC 118 (1928) 4 SATC 71, ITC 967 (1962) 24 SATC 721

151 Reliance Land & Investment Co (Pty) Ltd v CIR, Durban North Traders Ltd v CIR, ITC 1200 (1971) 36 SATC 34 at 39

152 ITC 1412 (1986) 48 SATC 157, ITC 1413 (1985) 48 SATC 167 at 171

153 ITC 1412 (1986) 48 SATC 157

154 ibid

155 ITC 1413 (1985) 48 SATC 167 at 171, ITC 1450 (1989) 51 SATC 70 at 76

156 ITC 1413 (1985) 48 SATC 167 at 171

157 ITC 1450 (1989) 51 SATC 70 at 77

158 ibid

159 at 78 But see ITC 1413 (1985) 48 SATC 167 at 171 where the court took a more narrow view of permanence

160 ITC 1125 (1972) 35 SATC 122 at 123-4, ITC 1412(1986) 48 SATC 157, ITC 1472 (1990) 52 SATC 102

161 See, for example, CIR v Stott, Hv COT (1960) 24 SATC 738

162 ITC 668 (1948) 16 SATC 135, ITC 677 (1949) 16 SATC 245, ITC 692 (1950) 16 SATC 509, ITC 118 (1968) 30 SATC 133, ITC 1153 (1971) 33 SATC 140

163 Barnato Holdings Ltd v CIR at 91, ITC 1432 (1988) 50 SATC 70 at 72

140 Barnato Holdings Ltd v SIR at 91, ITC 1432 (1988) 50 SATC 70 at 72

141 Natal Estates Ltd v SIR at 220, Berea West Estates (Pty) Ltd v SIR at 62, ITC 1481 (1990) 52 SATC 285 at 295

142 Berea West Estates (Pty) Ltd v SIR at 58-9, ITC 1481 (1990) 52 SATC 285 at 295

143 ibid

144 Natal Estates Ltd v SIR at 220 Reference to this quote was made in ITC 1481 (1990) 52 SATC 285 at 295

145 ITC 1239 (1975) 37 SATC 289 at 293

146 ibid

147 ITC 1226 (1975) 37 SATC 35

148 ITC 1431 (1988) 50 SATC 60 at 66, Orex Mining & Exploration (Pty) Ltd v Secretary for Finance at 373

149 ITC 595 (1945) 14 SATC 252, ITC 692 (1950) 16 SATC 509, Goodrick v CIR (1959) 23 SATC 1, ITC 967 (1962) 24 SATC 721, Barnato Holdings Ltd v CIR, ITC 1362 (1981) 44 SATC 182 at 186

150 Reliance Land & Investment Co (Pty) Ltd v CIR, LHC Corporation of SA (Pty) Ltd v CIR, Durban North Traders Ltd v CIR, ITC 1200 (1971) 36 SATC 34 at 38-9

127 ITC 743 (1951) 18 SATC 294

128 ITC 1055 (1964) 26 SATC 264

129 ITC 1010 (1963) 25 SATC 281

130 CIR v Richmond Estates (Pty) Ltd

131 ITC 246 (1932) 6 SATC 377

132 ITC 1070 (1965) 27 SATC 150

133 ITC 1355 (1982) 44 SATC 132, ITC 1379 (1983) 45 SATC 236

134 ITC 1277 (1978) 40 SATC 204, ITC 1278 (1978) 40 SATC 210, ITC 1312 (1980) 42 SATC 188, ITC 1317 (1980) 42 SATC 235, ITC 1325 (1980) 42 SATC 297

135 ITC 1348 (1981) 44 SATC 46, ITC 1436 (1988) 50 SATC 122

136 CIR v Strathmore Exploration & Management Ltd at 383, ITC 1451 (1989) 51 SATC 93 at 96

137 ITC 1362 (1981) 44 SATC 182 at 186-7

138 ITC 1239 (1975) 37 SATC 289 at 293, ITC 1507 (1991) 53 SATC 425 at 438

139 ITC 1561 (1993) 55 SATC 305

114 CIR v Nedbank Ltd

115 African Life Investment Corporation (Pty) Ltd v SIR. Barnato Holdings Ltd v SIR. ITC 1416 (1987) 49 SATC 35 at 38

116 Willcox v CIR. Marshall Industrials Ltd v CIR. Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 373

117 See n 116 above. SIR v Rile Investments (Pty) Ltd at 141

118 ITC 1355 (1982) 44 SATC 132. ITC 1379 (1983) 45 SATC 236

119 Strathmore Holdings (Pty) Ltd v CIR (1959) 22 SATC 203

120 CIR v Nedbank Ltd

121 Barnato Holdings Ltd v SIR at 91. ITC 1432 (1988) 50 SATC 70 at 72

122 ITC 1348 (1981) 44 SATC 46 at 48. ITC 1391 (1985) 47 SATC 66 at 74

123 ITC 129 (1928) 4 SATC 129. ITC 458 (1940) 11 SATC 178. CIR v Strathmore Exploration & Management Ltd. ITC 1451 (1989) 51 SATC 94

124 ITC 1165 (1972) 35 SATC 122. ITC 1508 (1991) 53 SATC 442 at 449-50

125 John Bell & Co (Pty) Ltd v SIR at 101-2. ITC 1299 (1980) 42 SATC 45 at 50

126 See, for example, Natal Estates Ltd v SIR. ITC 1431(1988) 50 SATC 60. SIR v Rile Investments (Pty) Ltd. CIR v Guardian Assurance Co of SA Ltd at 151. Berea Park Avenue Properties (Pty) Ltd v CIR at 171

104 Natal Estates Ltd v SIR at 200, SIR v Rile Investments (Pty) Ltd at 141

105 SIR v The Trust Bank of Africa Ltd at 106, SIR v Rile Investments (Pty) Ltd at 141

106 Elandsheuwel Farming (Edms) Bpk v SBI

107 Malan v KBI at 75, ITC 1431 (1988) 50 SATC 60 at 67

108 African Life Investment Corporation (Pty) Ltd v SIR at 176, ITC 1239 (1975) 37 SATC 289 at 291, ITC 1299 (1980) 42 SATC 45 at 50-1

109 'B' Co Investments Ltd v COT (1965) 27 SATC 81 at 86-7, COT v BSA Co Investments Ltd (1966) 28 SATC 1, 'T' Co Ltd v COT (1966) 28 SATC 67 at 73-4, ITC 1223 (1975) 37 SATC 24 at 27, ITC 1311 (1980) 42 SATC 183 at 185-6

110 ITC 1185 (1972) 35 SATC 122 at 123-4, ITC 1541 (1992) 54 SATC 408 at 414

111 Wilson v CIR (1926) 2 SATC 12

112 SIR v The Trust Bank of Africa Ltd at 106

113 LHC Corporation of SA (Pty) Ltd v CIR, CIR v Strathmore Consolidated Investment Co (Pty) Ltd, SIR v The Trust Bank of Africa Ltd, ITC 1185 (1972) 35 SATC 122, ITC 1431 (1988) 50 SATC 60 at 66

Management Ltd. African Life Investment Corporation (Pty) Ltd v SIR. ITC 1169 (1971) 34 SATC 73. ITC 1198 (1973) 36 SATC 14 at 16. Natal Estates Ltd v SIR at 220. SIR v The Trust Bank of Africa Ltd at 104

95 Natal Estates Ltd v SIR at 220. SIR v Rile Investments (Pty) Ltd at 141

96 ITC 336 (1935) 8 SATC 344

97 ITC 975 (1961) 24 SATC 804. ITC 1299 (1980) 42 SATC 45 at 49

98 ITC 677 (1949) 16 SATC 245

99 CIR v Richmond Estates (Pty) Ltd. SIR v The Trust Bank of Africa Ltd at 106. SIR v Rile Investments (Pty) Ltd at 141. ITC 1348 (1981) 44 SATC 46 at 47. Onyx Mining & Exploration (Pty) Ltd v Secretary for Finance at 373. ITC 1507 (1991) 53 SATC 425 at 437. Berea Park Avenue Properties (Pty) Ltd v CIR at 171

100 ITC 1431 (1988) 50 SATC 60 at 66

101 Berea West Estates (Pty) Ltd v SIR (1976) 38 SATC 43. J M Malone Trust v SIR (1977) 39 SATC 83 at 92

102 SIR v The Trust Bank of Africa Ltd at 106. ITC 1236 (1975) 37 SATC 237 at 242

103 CIR v Malcomess Properties (Isando) (Pty) Ltd at 166

86 See First Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa RP 24/1969 at 111, E B Broomberg 'The Taxation of Profits on Property Transactions' (1971) 88 SALJ 445 at 450

87 See n 83 above

88 Realisation Co v COT (1951) 17 SATC 139, ITC 758 (1932) 19 SATC 94 at 96, ITC 1244 (1975) 38 SATC 7 at 10

89 See, for example, ITC 1185(1972) 35 SATC 122, Constantia Heights (Pty) Ltd v SIR, ITC 1325 (1980) 42 SATC 297, Malan v KBI (1981) 43 SATC 1, ITC 1355 (1982) 44 SATC 132, ITC 1379 (1983) 45 SATC 236, ITC 1412 (1986) 48 SATC 157, CIR v Middelman at 327

90 CIR v Gribnitz (1988) 50 SATC 127 at 135, ITC 1507 (1991) 53 SATC 425 at 437

91 ITC 1164 (1971) 33 SATC 247 at 249

92 SIR v Gallagher (1978) 40 SATC 39 at 50, Malan v KBI at 7, ITC 1348 (1981) 44 SATC 46 at 49, ITC 1436 (1988) 50 SATC 122 at 125, ITC 1472 (1990) 52 SATC 102

93 See, for example, Constantia Heights (Pty) Ltd v SIR, ITC 1161 (1970) 33 SATC 198, ITC 1244 (1975) 38 SATC 7 at 10

94 See Reliance Land & Investment Co (Pty) Ltd v CIR (1946) 14 SATC 47, LHC Corporation of SA (Pty) Ltd v CIR, CIR v Strathmore Exploration &

77 SIR v Trust Bank of Africa Ltd at 105

78 ITC 1412 (1986) 48 SATC 157

79 ibid.

80 SAM v CQT (1980) 42 SATC 1at 6, Matla Coal Ltd v CIR (1987) 48 SATC 223 at 247, ITC 1427 (1988) 50 SATC 25

81 LHC Corporation of SA (Pty) Ltd v CIR (1950) 17 SATC 125 at 133, CIR v Richmond Estates (Pty) Ltd at 365-6, CIR v Guardian Assurance Co. of SA Ltd at 148-9

82 CIR v Guardian Assurance Co. of SA Ltd at 149

83 See, for example, ITC 1185 (1972) 35 SATC 122, Constantia Heights (Pty) Ltd v SIR, Malan v CIR (1981) 43 SATC 1, CIR v Nedbank Ltd, Matla Coal Ltd v CIR

84 Malan v KBI (1983) 45 SATC 59

85 ITC 1134 (1969) 31 SATC 225 at 227, ITC 1162 (1970) 33 SATC 201 at 204, ITC 1185 (1972) 35 SATC 122 at 123-4, ITC 1391 (1985) 47 SATC 66 at 72, ITC 1522 (1972) 54 SATC 185, ITC 1560 (1993) 55 SATC 294 at 303

62 ITC 1366 (1983) 45 SATC 33, ITC 1431 (1988) 50 SATC 60 at 67-8

63 African Life Investment Corporation (Pty) Ltd v SIR at 175, CIR v Tod at 9

64 African Life Investment Corporation (Pty) Ltd v SIR at 176

65 CIR v Tod at 13

66 Barnato Holdings Ltd v SIR at 93

67 African Life Investment Corporation (Pty) Ltd v SIR

68 ITC 1354 (1982) 44 SATC 118 at 128

69 Ropty (Edms) Bpk v SBI (1981) 43 SATC 141

70 De Beers Holdings (Pty) Ltd v CIR (1986) 47 SATC 229 at 254, CIR v Pick 'n Pay Employee Share Purchase Trust at 281

71 CIR v Pick 'n Pay Employee Share Purchase Trust at 281

72 ibid

73 ibid

74 African Life Investment Corporation (Pty) Ltd v SIR, Barnato Holdings Ltd v SIR at 93, CIR v Nussbaum (1996) 58 SATC 283

75 Overseas Trust Corporation Ltd v CIR

76 CIR v Richmond Estates (Pty) Ltd

57 African Life Investment Corporation (Pty) Ltd v SIR (1969) 31 SATC 163, CIR v Guardian Assurance Co of SA Ltd

58 CIR v Stott; CIR v Lydenburg Platinum Ltd, CIR v Goodrick (1942) 12 SATC 279; New Mines Ltd v CIR, CIR v Richmond Estates (Pty) Ltd, CIR v Consolidated Investments Ltd (1959) 22 SATC 214 at 224-5, ITC 1153 (1971) 33 SATC 140 at 147, ITC 1185(1972) 35 SATC 122 at 123, Natal Estates Ltd v SIR; SIR v Rile Investments (Pty), Greenband Properties (Pty) Ltd v CIR, ITC 1522 (1992) 54 SATC 186

59 See COT v Levy (1952), CIR v Paul (1956) 21 SATC 1, COT v Glass (1962) 24 SATC 499; ITC 1162 (1970) 33 SATC 201 at 203-4; ITC 1185 (1972) 35 SATC 122 at 123; ITC 1211 (1974) 36 SATC 105 at 108, SIR v The Trust Bank of Africa Ltd; ITC 1236 (1975) 37 SATC 237 at 242, Bloch v SIR at 14, CIR v Nedbank Ltd; ITC 1412 (1986) 48 SATC 157, ITC 1431 (1988) 50 SATC 60 at 67, CIR v Middelman (1990) 52 SATC 323 at 328, Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 373, ITC 1507 (1991) 53 SATC 425 at 438, CIR v Pick 'n Pay Employee Share Purchase Trust at 280,

60 Durban North Traders Ltd v CIR (1956) 21 SATC 85 at 97, African Life Investment Corporation (Pty) Ltd v SIR at 175-6, Barnato Holdings Ltd v SIR at 92-3, Bloch v SIR at 14

61 COT v Glass at 517, African Life Investment Corporation (Pty) Ltd v SIR at 175-6

48 CIR v Richmond Estates (Pty) Ltd

49 John Bell & Co. (Pty) Ltd v SIR, Elandsheuwel Farming (Edms) Bpk v SBI

50 ITC 1350 (1981) 44 SATC 54 at 56, Greenband Properties (Pty) Ltd v CIR at 157

51 SBI v Aveling, SIR v Rile Investments (Pty) Ltd (1978) 40 SATC 135 at 152, ITC 1350 (1981) 44 SATC 54 at 56, Greenband Properties (Pty) Ltd v CIR at 157

52 CIR v Modified Investments (Pty) Ltd (1982) 43 SATC 257 at 262-3

53 CIR v Richmond Estates (Pty) Ltd at 361-2, Yates Investments (Pty) Ltd v CIR at 374, Elandsheuwel Farming (Edms) Bpk v SBI at 177 and 178-9, SBI v Aveling at 17, Greenband Properties (Pty) Ltd v CIR at 157

54 CIR v Stott at 261-2, ITC 1185 (1972) 35 SATC 122 at 128, SIR v The Trust Bank of Africa Ltd at 103, Berea West Estates (Pty) Ltd v SIR (1976) 38 SATC 43 at 61, John Bell & Co (Pty) Ltd v SIR at 101-2

55 CIR v Stott at 261, Natal Estates Ltd v SIR at 218, John Bell & Co (Pty) Ltd v SIR at 102, ITC 1348 (1981) 44 SATC 46 at 49

56 CIR v Richmond Estates (Pty) Ltd at 366, CIR v Guardian Assurance Co of SA Ltd

It was held not only that a discount does not accrue until maturity, but also that it differs from interest in that interest accrues from day to day or at fixed intervals whereas a discount does not [12]

Lord Fraser found that the true nature of the bank's activities was that it purchased and sold assets, as long as it held an asset, it could not realize a profit or loss in respect of it He found that if bills were ordinary commodities, there would be no doubt as to this position The fact that the bills were for fixed sums of money did not alter the position [13]

Lord Fraser was of the opinion that there is an essential difference between interest and discount The tax consequences which followed from this were, first, that interest is realized from time to time whereas, in the case of a discount, nothing is realized until the bill is sold Second, he held that interest can be calculated in advance This cannot be done in the case of a discount [14] These views have been criticized, the first on the ground that it is not a reason but a restatement of the point, and the second because it is a non sequitur It is argued that the second reason is itself a non sequitur, because it is possible to calculate interest in advance only if it is assumed that the debt is held to maturity A similar assumption in the case of a discount means that the discount can also be calculated in advance If the debt is sold before maturity, the price will vary in both cases depending on interest rates [15]

financial statements were prepared for commercial purposes and took account of gains from discounting by bringing into the income statement for each fiscal year a proportionate part of the difference between the price paid for the bill and its value at maturity. The bank maintained that discounting profits should not be anticipated and that they are not chargeable to income tax until they accrue at sale or maturity of the bill. The Crown argued to the contrary. The bank was successful in the lower courts and the matter was ultimately considered by the House of Lords. It was held in the House of Lords, Lords Diplock and Russell dissenting, that when the bank discounted or purchased a bill it acquired an asset. The bank could not realize a profit in respect of the bill until it was sold or redeemed. Thus, no part of the profits anticipated on sale or maturity could be included in the bank's taxable profits prior to sale or maturity of the bill. The Crown's appeal was, accordingly, dismissed.[8]

Had the Crown been successful on appeal, income tax would have been chargeable under schedule D case I.[9] The issue was dependent upon the true nature of the discount or purchase of a bill.[10] No distinction was drawn between the issue of a post-dated note at a discount on its face value and the purchase and sale of a post-dated bill or note at a discount on its face value.[11] The majority in the House of Lords held that the purchasing or discounting of a bill constitutes the acquisition of an asset and that a profit or loss in respect of it can only be realized when the bill is sold or redeemed.[12]

types of instruments, the position is fairly complicated. There are, however, still anomalies in this area of the law.

6.2 MEANING OF DISCOUNT

Discount means the deduction made from the amount of a bill of exchange or promissory note by a person who gives value for it before it is due.[4]

This meaning covers both the types of discounting discussed. Thus it includes the situation in which a person issues a post-dated promissory note at a discount on its face value and also that in which a person purchases a bill, note or bond at a discount on its face value and makes a profit on its sale or redemption.

The House of Lords, in a majority decision, has held that discounts are distinguishable from interest.[5] In Willingale (Inspector of Taxes) v International Bank Ltd[6] the court considered whether the accruing of a discount was an anticipation of a profit.

The facts were that the taxpayer bank was incorporated to provide medium-term finance in world markets to commercial companies. A large part of its business consisted of the discounting or purchase of bills issued by borrowers in various parts of the world. Generally, the bank held the bills until maturity although they were sometimes sold prior to maturity. The bank's

Section 18 of the Income and Corporation Taxes Act of 1988 sets out, inter alia, the general scope of the charge to tax under schedule D. It covers annual profits or gains accruing to residents of the United Kingdom either from property wherever it might be situated or from trades, professions or vocations wherever they might be carried on. It also includes the taxation of annual profits or gains arising or accruing to non-residents of the United Kingdom from property, trades, professions or vocations examined within the United Kingdom. In addition its ambit includes the taxation of other annual profits or gains not charged under the other schedules.

Section 18(3) of the Income and Corporation Taxes Act of 1988 specifies the various cases within schedule D which cover various types of income encompassed within schedule D.

All discounts are chargeable to tax under schedule D case III. Schedule D case I charges tax, inter alia, in respect of the annual profits or gains arising or accruing to any person residing in the United Kingdom from any trade, profession or vocation.

These provisions will be examined insofar as they relate to discounting transactions. Both straight debt instruments and deep discount securities will be examined. It will be seen that, although there has been a certain amount of development in the case law and in legislation covering the taxation of these

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6 TAXATION OF PROFITS IN THE UNITED KINGDOM

6.1 INTRODUCTION

The taxation of discounts from sources within the United Kingdom will be analysed in this chapter.[1] Whilst discounts are specifically chargeable to tax under schedule D case III,[2] where profits or gains from discounts are earned in the course of carrying on a trade, they are chargeable to tax under schedule D case I.[3]

Two types of discounting transactions need to be examined. The first involves the issue of a post-dated bill, note or bond at a discount on its face value. The second type of transaction is that in which a person acquires a bill, note or bond at a discount on its face value and subsequently sells or redeems it at a profit. The instruments used in these transactions are commonly referred to as straight debt instruments.

Both of these types of transactions are distinguishable from interest. They fall within the meaning of discounts and are covered by schedule D cases III and I. There is specific legislation dealing with the taxation of deep discount bonds. This legislation will be examined in detail.

231 at 451-3

232 at 452

233 at 448 The court referred to SIR v The Trust Bank of Africa Ltd at 108

234 ITC 1543 (1992) 54 SATC 446 at 448 The court referred to Elandsheuwel Farming (Edms) Bpk v SBI at 180-2

235 ITC 1543 (1992) 54 SATC 446 at 449 The court referred to SIR v The Trust Bank of Africa Ltd at 105, John Bell & Co (Pty) Ltd v SIR at 97, and CIR v Modified Investments (Pty) Ltd at 260

236 ITC 1543 (1992) 54 SATC 446 at 449

237 at 449-50

238 (1972) 35 SATC 122 at 123-4 The passage was cited with approval in Malan v KBI (1981) 43 SATC 1 at 7

239 ITC 1543 (1992) 54 SATC 446 at 453-4

240 John Bell & Co (Pty) Ltd v SIR at 103

241 Elandsheuwel Farming (Edms) Bpk v SBI at 177

242 at 7

243 'The 1995 Income Tax Act' (1995) 44 The Taxpayer 101 at 108-9

216 at 219-20

217 at 220-1

218 at 221-2

219 at 222-3

220 at 223 The court referred to SBI v Aveling at 17-18

221 ITC 1526 (1992) 54 SATC 216 at 223 The court referred to Elandsheuwel Farming (Edms) Bpk v SBI at 181 and Bloch v SIR at 18

222 ITC 1526 (1992) 54 SATC 216 at 223

223 (1982) 44 SATC 132

224 (1983) 45 SATC 236

225 (1992) 54 SATC 209

226 ITC 1526 (1992) 54 SATC 216 at 224

227 at 225-6

228 (1992) 54 SATC 446

229 at 450-1

230 at 451

201 See sch 9 and s 36 of the Finance Act of 1984 and sch 11 and s 46 of the Finance Act of 1985

202 See n 38 above

203 LHC Corporation of SA (Pty) Ltd v CIR, Durban North Traders Ltd v CIR

204 (1982) 44 SATC 132

205 (1983) 45 SATC 236

206 ITC 1525 (1992) 54 SATC 209, ITC 1526 (1992) 54 SATC 216 and ITC 1543 (1992) 54 SATC 446

207 (1992) 54 SATC 209

208 at 212-13

209 at 213 The court referred to Bloch v SIR at 18

210 ITC 1525 (1992) 54 SATC 209 at 213

211 (1987) 49 SATC 42 at 44

212 at 44, ITC 1525 (1992) 54 SATC 209 at 213

213 ITC 1525 (1992) 54 SATC 209 at 213

214 at 214-5

215 (1992) 54 SATC 216

191 See Burmah Steamship Co Ltd v IRC (1930) 16 TC 67, Verrinder Ltd v CIR (1949) 16 SATC 48, CIR v Illovo Sugar Estates Ltd (1951) 17 SATC 387. Although these cases deal with compensation payments for actual loss, it could be argued that the same principle should apply in respect of compensation payments for potential loss. See also Lomax (HM Inspector of Taxes) v Peter Dixon & Son Ltd 25 TC 353, which was based on different reasoning.

192 The basis of the argument would be that the instrument was acquired as a long-term investment and to yield a market related interest over the period that it is held. In the circumstances, the R20 should be treated as a capital profit resulting from the realization of the investment.

193 See n 17 above.

194 See n 89 above.

195 See n 162 above.

196 See n 118 above.

197 See n 128 above.

198 See n 131 above.

199 See n 149 above.

200 (1975) 37 SATC 193 at 201.

176 ITC 1413 (1985) 48 SATC 167

177 Beren West Estates (Pty) Ltd v SIR, J M Malone Trust v SIR

178 ITC 1431 (1988) 50 SATC 60 at 66

179 Tuck v CIR (1988) 50 SATC 98 at 115

180 Oryx Mining & Exploration (Pty) Ltd v Secretary for Finance at 373

181 ibid

182 CIR v Guardian Assurance Co of SA Ltd at 151

183 Barnato Holdings Ltd v CIR

184 ibid

185 ibid

186 ibid

187 ibid

188 Deceased Estate v COT (1949) 16 SATC 305, ITC 1187 (1972) 35 SATC 141 at 144, ITC 1191 (1973) 35 SATC 194 at 196, ITC 1256 (1976) 39 SATC 51, ITC 1299 (1980) 42 SATC 45 at 50

189 See n 149 above

190 (1938) 10 SATC 261

The taxpayers argued that the original issue of the promissory note was not a discount. Assets were sold, and part of the sale price was left outstanding for the period of the currency of the note. However, no evidence was put forward as to the manner in which the agreement for the sale of the assets was arrived at. In the absence of evidence as to the nature of the agreement of sale, the court assumed that the promissory note was issued at a discount.[45]

Thereafter, the taxpayers argued that the discounting profit was of a capital nature and not chargeable to income tax. The argument proceeded on the basis that where a discounting lasts for a period of up to one year, on the authority of National Provident Institution,[46] the profit resulting from it is of an income nature. If the discounting lasts for more than one year, it is of a capital nature. The court rejected this argument as there was no basis for drawing a distinction which was based on the period of the discount.[47]

The court drew attention to the fact that where a purchaser purchases a promissory note at a discount on its face value, the value of the note will be determined by not only the original discount, but also by other factors such as interest rates. It did not consider it logical to tax a purchaser on the whole of the profit made by him because not all the profit may have been made from the original discount. However, there is no authority supporting this distinction. Thus it was held that the profit realized at maturity was a discount chargeable under schedule D case III.[48]

In Ditchfield v Sharp & others[48] the taxpayers were trustees of a settlement which did not carry on a trade in securities or promissory notes. The taxpayers purchased a promissory note with a maturity date approximately three years later. The note had been originally issued to secure the outstanding consideration from the sale price of certain assets. The note was held until maturity, at which stage the trustees redeemed it and received its face value.[49] The taxpayers made a profit on redemption and were assessed to tax on the profit under schedule D case III. One of the issues before the court was whether the profit realized on redemption of the note was a discount within the meaning of s 109(2) of the Income and Corporation Taxes Act of 1970.[50] The Crown contended that the profit was of an income nature and that it was, accordingly, taxable. The taxpayers, on the other hand, argued that the profit was not taxable as it was of a capital nature.[51]

The Special Commissioners decided against the Crown and the matter went on appeal to the Chancery Division.[52] In the Chancery Division the Crown argued that the original issue of the promissory note was a discounting transaction and that, in the circumstances, the profit on redemption made by the taxpayers was a discount. The argument of the Crown proceeded on the basis that the profit was an income profit which was an annual profit or gain which was chargeable under schedule D case III. As this profit was an annual profit in the year of redemption, it was argued that the decision of the Special Commissioners was erroneous.[53]

be made between a return on capital and a return for a capital risk In this case the interest constituted a reasonable return on capital On the facts of the case, the premium and discount constituted a return for the capital risk undertaken and were held to be of a capital nature

The case illustrates the importance of the fact that the taxation consequences of a transaction do not necessarily reflect the intention of the parties involved For example, on the facts of this case, had the parties reflected the capital risk in the rate of interest and not provided for a discount or premium, the full interest would have been treated as being of a revenue nature, conversely, had the notes not provided for the payment of interest and the return of capital been reflected in the discount and premium, the full discount and premium would probably also have been treated as being of a revenue nature

The distinction drawn by the court between the issue of a debenture at a discount on its face value and the discounting of a bill of exchange is also notable Clearly, this distinction is of particular relevance in determining a discount Whilst the court was concerned with the question whether the discount and the premium constituted income chargeable under schedule D case IV or V or were of a capital nature the court was influenced by schedule D case III This is clear from the reference to the latter provision in the judgment Unlike the case of National Provident Institution the court was concerned with a longer term loan

The Appeal Court distinguished the position of the issue of a debenture at a price different from its redemption price and the position of the discounting of a bill of exchange or a Treasury Bill. The court regarded these as completely different commercial transactions. The court was of the opinion that the use of a debenture did not fall within schedule D case III. If it fell within this provision, it would follow that profits realized by selling the debenture on the market would be taxable as income as well as profits made by the original subscriber who holds the debenture until it matures. In the case of the discounting of a bill of exchange, the discount is the normal reward that a person obtains for his money.[16]

The court's three main conclusions were, first, that where a loan is made which constitutes a reasonably sound security and which provides for a reasonable commercial rate of interest, there is no presumption that any discount or premium relating to such loan is in the nature of interest. Second, the true nature of a discount or premium may only be ascertained from all the circumstances. Third, in determining the true nature of a discount or premium, one should take into account all relevant circumstances including the term of the loan and the extent to which the parties considered the capital risk.[17]

The facts of this case are particularly interesting in that the court was concerned with bills of exchange issued at both a discount and a premium and which provided for the payment of a reasonable commercial rate of interest. The approach adopted by the court is commendable in that a distinction should

to tax under schedule D cases IV or V or whether they were of a capital nature [39]

The matter came before the Commissioners for the Special Purpose of the Income Tax Act who discharged the assessments against the taxpayer [40] The matter was thereafter considered by MacNaughton J in the King's Bench Division who allowed the Crown's appeal [41] This decision was reversed by the Court of Appeal [42]

The Appeal Court found that the rate of interest provided for in the note was an ordinary commercial rate In addition, the taxpayer was concerned about political risks and how these might affect the repayment of the capital Accordingly, the notes were issued at both a discount and a premium [43] The court found at where a loan is made at or above a reasonable commercial rate of interest, there is no presumption that any discount at which the loan is made or premium at which it is paid is of an interest nature The true nature of the discount and premium can only be determined from all relevant circumstances The circumstances which should be considered include the term of the loan, the stipulated rate of interest, the nature of the capital risk and the extent to which this is relevant to the contracting parties The court held that the discount and premium were of a capital nature and not chargeable to tax under schedule D case III [44]

In IRC v Thomas Nelson & Sons Ltd[17] the issue was whether premiums paid by a borrower for early repayment of a loan were of an income nature or in the nature of accretions to capital. The court held that, having regard to the terms of the contract, the premiums must have been calculated by reference to the period of the loan and not to any element of capital risk. Having regard to this and the rate of return, it held that the premiums were of a revenue nature. The loans were made in India to a company carrying on business there. The premiums were therefore held to be profits or gains within the meaning of schedule D case V.[18]

Whilst this case did not deal with the meaning of a discount, it constitutes an authority on the approach of the courts in determining whether the profit by way of a premium is of a revenue nature or whether it is an accretion to capital. It should, however, be appreciated that it dealt with premiums on loans and not bills of exchange.

In Lomax v Peter Dixon & Son Ltd[19] the court was concerned with a long term loan to a Finnish company in circumstances in which the borrower paid a reasonable commercial rate of interest and secured the loan by the issue of notes at a discount of 6%. Interest was payable on the notes and they were repayable at a premium of 20% in certain circumstances. The issue was whether the discount and premium were of an income nature and chargeable

discount was the amount by which the value of the bill had increased by advance towards maturity.

The House of Lords rejected this conclusion and followed the reasoning of Rowlatt J in the King's Bench Division and Warrington LJ.[11] Viscount Haldane followed the reasoning of Warrington LJ to the effect that the total of the profits received by the sellers after deducting losses cannot exceed the difference between the original purchase price and the payment at maturity. Thus the profits or losses made by various holders of a bill between the dates of issue and maturity merely affect the distribution of the discount between the various holders.[12] Viscount Cave held inter alia that whilst the value of a bill in the market may vary according to the value of money there is no real analogy to capital as the amount secured by the bill remains unaltered.[13] Lord Wrenbury accepted that the [illegible] constituted a [illegible]

1853 or whether the differences were accretions to capital and not profits on discount within the meaning of the language of schedule D case III The taxpayer had bought Treasury Bills at the Bank of England The bills were bought at a discount on their face values and matured after intervals of three, six and nine months Some of the bills were sold prior to maturity, some were redeemed at maturity and some converted into 5% War Loan Stock The taxpayer was not assessed to tax on the balance of its profits and gains under schedule D case I [40]

In the King's Bench Division, Rowlatt J held, inter alia, that the difference between the a ounts paid for the purchase of the bills and the amounts received on realization constituted profit on discount within the meaning of schedule D case III In addition, I held that where the holder of a Treasury Bill realizes it before maturity, any profit made on realization results from the fact that the bill was bought at a discount Thus, such profits are also chargeable to tax as discounts in terms of schedule D case III [41]

The Court of Appeal held, inter alia, Warrington LJ dissenting, that the differences between amounts paid and received were not necessarily taxable as profits on discounts The majority held that the differences might partly represent accretions to capital and partly profit by way of income Such accretions of capital may be due to the state of the money market, the rise or fall in the value of money and the rates of interest The only amount taxed as a

appropriate to refer, in addition, to a passage from the judgment of Vice-Chancellor Bacon in London Financial Association v Kelk

> 'The difference between "advancing", "lending money" and "discounting" is purchasing, not lending The discounter, whether of a bill or bond, or any other security, becomes the owner If the thing bought turns out when realised to be of less value than the price paid for it, the loss falls upon the purchaser or discounter If a profit or gain is made upon the transaction, it belongs wholly and exclusively to the discounter or purchaser '[28]

This passage, together with Willingale, provides clear authority that the purchase and subsequent sale at a profit of a bill, note or bond is a transaction of purchase and sale and not a transaction of loan

6 3 REVIEW OF THE CASE LAW ON THE TAXATION OF DISCOUNTS

A number of cases that have dealt with the taxation of discounts These cases are discussed below

In The National Provident Institution v Brown[31] the House of Lords had to decide, inter alia, whether differences between amounts paid and amounts received in respect of Bank of England Treasury Bills were profits on discounts within the meaning of schedule D case III of the Income Tax Act of

accrued either when the loan agreement was entered into or when the interest was due and payable. He did not express a firm opinion as to when accrual takes place in these circumstances. The distinction which he drew between this type of loan and a discount was based on the fact that the purchaser of a bill is entitled to sell the bill when he likes or keep it until maturity.[37] It is submitted that this distinction is untenable, as it is also possible for a creditor to cede a debt for value prior to due date.

The issue should have been based on the meaning of accrual in the context of a discount. If the majority had held that the issue of a post-dated note at a discount was a loan, that finding would not necessarily have resulted in the bank being chargeable to tax annually on post-dated notes issued to it. It would then have been necessary to determine, in that type of transaction, when accrual of the discounting profit took place.

However persuasive the criticisms of the decision in Willingale might be, it reflects, nonetheless, the current law of the United Kingdom.

Willingale covers both the situation of the issue of a post-dated bill, note or bond at a discount on its face value, and the purchase and sale of a bill, note or bond at a discount on its face value. Where a post-dated bill, note or bond is purchased at a discount on its face value and subsequently sold or redeemed at a profit, the profit is clearly distinguishable from interest. In this regard, it is

interest is payment by time for the use of money.[32] Consequently it has been argued that there is no essential difference between discount and interest.[33]

Lord Salmon made the point that where a bill is bought in a foreign currency, possible exchange rate fluctuations make it difficult to predict the profit that the bill might yield at maturity. This point does not, with respect, affect the principle of the matter. A loan may also be in a foreign currency and interest payments may also fluctuate depending upon the exchange rate between the currencies concerned.[34]

The criticisms of the majority judgment have a certain amount of substance. It can be argued that the issue of a post-dated promissory note at a discount on its face value is a transaction of loan. However, it can also be contended that the purchase and sale of a post-dated bill or note at a discount on its face value is a contract of purchase and sale and not loan.[35]

As far as the issue of a post-dated note at a discount on its face value is concerned, the judgment emphasized the fact that interest accrues from day to day whereas a discount accrues only at sale or maturity of the bill.[36] The type of loan envisaged was not indicated, but presumably it was the type of loan in which interest accrues on a daily basis and is paid at monthly intervals. A more appropriate type of loan to consider is that in which the interest is payable only when the principal is due and payable. Lord Salmon considered this to be a most unusual type of loan. He indicated that it was possible that the interest

The majority in Willingale based their decision on the principle that profit is not taxed until it is realized [16] They held that the institution acquired assets and did not realize a profit whilst it continued to hold them [17]

Although the institution had in its financial statements accrued the discounting profit over the period from acquisition of the bill to the date when the bill matured, the majority held that from an income tax point of view, such treatment constituted an anticipation of an unrealized profit [18]

Counsel for the crown argued that the principles of commercial accounting should prevail However, the majority found that financial statements drawn up on the basis that the profit on the bills were shown as and when realized would have been in accordance with proper accounting principles provided there was full disclosure of this in the financial statements [19]

Counsel for the Crown also contended that the accrual of the present value of a future debt did not offend the principle that profits and l. ses cannot be anticipated However, the authorities quoted only supported this contention where the receipt involved had been earned for services rendered or goods supplied in the earlier year The majority held that where the institution required post-dated bills it did not render services to the issuers of the bills [20]

The majority decision has been criticized because no valid reasons were given for distinguishing between discounts and interest [21] It has been held that

trusts,[98] underwriters[99] and multiple issues.[100] It is beyond the scope of this thesis to examine these provisions.

Special rules apply where a deep discount security is redeemed prior to redemption date. In this situation the person who was the beneficial owner of the security immediately before redemption will be deemed to have received income for the period between the acquisition and disposal of the security. The income is calculated by deducting from the redemption price the issue price of the security when he acquired the security subsequent to its issue, he should also deduct the accrued income attributable from the date of issue of the security to the date when he acquired it.[101]

Insofar as it is not covered by specific legislation, the profit on the sale or redemption of a deep discount security arises in the year of assessment or accounting period in which the proceeds are received.[102]

Following the promulgation of the Finance Act of 1984 it became apparent that special purpose vehicle companies could be formed to acquire certain types of securities such as United States Treasury Bonds and United Kingdom Gilts. Such a company could acquire interest-bearing securities and itself issue a series of deep discount securities. The securities would mature at intervals so that the income elements matched each interest payment received and the final security would represent the principal sum. This device was known as coupon-stripping and enabled an investor to defer his tax liability on the bonds

A disposal of a deep discount security may also be treated as a disposal for capital gains purposes. In this situation, there may also be capital gains tax chargeable.[78] In calculating the disposal consideration for capital gains tax, account must be taken of any income charge.[79]

If the income charge exceeds the consideration received on disposal, such excess is regarded as additional enhancement expenditure which was incurred immediately prior to disposal.[80]

There are three types of transactions which give rise to an income charge but not a capital gain. First, where a deceased person's estate includes a deep discount bond and he was competent to dispose of it prior to death. In this situation, he is treated as having disposed of the security immediately before his death.[81] Second, where there is a conversion or exchange of securities or a reconstruction or amalgamation in terms of which the securities are deemed to have been exchanged and to which s 132, 135 or 136 of the Taxation of Chargeable Gains Act of 1992 apply. In this situation, the beneficial owner of the securities is deemed to have disposed of them immediately prior to the conversion or exchange, as the case may be.[82] Third, where no gain or loss arises in the hands of the transferor.[83]

Special provisions apply to deep discounting transactions involving various types of companies,[84] charities,[85] retirement benefit schemes,[86] stock lending,[87]

It will be noted that the calculation of the accrued income is similar to the calculation of accrued interest in terms of s 24J of the South African Income Tax Act applying the yield to maturity basis. This basis is discussed in section 3.5 above, and it is clear that the only difference is that the calculation of accrued income under the legislation in the United Kingdom excludes any interest paid. The interest paid is reflected separately as interest. Section 24J of the South African Income Tax Act provides that the accrued interest includes any interest actually paid. This difference is not material and merely one of form. It should, however, be appreciated that s 24J of the South African Income Tax Act allows the application of other acceptable methods of calculation of accrued interest such as the weighted capital method. If one applies a different method of calculation, the results may differ from those obtained by applying the yield to maturity basis of calculation under s 24J of the South African Income Tax Act and the accrued income under the legislation in the United Kingdom.

It should be appreciated that the profit on the sale of a deep discount security may have two elements. The first will be the chargeable portion of the discount in terms of schedule D case III or IV, as the case may be.[86] The second may be a gain or loss resulting from fluctuations in market interest rates or other related factors. This latter gain or loss is generally treated as being of a capital nature.[87]

redemption price of £10 000 000 is issued for £9 000 000. The annual yield to maturity would be 11.4233%. The accrued income would be as follows

Year	Cash flows (Pounds)	Interest (Pounds)	Accruals (Pounds)
0	9000000		
1	1000000	1000000	28097
2	1000000	1000000	31307
3	1000000	1000000	34883
4	1000000	1000000	38868
5	1000000	1000000	43308
6	1000000	1000000	48255
7	1000000	1000000	53767
8	1000000	1000000	59909
9	1000000	1000000	66753
10	1000000	1000000	74378
11	1000000	1000000	82874
12	1000000	1000000	92341
13	1000000	1000000	102891
14	1000000	1000000	114643
15	11000000	1000000	127739

The accrued income is determined for each income period by applying the following formula

$$\frac{(A \times B) - C}{100}$$

where

A is the adjusted issue price, in other words the issue price plus the accrued income for previous periods,

B is the yield to maturity, and

C is the amount of interest attributable to the income period [84]

The income period is the period for which interest is paid. If no interest is payable the income period is each year ending before the anniversary of the issue of the security, or any shorter period from such an anniversary to the earliest redemption date [85]

In order to understand the effects of the formula, it is appropriate to consider an example. Assume a 15-year bond with a coupon rate of 10% and a

This definition was extended in 1989 to redeemable securities issued by public bodies at a deep discount. There is excluded from the definition securities in terms of which the redemption amount is limited to the retail prices index or a similar foreign general index of prices and certain types of securities issued in two or more tranches under the same prospectus.[75]

Further types of securities which are excluded from the definition of a deep discount security are securities issued by a company on or after 1 August 1990 in terms of which they can be converted into share capital in a company,[76] securities issued on or after 1 August 1990 in terms of which there is more than one date on which the issuing company or public body may be compelled to redeem,[77] and securities which are qualifying convertible securities.[78]

The discount is treated as income and accrues on a compound basis.[79] It is charged to tax when the security is disposed of or redeemed.[80] The charge to tax is under schedule D case III or, in the case of a foreign security, schedule D case IV.[81]

The accrued income attributable to a period of ownership is the aggregate of income elements for the income periods in the period of ownership.[82]

There are circumstances in which the holder of a security is liable to tax on the income element of the discount as it accrues instead of on disposal or redemption.[83]

constituted a true and fair reflection of the business. Third, the instruments involved had to have a life of one year.

Thus, in 1984, schedule 9 to s 36 of the Finance Act of 1984 was enacted to deal specifically with deep discount securities issued after 13 March 1984. These provisions were substantially re-enacted in 1988 in schedule 4 to s 57 of the Income and Corporation Taxes Act of 1988 and further amendments were effected in schedule 10 to s 94 of the Finance Act of 1989. Convertible securities were covered in schedule 10 to s 56 of the Finance Act of 1990.

A deep discount security is defined for the purposes of this legislation as any redeemable security that a company issues at a discount of either more than 15% of its redemption value or more than 1/2% per year over the term of the security. There is no requirement that the issuing company should be resident in the United Kingdom. The discount is the amount by which the issue price is less than the amount payable on redemption. It therefore includes premiums in appropriate circumstances.[72] Where securities issued before 14 March 1984 have been exchanged for new securities which would otherwise qualify as deep discount securities, the new securities may qualify as deep discount securities in certain circumstances.[73] Deep discount securities do not include shares in a company, securities the redemption value of which is linked to the retail prices index or a corporation foreign index, and securities that are wholly or partly treated as a distribution for corporation tax purposes.[74]

compromise in terms of which a portion of the profit was allocated as a discount and a portion of the profit was allocated as a capital gain arising as a result of market factors. At all stages it was accepted that, if the investor was taxable on his profit, he was taxable on a receipts basis when the bond was sold or redeemed.[68]

The profit on sale or redemption of a bond by a person dealing in such instruments, such as a bank or other financial institution, was clearly of an income nature and therefore chargeable to tax. However, Inland Revenue argued that if the profit was accrued annually for accounting purposes, it should be chargeable to income tax on a similar basis.[69] In Willingale the majority in the House of Lords held that no part of discounting profits could be included in the bank's taxable profits prior to the sale or maturity of the bill. Thus, Inland Revenue did not succeed in its argument to tax the discounting profits of banks and other financial institutions on an accrual basis.[70]

Revenue responded to the judgment in Willingale by accepting it but narrowing its application.[71] The principles laid down in Willingale were applied if the following three requirements were met. First, a taxpayer was not permitted continually to change the basis of taxation of discounts. Either the realization or the accrual system had to be adopted and, thereafter, it was not possible to change the basis. Second, where the realization basis was adopted, an auditor's certificate was required to the effect that the financial statements

exception is the unrealized gain on a quoted security. Such a gain is often excluded as it is not actually ascertained."[65]

6.5 DEEP DISCOUNT BONDS

Generally deep discount bonds yield very low or zero interest and are therefore issued at a substantial discount. Thus, in the early 1987, a typical ten-year zero interest bond would be issued at a discount of 75%. This would provide an investor with a return of approximately 15% per annum. The return to the holder is therefore, wholly or partly, in the form of discount."[66]

Applying the general principles arising from the case law to the situation of a person investing in a deep discount bond, particularly if there is no coupon rate on the bond, the profit should be treated as either a discount or interest, depending upon the circumstances, and the recipient should be charged to income tax on it.[67]

The application of these general principles gave rise to certain problems. First, if a bond had a coupon rate attaching to it, there was uncertainty as to whether or not it was a deep discount bond. Second, it was argued by certain taxpayers that a person investing in a bond acquired at a discount on its face value could only receive a discount if he redeemed the bond. If the bond were sold, the investor would argue that he had not received a discount, but a capital gain. Frequently the investor and Inland Revenue would reach a

The position is, therefore, that if A issues a straight debt instrument, such as a post-dated promissory note, to B at discount on its face value, it is necessary to examine the circumstances of the issue and B's situation in order to determine B's liability for tax. If B is not carrying on a trade in financial instruments, there are circumstances in which any profit from the sale of the instrument would be of a capital nature and not chargeable to income tax. An example of capital profit would be profit relating to compensation paid to B in respect of his capital risk. However, where the discount constitutes a revenue profit, B will be chargeable to tax at the time of the sale or redemption of the instrument.

It should be appreciated that where the profit made by B is of a capital nature, and where B is a company, there is a possibility of B's being chargeable to corporation tax on its capital gain. In order for liability to arise either B would have to be the holder in due course in respect of the instrument, or the instrument would have to be debt on security."[1]

The position is different where B is, for example, a bank or financial institution, and carries on a trade of dealing in securities. In these circumstances, B will be chargeable to tax on its profit from the sale or redemption of the promissory note."[2] Such profits will constitute normal trading profits. Generally, trading profits are chargeable to tax according to generally accepted accounting practice. Thus, such profits will frequently be taxable on the accrual basis. There are, of course, exceptions to this general rule. An example of an

question arises whether the £20 is of a revenue or capital nature. This type of situation could arise, for example, where B issues A with a post-dated promissory note. The face value of the note is £120, the issue price is £100 and the note provides for a reasonable commercial rate of interest to be payable on the note. The £20 could represent deferred interest or the discount in the case of a note, or it could represent compensation for the capital risk taken by A. It is necessary to examine all the circumstances of the transaction in order to ascertain the nature of the £20. If it were established that the parties intended the £20 to compensate A for his capital risk, then the £20 would probably be regarded as being of a capital nature. If there was no such proof, one could possibly draw an inference from the period of the loan or in the case of the issue of a note at a discount, the period from the date of issue to the maturity date of the note. The shorter the period, the stronger the argument that the £20 is deferred interest or a discount chargeable to tax. The longer the period, the stronger the argument that the £20 is to compensate A for his capital risk."[1]

If the principal amount loaned or the face value on the note is index-linked the increase in the amount repaid at redemption may, except where the lender or maker of the note, as the case may be, is a bank or other financial concern, be treated as capital. The increase should not, however, exceed the fall in the real value of the principal as a result of inflation, and a reasonable commercial rate of interest on the principal should be charged."[2]

6.4 SPECIFIC SITUATIONS IN RESPECT OF STRAIGHT DEBT INSTRUMENTS

The more important cases on the meaning of discounting reveal that there are a number of different situations to consider

If A advances B £100 on condition that B will pay A £110 after one year, it is necessary to examine the contract and all the circumstances of the case to ascertain the nature of the increment of £10. If the contract does not explain the nature of the £10 then, in the absence of any other relevant facts, the £10 will probably be held to be interest. The reason for this may be that as the transaction is a commercial transaction, A must be presumed to have acted on a commercial basis and to have required interest as a return on his investment. A further factor which tends to indicate that the £10 is interest is that £10 represents a reasonable commercial return on the loan of capital of £100 for a period of one year.[58] However, if it is clear from the contract or instrument that the £10 is a discount, the £10 will be treated as a discount and will be distinguishable from interest.[59]

In the case of a discount received, there will only be an accrual when the instrument is sold or redeemed.[60]

If, on the other hand, A advances to B £100 at a reasonable commercial rate of interest and it is stipulated that B will pay A £120 at maturity of the loan, the

redemption under the new option exceeds the amount payable on the previous option by more than 15% of the amount payable under the new option, or 5% of the amount for each complete year between the redemption date under the previous option and the redemption date under the new option [166]

The discount element in a qualifying convertible security is chargeable to tax under schedule D case III or case IV [167] The charge arises where, on or after 9 June 1989, the holder of a qualifying convertible security either transfers it when there is at least one unexercised option for early redemption or redeems it by exercising an option for early redemption [168] No charge arises where a qualifying convertible security is converted to share capital of a company or where such a security is redeemed on maturing [169] The person who is chargeable to tax is the person making the transfer or exercising the option [170] The income is treated as arising in the year of assessment in which the chargeable event occurs and a tax is computed on the income arising in the year of assessment for which the computation is made [171]

The amount which is chargeable to tax is the lesser of the total income element and the amount obtained on transfer or redemption [172] Where the security is a foreign security and the person chargeable to tax is either not domiciled in the United Kingdom, or, being a common law citizen or a citizen Republic of Ireland, is not ordinarily resident in the United Kingdom, tax is chargeable under schedule D case IV In these circumstances, tax is chargeable on the remittance basis [173]

(c) the new redemption date should not be less than one year after the old redemption date.

(d) the new redemption amount should not be less than the old redemption amount.

(e) yield to maturity to the new redemption date should not be greater than a reasonable commercial return, and

(f) the obtaining of a tax advantage should not be the main or one of the main benefits [63]

A qualifying convertible security will cease to be such if certain events occur after it has been issued [64] These events are if -

(a) if the security ceases to be quoted on a recognized stock exchange.

(b) the interest is varied or becomes variable.

(c) the redemption amount or interest becomes payable in a different currency.

(d) the holder of the security becomes entitled to a new option for early redemption which is not a qualifying provision for redemption, or

(e) more than 10% of the securities issued under the relevant prospectus are held by connected companies [65]

A deep gain arises where the amount payable on redemption exceeds the issue price by more than 15% of the amount payable or, 5% of that amount for each complete year between the date of issue and the redemption date [66] Where a new option is granted, there is a deep gain where the amount payable on

(8) The obtaining of a tax advantage is not the main or one of the main benefits that might be expected to accrue from the issuing of the security [146]

(9) The security carries a right to interest and either the first interest payment date falls on the same day in the month as the day of issue or occurs in the sixth month after the month in which that day falls or the first interest payment day falls on the first anniversary of the day of the issue [147]

(10) Where there is more than one interest payment date, and where the requirements stipulated in the ninth condition above apply [148]

The general rule is that a security which was a qualifying convertible security when it was issued continues to be one [149] This does not apply in certain circumstances where a security becomes subject to a later option and where certain prohibited events occur [150] A security will be a qualifying convertible security if it becomes subject to a call option for redemption and, prior to the option being granted it was a qualifying convertible security and if certain requirements are fulfilled [151] The requirements are

(a) the security must become subject to the call option within 30 days of the original redemption date.

(b) the issuer should not have indicated that the security might become subject to the call option prior to 30 days from the original redemption date.

A qualifying convertible security is one which fulfils the eight conditions listed below and either the ninth or the ninth and ten conditions as the case may be which are also listed below [148]

The ten conditions are

(1) A security must be issued by a company on or after 9 June 1989 [149]

(2) The security is not a share in a company, is redeemable and was not issued in circumstances in which it is treated as a distribution of a company [150]

(3) The security was quoted on a recognized stock exchange [151]

(4) Under the terms of issue the security is convertible into ordinary share capital of the issuing company, it carries no right to interest or carries a right to interest at a fixed rate determined at the date of issue and any redemption amount and interest is payable in the currency in which the issue price is denominated [152]

(5) At the time of issue of the security is subject to only one qualifying provision for redemption [153]

(6) The yield to redemption for the relevant redemption period constitutes a reasonable commercial return [154]

(7) The security would not be a deep discount security or a deep gain security if it were not for the option of early redemption [155]

The income is treated as arising in the year of assessment in which the transfer takes place and the tax is computed on the income arising in the year of assessment for which the computation is made [144]

The chargeable amount is therefore simpler to calculate than that in respect of deep discount securities or qualifying convertible securities. The latter relate to discount accrued during the period of ownership in relation to the discount over the term of the security. However, in the case of a deep discount security, the charge is on the actual profit realized on transfer or redemption. In the circumstances, no chargeable gain arises on the transfer of a deep gain security [145]. There are a number of special provisions in the legislation dealing, for example, with death and transfers between connected persons, but it is beyond the scope of this thesis to examine these various provisions in any detail [146]

6.7 CONVERTIBLE SECURITIES

There were further rules introduced in the Finance Act of 1990 for the taxation of deep discounts on qualifying convertible securities. These are, generally, quoted redeemable securities issued by a company and which give the holder rights to convert them into shares in the issuing company or to require redemption. In the circumstances the new rules in the Finance Act of 1990 apply and not the rules which apply to deep discount securities or deep gains securities [147]

purchased by a person other than the issuer, the security be converted into another kind of security or the security be redeemed in circumstances other than any of the qualifying circumstances stipulated [139]

(7) Where the issue is handled by an agent or underwriter, the offer contains no provision for the security to be repurchased by the issuer, converted into another kind of security, or redeemed within a period of five years from the date of issue, and the offer contains no provision enabling the holder of the security to require the security to be purchased by a person other than the issuer within five years of the date of its issue [140]

A convertible security is one issued by a company before 9 June 1989 in terms of which it can be converted into or exchanged for share capital in a company In addition, either or both the security or the share capital in the company into whose share capital the security can be converted or for whose share capital the security can be exchanged must be quoted on a recognized stock exchange within one month of the date of issue of the security [141]

The income on a deep gain security is chargeable to tax under schedule D case 3 or case 4 [142] Where a transfer of a deep gain security takes place on or after 14 March 1989 the income which is chargeable to tax is the amount by which the proceeds obtained on transfer exceed the amount paid on acquisition [143]

A qualifying index security is a security which fulfils seven conditions [113]

The conditions are

(1) The security is denominated in sterling and the redemption proceeds are linked to the retail prices index. the security is denominated in a foreign currency and the redemption proceeds are linked to a similar general index of prices published in the country in whose name the currency is denominated. or the security was quoted on a recognized stock exchange and the redemption proceeds are linked to a published index of prices of shares quoted on a recognized stock exchange [114]

(2) The terms of issue do not provide for the conversion into or redemption in a currency other than that in which the security is denominated on issue [115]

(3) A reasonable commercial rate of interest is payable on the security at least once a year and the interest is determined by reference to the same index as that relating to the redemption proceeds [116]

(4) Where the redemption proceeds and interest are index linked. the index must be applied precisely and without restriction [117]

(5) The security is issued for a definite stated period and the period commences on date of issue and is for five years or more [118]

(6) The terms of issue do not entitle the holder of the security to do certain things within five years of the date of issue The prohibited activities are that the security be repurchased by the issuer. the security be

(c) The condition is not one of a number and at least one of the conditions was certain or likely to occur.[124]

(d) The obtaining of a tax advantage is not the main or one of the main benefits that might be expected to accrue from the provision for redemption.[125]

Insofar as the second condition is concerned, a security is excluded if it is -

(a) a deep discount security;[126]

(b) a share in a company;[127]

(c) a qualifying index security;[128]

(d) a convertible security;[129]

(e) a gilt-edged security issued before 14 March 1989 or issued on or after that date but under the same prospectus as a gilt-edged security issued prior to that date;[130]

(f) a gilt-edged security issued under a prospectus under which no securities were issued before 14 March 1989, which was issued otherwise than on the occasion of the original issue under the prospectus and where all the securities issued under the original issue under the prospectus were gilt-edged securities which were not deep gains securities;[131] or

(g) a security which was not a gilt-edged security and was issued under the same prospectus as any other security which was issued before it and which is not a deep gain security.[132]

A deep gain security is a redeemable security which fulfils two conditions [117] The first condition is that, taking into account circumstances at date of issue of the security and assuming it will be redeemed, the amount payable on redemption might constitute a deep gain [118] The second condition is that the security is not specifically excluded [119]

Insofar as the first condition is concerned, certain types of redemptions do not result in a security being deemed to be a deep gain security These types of redemptions are

First, any redemption made prior to maturity only at the option of the issuer of the security [120]

Second, any redemption made prior to maturity exercisable only on the effluxion of time or the happening of a certain or likely event [121]

Third, where a security was issued on or after 13 November 1991, redemption does not include a redemption made prior to maturity where four conditions are fulfilled These conditions are

(a) If the condition was fulfilled, the interests of the holder of the security might be adversely affected [122]

(b) The condition is neither certain nor likely to be fulfilled [123]

Where a bank or other financial institution acquires a security, the position is different [11] Revenue argues that the deep discount rules do not apply to such a transaction Thus, the general principles will apply in the case of a dealer in securities The dealer will therefore argue that it is taxable on a realization basis whereas Revenue will argue that the discounting profit is chargeable to tax on the accrual basis If the principles laid down in Willingale[11] apply, the dealer will be taxable on the realization basis If not, Revenue will endeavour to tax such profits on an accrual basis

6 6 DEEP GAIN SECURITIES

A security will constitute a deep discount security if, at the time of issue the discount exceeds certain specified limits However, where a security is issued with either a variable interest rate or a floating coupon rate, it may not be possible to determine in advance the amount of discount which will accrue on the security In these circumstances the security may not fall within the definition of a deep discount security Legislation was introduced in 1989 to deal with securities which contains certain variable features These securities are known as deep gain securities [11]

A deep gain exists where the amount payable on redemption of the security exceeds its issue price by more than 15% of the amounts so payable or 1/2% per annum for each completed year between the date of issue and the redemption date [11]

Third, where neither of the first two categories apply, but in the first income period of the securities issued, at least 75% of the company's assets include relevant securities [110]

Fourth, where deep discount securities fall within any of the other categories and are replaced with new securities by way of conversion or exchange [111]

It is, therefore, clear that deep discount security is now clearly defined It is a security which is issued at a discount of more than ½% per year Thus, a security issued for a period of ten years would only be required to be issued at a discount of 5% of its face value An exception to this is an index-linked security Thus, if a security is issued at a discount on its face value and its redemption price is linked to a retail price index, it will not constitute a deep discount security

A person holding a deep discount security as an investor will be taxed only on any discount profit made by him when such profit is realized He will no longer be able to claim that the whole of the discounting profit made by him is not taxable as it is of a capital nature However, the portion of the gain resulting from fluctuations in the market interest rates or other related factors will generally be treated as being of a capital nature and will not, therefore, be taxable These rules will also apply to an intermediate purchaser and seller who has acquired and held the security for investment purposes Such an investor is chargeable to tax on a proportionate share of the profit [112]

until maturity [103] Accordingly the Finance Act of 1985 contained provisions to combat this type of scheme [104]

These provisions apply to any deep discount security issued on or after 19 March 1985 [105] Where a person acquires a chargeable security as defined, he is chargeable to tax on the income element of the discount for each income period of the security which ends within the period of ownership of the security [106]

There are four categories of chargeable securities covered by these provisions

First, where deep discount securities are issued by a company and immediately before the issue the company's assets included relevant securities of at least 75% of the value of all of its assets and/or the terms of the issue of the securities are determined by reference to relevant securities which the company holds or intends to acquire [107] Relevant securities are defined as loan stock or similar securities excluding United Kingdom corporate bonds [108]

Second, where deep discount securities are issued by a company and it holds or intends to acquire United Kingdom corporate bonds in the circumstances set out in the first category above [109]