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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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per year provided that the period to redemption is less than 30 years or in any other case, 15%.[217]

Where a loss is sustained on the transfer or redemption of a discounted security, and if the person transferring or redeeming the security has made a profit on the transaction, such profit will be tax exempt, relief in respect of the loss will not be granted except in respect of discounting profits in that particular year.[218]

The consultative document refers to the position of types of shares which have many of the characteristics of bonds and which are treated as non-equity shares for accounting purposes. Examples of these types of shares are permanent interest-bearing shares issued by building societies and certain types of redeemable preference shares. The types of preference shares included are those in respect of which the investor is assured of a virtually certain sum on redemption. It is proposed that these types of shares should be treated as bonds for the purposes of the new rules. The effect of this would be that gains and losses in respect of the shares would be of an income nature. Issuers would be able to deduct any coupon relating to the shares, subject to the rule that any excess over a normal commercial return on the principal secured would be treated as a distribution.[219]

The new rules will apply to certain types of convertible securities. They will specify the criteria that will apply in order for the securities to fall within the

There will be detailed provisions covering discounted securities. They will provide that where a person releases the profit from the discount on such a security, he will be chargeable to income tax on the profit under schedule D case III. Where the security is outside the United Kingdom, the profit will be chargeable under case IV of that schedule.[212] A profit will be realized on the transfer or redemption of the security. The profit will be calculated as the excess of the transfer or redemption proceeds over the costs of the security. The costs include the costs of acquisition by the transferor or the person entitled to the redemption proceeds, and the costs of redemption or transfer.[213] Where a person sustains a loss in respect of a discounting transaction, and makes a claim for it before 31 January of the second year following the end of that year of assessment, he will be entitled to relief in respect of that loss. The loss will be calculated on the basis of the excess of the costs over the proceeds of the transfer or redemption proceeds.[214]

The type of security that will be affected by these provisions are deep gain securities.[215] Those that will be specifically excluded will be shares in a company, gilt-edged securities that are not strips, excluded indexed securities, life assurance policies, certain capital redemption policies and certain securities issued under the same prospectus as other securities which were previously issued but are not themselves relevant discounted securities.[216] A deep gain security is one in respect of which the security is issued at a discount of more than the relevant percentage. The relevant percentage is similar to that applicable to deep discount securities. It is either a percentage equal to $\frac{1}{2}$%

proportion to the market value as is borne by the market value of the strip to the market values of all the strips exchanged for the security.[207] Conversely, there will be provisions covering the situation where strips of a gilt-edged security are consolidated into a single gilt-edged security by way of exchange. Each strip will be deemed to have been redeemed at the time of the exchange at its market value. The person exchanging the strips will be deemed to have acquired the security for the aggregate of the market values of the strips which have been exchanged.[208] A person who holds a strip on 5 April in any year of assessment and does not redeem or transfer it on that day will be deemed to have transferred it on that day. He will be deemed to have transferred it at its market value and to have acquired it for the same value the next day.[209]

There will be provisions dealing with so-called manufactured interest. They will apply where such interest is payable by, or on behalf of or to a company under a contract or arrangement relating to the transfer of an asset representing a loan relationship. Such amount, when paid, will be treated as interest under that relationship.[210] The manufactured interest will be treated as if it were interest under a loan relationship to which the company is a party. If manufactured interest is payable to the company, such interest will be treated as if real interest is payable.[211] The question whether the credits and debits are of a trading or non-trading nature will be determined according to the extent that the manufactured interest is paid for the purposes of the company's trade or is received as an integral part of the trading activities.[212]

comprised. In the latter case, the period will differ from the first period for purposes of giving effect to a valuation in relation to rights and liabilities under the security.[352]

Where a loan relationship is linked to the value of chargeable assets, the amounts which will be taken into account in respect of this relationship will be the amounts relating to interest. In this regard, only an authorized accrual basis of accounting will be used to ascertain those amounts. A loan relationship will be linked to the value of chargeable assets if the amount payable to discharge the money debt is equal to the amount determined by applying a relevant percentage change in the value of chargeable assets to the amount regarded as the original loan from which the original money debt arises.[353]

There will be provisions dealing with gilt strips. These provisions will have effect in respect of an authorized accrual basis of accounting. They will apply where there is a loan relationship in respect of a gilt-edged security or a strip of such an instrument.[354] Strips means 'separate trading of registered interest and principal of securities'.[355] Where a gilt-edged security is exchanged by a person for strips of that security, there will be two consequences. First, the security will be deemed to have been redeemed at the time of the exchange. The redemption will be deemed to have taken place at its market value. At the same time the person will be deemed to have acquired each strip. He will be deemed to have acquired each strip for the amount which bears the same

normal restrictions for charges. Individual investors could offset any losses against case III income and any excess could be offset against other income. It is also proposed that foreign source income be taxed under case III. Financial traders would be liable under case I on their trading profits and losses. Pension funds and charities would retain their exempt status.[199]

The new rules will apply to bonds and to holdings of bonds wherever issued. The new rules will apply to all gilts, including stripped and indexed gilts.[200] In the case of an index-linked gilt, the adjustment will provide for the credits and debits to be accounted for as non-trading items. The adjustment will be made wherever the security gives credits or debits by reference to the value of the security at two different times and there is a change in the retail price index between those two times. The adjustment is effected by taking the value of the security at the earlier time. This value is adjusted by reference to the percentage movement in the retail price index between the two times.[201] A security will be an excluded index-linked security if the amount payable on redemption is linked to the value of chargeable assets. An amount will be linked to the value of chargeable assets if it is equal to an amount determined by applying a relevant percentage change in the value of the assets to the amount for which the security was issued. The relevant percentage change in the value of the chargeable assets refers to the percentage change in the value of the assets or in any index of the value of such assets over the relevant period. The relevant period is either the period between the issue of the security and its redemption or any other period in which that period is

The main advantages of the proposed reforms are that the tax treatment will be closer to the accounting treatment and the possibility of artificial tax deferrals being created will be eliminated [1]

The consultative document states that the rules should be the same for all United Kingdom holders of gilts and bonds However, it is considered that an accruals or mark-to-market basis of taxation would be too complex for most of the non-corporate holders [2] Inland Revenue has decided that, as a general rule, non-corporate holders will continue to pay tax on interest on the current basis However, there will be a threshold above which non-corporate investors will be taxed on the same basis as corporate holders This threshold has been set at £200 000 Where non-corporate investors are above this level, all gains and losses will either be taxed or subjected to tax relief, as the case may be [3] In the case of non-corporate investors, there will be no gain or loss on death In this situation, transfer to heirs and legatees will be at market value Gains and losses will be deferred in the case of transfers between spouses Such transfers will, therefore, be effected at neither a gain nor a loss [4]

The consultative document contains a discussion on the tax treatment of profits and losses in respect of financial instruments within the various cases under schedule D It is proposed that the profits of companies be covered by case III and losses be assimilated to the general treatment of charges Thus, surplus losses could be offset against profits of other group companies, or could be carried forward to be offset against future profits subject to the

discount income relating to the period in question is £10 000. Thus, company A's income for the period would be £110 000.

If company A sold the bond at the end of the accounting period for £900 000, and assuming the accrued discount for previous accounting periods was £20 000, the position would be as follows:

| | |
|---|---|
| Interest | 100000 |
| Loss on sale of bonds i.e. difference between the cost and accrued discount, and the sale proceeds | ( 70000) |
| Taxable income | 30000 |

Inland Revenue has indicated that flexibility will be given as to the methods of computation of accrued income. The general approach will be, when possible, to allow corporate investors to base their computations on their financial statements. The 'lower of cost or net realisable value' basis will not be acceptable. It is, however, pointed out that where debt is acquired at par and corporate investors adopt the accruals approach, the effect of the new rules will be similar to the 'lower of cost or net realisable value' basis. The effect of the new rules for companies will be that the accrued income scheme and the rules for the taxation of securities at a deep discount will disappear.[93]

the payment is received. The second is six years after the end of the accounting period for which the credit in respect of the interest was brought into account for the purposes of this provision."[12]

The consultative document gives two examples, both of which assume that the taxpayers are companies with 12-month accounting periods. In the examples, the facts are that company A holds a bond with a market value of £1 million at the beginning of the accounting period. The bond is redeemable at par. The bond was acquired for £950 000. The coupon is 10% and, at the end of the period, the market value of the bond was £900 000."[13]

If company A adopts the mark-to-market approach, its tax liability for the accounting period is calculated as follows:

| | |
|---|---|
| Interest | 100000 |
| Change in value of bonds during the period | ( 100000) |
| | Nil |

If company A adopts the straight-line accruals approach, the interest for the period would be £100 000. In addition, company A would have to account for the accrued element of the discount. As the discount for the period from date of acquisition to maturity is £50 000, it is assumed that the portion of the

into account interest and discounts which have accrued during the accounting period in question [87]

The new rules will provide a degree of flexibility with regard to the computation of the income and expenses, provided the approach adopted is consistent It is interesting to note that there will be provision for changes in the accounting method Where, in a loan relationship, there is a change in the authorized accounting method at the beginning of an accounting period, certain assumptions ill be made These assumptions will be that the company has ceased to be a party to the loan relationship with effect from the end of the immediately preceding period and again became a party to the relationship with effect from the beginning of the current period, the new relationship is separate from the previous one, the amount payable on the termination of the previous relationship and the commencement of the new one is a fair value, and the amount payable became due when the relationship changed In this situation, there is an accounting of the debits and credits and the net amount will be brought into account from when the change of the method takes effect [88] There will be provisions relating to where a company receives a payment of interest in respect of which tax has been deducted and the company has brought into account a credit in respect of that interest for an accounting period ending more than two years before receipt of the payment In these circumstances, the interest will be taken into account for the purposes of corporation tax in the accounting period in which the interest is received [89] A claim may not be make under this provision at any time after the later of two dates The first is two years after the end of the accounting period in which

redemption values and deep discount bonds with uncertain redemption dates An example of such a bond is a limited price index bond Such a bond may offer investors inflation-proofing up to a ceiling of, say, 5% per annum This type of bond would constitute a deep gain security The effect of such an issue would be that issuers would not be entitled to deduct the inflation-proofing element in the return Second, the rules did not encourage the development of an official strips market in gilts Such a market provides the opportunity for interest payments to be traded separately from the underlying gilt or bond [187]

It was proposed that, in terms of the new rules, corporate investors resident in the United Kingdom and United Kingdom branches of non-resident companies will be liable to tax on the so-called 'all-income' basis In other words, there will be no distinction between capital and revenue profits and losses in respect of gilts and bonds.[188]

Tax will be computed on an accruals or mark-to-market basis Interest received will be taxed on an accruals basis In calculating profits and losses for an accounting period, a company may adopt three possible methods of computation First, the company may reflect the value of the financial instruments at the market value excluding the value of the accrued interest In this situation, the interest accruing during the relevant period will be brought into account separately Second, the company may reflect the value of the financial instruments at the market value including the accrued interest Third, the company may adopt an accruals computation This will involve bringing

complexity of the legislation. There was a demand for a simplification of the legislation. The main reasons for this demand were that the existing legislation inhibited the evolution of financial markets and the development of new financial products, investors could incur losses which were not claimable for tax purposes, conversely, investors could make gains which were not taxable, similar instruments could have received different tax treatment as a result of minor differences, the existing legislation had the result that the tax treatment of financial instruments differed materially from normal accounting practice, and finally, the legislation provided scope for tax avoidance.[184]

As a result, Inland Revenue issued a consultative document on 25 May 1995 on the taxation of gilts and bonds.[185] In a press release issued by Inland Revenue on 10 July 1995, it was announced that new rules would apply in respect of the taxation of gilts and bonds. The new rules would apply for companies with effect from 1 April 1996, and for the few private investors affected by the new rules with effect from 6 April 1996.[186] Sections 80 to 105 of the Finance Act of 1996 cover the legislative changes. These provisions deal with the whole spectrum of loan relationships.

The existing rules hindered market development in two main respects. First, they made it difficult to develop and market new types of products. For example, an issuer of a deep gain security who was not taxable under Schedule D case I was not entitled to a deduction of his full costs in respect of the issue of the instrument. In addition, investors were not entitled to tax relief in respect of losses incurred by them relating to their investments in such securities. Clearly, these rules discouraged the issue of bonds with uncertain

The income element for an income period is determined according to the following formula

$$\frac{A \times B}{100} - C$$

Where

A is the adjusted issue price of the security.

B is the yield to redemption.

C is the interest if any payable in respect of the income period.[174]

Where the period of ownership includes only part of an income period, the income element is determined on a pro rata basis.[175] The total income element in the determination of the chargeable amount is the aggregate of the income elements and partial income elements relating to the ownership period in question.[176] There are specific provisions dealing with death,[177] transactions between connected persons,[178] underwriting,[179] trustees,[180] charities,[181] retirement benefit schemes,[182] and stock lending.[183] It is beyond the scope of this thesis to discuss these provisions in detail

## 6.3 TAX REFORM

Since the introduction of legislation dealing with the taxation of gilts and corporate bonds, the government received regular complaints concerning the

tax on the income element of the discount as it accrues instead of on disposal or redemption. This accrued income is determined on the basis of a formula.

The profit on the sale of a deep discount security has two elements. The first is the chargeable portion of the discount in terms of schedule D case III or IV. The second is a gain or loss resulting from fluctuations in market interest rates or other related factors. This gain or loss is generally treated as being of a capital nature.

Insofar as it is not covered by specific legislation, the discount on deep discount securities is chargeable to tax as income of the lender when it is paid on redemption.

In 1985 measures were introduced to combat a tax planning device known as coupon-stripping. This enabled an investor to defer his tax liability until the relevant securities matured.

In 1989 legislation was introduced to levy an income charge under schedule D case III or IV in respect of a deep gain securities. The charge arose on the transfer or redemption of the security on the full amount of the gain realized. In the circumstances no charge for capital gains tax arose. The legislation included provisions covering the situation where a security did not constitute a deep gain security at the time of issue but upon the occurrence of subsequent events, it was deemed to be a deep gain security.

of the Income Tax Act that was inserted by s 20(1)(a) of the Income Tax Act of 1990. The effect of this decision and the legislative amendment to the definition of gross income was that the discounting profit accrued to the holder of the financial instrument at the time when it was issued to him. Thus, prior to the enactment of s 24J, the position in South Africa was in fact worse than the common law position in the United Kingdom. The effect in South Africa of s 24J is to apply an accruals basis to the taxation of discounting profit except in the case of a corporate trader. In practice an investor will receive no recognition of the fact that his discounting profit is of a capital nature in the accrual periods prior to that in which the instrument is transferred. Therefore it is submitted that the position in South Africa in applying the accruals basis to taxing discounting profits and the lack of recognition of the capital nature of the discounting profits of an investor are inequitable. Whilst the common law position in the United Kingdom was not entirely equitable, it was more equitable than the position in South Africa.

In 1984 specific legislation was passed dealing with deep discount securities.

A deep discount security is a 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. The discount is treated as income and accrues on a compound basis. It is taxable when the security is disposed of or redeemed. There are circumstances in which the holder of a security is liable to

profit arising from the indexation of the principal is of a capital nature. Once again the South African approach is perhaps inequitable as such increased profit resulting from the indexation of the principal relates to the preservation of the underlying capital value and, as such, should be of a capital nature.

The general rules gave rise to certain problems in the case of deep discount securities. The main problem was that, in the case of investors, there was uncertainty as to when there was a discount.

This applied particularly if a security was sold and not redeemed. In these circumstances, the investor would argue that he had not received a discount but a capital gain. It was, at all stages, accepted that if any portion of the profit was taxable, liability arose on the realization basis. In the case of a financial dealer, all profits were of a revenue nature and therefore taxable. Revenue argued that such profits were taxable on the accrual basis. Willingale held that discounting profits should be taxable on the realization basis. Revenue's response to this judgment was to interpret it narrowly and only to permit financial dealers to be taxed on the realization basis if certain conditions were met. This issue is also a factor in South Africa. It is submitted that a realization basis of taxing discounts is equitable as the tax on the profit is payable at a time when the taxpayer actually receives or becomes entitled to receive the profit. Prior to the enactment of s 24J in South Africa the position was determined by the Appellate Division decision in CIR v People's Stores (Walvis Bay) (Pty) Ltd and the proviso to the definition of gross income in s 1

probably be presumed to be interest. However, if the instrument involved is a promissory note and the transaction is clearly one of discounting, the profit will clearly be a discount. This type of transaction would be regarded as akin to a loan in South Africa. As stated above, this approach has the attraction of reflecting the substance of the transaction.

The next situation is that in which B issues A with a post-dated promissory note with a face value of £120, an issue price of £100 and a reasonable commercial rate of interest payable on the face value. Depending upon the circumstances and particularly the period to the date of maturity of the note, the £20 could represent a taxable discount, or it could represent a capital gain to compensate for a capital risk. The position in South Africa is by no means certain. It is arguable that the £20 is of a capital nature. However, on the other hand, as an original issue discount is akin to a transaction of loan in South Africa the discount would probably be treated as interest and would be taxable as a revenue profit. Whilst one can understand the approach adopted in South Africa, the position in the United Kingdom is more equitable as the £20 represents a payment to reward the investor for the risk of a capital loss.

Where the face value of a post-dated promissory note is index linked and a reasonable commercial rate of interest is chargeable on the face value of the note, it is possible that, where the increased profit arising from the indexation of the principal is not part of the recipient's trade, such profit may be of a capital nature. In South Africa it would be difficult to argue that the increased

been criticized In spite of this criticism this classification represents the current law This approach is different from that which has been adopted in South Africa where an original issue discount is regarded as a transaction of loan, and the discount as akin to interest The approach is similar in the case of the purchase and sale of a financial instrument In this case, the discounting profit is treated as a trading profit in both countries It is submitted that the approach adopted in South Africa to the classification of a discounting profit is preferable as it accords with the substantive position

Discounts are chargeable to income tax in the United Kingdom under either schedule D case III or schedule D case I Schedule D case III applies in respect of annual profits or gains accruing to residents of the United Kingdom in respect of all discounts However, where the annual profits or gains from discounts arise or accrue to any person residing in the United Kingdom from any trade carried on in the United Kingdom, then schedule D case I applies No distinction is made between 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 prior to maturity date Profits from both of these types of transactions are chargeable to tax under schedule D case I or III, as the case may be

A number of different situations can arise If A advances B £100 on condition that B will pay A £110 after one year, all the circumstances of the case need to be examined in order to determine the nature of the increment of £10 If it is not clear from the contract what is the nature of the transaction, the profit will

was acquired for £1 000, it had a market value of £900 at transition date and was subsequently redeemed for £1 000 If one applied a kink test, the taxable gain on redemption would be nil The reason for this is that the bond was redeemed at the taxpayer's acquisition cost If one did not apply a kink test, there would be a taxable gain of £100 under the new rules [243] Inland Revenue has indicated that it is continuing discussions regarding the most appropriate way of dealing with the transition [244]

## 6 9 CONCLUSION

Discount has been defined as meaning the deduction made from the amount of a bill, note or bond by a person who gives value for it before it is due This definition covers both the issue of a post-dated bill, note or bond at a discount on its face value and the purchase and sale of such an instrument prior to maturity date

It has been held that discounts are distinguishable from interest The purchase and sale of a post-dated bill, note or bond at a discount on its face value has been held to be a purchase and sale and not a contract of loan The classification of an original issue discount as a discount and not interest has

At this stage it is not clear how a strips market in corporate bonds would operate. However, it was considered that the proposed reforms would remove some of the tax constraints which could inhibit the development of such a market.[39]

Transitional arrangements are discussed in the consultative document.[40] It is proposed that taxpayers should be able to mark-to-market their existing holdings at the date of commencement of the new rules. If they elect to adopt the accruals basis of taxation, they should be able to start using this basis from that date. Gains and losses relating to the period prior to the commencement date would be treated in accordance with the current rules. Where this resulted in taxable gains and losses, such gains and losses would only be brought to account on the subsequent disposal of the bond or gilt.[41]

One of the issues to consider is how to simplify the transition to the new rules. If there is no realistic and readily available price at which bondholders can convert their bonds at the date of commencement of the new rules, is there any way in which bondholders can bring their bonds into account without marking them to market at the date of implementation of the new rules? There is a discussion of the so-called 'kink test' in the consultative document.[42] These are a set of rules aimed at ensuring that taxpayers are not taxed on more gains or relieved on more losses than would have been the case had they held the bond over the full period to its maturity, including the period covered by the transition. A simple example illustrating this test is if one assumes that a bond

coupon strips and corresponding coupon payments to be treated under the rules for deduction of tax at source. Rules for quarterly accounting will be introduced.[214]

There are certain problems relating to a gilt strips market. Under the present rules the holder of a gilt in stripped form falling under the rules relating to deep discount bonds will have a tax deferral benefit which outweighs most non-tax considerations. Whilst this could be mitigated, there would still be strong tax incentives to hold or avoid strips as the corresponding unstripped gilt moved above or below par. In addition, strips derived from the same gilt, but created at different times, would have different discounts at dates of issue. They would not, therefore, be mutually fungible.[215]

One option would be for United Kingdom corporate holders to account for the maturity proceeds of the coupon strips in the quarterly accounting arrangements. Alternatively, strippable gilts could be exempt from withholding tax. Interest on strippable gilts would be paid gross and would be excluded from quarterly accounting. This would apply regardless of whether the gilts were held in a stripped or unstripped form.[216] Unstrippable gilts would remain subject to withholding tax or quarterly accounting where appropriate.[217] It has been decided that strippable gilts should be exempt from the withholding tax and quarterly accounting arrangements being introduced in connection with gilt repos.[218]

be taxable on the full amount of their profits. No special rules will apply to the indexation element.[49]

Limited price index bonds give inflation protection up to certain limits to bondholders. They may take different forms. For example, they may stipulate that there are no interest payments in the first few years of the bond. These bonds would be classified as deep gain securities under the present rules. Thus, the current position is that the issuer will not be able to deduct the costs relating to the indexation and investors will not be entitled to tax relief in respect of any losses incurred by them. The proposal is that such bonds should be fully covered by the new rules. Thus issuers would be entitled to deduct the cost of the limited indexation in the computation of their profits.[50]

At present there is a distinction between securities and other forms of debt such as overdrafts, trade debts and loans. It is proposed that this distinction will remain. Thus the new rules will not apply to such other forms of debt.[51]

Options, warrants, futures and other derivatives in gilts and bonds will be covered by the new rules. Profits and losses relating to such derivatives will be treated as being of an income nature. Corporate holders will account for tax purposes on a mark-to-market or acceptable accruals basis.[52]

The new rules will apply to stripped gilts. Therefore, returns will be brought to account on an accruals or mark-to-market basis. It will be necessary for

In the case of indexed bonds, it could be argued that where the redemption price is linked to an official price index the tax treatment should be similar to that relating to indexed gilts. The issue which arises is whether it is appropriate for bonds linked to share indices to be treated differently from shares which remain within the capital gains rules. Apart from this issue, in analyzing the situation in respect of corporate bonds, one must consider the position of the issuer as well as the position of the investor. If one makes an adjustment in the hands of a bondholder for the indexation of a bond, it should be appreciated that one must make a corresponding adjustment to the deduction claimable by the issuer of the bond. The experience has been that where the tax positions of issuers and investors have been symmetrical, indexed bonds appear to have had little attraction. The types of situations which have made indexed bonds attractive are those in which the investor is not taxed on the indexation and the issuer is tax exempt or has a tax loss, or the issuer is able to deduct the costs of indexation in two circumstances. The first is where the costs are deductible either under the rules of a foreign tax code and the second is where the issuer is a financial trader chargeable to tax under schedule D case I. If indexed bonds were treated in the same way as indexed gilts, financial traders issuing such bonds would no longer be entitled to deduct the costs of indexation. However, opportunities for tax arbitrage would still exist where issuers are subject to foreign tax jurisdictions and not subject to tax in the United Kingdom.[37] It has been decided that issuers of indexed bonds will receive full tax relief for their costs and that investors will

In addition to the types of instruments referred to above, there are other non-equity shares which could fall within the new rules. In theory, the dividing line should be that shares which give the holder a proprietorial interest in the company should fall outside the new rules and shares which do not should be covered by the new rules. In practice, the dividing line is not always so clear.[25]

It has been decided that the new rules will not apply to two types of bonds. The first is bonds which, at the time of issue, there is a genuine possibility of future conversion or exchange into equity. The second is bonds whose redemption value is linked to share or commodity values. Where these types of bonds are held by companies, the interest, discounts and premiums applying to them will be taxed on the accruals basis.[26] It has also been decided that the new rules will not apply to non-equity shares, including zero coupon preference shares. However, if this results in distortions, the position will be reviewed.[27]

If the new rules were to apply to indexed gilts, holders of existing gilts would suffer substantial losses. The reason for this is that new issues would require higher pre-tax yields. The effectiveness of inflation-hedging would be affected by taxation. It has, therefore, been decided that the new rules will not apply to these types of gilts.[28]

new rules. The security should represent a creditor relationship of the company, and the rights attaching to it should include the option of the company's becoming entitled to acquire any shares in a company. The extent to which the shares may be acquired should not be determined by using a specified cash value or be ascertainable by reference to the terms of these provisions. The security should not be a relevant discount security and, at the time of its creation, there should have been little likelihood that the right to acquire the shares would be exercised to a significant extent. Finally, the securities, particularly when sold, should not form an integral part of the company's trade.[220] The amounts which will be . for in terms of the new rules will be those relating to interest.[221] This will be determined by applying an authorized accruals basis of accounting.[222] The consideration for any acquisition or disposal of such a security shall be taken into account in determining the interest. So much as relates to interest or accrued interest will be treated as not forming part of the consideration for the purposes of the rules.[223]

The case of bonds which are convertible into shares and which differ from those described above is more difficult to resolve. On the one hand, where the price of the bond is closely linked to that of the associated share, one could argue that it should fall outside the new rules. On the other hand, where it is unlikely that the bonds will be converted to shares, their value will be similar to non-convertible bonds.[224]

at less than its nominal value minus X. Thus Walton J argued that, in the example given, the profit earned by the holder at maturity of the note was not wholly as a result of the original discount

58 Lomax (HM Inspector of Taxes) v Peter Dixon & Son Ltd, The National Provident Institution v Brown, Lord Howard de Walden v Beck (HM Inspector of Taxes) 23 TC 384, Bennett v Ogston

59 Willingale v International Commercial Bank Limited, Ditchfield v Sharp & others

60 Willingale v International Commercial Bank Limited

61 Lomax v Peter Dixon & Son Ltd To illustrate the type of contract in which compensation was given for capital risk, Lord Greene MR gave as an example the contracts of loan that used to be given on a gold basis when the currency had left, or was about to leave, the gold standard In such contracts the amount to be repaid was fixed to the price of gold at repayment Thus, if the currency depreciated, there was an increase in the amount of sterling to be repaid at maturity

62 Inland Revenue press release 25 June 1982 Simon's Taxes 3 rev ed (1983) vol B part B5 at para 5 202

63 See The Tax Treatment of Capital Market Instruments Worldwide (September 1987) at 6-7 A bond is not subject to capital gains tax unless it is a qualifying corporate bond A qualifying corporate bond is a security that is quoted on a

46 at 366

47 at 367

48 1982 STC 124

49 at 129-30

50 at 130-1 Section 109(2) of the Income and Corporation Taxes Act of 1970 has now been re-enacted as s 18(3) of the Income and Corporation Taxes Act of 1988

51 at 130

52 at 129-34

53 at 131

54 at 131-2

55 (1921) 8 TC 57

56 Ditchfield v Sharp & others at 132-3

57 Walton J was bound by the decision in The National Provident Institution v Brown, but was of the view that the law was unsatisfactory. In order to illustrate the weakness in that decision the learned judge gave an example of a non-interest-bearing promissory note issued at a discount of X when interest rates are low. If the interest rates subsequently increase, the market value of the note reduces. If, at that stage, a person acquires the note, he will acquire it

39 25 TC 353. This decision was followed in Davies v Premier Investments Co Ltd 27 TC 27. The decision in Lomax (HM Inspector of Taxes) v Peter Dixon & Son Ltd 25 TC 353 contains an important review of the law relating to discounts. There are a number of cases that have dealt with the distinction between annuities and instalments of capital. Where there have been payments which do not constitute annuities, some cases have determined whether there was an income element in the payments and whether these constituted interest. See also IRC v Ramsay 20 TC 79, IRC v Wesleyan & General Assurance Society 30 TC 11, Campbell v IRC 45 TC 427, Ridge Securities Ltd v IRC 44 TC 373, Vestey v IRC 40 TC 112, IRC v Church Commissioners for England 1976 STC 339, IRC v Plummer 1979 STC 793, Perrin v Dickson 14 TC 608, Chadwick v Pearl Life Insurance Co (1905) 2 KB 507, Ruskin Investments Ltd v Copeman 25 TC 187, Scoble v Secretary of State for India 4 TC 478. It is, however, beyond the scope of this thesis to examine these cases as they are not directly relevant to the discussion on discounts.

40 Lomax (HM Inspector of Taxes) v Peter Dixon & Son Ltd at 354-7

41 at 356-7

42 at 357-60

43 at 360-8

44 at 365

45 at 365-7

23 See Bennett v Ogston 15 TC 374 at 379

24 Willingale v International Commercial Bank Limited at 77

25 1978 British Tax Review 69

26 Willingale v International Commercial Bank Limited at 77 and 81

27 at 78

28 (1879) 26 LR 107 Ch D

29 8 TC 57

30 at 58-65

31 at 65-70

32 at 71-81

33 at 81-100

34 at 83

35 at 87

36 at 95

37 22 TC 175

38 at 180-1

8 at 79

9 at 80

10 at 77

11 at 77-83 and 85-8

12 at 77, 81 and 87

13 at 80-5

14 at 81

15 See 'Current Notes Wrong Again Willingale v International Commercial Bank Limited' 1978 BTR 69 at 69-70

16 Willingale v International Commercial Bank Limited at 78, 80-1 and 87

17 ibid

18 at 80 and 86-7

19 at 80 and 87

20 at 82 and 87

21 1978 British Tax Review 69

22 See, for instance 'Notes of Cases A Matter of Interest Willingale v International Commercial Bank Limited' 1977 BTR 236

## FOOTNOTES

1 United Kingdom means Great Britain (England, Wales and Scotland) and Northern Ireland. See sch 1 of the Interpretation Act of 1978.

2 s 18(3) of the Income and Corporation Taxes Act of 1988.

3 s 18(3) of the Income and Corporation Taxes Act of 1988.

4 See the definition of discount in H W Fowler & F G Fowler The Concise Oxford Dictionary 5 ed (1966). See also Torrens v IRC 18 TC 262 at 267.

5 See Willingale (Inspector of Taxes) v International Commercial Bank Ltd 1978 STC 75. The courts have held that the profit on the sale of interest-bearing securities prior to the date of payment of interest is not of an interest nature. See Wigmore (HM Inspector of Taxes) v Thomas Summerson & Sons Ltd 9 TC 577 and IRC v Oakley 9 TC 577, in which it was held that where interest-bearing securities are sold shortly before payment of the interest, the full amount of the interest is taxable in the hands of the purchaser of the securities. As regards securities generally, see The National Provident Institution v Brown 8 TC 57, Ditchfield v Sharp & others 1982 STC 75.

6 1978 STC 75.

7 at 75-88.

no distinction should be made between distributions and excess income The full coupon should be treated as akin to interest It is further submitted that the treatment of preference shares as loan instruments has the advantage of giving effect to the substantive nature of this type of share and it has a certain amount of merit Preference shares are treated as equity instruments in s 24J in South Africa and are not therefore taxable in terms of this section Possibly the South African approach should be reviewed as it is submitted that the United Kingdom approach is preferable Such an approach should also be taken in the case of convertible securities Effect should be given to the substantive nature of the instrument If it is likely to be converted to an equity security, it should be treated as an ordinary share In South Africa the approach should be similar to that adopted in the United Kingdom Shares that give the holder a proprietorial interest in the company should not be covered by s 24J and shares which do not should be covered by s 24J

Finally, it is clear that there are certain aspects of the new rules in the United Kingdom that have merit and highlight areas that could be applied in South Africa in order to improve some of the deficiencies that exist in s 24J In addition, there are aspects of s 24J which could be adopted in the United Kingdom which could make the new rules simpler and more equitable

Both the United Kingdom and South African rules enable the development of a strips market. The rules in the United Kingdom have specific rules covering strips whereas the general rules contained in s 24J would apply to strips in South Africa. It is important that there is adequate flexibility in the rules for the development of such a market. This flexibility exists in the legislation in both countries.

The new rules in the United Kingdom deal specifically with certain types of instruments such as those creating manufactured interest and deep gain securities. It is submitted that once specific types of instruments are covered in the legislation this has the effect of making the rules more complex and could lead to amendments as schemes are developed to take advantage of the distinctions contained in the legislation. In this regard, the approach adopted in s 24J is preferable in that it does not distinguish between different types of instruments.

The rules in the United Kingdom apply to bonds and various types of loan instruments. They also apply to non-equity shares such as certain types of building society and preference shares. The effect of these rules insofar as they apply to preference shares is that gains and losses relating to them are treated as being of an income nature. Issuers may deduct any coupon relating to the shares subject to the rule that any excess over a normal commercial return is treated as a distribution. It is submitted that preference shares should either be treated as loan or equity instruments. If they are treated as loan instruments,

that the South African basis of valuing trading stock is a preferable basis to apply in the case of trading stock consisting of financial instruments

The distinction in the United Kingdom between corporate and non-corporate holders of financial instruments has the advantage of being practical and realistic Non-corporate holders below a certain threshold continue to pay tax on interest on the current basis This approach is preferable to that applicable in South Africa where the rules contained in s 24J apply to all holders Corporate traders have the advantage in South Africa of being able to account for trading stock in the normal manner and not on the accruals basis Apart from this distinction and the fact that an income instrument can only be held by non-corporate holders, there is no distinction in s 24J between corporate and non-corporate holders It is submitted that the United Kingdom approach should be adopted in South Africa so that the smaller non-corporate holders are not faced with the complex provisions of s 24J

The new rules in the United Kingdom give recognition to indexed gilts and loan relationships linked to the value of chargeable assets For example, in the case of an index-linked gilt the adjustment provides for the credits and debits are accounted for as non-trading items No such distinction is made in s24J of the South African Income Tax Act The approach adopted in the United Kingdom is certainly equitable in that it has the effect of not taxing inflationary gains but on the other hand it does make the rules more complex

In terms of the new rules tax is computed on an accruals or mark-to-market basis Interest received is taxed on an accruals basis In principle this approach is similar to that adopted in South Africa with the promulgation of s 24J and cannot be criticized

In order to calculate the profits and losses a company may adopt three methods of computation These are reflecting the market value of the instrument without taking account of the interest and accounting for the interest separately, reflecting the market value of the instrument including interest and, lastly, adopting an accruals basis of computation The approach taken is s 24J in South Africa is not dissimilar Companies which are trading in financial instruments may account for the instruments as trading stock and reflect the value of the instruments at their cost or market value, whichever is the lower In effect, the tax is payable in this situation on the sale or redemption of the instrument It is submitted that this approach is equitable as the taxpayer will have received or will be entitled to receive the proceeds from the sale of the instrument at the time when the liability for payment of the tax arises In the United Kingdom the 'lower of cost or net realisable value' is not acceptable However, where debt is acquired at par, the effect of these rules is similar to the 'lower of cost or net realisable value' basis for accounting for the instruments It is submitted that, in the interests of simplicity, there should not be a distinction between the accounting of ordinary trading stock and financial instruments held and not disposed of by a trader Therefore, it is submitted

The amount of the income tax charge is the lesser of the amount obtained on transfer or redemption or the total income element in the discount for the period of the ownership. Where there is no income tax charge the normal capital gains tax rules apply.

The legislative rules in the United Kingdom covering discounting transactions were unduly complex. Consequently they inhibited the evolution of financial markets and the development of new financial products and resulted in inequitable discrepancies in the tax treatment of certain types of discounting profits and losses. From a South African viewpoint these rules illustrate two facts. First, if the legislation covering the taxation of discounting transactions becomes too complex it can inhibit the development of the financial markets. In view of the developments in the financial markets, particularly the development of a swaps market, and the creation of new types of financial instruments, it is important that there is flexibility in the system to allow such developments. Second, if the legislation covering these types of transactions is too complex, it can result in the legislation becoming even more complex as schemes are developed to circumvent the [illegible]n. Despite its complexity, the legislation may still not achieve the objectives that the legislators intended.

New rules have been promulgated in the United Kingdom. They apply to companies with effect from 1 April 1996 and to the private investors affected by the rules with effect from 6 April 1996. They deal with all types of loan transactions.

The events which gave rise to a security being deemed to be a deep gain security were

(1) the issue of further securities under the same prospectus as the original security as a result that at any time more than half of the value of the security is issued under the prospectus constituted deep gain securities

(2) the terms of a qualifying indexed security were varied by agreement so that they were no longer excluded as deep gain securities, and

(3) an event took place after the issue of a qualifying convertible security in terms of which it ceased to be excluded as a deep gain security

In 1990 legislation was introduced in order to tax the discount element on a transfer or early redemption of a qualifying convertible security Such a security is one quoted on a recognized stock exchange, grants the holder a single option for early redemption, carries a right to convert the security into equity shares in the issuing company and would, but for the legislation, constitute a deep discount or deep gain security

Income tax is chargeable either where the holder transfers the security at a time when at least one option for early redemption is still open or where he redeems his security by exercising an option for early redemption An income tax charge arises where the security is redeemed at maturity

135 para 2(3) of sch 11 to s 94 of the Finance Act of 1989 Paragraph 2(14) discussed in n 134 applies to this paragraph

136 para 2(4) of sch 11 to s 94 of the Finance Act of 1989 Paragraph 2(14) discussed in n 134 applies

137 para 2(5) of sch 11 to s 94 of the Finance Act of 1989

Paragraph 2(9) provides that a redemption does not include any redemption which may be made prior to maturity only at the option of the issuer

Paragraph 2(10) provides that where the redemption proceeds or interest are index linked for a notional period in place of a later actual period (a process known as lagging) this condition is treated as fulfilled if two further conditions are fulfilled First, the notional period must start not more than eight months before the actual period starts and must end not more than eight months before the actual period ends Second, the index applied for the notional period must be applied precisely and without restriction

Paragraph 2(11) provides that where the redemption proceeds are not less than an amount stated in the terms of issue, this condition will still be fulfilled if a security was issued prior to 9 June 1989 and the amount stated does not constitute a deep gain

Paragraph 2(11A) stipulates that where the redemption proceeds are not le than a specified percentage of the issue price, this provision shall not prevent this condition being fulfilled if the specified percentage is not greater than 10%

130 para 1(5)

131 para 1(6)

132 para 1(7)

133 para 2

134 para 2(2)

Paragraph 2(14) provides that when issues are handled by an agent or underwriter, the terms of issue include any terms on which the agent or the underwriter offers a security

Paragraph 2(8A) provides that if a security was issued before 9 June 1989 and was not quoted on a recognized stock exchange at the time of issue, but was so quoted on 8 June 1989, for the purposes of the third category it is deemed to have been quoted at the time it was issued

Paragraph 2(8B) provides that if the security was issued on or after 9 June 1989 and was quoted on a recognized stock exchange after it was issued but prior to the end of the qualifying period, for the purposes of the third category, it is deemed to have been quoted at the time it was issued The qualifying period is the period of one month beginning with the day on which the security was issued

121 para 1(3A) of sch 11 to s 94 of the Finance Act of 1989 This provision does not apply to a redemption made in pursuance of the exercise by the holder of the security of an option

122 para 1(3B)(*a*) and 1(3E)(*a*) of sch 11 to s 94 of the Finance Act of 1989 Paragraph 1(3C) and 1(3F) provides that this condition is fulfilled if it is fulfilled by reference to any one potential holder irrespective of whether it is fulfilled by reference to any other potential holder

123 para 1(3B)(*b*) and 1(3E)(*b*) of sch 11 to s 94 of the Finance Act of 1989 In terms of para 1(3D) and 1(3G) where the security is one under which the terms of issue can be converted into or exchanged for a security of a different kind and it falls to be decided whether the conditions set out in subparas (3B)(*b*) or (*c*) and (3E)(*b*) or (*c*) are fulfilled The condition is not treated as fulfilled unless it is fulfilled having regard only to circumstances in which the right to convert or exchange are unlikely to take place

124 ibid

125 para 1(3B)(*d*) and 1(3E)(*d*) of sch 11 to s 94 of the Finance Act of 1989

126 para 1(4)(*a*)

127 para 1(4)(*b*)

128 para 1(4)(*c*)

129 para 1(4)(*d*)

109 para 2(2) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

110 para 3 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

111 para 2(4) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988 The conversion must be one to which s 132 of the Taxation of Chargeable Gains Act of 1992 applies and the exchange must be one to which either s 135(3) or 136(1) of the Taxation of Chargeable Gains Act of 1992 apply

112 The Tax Treatment of Capital Market Instruments Worldwide at 52

113 ibid

114 1978 STC 75

115 See sch 11 to s 94 of the Finance Act of 1989

116 para 1(9) of sch 11 to s 94 of the Finance Act of 1989 It should be noted that para 10 provides that the amount payable on redemption does not include any amount payable by way of interest

117 para 1(1) of sch 11 to s 94 of the Finance Act of 1989

118 para 1(2) of sch 11 to s 94 of the Finance Act of 1989 If the security is capable of redemption on more than one occasion, the condition is fulfilled if it is fulfilled as regards any one of these occasions

119 para 1(4) of sch 11 to s 94 of the Finance Act of 1989

120 para 1(3) of sch 11 to s 94 of the Finance Act of 1989

97 para 16 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

98 para 17 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

99 para 18 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

100 para 11B

101 para 11(1) and (2)

102 The National Provident Institution v Brown at 80 and 83

103 Simon's Taxes at para B5.4.15

104 para 3(1) and (2) of sch 9 of the Finance Act of 1984, now incorporated in para 2(1) and (2) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

105 para 2(1) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

106 para 3(1) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988 Where the income period falls only partly prior to acquisition of the security, there is provision for the income element for that period to be apportioned para 3(2)(b)

107 para 2(1) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988 In terms of para 2(7)(a) a company holds assets if it has a beneficial interest in them and acquires them if it acquires such an interest in them

108 para 2(6) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

where a period is less than an income period, the income element for that period is pro-rated

86 paragraph 4(1)(a) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

87 Simon's Taxes at para B5.414. J Tiley (ed) Butterworths UK Tax Guide 1993-4 12 ed at para 9.50

88 paragraph 7(1) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

89 s 118(1)(*a*) of the Taxation of Chargeable Gains Act of 1992

90 s 38(1)(*b*) of the Taxation of Chargeable Gains Act of 1992

91 para 7(2) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

92 para 7(3) and (4) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988. See also ss 188(3)(*a*) and (*b*), 128(3) and 38(1)(b) of the Taxation of Chargeable Gains Act of 1992

93 s 118(4) of the Taxation of Chargeable Gains Act of 1992

94 paras 9 and 10 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

95 para 14 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

96 para 15 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

securities is not later than that of the old securities. Second, no additional consideration is given for the conversion or exchange other than the new securities. Upon the disposal of the new securities, the accrued income attributable to the period of ownership of the old securities is added to that of the new securities.

When a deep discount security is disposed of or acquired under a contract, para 8 stipulates that the date of disposal or acquisition is either the date the contract was concluded or, if it is conditional, the date of fulfilment of the condition.

81 Para 4(1)(a) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988.

82 Para 4(2) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988.

83 This relates to deep discount securities issued after 18 March 1985 and covered by para 2 of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988. The provisions relate to coupon-stripping and are discussed below.

84 para 4(3) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988.

85 An income period is defined in para 1(1)(f) as any year ending immediately before the anniversary of the date of issue of the security or any period which is less than a year and which begins on the issue date or its anniversary and ends on the date of redemption of the security. Paragraph 4(4) provides that

77 para 1(1B) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

78 para 21

79 The yield to maturity in relation to a security has been defined in para 1(1)(h) of sch to s 57 of the Income and Corporation Taxes Act of 1988 It means a rate such that if a sum equal to the issue price of the security were invested at that rate, the value at redemption date would equal the amount payable on the security at redemption date The rate must be compounded at the end of each income period and interest attributable to an income period cannot be deducted after applying the rate

80 para 4(1)(a) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988. A disposal takes place when there would be a disposal under the rules relating to capital gains tax See paragraph 7(1) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988 There is a deemed disposal by a deceased immediately prior to death in terms of para 7(2)

Paragraph 7(3) provides that where deep discount securities are converted in terms of which s 132 of the Taxation of Chargeable Gains Act of 1979 applies or exchanged in circumstances in which s 135(1) of the Taxation of Chargeable Gains Act of 1992 applies, the beneficial owner of the securities is regarded as having disposed of them immediately before the conversion or exchange In terms of para 7(4), when deep discount securities have been converted into or exchanged for other deep discount securities, there is no deemed disposal if two conditions exist First, the redemption date of the new

(iii) issued under a prospectus under which no securities were issued before 14 March 1989, it was not an original issue under the prospectus and the original issue related to gilt-edged securities which were not deep discount securities

However, where the aggregate nominal value of securities issued under the prospectus which would otherwise be deep discount securities exceeds the aggregate nominal value of other securities, all securities issued under the prospectus will be treated as deep discount securities in terms of paragraph 19.

(b) A security which is not a gilt-edged security and it was issued under the same prospectus as another security issued prior to it which was not a deep discount security

If the aggregate nominal value of securities issued under the prospectus which would otherwise be deep discount securities exceeds the aggregate nominal value of other securities, all securities issued under the prospectus will be treated as deep discount securities in terms of para 20

A gilt-edged security is one listed in sch 2 of the Capital Gains Tax Act of 1979

76 para 1(1A) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1988

72 See para 1(1)(c) and (d) of the sch 4 to s57 of the Income and Corporation Taxes Act of 1988

73 See paragraph 1(2) of the 4th schedule to s 57 of the Income and Corporation Taxes Act of 1988 The new securities will qualify as deep discount securities if they were issued by a company and

(a) the old securities would have qualified as deep discount securities had they been issued after 13 March 1984,

(b) the redemption date of the new securities is later than the redemption date of the old securities,

(c) the redemption proceeds of the new securities exceed those of the old securities

74 See para 1(1)(d) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1982

75 See para 1(1)(dd) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1982 inserted by paragraph 2(2) of sch 10 of s 93 of the Finance Act of 1989 The types of securities issued under two or more tranches under the same prospectus which are excluded from the definition are the following

(a) A gilt-edged security -

(i) issued before 14 March 1989,

(ii) issued after 14 March 1989 but under the same prospectus as a gilt-edged security issued before that date

72 See para 1(1)(c) and (d) of the sch 4 to s57 of the Income and Corporation Taxes Act of 1988

73 See paragraph 1(2) of the 4th schedule to s 57 of the Income and Corporation Taxes Act of 1988 The new securities will qualify as deep discount securities if they were issued by a company and

(a) the old securities would have qualified as deep discount securities had they been issued after 13 March 1984,

(b) the redemption date of the new securities is later than the redemption date of the old securities,

(c) the redemption proceeds of the new securities exceed those of the old securities

74 See para 1(1)(d) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1982

75 See para 1(1)(dd) of sch 4 to s 57 of the Income and Corporation Taxes Act of 1982 inserted by paragraph 2(2) of sch 10 of s 93 of the Finance Act of 1989 The types of securities issued under two or more tranches under the same prospectus which are excluded from the definition are the following

(a) A gilt-edged security -

(i) issued before 14 March 1989,

(ii) issued after 14 March 1989 but under the same prospectus as a gilt-edged security issued before that date.

United Kingdom stock exchange or issued by a United Kingdom quoted company It must be a normal commercial loan and should be quoted in sterling

64 Income tax is chargeable in terms of sch D case I

65 See The Tax Treatment of Capital Market Instruments Worldwide at 6

66 E J Henbrey 'Practical Problems Deep Discount Bonds' 1982 BTR 74 and 'Current Notes Discounts' 1982 British Tax Review 193 These bonds were attractive to United States borrowers because, for United States tax purposes, the discount is tax deductible over the life of the bond Thus a borrower can obtain a tax deduction without paying current interest Conversely investors are taxable in the United States over the life of the bond This did not affect issues of bonds in the United States as many were purchased by tax exempt funds

67 Willingale v International Commercial Bank Limited, Ditchfield v Sharp & others

68 See The Tax Treatment of Capital Market Instruments Worldwide at 50

69 ibid

70 Willingale v International Commercial Bank Limited

71 See The Tax Treatment of Capital Market Instruments Worldwide at 51

215 para 3(1) of sch 13 of the Finance Act of 1996

216 para 3(2) of sch 13 of the Finance Act of 1996

217 para 3(3)-(4) of sch 13 of the Finance Act of 1996 In terms of para 3(5), redemption does not include redemption made before maturity otherwise than at the option of the holder of the security Where the security can be redeemed at the option of the holder prior to maturity, it is presumed that the security will mature at the earliest date at which the holder may require the security to be redeemed

218 Para 7 of sch 13 of the Finance Act of 1996

219 The Taxation of Gilts and Bonds at 12 Note that the taxation of excess returns as a distribution is covered in s 209(2)(d) of the Income and Corporation Taxes Act of 1988

220 s 92 (1) of the Finance Act of 1996

221 s 92 (2) of the Finance Act of 1996

222 s 92(3) of the Finance Act of 1996

223 s 92(5) of the Finance Act of 1996 Section 92(6) provides that disposal means a disposal within the meaning of the Taxation of Chargeable Gains Act of 1992 or a transaction which would have been a disposal but for s 127 or 116(10) of that Act

224 The Taxation of Gilts and Bonds at 13

Paragraph 5 covers the position of conversion. Where a security is extinguished by conversion into shares in a company or other securities, this paragraph applies. In this situation the security is deemed to have been redeemed and the redemption proceeds are the market value of the shares or securities into which the securities are being converted.

Paragraph 6 covers the position of transfers or redemptions by trustees and personal representatives. Paragraph 8 covers transfers between connected persons. In these situations the transfers are deemed to have been effected at market values.

Paragraph 9 provides that where transfers are made and the consideration is not wholly or partly in money's worth, or the transfers are not at arm's length, the transfers will be deemed to have been made at the market value of the securities.

Paragraph 10 covers the issue of securities in separate tranches. Paragraph 11 stipulates that where a transfer takes place and ss 710-728 of the Income and Corporation Taxes Act of 1988 apply, the transfer is not regarded as such for the purposes of sch 13. Paragraph 12 stipulates that for the purposes of the tax avoidance provisions a discounting profit will be taken into account where the person realizing it is a non-resident or not domiciled in the United Kingdom. It is, however, beyond the scope of this thesis to examine these provisions in detail.

214 para 2 of sch 13 of the Finance Act of 1996

207 Section 86 (3) of the Finance Bill 1996 See also para 14(3) of sch 13 of the Finance Act of 1996 Section 95(4) provides that references to market values relate to the values at the time of the exchange Section 95(5) and (6) covers the possibility of the treasury making regulations to determine the market values

208 para 14(4) of sch 13 of the Finance Act of 1996 Paragraph 14(5) and (6) provides for the possibility of the treasury making regulations relating to strips and the manner of determining their values

209 s 97(1) of the Finance Act of 1996

210 s 97(2) of the Finance Act of 1996

211 s 97(3) of the Finance Act of 1996 In terms of s 97(5) these provisions will not apply where the manufactured interest is not treated as interest in the hands of the recipient

212 para 1(1) of sch 13 of the Finance Act of 1996

213 Para 1(2)-(4) of sch 13 of the Finance Act of 1996 Paragraph 4 covers the meaning of transfer Transfer includes transfer by way of sale, exchange, gift or otherwise Where a person entitled to a relevant discounted security dies, he is treated as transferring the security immediately prior to his death to his personal representatives The transfer is deemed to have taken place at the market value of the instrument on date of transfer

percentage change over the relevant period The change relates to the value of the asset or in any index of the value of such asset The relevant period means the period between the time of the original loan and the discharge of the debt The period may be a similar period which differs from the original period for valuation purposes Section 93(10) provides that an asset is a chargeable asset if any gain on its disposal on or after 1 April 1996 would be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act This assumes that the asset is an asset of the company and that chargeable gains that might accrue for the purposes of the Taxation of Chargeable Gains Act should be disregarded Section 93(12) states that a disposal of an asset is a disposal for the purposes of the Taxation of Chargeable Gains Act, or would be such a disposal but for the provisions of s 127 or 116(10) of that Act

204 s 95 of the Finance Act of 1996

205 Lawrence R Rosen Investing in Zero Coupon Bonds (1986) at 188 A strip is defined in s 93(7) of the Finance Act of 1996 as anything which is a strip of a gilt-edged security, including a strip Paragraph 14(1) of sch 13 of the Finance Act of 1996 provides that every strip will be treated as a relevant discounted security for the purposes of the schedule

206 s 95 (2) of the Finance Act of 1996 See also paragraph 14 (2) of schedule 12 of the Finance Bill 1996

199 The Taxation of Gilts and Bonds at 12 See also s 80 of the Finance Act of 1996

200 The Tax tion of Gilts and Bonds at 13

201 s 94(1)-(5) of the Finance Act of 1996 Section 94(6) provides that percentage adjustment is determined by reference to the difference between the indices in the months in which the two times fall An index-linked gilt is defined in s 94(7) as any gilt determined wholly or partly by reference to the retail price index

202 para 13 of sch 13 of the Finance Act of 1996 Paragraph 13(6) specifies that an asset is a chargeable asset in relation to any security if any gain accruing to any person on a disposal of that asset would be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act of 1992 Paragraph 13(7) stipulates that where it is being determined that the gain would be a chargeable gain, two assumptions are to be made First, that the asset is an asset of the person in question Second, the chargeable gains that might accrue under that Act should be disregarded

203 s 93 of the Finance Act of 1996 Section 93(4) provides that amounts will be accounted for as if the Taxation of Chargeable Gains Act of 1992 had effect in relation to the asset representing the relationship as it has in relation to an asset that does not represent the loan relationship Section 93(6) (7) and (8) stipulates that the reference to a relevant percentage change in the value of chargeable assets is a reference to the amount of the

190 The Taxation of ... ...d Bonds at 9 See also s 90 of the Finance Act of 1996 There must be no inconsistency or material difference between the way in which any accounting method is applied as regards the same loan relationship in successive accounting periods

191 s 91(1) and (2) of the Finance Act of 1996 Section 91(3) stipulates that in this type of situation every payment of interest is assumed to be a payment in discharge of the earliest outstanding liability to that company in respect of interest payable under the relationship Section 91(4) covers the identification of the earliest outstanding liability It must be identified according to the authorized accounting method most recently used in respect of that relationship If the accrual method is used, it is by reference to the time when the interest accrued If it is the mark-to-market basis, it will be the time when the interest became due and payable

192 s 91(6)

193 The Taxation of Gilts and Bonds at 9

194 The Taxation of Gilts and Bonds press release at 3

195 The Taxation of Gilts and Bonds at 10-11

196 The Taxation of Gilts and Bonds at 11

197 The Taxation of Gilts and Bonds press release at 2

198 The Taxation of Gilts and Bonds at 3

183 para 23

184 Inland Revenue The Taxation of Gilts and Bonds a consultative document issued on 25 May 1995 at 5-6

185 The Taxation of Gilts and Bonds

186 Inland Revenue The Taxation of Gilts and Bonds a press release issued on 10 July 1995

187 The Taxation of Gilts and Bonds at 7-8

188 The Taxation of Gilts and Bonds at 9 See also s 80 of the Finance Act of 1996 Section 80 envisages that the profits and gains and the deficits in respect of loan relationships shall be treated as profits and gains of the company's trade, and expenses of the trade in computing the profits and gains Non-trading deficits are covered in s 83 Such deficits may be offset against the company's profits in either the deficit period or earlier accounting periods, or may be eligible for group relief, or may be carried forward and set against non-trading profits for the next accounting period

189 The Taxation of Gilts and Bonds at 9 Section 86 of the Finance Act of 1996 covers the application of accounting methods in respect of loan relationships Section 86 (5) provides for the accruals and mark-to-market bases of accounting Section 87 deals with the situation where there is a connection between the company and the debtor or creditor as the case may be In these circumstances, the accruals basis of valuation [illegible]

(a) the period from the date of the issue to the date of the first interest payment, and

(b) any period beginning with the day after the first interest payment date and ending on the next interest payment date

Where the security does not carry a right to interest, each of the following is an income period

(a) the period from the date of issue to the anniversary date of the date of issue, and

(b) the period from the first anniversary date to the second anniversary date

175 para 15(4) and (5)

176 para 14

177 para 16

178 para 17

179 para 18

180 para 19

181 para 21

182 para 22

transfer made on a conversion of a security into ordinary share capital in a company. Where there is an agreement to transfer a security at a later date and the transferee becomes entitled to the security when the agreement is made, the transfer takes place when the transferee becomes entitled to this security.

169 Simon's Taxes at para B 5.429. It should be noted that these transactions are subject to capital gains tax, see at para C 2.813.

170 para 12(3) of sch 10 to s 56 of the Finance Act of 1990.

171 para 4(c) and (d).

172 para 13(1). Paragraph 13(2) provides that the amount obtained on transfer or redemption is the amount obtained by the transferor or the person entitled to the security immediately before redemption. In terms of para 13(3) such a person is regarded as obtaining in respect of the transfer or redemption the amount he actually obtains and any amount which he is entitled to obtain but does not.

Paragraph 13(4) provides has special provisions relating to death, transactions between connected persons and underwriters.

173 para 20 of sch 10 to s 56 of the Finance Act of 1990.

174 para 15(1), (2) and (3). The income period is defined in para 7. Where a security carries a right to interest, each of the following is an income period

156 para 2(9)

157 para 2(10)

158 para 2(11)

159 para 3(1)

160 para 3(2)

161 para 4(1) and (2)

162 para 4(3), (2), (6)

163 para 5(1) and (2)

164 para 5(3) Note that in terms of para 5(3)(c) a qualifying provision for redemption is defined in para ' and that para 1(*b*)-(*d*) apply Insofar as para 5(3)(*f*) is concerned, a relevant prospectus is defined in para 5(4) as a prospectus under which the security concerned was issued Paragraph 5(5) provides that connected companies are determined in accordance with para 4 of sch 11 to the Finance Act of 1988

165 para 6(1) and (2) of sch 10 to s 57 of the Finance Act of 1988

166 para 6(3)-(6)

167 para 12(4)(*b*)

169 para 12(1) and (2) In terms of para 10, transfer in relation to security means transfer by way of a sale, exchange, gift or otherwise It does not include a

142 para 5(2)(*b*)

143 para 5(1)

144 para 5(2)(*c*) and (*d*)

145 Simon's Taxes at para B 5.423

146 See, for example, paras 5(A), 6-23 of sch 11 to s 94 of the Finance Act of 1989

147 Simon's Taxes at para B 5.425

148 para 2(1) of sch 10 to s 56 of the Finance Act of 1990

149 para 2(2) of sch 10 to s 56 of the Finance Act of 1990

150 para 2(3) of sch 10 to s 56 of the Finance Act of 1990. Insofar as the third requirement is concerned, the security should not have been issued in the circumstances in which s 209(2)(e) of the Income and Corporation Taxes Act of 1988 apply

151 para 2(4) of sch 10 to s 56 of the Finance Act of 1990

152 para2(5)

153 para 2(6)

154 para 2(7)

155 para 2(8)

Paragraph 2(12) provides that the condition is fulfilled where a security was issued before 9 June 1989 and the redemption proceeds in certain qualifying circumstances are not less than a stipulated amount

Paragraph 2(12A) applies similarly where the redemption proceeds are stipulated to be not more than the issue price

Paragraph 2(13) lists the qualifying circumstances which apply to para 2(12) and 2(12A) The qualifying circumstances are, first, if there is a fundamental change in the rules governing the index then such change would be detrimental to the holders' interests, the index ceases to be published without being replaced by a comparable index, where a security is issued before 13 November 1991, certain circumstances which are certain or likely to occur, where a security is issued on or after 13 November 1991, certain circumstances for redemption which may be made before maturity are fulfilled where securities are issued on or after 13 November 1991 certain circumstances for redemption which may be made prior to maturity at the option of the holder of the security applies

It should be noted that para 2(14) applies and is set out in n 134 above

138 para 2(6) of sch 11 to s 94 of the Finance Act of 1989

139 para 2(7) The qualifying circumstances are listed in para 2(13) set out above

140 para 2(8)

141 para 3

This situation should have applied in the case of both a short-term promissory note and a long-term promissory note such as a deep discount bond

The criterion to be used in determining whether expenditure has actually been incurred is whether an absolute liability as opposed to a contingent liability has been incurred "[4] If the liability to pay the face value of the bond was dependent upon a future event or if the liability may have been reduced or fallen away in certain circumstances, such liability would have been contingent "[5] If the liability is contingent, it will not have been actually incurred for the purposes of the general deduction formula "[6]

The principle which has been established is that where a liability is dependent upon a future event, such liability has not been incurred "[7] The liability must be absolute and cannot be conditional or subject to any contingency "[8] This principle has been enunciated in various Appellate Division cases[9] and applied in a number of judgments delivered in the special courts[10] Whilst no purpose would be served in discussing all the special court decisions, it is appropriate to refer to two early special court cases in order to illustrate the types of situations that the courts have had to consider "[11]

In ITC 380[12] the taxpayer was a company which carried on a business of letting properties and dealing in land During the course of its business it had purchased properties which it had subdivided and sold under a hire-purchase system Sales were effected through an agent on a commission basis In terms

It is thus clear that a deep discount bond may be a promissory note [77] If so, it is therefore, by definition, an unconditional promise in writing made by one person to another It is signed by the maker The maker undertakes to pay a sum of money at a fixed or determinable time in the future to a specified person or his order or to bearer [78]

Thus, a promissory note and, indeed, a bill of exchange[79] is an unconditional liability incurred by the maker or payee to pay the face value of the note or bill at maturity It should, however, be appreciated that where a document containing a promise to pay money contains terms and conditions relating to the contract, the maker may not have incurred an unconditional liability to pay the face value of the note at maturity In this situation the document will not constitute a promissory note

Certain types of so-called promissory notes issued in the United States contain not only terms of payment of capital and interest but also various guarantees.[80] Such a document would probably not constitute a promissory note in South African law [81]

Therefore, when a person issues a post-dated promissory note at a discount on its face value he is incurring an unconditional liability to pay its face value to the holder in due course at maturity [82] In the circumstances the discounting expenses would have been incurred by the maker at date of issue of the note [83]

of the different types of instruments [1]. A deep discount bond, for example, may be a type of long-term promissory note [2]. However, because the maturity date of a deep discount bond is normally a date which is a longer period after its date of issue than is the maturity date of many promissory notes, the timing difference in the claiming of the deduction of the discounting expenses is more material. For example, if on 1 February 1988 A issued B with a promissory note at a discount on its face value and the maturity date was 1 April 1988, the discount expenses may have been deductible at the earliest in the year of assessment ending on 29 February 1988 instead of the year of assessment ending on 28 February 1989. However, if on 1 February 1988 A issued B with a deep discount bond at a discount on its face value and the maturity date was 1 February 1994, not only would the discount have been much greater, but the timing difference would have been greater. A may have been able to claim the discounting expenses as a deduction at the earliest in the year of assessment ending on 29 February 1988 instead of either spreading the deduction of the expenses in the years of assessment annually on 29 February 1988 and ending on 28 February 1994 or claiming the deduction of all the expenses in the year of assessment ending on 28 February 1994.

In order to determine whether the discounting expenses were actually incurred when a deep discount bond was issued, it is important to understand exactly what is a deep discount bond. It is a type of promissory note in terms of which the person issuing it undertakes to pay the bearer its face value on maturity date. The maturity date is normally a number of years after the issue date [3].

The place where the expenditure or loss is incurred is a factual enquiry [90] Where it is incurred outside South Africa, s 11(*b*) of the Income Tax Act applies In this event, there is deductible only so much of expenditure or losses as the Commissioner may allow [91]

The requirement in the general deduction formula that expenditure should be actually incurred during the year of assessment is of particular importance in the case of a person issuing a deep discount bond Assume A wishes to borrow R100 000 from B for a period of five years at a fixed interest rate of 14,5% per annum A could borrow the R100 000, pay the interest on an annual basis and repay the capital at the end of the five-year period Alternatively, A could issue B with a deep discount bond with a face value of R205 578 and a maturity date five years later B would pay A R100 000 for the bond

It is important to determine when A incurred his discounting expenses of R105 578 If he actually incurred them when the bond was issued then, provided the other requirements of the general deduction formula have been met, the expenditure would have been deductible at the date of issue of the bond [92]

It has been shown that expenditure is actually incurred when a liability to pay the expenditure has been incurred [93] The question is whether the liability to pay the face value on a bill, note or bond, including a deep discount bond, was incurred when the instrument was issued The principles are similar in the case

liability exists,[40] where there is no legal liability to pay the expenses,[41] or where there is merely a diminution in the value of assets.[42]

The courts have held that expenditure or losses are only deductible if, inter alia, they are incurred during the year of assessment.[43] The reason for this is that the basis of income tax is the assessment of annual income and expenses.[44] It is thus not possible to delay the payment of liabilities and thereby postpone to a later year of assessment the claim for deduction of the expenditure incurred.[45] However, where liabilities cannot be ascertained, they are deductible when finally ascertained.[46]

The basis of only permitting the deduction of expenditure incurred during a year of assessment is by no means clear. The requirement is not specifically laid down in the Income Tax Act. There is ample authority for the proposition that expenditure does not have to be claimed only in the year of assessment in which the income to which it relates is received or has accrued.[47] It has, however, been held that expenditure incurred in a year of assessment is not deductible in a later year of assessment.[48] Possibly, the basis for only permitting the deduction of expenditure in the year of assessment is that s 11(*a*) refers to 'expenditure ... incurred'; income tax is levied on an annual basis and the date for calculating a deduction is the last day of the year of assessment.[49]

Expenditure and losses do not cover the mere diminution in the value of an asset [70] In order for there to be an expenditure or loss, there must be an actual expenditure or outgoing [71]

Where A issues a bill, note or bond at a discount on its face value he undertakes to pay the holder of the bond its face value at maturity The discounting expenses will clearly constitute expenditure incurred by A [72] Where B acquires a bill, note or bond at a discount on its face value and negotiates it to C, who presents it for payment on due date, the discounting expenditure by B and C clearly constitute expenditure incurred by them [73]

## 7.3 ACTUALLY INCURRED

In order that expenditure or losses are deductible under the general deduction formula, they should have been actually incurred during the year of assessment The legislation is concerned with actual expenditure and not necessary expenditure [74] However, an expense actually incurred does not mean actually paid [75] Thus expenditure is deductible when the liability to pay it has been incurred [76] The liability to pay the expenditure must have been actually incurred [77] It has thus been held that expenditure or losses have been actually incurred where either monies have been actually paid out or where there is a legal liability to pay monies [78] The entry of a financial transaction in the taxpayer's books of account does not constitute the incurring of actual expenditure [79] A deduction may not be claimed where only a contingent

held to include a loss of trading stock as a result of a burglary,[5] business losses incurred as a result of the manufacture and sale of soft drinks,[6] irrecoverable advances by an insurance company to one of its agents,[7] losses resulting from theft by employees,[8] an expenditure or outgoing which a taxpayer deducts from his gross income,[9] losses resulting from the sale of investments,[10] irrecoverable losses,[11] losses incurred on supply contracts,[12] losses in respect of rental of premises,[13] losses resulting from the sale of shares,[14] stock losses,[15] losses resulting from theft,[16] irrecoverable advances to employees,[17] compensation paid for damages [18] and 'losses',[19] foreign exchange losses,[20] guarantee losses,[21] trading losses,[22] losses arising from the sale of businesses as going concerns[23], discounting losses,[24] and losses resulting from the sale of property.[25]

The inclusion of losses may be unnecessary as they will generally be followed by expenditure.[26] Where this is not the case, there are in certain cases specific provisions in the Income Tax Act covering them. Thus, for example, s 11(*i*) permits the deduction of a bad debts allowance, and a scrapping allowance is covered in s 11(*o*).

It can be argued that the meaning of expenditure is not only restricted to a voluntary payment of money.[27] There is no reason why goods having an ascertainable money value should not be given to settle a liability incurred.[28] In principle this is not different from settling the liability by a cash payment.[29]

moneys claimed as a deduction from income derived from trade, to the extent that such moneys were not laid out or expended for the purposes of trade

There is an examination of discounting expenditure and losses, not of a capital nature, actually incurred in the production of income This is followed by a brief discussion of the meaning of trade and s 23(g) Thereafter there is a discussion of the trading stock provisions contained in s 22 Substantial changes to the taxation of discounting transactions were introduced in s 21 of the Income Tax Act 21 of 1995 These were incorporated in a new s 24J These provisions are examined in detail in conjunction with the examination of the general deduction formula and s 22

## 7 2 EXPENDITURE AND LOSSES

The meaning of the word 'loss' in the general deduction formula is not clear In Jolle & Co (Pty) Ltd v CIR[1] the Appellate Division discussed its meaning The court held that the word 'loss' has several meanings and that its meaning in s 11(*a*) is obscure In a trading context the court held that the word may mean a deprivation, normally of an involuntary nature, suffered by the loser On the other hand expenditure normally means a voluntary payment of money[2] The court illustrated the difficulty of the meaning of the word by taking, as an example, damages incurred to a third party during trading activities The payment made to settle the damages is a loss, although once the payment has been made it may also be called expenditure[3] Losses have been

There is an examination of the treatment of this expenditure for income tax purposes. Expenditure is deductible from income if the requirements laid out in the Income Tax Act[1] relating to the deduction of expenditure are fulfilled. In this regard, the relevant provisions to consider are ss 11(*a*), 11(*h*), 23(*g*) and 24J of the Income Tax Act. As far as the second and third situations referred to above are concerned, it is important to examine s 24J and the effect of the trading stock provisions contained in s 22 of the Income Tax Act.

Sections 11(*a*), 11(*h*) and 23(*g*) are commonly referred to as the general deduction formula. Section 11(*a*) deals with expenditure or losses actually incurred in South Africa whilst s 11(*h*) deals with expenditure or losses actually incurred outside South Africa. Sections 11(*a*) and (*h*) set out the positive requirements for deductions, whilst s 23(*g*) sets out the negative requirements.

In order to determine the taxable income derived by a person from carrying on any trade within South Africa, s 11(*a*) permits the deduction from income so derived of expenditure and losses actually incurred in South Africa in the production of the income. It is provided that such expenditure and losses should not be of a capital nature. Section 11(*h*) is similar to s 11(*a*), except that it applies to expenditure and losses actually incurred outside South Africa and the deduction is limited to that amount of the expenditure as the Commissioner may allow. Section 23(*g*) prohibits the deduction of any

# DEDUCTION OF DISCOUNTING EXPENSES

## 7.1 INTRODUCTION

There is a discussion of the deductibility of discount expenditure in this chapter. In approaching this discussion, it should be appreciated that there are three situations to consider.

The first is where A issues a bill, note or bond to B with face value of R100 for R65. At the date the instrument is issued A will receive R65 from B. A undertakes to pay the holder of it R100 at the date of maturity, which may be several years after the date of issue. A will thus incur expenditure of R35 in the transaction.

The second is where B, having acquired the instrument from A for R65, negotiates it to C for R85. If the receipt of R85 is of a revenue nature in B's hands, he will want to claim a deduction of R65 being expenditure incurred in the production of the R85.

The final situation is where C presents the instrument for payment at maturity date and receives its face value of R100. C, on the same basis as B in the second situation, would want to deduct R85 from the receipt of R100 if the receipt were of a revenue nature.

241 at 18

242 at 19

243 ibid

244 The Taxation of Gilts and Bonds press release at 6

225 at 13-4

226 The Taxation of Gilts and Bonds press release at 4

227 The Taxation of Gilts and Bonds at 5

228 The Taxation of Gilts and Bonds at 14 and The Taxation of Gilts and Bonds press release at 4

229 The Taxation of Gilts and Bonds at 15

230 ibid. See also The Taxation of Gilts and Bonds press release at 4

231 The Taxation of Gilts and Bonds at 16

232 ibid

233 at 17

234 ibid

235 ibid

236 ibid

237 at 18

238 The Taxation of Gilts and Bonds press release at 7

239 The Taxation of Gilts and Bonds at 18

240 at 18-9

The learned judge stated that the liability to pay interest was subject to three conditions. These were that the loan was in existence, the interest was unpaid at the date or dates of payment thereof and the holder of the instrument was able to establish title to it [127]

In ITC 1485 the court was concerned with the deduction of interest in respect of NCDs. The conditions set out on the reverse side of the NCDs did not create any suspensive conditions. They were made payable 'to bearer' and did not contain any conditions restricting the type of person who may be the bearer [128]. The NCDs not only evidenced the deposits and their terms, but constituted negotiable instruments [129]. They could be used by the depositors, if they so wished, to secure payment in advance of due dates by negotiation to third parties [130]

It is not entirely clear whether the NCDs constituted promissory notes. Whilst they do not contain the express words 'I promise' or 'I undertake', it has been held that these express words are unnecessary in a promissory note [131]. It is, however, submitted that, in view of the fact that they contain conditions, they cannot be said to be unconditional promises to pay as envisaged in the definition of a promissory note. In the circumstances it is submitted that the NCDs constituted negotiable instruments [132]

the time during which the money is used It is incurred and accrues from day to day '[17]

No authority is quoted to support this statement

In ITC 1485 Melamet J referred to the manner in which the taxpayer's auditors had presented the schedules to the financial statements Whilst accepting that a court should only be concerned with permissible deductions in terms of the Income Tax Act, he referred to accounting practice to confirm -

'the extent to which a presently existing contractual liability to be discharged in another year should be treated as an expenditure incurred in the year of income '[18]

Finally, Melamet J stated that, although the taxpayer had undertaken to pay interest at a future date or dates, as the case may be, it does not follow that interest was incurred in the year of assessment in which the instrument was issued He indicated that this was contrary to the inherent character of interest [19]

In commenting on the aforesaid judgments of Melamet J, it is necessary to analyse them in detail

condition is only fulfilled in a later year of assessment, it is only deductible in the year of assessment in which the condition is fulfilled [115]

Melamet J found that the liability to pay interest was conditional upon, first the loan being in existence, second the interest being unpaid at the time which was stipulated for the payment of interest, and third the holder of the instrument being able to establish title to it [116] He went on to state that the loan could have been discharged for some reason and that it is a prerequisite that the loan was in existence at the time when the right to claim such interest arose [117] Interestingly, he stated, 'It matters not how unlikely the fulfilment of the condition is' [118]

Melamet J continued by stating that whilst the financial instrument may evidence a contractual liability to pay interest, the actual liability so to pay is incurred when interest accrues on the outstanding loan [119] He then referred to a quote from Halsbury The Laws of England[120] to the effect that interest accrues on a daily basis, even if payable at intervals, and must be apportioned in respect of the time between borrower and lender [121] He referred to sections in Words and Phrases Legally Defined[122] and The South African Law of Obligations[123] and then states the following

> 'Interest is an expense to compensate a lender for the time period during which the money is lent to a second party It cannot be incurred prior to

In ITC 1496 the taxpayer executed a promissory note in terms of which it undertook to pay a sum of money on a specified date The sum payable included two elements The first was the capital sum advanced by the bank, and the second was the discounting profit or fixed interest for the period ending on the redemption date The promissory note contained no additional conditions [108]

In both ITC 1485 and ITC 1496 Melamet J found that the interest which was included in the financial instruments involved could not be regarded in the hands of the taxpayers involved as 'expenditure actually incurred' in terms of s 11(*a*) in the year of assessment in which the instruments were issued or made, as the case may be His reasons were similar in both cases [109]

Melamet J accepted that, in order to be deductible in terms of s 11(*a*), there must be an absolute and unconditional legal obligation to pay such expenditure [110] It is not necessary for the expenditure to be discharged in the year of assessment in question [111] The authorities quoted by Melamet J in support of his statement were Caltex Oil[112] and Nasionale Pers [113] It is respectfully submitted that Melamet J was correct in making such statements and that it is a correct interpretation of the authorities cited by him

He then correctly cited Edgars Stores[114] as authority for the fact that if a conditional obligation is incurred in a particular year of assessment, and such

An NCD is a fixed deposit receipt issued by a bank or building society [104] It is negotiable in the secondary market which exists for such financial instruments The issuer normally undertakes to pay the amount of the deposit to the holder on the maturity date When an NCD is issued for a period of less than one year, interest is normally payable at the maturity date When an NCD is issued for longer than one year, interest may be payable either at maturity date or, more commonly, six monthly in arrears [105]

In ITC 1485 most of the NCDs which were issued provided for the payment of half-yearly interest payable in accordance with the interest expenses which were attached to the certificates Three NCDs provided that the amount borrowed together with interest was payable to bearer on the maturity date. The face of the NCDs contained information normally found on such instruments such as the taxpayer's name, issue dates, maturity dates, amounts deposited and annual rates of interest The conditions contained on the reverse side of the NCDs related to the terms of their issue and negotiation The conditions did not in any way create suspensive conditions relating to the payment of capital and interest [106]

A promissory note is defined as an unconditional promise in writing made by one person to another signed by the maker, and agreeing to pay on demand or at a fixed or determinable future date, a sum certain in money, to a specified person or his order, or to bearer [107]

The issue before the court was whether the interest payable on the NCDs issued during the relevant year of assessment was deductible by the taxpayer in terms of s 11(a). In this regard, it should be noted that the greater portion of the interest reflected on the NCDs was shown as being payable in instalments on dates falling in future years of assessment [97]

In ITC 1496[98] the taxpayer borrowed a sum of money from a bank. The capital borrowed, together with accrued interest, was repayable after a period of five years. In order to secure the repayment of the capital and part of th interest, the taxpayer executed a promissory note in terms of which it undertook to pay the bank a sum of money on the due date. The amount payable on due date represented the capital borrowed together with accrued interest calculated at the rate of 15% per annum for the relevant period [99]

One of the issues which the court considered was whether the interest payable in terms of the promissory note was deductible by the taxpayer in the year of assessment in which the note was issued. In this regard the court was concerned with the meaning of 'expenditure actually incurred' in s 11(*a*) [100]

In both cases Melamet J found in favour of the Commissioner [101]. The sections of his judgments dealing with the deductibility of interest are virtually identical.

In ITC 1485 the taxpayer issued NCDs[102] and in ITC 1496 the taxpayer issued a promissory note [103]

assessment in question. It means expenditure in respect of which the taxpayer has incurred an unconditional legal obligation to pay during the year of assessment. It is not necessary that the liability has been discharged during the year in question."[90]

Expenditure may only be deducted in the year in which it was incurred."[91] It is not necessary for expenditure to be due and payable for it to have been incurred. There must simply be an unconditional legal liability to effect payment."[92]

Whilst the principles enunciated above are clear, there have been two decisions recently delivered by Malamet J in the Transvaal Special Court which warrant specific attention."[93] The reasons are that these decisions are directly concerned with the meaning of 'expenditure actually incurred' as it relates to original issue discount expenses."[94]

In ITC 1485[95] the taxpayer was a banking company and carried on all business related to banking. The taxpayer's business was funded from interest earned on certain statutory investments from loans from its holding company and its subsidiaries and from deposit accounts held with the taxpayer. The taxpayer was obliged to pay interest on the monies received. The deposit accounts consisted of monies on fixed deposits and monies advanced against the issue of negotiable certificates of deposit (or, as they are referred to, NCDs) by the taxpayer."[96]

Corbett JA, who delivered the majority judgment,[86] stated that expenditure is only deductible in terms of s 11(*a*) if, inter alia, the taxpayer has incurred an unconditional legal obligation during the year of assessment in question. He pointed out that such obligation could be unconditional at the outset, or, although initially conditional, the condition could be fulfilled during the relevant year of assessment. However, if a conditional obligation is initially incurred and the condition is only fulfilled in a later year of assessment, the expenditure may only be deductible in such later year.[87]

The learned judge drew a distinction between expenditure which is subject to a condition which remains unfulfilled at the end of the relevant year of assessment, and expenditure in respect of which no condition attaches but which cannot be quantified until a later year of assessment. In the latter situation, the expenditure is not disallowable because the expenditure cannot be quantified at the end of the year of assessment.[88]

On the facts of the case, Corbett JA found that the obligation to pay the turnover rental was contingent until the turnover for the 12-month periods of the lease agreements was determined at the end of such periods. Thus, the expenditure was not actually incurred in a year of assessment which ended prior to the termination of the relevant lease period.[89]

It is clear that the expression 'expenditure ... actually incurred' in s 11(*a*) of the Income Tax Act does not mean expenditure actually paid during the year of

judgment, made it clear that expenditure was only deductible in terms of s 11(*a*) if the taxpayer has incurred an unconditional obligation in respect of it during the year of assessment in question [81]

The Appellate Division again considered the meaning of 'expenditure actually incurred' in s 11(*a*) of the Income Tax Act in CIR v Edgars Stores Ltd [82]

The facts were, briefly, that the taxpayer conducted its retail clothing business throughout Southern Africa in leased premises The annual leases provided for a basic rental and a turnover rental The turnover rental was based upon the lessee's turnover, as defined, for a 12-month period The period commenced from either the date of commencement of the lease, or its anniversary. In the circumstances, such turnover rental was only ascertainable after the last day of the taxpayer's year of assessment [83]

The court was required to determine the application of the words 'expenditure actually incurred' in s 11(*a*) in so far as they related to the turnover rental which could only be determined after the end of the taxpayer's years of assessment in question [84] In a majority decision the court held that such expenditure had not been incurred, and the taxpayer's appeal was dismissed [85]

In its financial statements as at 31 March of the same years, the taxpayer included as an expense half of the anticipated bonus payable. The Commissioner disallowed such expenditure. In the Appellate Division the taxpayer contended that the expenditure was not limited to a particular employee, but to all employees, and that such expenditure was an inevitable commercial reality. The taxpayer's obligation to pay the bonus was subject to a resolutive condition. The obligation to pay the pro rata portion of the bonus arose at the end of each month and ceased only if the employee's service terminated.[79]

The court held that the taxpayer had concluded contracts with its employees individually. The court held further that it was unnecessary to refer to the conditions as resolutive or suspensive. The fact was that at 31 March it was not possible to determine which employees would remain in the taxpayer's employment as at 31 October of the same calendar year. In the circumstances, the taxpayer's appeal was dismissed.[80]

On the facts, this judgment is consistent with an application of the meaning of 'expenditure actually incurred' as discussed above. The taxpayer had not actually incurred the relevant portion of the bonus as at the end of its financial year. The reason was that the payment of such bonus was dependent upon the employee's remaining in the taxpayer's employ as at the end of the following October. Therefore, at the end of its financial year, it could not be said that such expenditure had been actually incurred. Hoexter JA, who delivered the

equipment would become pledged to the customer as security for the due and proper performance of the contract Thus, the company's liability to incur the repatriation expenses of the vessels and equipment was contingent upon its performance under the contract Accordingly, the court held that the repatriation expenses had not been actually incurred by the company [76]

There have been some recent Appellate Division decisions concerning the meaning of 'expenditure actually incurred' It is appropriate to refer briefly to these cases

In Nasionale Pers Bpk v KBI[77] the facts were that, prior to the tax years in question, the taxpayer paid its staff bonuses on a discretionary basis No specific policy applied to such payment During the first year in question the taxpayer altered its conditions of employment by introducing provision for an annual bonus which would be payable to employees who had completed a full year's service The amount of the bonus was equivalent to one month's salary A pro rata reduction applied in the case of shorter service It was provided that the bonus was payable to employees in the taxpayer's employ on 31 October of the relevant tax year The full amount of the bonus would be reclaimed from any employee who, after receipt of the bonus, gave notice of intention to resign before 31 October of the relevant tax year Subject to this stipulation bonuses were paid on 30 September of the years in question [78]

of the agency agreement the company retained half of the commission earned by the agent until completion of the sale In the event of a sale falling through the company debited the agent with the full amount of the commission originally credited to him The company sought to deduct the full amount of the commission which it had originally credited to the agent

The court held that expenditure is actually incurred where monies are actually paid out or where an obligation to pay money has been incurred [73] The court found on the facts that the company was under no legal liability to pay the balance of the commission to the agent The agency agreement provided that in the event of the sales falling through, the agent would have been obliged to refund to the company the half of the commissions received in respect of these sales [74]

ITC 380 illustrates the type of situation in which a contingent liability may arise. Another example is ITC 969 [75] In this case the appellant company was a subsidiary of a Dutch company. It had been formed in South West Africa to tender for and carry out a contract in that territory In order to complete the contract, the company entered into an agreement with its holding company for the hire and transport to South West Africa of vessels and equipment required for the contract The company sought, inter alia, to claim the deduction of the estimated cost of the return to the Netherlands of the vessels and equipment The court found that, in terms of the main contract in South West Africa, if the company failed to fulfil all of its terms and conditions the vessels and

The matter was considered by the General Commissioners of Income Tax who confirmed the assessment. The taxpayer's appeal was discussed by Goulding J in the Chancery Division [181]. The taxpayer, being dissatisfied with this decision, took the matter on appeal to the Court of Appeal where the judgment was delivered by Shaw LJ [182].

The court referred, with approval, to the judgment of Rowlatt J in Wigmore [183]. Although the court in Wigmore considered the position from the point of view of the vendor and Schaffer considered the position from the point of view of the purchaser, the court in Schaffer did not consider that the principle was different [184]. Accordingly, the court dismissed the taxpayer's appeal [185].

It is, therefore, clear that the apportionment of interest concept referred to by Halsbury does not apply when capital market instruments such as loan stock are being traded in England. Thus, it is not only incorrect to apply the English principle of apportionment of interest to capital market transactions in England, but it is incorrect to refer to this principle as authority for its application in South Africa.

Fourth, and in any event, English law draws a distinction between interest and discount [186]. The issue of a promissory note at a discount on its face value will be regarded in English law as a discounting transaction. Thus the profit made by the person advancing the funds is treated as a discounting profit. The significance of this is that, in English law, it has been held that a discount does

Not surprisingly, Rowlatt J found in favour of the taxpayer. He described as 'absurd' the idea that a person would pay a sum for interest which sum would only be received a few months later. He went on to state

> 'The truth of the matter is that the seller does not receive "interest" and "interest" is the subject matter of the taxation. He receives the price of the expectancy of interest.'[169]

It is interesting to note that, unlike Malamet J, even counsel for Revenue in Wigmore did not contend that, where there is continuous ownership of the instrument, the principle of apportionment should apply.

A further example of the limitation of the principle of apportionment in the case of capital market instruments is Schaffer v Catermole (Inspector of Taxes).[170] The facts were that the taxpayer purchased certain 6½% Treasury Loan Stock. The interest on the stock was paid half yearly. The purchase price paid by the taxpayer for the stock included accrued interest for the period from the date that interest was last paid in respect of the stock and the date when the taxpayer purchased the stock. Thereafter taxpayer received interest payments in respect of the stock in the normal manner. He was assessed income tax on this interest. He argued that he was only liable to income tax on that part of interest accruing to him after the date of purchase of the stock.[171]

For example, in Wigmore (HM Inspector of Taxes) v Thomas Summerson & Sons Ltd[174] the taxpayer sold a holding of War stock. The stock was sold with interest rights and the sale price was increased to take into account the fact that the sale had taken effect during an interest period and the purchaser benefited from this because interest had, in effect, accrued on the stock in the period between the date when interest on the stock was last paid and the date of sale.[175]

The taxpayer was assessed to tax on the interest that was deemed to have accrued on the stock from the date when interest was last paid and the date of sale. The matter was considered by the Commissioners for the General Purposes of the Income Tax Acts who found in favour of the taxpayer. Thereafter, it came before Rowlatt J in the King's Bench Division.[176]

When the matter was argued before Rowlatt J, counsel for Revenue limited himself in certain important respects. First, he did not contend that the principle of apportionment should apply where income was taxed by deduction. In other words, he argued that apportionment should apply to interest not taxed by deduction, but not to interest taxed by deduction. Second, he conceded that even where interest is not taxed by deduction, the rule of apportionment does not apply where the holder of an instrument holds it continuously from year to year. Third, he did not seek to apply the principle of apportionment when the change in ownership was not in consequence of a sale.[177]

It is therefore clear that the old Dutch authorities were of the view that Dutch law did not apply an automatic rule of apportionment to interest. This approach was referred to with approval by the South African courts, including the Appellate Division. Accordingly, the old English rule of apportionment has not been followed in South Africa.

Second, the reference to Halsbury and the authorities quoted therein is to the accrual of interest and not the incurring of interest expenditure.[168] The tests used to determine whether there is a receipt or accrual in terms of this definition of gross income in s 1 of the Income Tax Act are clearly different from those used to determine whether expenditure is deductible in terms of s 11(*a*).[169]

Third, the English authorities referred to were considering different legislation.[170] The only possible value that they could have would be persuasive value.[171] They certainly cannot be used in preference to South African Appellate Division decisions by which Melamet J should have been bound in terms of the doctrine of stare decisis.[172]

In any event, it would appear that the apportionment of interest concept referred to by Halsbury has limited application, particularly with regard to capital market instruments.[173]

The Dutch authorities on this issue were referred to in Kelly v Holmes Bros by De Villiers JP [64] He stated that

> 'It is sufficient for the purpose of this case to say that by the Roman-Dutch law a future date fixed for the payment of money is considered to be stipulated for the benefit of the debtor, so that he may waive that benefit and pay before the date fixed, unless it appears from the express words of the contract or (presumably) from other admissible considerations, that the time stipulation was made for the benefit of the creditor as well as the debtor, or of the creditor alone '[65]

The issue was considered by the Appellate Division in Bernitz v Euvrard [66] Watermeyer ACJ, who delivered the judgment of the court, set out the law more concisely as follows

> 'It is a well-recognised principle of our law that where a future date has been fixed for payment of a debt, a presumption arises that such future date was fixed for the benefit of the debtor, and consequently he can anticipate the date of payment To this rule there are exceptions, one of which occurs when the future date has been fixed partly for the benefit of the creditor, and in that case the debtor cannot pay before the agreed date unless, possibly, he pays interest up to the agreed date as well '[67]

benefit, the borrower cannot repay the debt earlier than the agreed repayment date unless he is prepared to pay additional interest to cover the period between the date of payment and the later agreed date [163]

In a later passage, Voet stated

> 'Moreover any person who takes money on loan for a year, and has promised that he will return the principal sum with interest when a year has passed, cannot repay the principal sum sooner, except with the addition to it at the same time of interest for the whole year He cannot be released by paying it in proportion to the time during which he has used the principal sum The attaching of a day to money held at usury appears, at any rate if you look at the start of the matter, to have been made for the sake of the creditor, contrariwise to what we should have to say in the case of a grant of the gratuitous use of money '[164]

Van der Keessel referred to the transaction of a loan of money where interest accrues on the outstanding capital He stated that a debtor is not entitled to anticipate the repayment date and thereby escape liability for interest Van der Keessel was of the opinion that the ' van of money on interest is normally made for the benefit of the creditor and the debtor [165]

anticipates the agreed payment schedule and to settle his full indebtedness at an earlier date than that stipulated in the agreement between the parties

The questions to be answered are whether the debtor is entitled to settle the debt in this manner and whether he is only liable for interest to the date of payment of the outstanding debt or for the interest for a longer period [15]

Van Leeuwen stated that where a repayment date has been fixed, a debtor may repay the debt on the agreed date or he may anticipate such date Thus he may, against the creditor's wishes, repay the debt earlier than the agreed repayment date The reason for this is that the deferral of the repayment date is for the debtor's benefit However, this rule will not apply where the repayment date has been agreed to for the benefit of the creditor and it has been specifically stipulated that the debtor cannot repay the debt earlier than the agreed date [16]

Voet adopted a similar approach to Van Leeuwen He stated that a loan can be repaid earlier than the agreed repayment date if the date has been fixed for the benefit of the debtor However, if it has been fixed for the benefit of the creditor, the date for repayment cannot be anticipated Thus, where a repayment date is fixed for the benefit of the borrower, in order to enable him to have additional time to collect the money required to repay the loan, he can compel the lender to accept an earlier settlement of his indebtedness On the other hand, where the repayment date has been prescribed for the lender's

As authority for his contention that interest is incurred from day to day, Melamet J referred to Halsbury,[154] Words and Phrases Legally Defined[155] and Lee & Honore.[156]

The reference to these authorities by the learned judge is open to criticism for a number of reasons.

First, if one has regard to the authorities cited by Melamet J, it will be noted that they refer to English authority. Halsbury covers the laws of England. Words and Phrases Legally Defined is an English legal dictionary. The reference to Lee & Honore is to its first edition published in 1950. The passage referred to is based on English law. It stated that, inter alia, 'in the absence of any authority to the contrary" the ancient English rule of apportionment" might well be followed in South Africa.[157]

This passage was not repeated in the second edition of Lee & Honore published in 1978.[158] There is, in fact, South African authority to the contrary.

The type of situation in which this issue has been considered by South African legal authorities is where a creditor is owed money by a debtor and the parties have agreed to conditions relating to the repayment of the debt. Such conditions include, for example, interest on the outstanding debt and the terms of payment of capital and interest. The issue arises where the debtor

As there was no evidence in either of the cases to support the learned judge's assertion that the actual liability is incurred when the interest accrues on the outstanding loan, one must assume that the learned judge considered that his proposition was founded on a legal basis With the greatest respect, this does not seem to be the case As has been stated, the financial instruments created unconditional liabilities and the rights to enforce the obligations in underlying contracts on which the instruments were based were suspended [149] In any event, the learned judge, having referred to Caltex Oil[150] earlier in his judgments, appears to have ignored the principles enunciated in that case In Caltex Oil Botha AJA stated

> 'We are not concerned with the case where the devaluation occurs in a subsequent year before the liability is discharged In the latter case the quantification for the purpose of s 11(*a*), at the end of the tax year, of the expenditure actually incurred during that year, is not affected by the subsequent devaluation of the foreign currency '[151]

The same reasoning with respect, applies to ITC 1485[152] and ITC 1496.[153] The liability for interest was incurred during the years of assessment in question and the learned judge should not have been concerned with unlikely events that he considered could, conceivably, arise in subsequent years of assessment

title to it, but this does not create a condition suspending the liability to pay interest

A further point to consider in respect of the learned judge's assertion that the interest liability was conditional is the position of a holder in due course [144] If the promissory note in question was negotiated to a holder in due course, he would have acquired the instrument free from any defect in the title of prior parties as well as from personal defences available to prior parties among themselves.[145]

The maker of a promissory note is liable to pay it according to its tenor and is precluded from denying to a holder in due course the existence of the payee and his then capacity to indorse [146]

In the circumstances, it is difficult to accept that the taxpayer's liability under the note in ITC 1496[146] was conditional in respect of a possible claim by a person holding the note as a holder in due course.

The next point raised by Melamet J was that whilst the financial instrument may evidence a contractual obligation to pay interest, the actual liability is incurred when the interest accrues on the outstanding loan [147] He then referred to various authorities in an attempt to justify the proposition that interest is deductible on a daily basis over the period of the loan, as it is incurred and accrues from day to day [148]

It must be accepted that an NCD reflects an underlying contract between the issuer and the depositor and a promissory note reflects such a contract between the maker and the payee [138] The underlying contract is the causa for the contract on the instrument [139] The obligation in the underlying contract and the obligation arising from the instrument both exist [140] They are interdependent Where there are two such obligations in respect of the same performance, the creditor does not have a free election to enforce the obligation relating to the underlying contract Once the creditor accepts the negotiable instrument, the right to enforce the obligation in respect of the underlying contract is suspended until maturity of the instrument When the creditor claims payment of the obligation relating to the underlying contract he must account for the negotiable instrument [141]

Thus, if the creditor were to negotiate the instrument, the debtor cannot be sued by the holder of the instrument as holder, and by the creditor on the basis of the obligation created by the underlying contract In this situation the holder is subject to the same restrictions in relation to the obli[illegible] the underlying contract as the creditor was prior to negotiation of this instrument [142]

In the circumstances, it cannot be argued that the liability to pay interest contained in the instruments was subject to the existence of the underlying contract or the interest in respect of the underlying contract's being unpaid at payment date Clearly the holder of this instrument should be able to establish

A negotiable instrument is a document which is by custom and trade usage transferable in the same way as cash [143] It is transferable by delivery and is capable of being sued upon by the holder [144]

In ITC 1496 the court considered the deductibility of discounting expenses or interest contained in a promissory note A promissory note, by definition, constitutes an unconditional liability of the maker to pay the face value of the note at maturity date [145]

In ITC 1485 and ITC 1496 the stated facts do not indicate that the persons who deposited or advanced the monies in question did so subject to the three conditions referred to above be Melamet J [146] It therefore follows that the only basis upon which Melamet J could have found that these conditions existed was if these conditions arose by virtue of the nature of the instruments themselves In other words, the issue of an NCD or promissory note will automatically result in the creation of these conditions

With the greatest respect to the learned judge, this cannot be correct In the case of a promissory note, one cannot create an unconditional liability which is subject to conditions The instrument itself, whether it is an NCD or a promissory note, is the document which evidences and embodies the contractual rights and its possession is essential in enforcing these rights [147]

This formula raises a number of issues which have been discussed in chapter 3. It is, however, necessary to refer to them briefly.

First, accrual is determined for an accrual period. The accrual periods 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. The other is the period elected by the holder or issuer, as the case may be.[214]

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.[215] 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.[216]

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

amendment was effected by s 14 of the Income Tax Act 36 of 1996. It provides that s 24J applies to all instruments issued on or before 15 March 1995 and which were unredeemed on 14 March 1996. The application of retrospective legislation to these instruments is unfortunate and government should be discouraged from continuing this practice.

Special provisions apply, insofar as they relate to holders, to instruments which were issued on or before 15 March 1995 and which were unredeemed on 14 March 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, are, for tax purposes, accounted for on the date of the instrument's transfer or maturity, whichever is the earlier.

Section 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 the incurral of expenditure. The issue of the accrual of income has been discussed in chapter 3.

Interest is defined as including the gross amount of interest, related finance charges, discount or premium receivable as a result of a financial arrangement.[20] 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.[21]

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. Section 21(2) of the latter Act 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 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 transitory 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

the final maturity date, the taxpayer was still liable for the full amount of the finance charges The taxpayer sought to deduct the full amount of the finance charges in the year of assessment in which the agreement was signed and the R5 million was advanced [209]

The Commissioner refused to allow the deduction claimed on the grounds that interest could not be incurred prior to the use of the capital lent, the interest was incurred and accrued from day to day and the liability to pay interest was conditional upon the loan being in existence when the interest payments became due [210] It was argued on behalf of the Commissioner that the existence of an unconditional legal liability was not enough to establish whether expenditure has been actually incurred It should also relate to a past event In addition, the capital involved should be used or employed in incurring the expenditure in question Van Zyl J rejected these arguments He referred to ITC 1485 and ITC 1496 as well as the judgment of Van Dijkhorst J in ITC 1587 and agreed with the criticism by Van Dijkhorst J of the judgments of Melamet J in ITC 1485 and ITC 1496 In the circumstances, he allowed the taxpayer's appeal [211]

The judgments of Van Dijkhorst J in ITC 1587 and Van Zyl J in ITC 1588 are important because they reject the proposition regarding the accrual of interest advanced by Melamet J in ITC 1485 and ITC 1496 The judgments of Melamet J have been criticized above, and the judgments of Van Dijkhorst J and Van Zyl J reinforce these criticisms

available to the borrower, no right to interest accrues. Van Dijkhorst J agreed with this reasoning. A loan agreement gives rise to reciprocal obligations. A failure by the lender to perform disentitles him to claim performance from the borrower. The learned judge then correctly pointed out the difficulty in reconciling this reasoning with that in ITC 1485 and ITC 1496.[306]

In the circumstances, Van Dijkhorst J did not accept the principle that, as a general rule, interest accrues from day to day. This principle was too widely stated and was incorrect. Accordingly, he found that the discount charges constituted expenditure unconditionally incurred by the taxpayer on 15 September 1988 and these expenses were deductible in the taxpayer's year of assessment ending on 30 September 1988.[307]

In ITC 1588[308] the facts were that the taxpayer was a public company which had been liquidated. It sought to deduct certain expenditure relating to a year of assessment prior to its liquidation. The expenditure related to a loan agreement concluded between the taxpayer and A, a subsidiary company of the B group of companies. In terms of the agreement, a sum of R5 million was advanced and paid over to the taxpayer. The agreement provided that the taxpayer incurred an unconditional liability to pay the finance charges. There was provision for A, after the final maturity date, to calculate interest on the facility at the prime rate over the period of the loan. If such amount exceeded the original finance charges, the taxpayer agreed to pay A the difference. The agreement provided that in the event of the capital lent being repaid prior to

"the actual liability to pay" The liability to pay the amount due on a note on due date arises upon issue thereof It is in its nature contractual It is actual in the sense that it is real, it exists, it is not contingent The interest was not separately specified on the promissory note and the debt payable on maturity could not be split ex facie the note into capital and interest There was no way in which earlier payment of the note than on due date could bring about a reduction of interest unilaterally The unlikely possibility of a later agreement to grant a reduction of interest upon earlier redemption of the note cannot affect the original unconditional nature of the transaction "[304]

Interestingly, Van Dijkhorst J referred to the unreported case of X Investments (Pty) Ltd (case no 9680) in which Melamet J delivered the judgment In this judgment, Melamet J stated that the terms of a loan agreement determine when the lender of money becomes entitled to the interest on the capital lent In considering the nature of the agreement in question, the interest was only payable at the end of the period of the loan The lender's entitlement to interest was conditional upon his willingness and ability to make the money available to the borrower for the period of the loan In the circumstances, Melamet J stated that the interest did not accrue to the lender until the end of the period of the loan, unless the contract specified otherwise.[305] In discussing this judgment, Van Dijkhorst J stated that the accrual of interest was dependent upon the terms of the contract If the period of the loan is fixed and the money is paid over, the interest accrues If the money is not made

The learned judge referred to the authorities relied upon by Melamet J to substantiate his conclusion that interest accrues from day to day and stated that he did not consider them binding upon him He went on to state that the full terms and conditions were not set out in the judgment in ITC 1485 It was not, therefore, clear whether the finding of Melamet J that the NCDs were not unconditional was solely based on the fact that, in his opinion, interest accrues on a daily basis However Van Dijkhorst J indicated that this was the view held by Melamet J when one considers his judgment in ITC 1496[30] In considering ITC 1496, he stated

> 'If there were no unconventional terms and conditions attached to the promissory note concerned we respectfully fail to see how the mere possibility that the parties may in future decide to cancel the note before due date can make the note conditional That contingency exists in the case of all contracts (even holy matrimony) but this does not detract from the finality of the agreement Neither can it be said that a note is conditional because the holder must establish his title thereto The promise to pay is unconditional in favour of whoever is the holder of the note This is inherent in the concept of a promissory note Section 87(1), Bills of Exchange Act 34 of 1964

> We respectfully do not go along with the learned judge's distinction between "a contractual liability to pay interest at some future date" and

deductibility of the discount charges He stated that expenditure is incurred in the tax year in which an unconditional liability for the expenditure is incurred and not in the tax year in which it is paid He reiterated that expenditure is only deductible in the year in which it is incurred Accordingly, he found that on 15 September 1988 the taxpayer incurred a legal liability to pay the face value of the notes when they matured The liability was unconditional, and it included the discount charges "[51]

The learned judge then referred to ITC 1485 and ITC 1496 With regard to ITC 1485, he stated that the proposition that interest cannot be incurred prior to the use of the capital and that it accrues from day to day was too broadly stated He went on to state the following

> 'Nothing prevents parties to calculate the interest, which is compensation for money lent, not on a daily basis but on a weekly or monthly basis or just in a lump sum In fact a borrower who has borrowed a lump sum for a year at a specified interest cannot under our common law unilaterally reduce the sum of interest by a accelerated payment of capital Voet 22 1 9; Voet 12 1 20, Bernitz v Buyrard 1943 AD 595 at 602 If on the other hand the capital is repayable at will and the interest is calculated on a daily basis the above-stated proposition that the interest accrues from day to day is correct "[52]

constituted a sale of an asset. The loss incurred was of a capital nature and was not, therefore, deductible from the taxpayer's gross income.[197]

Van Dijkhorst J then examined the nature of the transaction and concluded that it could not be regarded as the sale of promissory notes. He examined the difference between the discounting of a bill and the lending of money. He stated that in a discounting transaction the seller of the bill does not undertake to repay it on due date. The signatories to the bill have those obligations. If the seller is a signatory to the bill, his liability arises as a result of this fact and not because he is the seller.[198] Where a bill is sold by way of discount, the bill itself has an inherent value. On the other hand, where a person offers his own promissory note, a discount house is merely obtaining the maker's written promise. The strength of the note is dependent on the maker's worth. Such a transaction could not be regarded as a sale. The fact that the person who negotiates the note endorses it would not change the nature of the transaction. Accordingly, he rejected the argument that the transaction was a sale of promissory notes with a prepayment of costs. He found that there was no loss. If the difference between the discounted and face values of the notes were to be regarded as a loss, such loss would not be regarded as being of a capital nature.[199]

Van Dijkhorst J found that the transaction was a loan of money raised on the money market by the taxpayer. B acted for the taxpayer and B's commission and stamp duties were immediate costs.[200] He then considered the

drawn by the taxpayer in favour of B or order, endorsed by B and discounted in the market [194]

On 15 September 1988 the taxpayer issued promissory notes with a face value of R35 million and a redemption date of 15 December 1988 B accepted the notes on 15 September 1988 No money changed hands on this day B retained the monies received in terms of the arrangement with the taxpayer The transactions were reflected in the books of account of the taxpayer [195]

The taxpayer argued that the discount charges, commission and stamp duty constituted an expense incurred on 15 September 1988 The taxpayer's financial year ended on 30 September 1988 It was common cause that the commission and stamp duty were deductible The issue was whether the discount charges were deductible The taxpayer argued that as the discount charges were incurred on 15 September 1988, these expenses were incurred during its financial year ended on 30 September 1988 [196]

Counsel for the Commissioner argued that the discount charges were not incurred in the taxpayer's financial year ended on 30 September 1988 as the taxpayer was only legally liable to pay these expenses on 15 December 1988 It was further contended that, following the decision in ITC 1485, discount charges should be treated as interest and should be calculated de die in diem On this basis, most of the expenses would fall into the following financial year Alternatively, counsel for the Commissioner contended that the transaction

ignoring the English law on discounts and the distinction drawn between interest and discounting by the House of Lords

After these cases, the issue of the deductibility of discount charges was considered by different judges in the Special Courts. The first of these cases was considered by Van Dijkhorst J in ITC 1587 [96]. The facts were that the taxpayer carried on the business of full maintenance leasing. Its issued shares were held, directly or indirectly, by A and B equally. Originally, the taxpayer leased vehicles from B and on-leased them to its customers under full maintenance leases. Subsequently, the taxpayer and B agreed that finance costs could be reduced by raising money in the money market by way of banker's acceptances and similar instruments. The taxpayer would issue promissory notes and these notes would be discounted in the money market by B. The rates would be below the bank overdraft rate. The cost to the taxpayer would be the endorsement commission, stamp duty and a discount charge. These financing arrangements were implemented by the parties. The funds raised in this manner were lent to B at rates which were similar to those charged under the financial leases. The terms upon which B discounted the notes were standard terms applicable to this type of financing. Minor variations were set out in a letter of credit advising of the special terms and conditions. These terms included those dealing with the security, the facility and its cost. The acceptance commission, discount charges and stamp duty became payable whenever a bill was accepted. The promissory notes were

not accrue until maturity. It therefore differs from interest in that interest accrues from day to day or at fixed intervals whereas a discount does not.[187] Thus, particularly in ITC 1496,[188] it was, with respect, inappropriate for Melamet J to seek the analogy of interest in English law in order to justify his contention that discounting expenditure is deductible on an annual basis.

In ITC 1485[189] Melamet J referred to accounting practice in order to confirm the treatment of expenditure which has been incurred but which will only be paid in a later year of assessment. Once again, having referred to Caltex Oil[190] earlier in his judgment,[191] Melamet J chose to ignore this Appellate Division decision which dealt with the same issue. In this regard, it is sufficient simply to refer to the following portion of the judgment of Botha AJA in Caltex Oil:

> 'The court is only concerned with deductions permissible according to the language of the Income Tax Act and not debits made in a taxpayer's books of account for deduction even though considered proper from an accountant's point of view.'[192]

The final comment that can be made on these two judgments of Melamet J is that it is regrettable that, on such an important issue, a judge in a Special Income Tax Court should arrive at an erroneous conclusion and ignore Roman and Roman-Dutch law, decisions of the Appellate Division of the Supreme Court, and selectively quote from certain authorities on English law completely

taxable income Thus, where interest is deemed to have deductible by the issuer of an instrument in terms of s 24J(2), the issuer may not also deduct the discount expenses or interest actually incurred or paid by him in terms of the instrument [241] Where the term of an instrument issued on or before 15 March 1995 is extended or its terms or conditions 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 [242] 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 [243] Section 24J5A) provides that any amount which has been deemed to have been incurred by a person in terms of s 24J shall not be deducted more than once from the income of that person as a result of an application of s 24J

Where there is more than one issuer in relation to an instrument, one must exclude all amounts paid or payable, or received or receivable by other issuers of the instrument when calculating the accrual amount of the holder [244] 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

Once the total amount has been determined, the second part of the calculation is to determine the adjusted gain. This gain constitutes the extent to which the total amount exceeds the sum of the transfer price or redemption payment in question and any payments made by the issuer in terms of the instrument during the accrual period.[228] An example of the calculation of such a gain where an alternative method of calculating interest has not been applied by the issuer is given in the Explanatory Memorandum[229] and has been discussed in chapter 3.

Section 24J(4)(a) provides that an adjusted gain on transfer or redemption of an instrument is deemed to have accrued to such person in the year of assessment in which the transfer or redemption takes place. Where such gain includes an accrual amount or an amount determined in accordance with an alternative method, and such amount has been allowed as a deduction from the income of such issuer during the year of assessment in which the instrument is transferred or redeemed or in a previous year, s 24J(4A)(b) provides that such amount must be included in the issuer's income in the year of assessment in which the instrument is transferred or redeemed.

The adjusted loss incurred by the issuer is calculated by first determining a total amount. Where an alternative method of calculating interest in respect of the instrument has not been applied by the issuer, this is determined by adding the transfer price or redemption payment and any payments made by the issuer in respect of the instrument during the accrual period. The loss constitutes the

R1 000 000 on 31 December 1995 An amount of R1 300 000 is repayable on 31 December 1997 The taxpayer's financial year ends on 28 February The yield to maturity assuming an annual accrual period is 14.01754% per period The cash flows relating to the financial instrument are set out in the table below

| Month | R |
|---|---|
| 31 December 1995 | 1 000 000 |
| 31 December 1996 | 0 |
| 31 December 1997 | (1 300 000) |
| | (300 000) |

Based on these cash flows, the incurral of interest by the taxpayer is set out in the table below

| Tax year | Period | AIM (R) | Note | Yield | Incurral (R) |
|---|---|---|---|---|---|
| 1995/6 | 28 Feb 1996 | 1 000 000 | 1 | 0.1401754 | 22 980 |
| 1996/7 | 31 Dec 1996 | 1 000 000 | 2 | 0.1401754 | 117 195 |
| 1996/7 | 28 Feb 1997 | 1 140 175 | 3 | 0.1401754 | 24 835 |
| 1997/8 | 28 Feb 1998 | 1 140 175 | 4 | 0.1401754 | 133 990 |

| 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 |

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

$$\frac{\text{Total interest} \times \text{Monthly balances}}{\text{Total monthly balances}}$$

The detailed calculation is as follows

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.[237]

The Explanatory Memorandum contains a discussion and example on the alternative methods of reflecting the spread of interest for accounting purposes.[238] 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

payable by him exceeds the interest receivable by him in respect of the instrument, he will be regarded as the issuer."

A company whose business consists of dealing in instruments may elect a different basis for it to be taxed on its interest.[76] The basis on which the company will be taxed will be to apply a market valuation in respect of the instruments. The company must make the election in writing and must submit a statement setting out in detail the methodology that the company 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. 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. 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. 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

redemption proceeds, as the case may be, and any other payments received by the holder during the accrual period in question

Where an alternative method has been applied, the loss is determined by adding the adjusted initial amount in relation to the instrument and all amounts determined by applying the alternative method and any other payments made by the holder in terms of the instrument during the period from acquisition to the date that the instrument is transferred or redeemed There must be deducted from this amount the transfer price or redemption proceeds, as the case may be, and any other payments received by the holder during the accrual period in question

In terms of s 24J(4)(b) any such loss on transfer or redemption of the instrument is deemed to have been incurred in the year of assessment in which the instrument is transferred or redeemed Section 24J(4A)(a) stipulates that where such loss relates to an income instrument representing an accrual amount or an amount determined according to an alternative method and where such amount has been included in the holder's income in a previous year of assessment, such amount is allowable as a deduction from the holder's income in the year of assessment in which the instrument is transferred or redeemed

Where s 24J applies, any interest paid by a person in terms of an instrument is not taken into account for the purposes of s 11 in calculating such person's

extent to which this amount exceeds the initial amount of the instrument, the accrual amounts in relation to previous accrual periods and the current period, and any other payments received by the issuer less any payments made by the issuer in previous accrual periods. Where an alternative method of calculating interest in respect of the instrument has been applied by the issuer, this is determined by adding the transfer price or redemption payment and any payments made by the issuer in respect of the instrument during the period from the date of issue or acquisition of the instrument by the issuer until the issuer transfers or redeems the instrument. The loss constitutes the extent to which the total amount exceeds the initial amount of the instrument, all amounts determined in accordance with such alternative method and any other payments received by the issuer during the period from the date of issue or acquisition of the instrument by the issuer until the issuer transfers or redeems the instrument.[240]

The definition of 'adjusted loss on transfer or redemption of an instrument' contained in s 24J(1) also covers the situation from the viewpoint of the holder of an income instrument.

Where an alternative method has not been applied, the loss is determined by adding the adjusted initial amount in relation to the instrument and the accrual amount in respect of the accrual period in which the instrument is transferred or redeemed. There must be deducted from this amount the transfer price or

1 R1 000 000 x 0,1401754 x 306/366

2 R1 000 000 x 0,1401754 x 306/366

3 R1 140 175 x 0,1401754 x 59/365

4 R1 140 175 x 0,1401754 x 306/365

Where an issuer makes a profit or loss on the sale or redemption of an instrument, the adjusted profit or loss, as the case may be, is deemed to have accrued to him or have been incurred by him, as the case may be, in such year of assessment [27]

The adjusted gain from the issuer's perspective is determined by first determining a total amount Where an alternative method of calculating interest in respect of the instrument has not been applied by the issuer the total amount is determined by adding the initial amount, the accrual amounts in relation to previous accrual periods and any payments received by the issuer less any payments made in previous accrual periods There is added to the adjusted initial amount any payments received by the issuer in the relevant accrual period Where an alternative method of calculating interest in respect of the instrument has been applied by the issuer the total amount is determined by adding the initial amount, and all amounts determined in accordance with the alternative method and any other payments received by the issuer from the date of issue or acquisition until the transfer or redemption of the instrument by the issuer

Having considered the issues arising from the formula, it is now necessary to consider the application of the formula to the issuer of an instrument. There is deemed to have been incurred by the issuer an amount of interest. There are two bases for calculating the interest that is deemed to have been incurred by the issuer. 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.[223] 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 he 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.[224] In the 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.[225]

An example on the incurral 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.[226] In the example the taxpayer enters into an agreement in terms of which he receives an amount of

March 1995. The definition of an instrument contains a general definition, certain inclusions and certain exclusions. The general definition covers any form of interest-bearing arrangement. 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 would qualify for an allowance under s 24(2) of the Income Tax Act.[222] It should be noted that the definition of an instrument does not include a share. It could be argued 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 that are linked to an official price index. It is submitted that the approach adopted in the United Kingdom has merit. Securities that give the holder a proprietorial interest in a company should not be covered by s 24J and securities which do not should be covered by s 24J.

calculating amounts receivable after the date when the calculation is made [217] 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 [218] 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 [219] 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 [220]

The third issue arising from the formula is the meaning of the adjusted initial amount Insofar as an issuer is concerned, it is the sum of the issue price, the accrual amounts from previous accrual periods and any other payments received by the issuer in previous accrual periods less any payments made by him in respect of the instrument [221]

The fourth issue relates to the type of instrument covered by the formula When considering the position of an issuer, the formula applies to instruments This is different from the case of a holder where the formula applies to income instruments 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

produce income [253] There must, therefore, be a factor linking expenditure to income so that it may be established that the expenditure has been incurred in the production of income [254]

The most important factor that the courts have to take into account is the purpose of the act which resulted in the incurring of the expenditure [255] If the act is performed with the purpose of earning income, expenditure attendant upon it is deductible [256] When considering the deductibility of interest, for example, the ultimate use or destination of the money borrowed is not a decisive factor [257]

The act entailing the expenditure must have been incurred with the purpose of earning income [258] It does not matter whether the income will be earned in a year of assessment after that in which the expenditure is incurred [259] The income referred to is income as defined in s 1 of the Income Tax Act, namely, gross income less exempt income [260] Therefore, expenditure incurred in order to produce income which is not from a South African source is not deductible [261]

The expenditure must not be incurred as a scheme to improve the financial appearance of the business [262] nor to enable a company to purchase its own shares, [263] nor to be utilized for non-productive purposes [264] However, if, for example, money is borrowed to fund working capital, the interest incurred on the loan is deductible [265]

87(1) of the Bills of Exchange Act 34 of 1964 as an unconditional liability of the issuer to pay the face value of the note to the note's holder in due course at the note's maturity is a factor against an application of the law of reciprocal obligations to the situation in which a promissory note is issued If this interpretation did not apply, the definition of a promissory note would be ineffective

Having examined the situation where A issues a bill, note or bond to B at a discount on its face value, it is necessary to discuss the situation where B negotiates the instrument to C who presents it for payment at maturity The issue to be considered is at what stage do B and C actually incur their expenditure relating to the transactions If one applies the general principles relating to the incurring of expenditure as discussed above, it is clear that both B and C will have incurred their expenditure when they incurred an absolute liability to pay for the instrument

## 7 5 IN THE PRODUCTION OF INCOME

It is not enough merely to establish that expenditure and losses are deductible if incurred in the year of assessment [90] The expenditure and losses must be connected with the earning of profits and not be incidental to the business being conducted [91] Thus, expenditure and losses must have been incurred in the production of income [92] Generally, expenditure and losses do not directly

The court considered whether the taxpayer incurred an absolute and unqualified legal liability in respect of the deduction sought by it. The court found that, on the evidence, the taxpayer was only required to pay the purchase price in respect of the contracts against receipt of the bills of lading and relevant invoices. The court found that the taxpayer did not incur an unconditional liability to effect payment prior to receipt of the documents.[246]

The court referred to ESE Financial Services (Pty) Ltd v Cramer[247] covering the principle of reciprocal obligations and held that the taxpayer had not incurred an unconditional liability in the year of assessment in question. Accordingly, the court dismissed the taxpayer's appeal.[248]

In ITC 1444 the principle of reciprocal obligations applied in that the liability of the taxpayer to pay the purchase price was conditional upon the performance or tender of performance by the seller.[249] Clearly, the facts of this case were somewhat unusual in that the contract was only concluded when payment for the materials bought was effected. It is submitted that, on the facts of the case, the court correctly applied the principle of reciprocal obligations.

In considering the application of this principle to the issue of a bill, note or bond, it could possibly be argued that the liability of the issuer to pay the face value on the instrument is conditional upon the holder presenting it to him for payment. It is, however, submitted that the definition of a promissory note in s

be distinguished from that in which obligations merely need to be performed consecutively."[42]

The question arose for consideration in ITC 1444.[43] In this case the taxpayer sought to deduct an amount in respect of commitments for production materials. The taxpayer imported certain production materials used in its process of manufacture. The price of these materials in the world market was volatile. The taxpayer sought to protect itself from these price fluctuations. It did so by entering into certain arrangements with the overseas companies. The latter, acting as agents of the taxpayer, entered into contracts to purchase the production materials. The production materials were manufactured from certain raw materials. The contracts for the purchase of the raw materials were such that at no time did the taxpayer actually acquire the raw materials for which the contracts were concluded. The taxpayer merely acquired the right to purchase supplies of the production materials. In addition, the contracts provided a method for determining the price of the production materials.[44]

The amount which the taxpayer sought to deduct was that relating to the purchase of future supplies of the production materials. The delivery of the materials was effected in later years of assessment. The court accepted that the price of the materials was either fixed or determinable and that in each case there was a binding and enforceable contract.[45]

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 to only 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 final question to consider is whether the incurring of a liability in respect of a bill, note or bond is affected by the law relating to reciprocal obligations. The general principle relating to reciprocal obligations is discussed in chapter 3 to the extent that it affects the accrual of gross income. It will be recalled that reciprocal obligations apply in bilateral contracts where one party cannot call upon the other party to perform his obligations under the contract unless he himself has fulfilled his obligations or is ready to perform his part of the contract.[240] In other words, a person's right to performance is conditional on his re-performance of a reciprocal obligation.[241] This type of contract should

| 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 |

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

| Year | Amount (Rands) | Yield to maturity | Actual | Straight-line | Weighted capital |
|---|---|---|---|---|---|
| 0 | xxxxxx | | | | |
| 1 | 1000000 | 1028097 | 1028097 | 1066667 | 1102125 |
| 2 | 1000000 | 1031307 | 1031307 | 1066667 | 1105946 |
| 3 | 1000000 | 1034883 | 1034883 | 1066667 | 1110204 |
| 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 |

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

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 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

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.[20] 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 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 Revenue. 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 first issue is whether one basis of calculation is acceptable in some circumstances and not acceptable in other circumstances. For example, if one

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 | 20 | -96 |
| 3 | 0 | 45 | -109 |
| 4 | 0 | 40 | -98 |
| 5 | 0 | 25 | -61 |
| 6 | 0 | 0 | 0 |

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

| 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** |

| | 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 | 1725 | 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 accruals are, therefore, as follows

| Mont h | Cumulative Accrual | Monthly Accrual |
|---|---|---|
| 1 | 171 | 171 |
| 2 | 309 | 138 |
| 3 | 413 | 104 |
| 4 | 483 | 70 |
| 5 | 518 | 35 |
| 6 | 518 | 0 |
| | 518 | 518 |

to give a precise and comprehensive definition of expenditure of a capital nature [325] In CIR v George Forest Timber Co Ltd [326] and New State Areas Ltd v CIR [327] a general distinction was drawn between capital and revenue expenditure [328]

The word 'capital' must be given its ordinary meaning [329] Capital expenditure includes money and all forms of property which are used or capable of being used to produce income or wealth This is the type of capital that is referred to in the phrase 'expenditure of a capital nature' [330]

The facts of each situation should be examined to determine whether the expenditure in question is of a capital or revenue nature [331] The true nature of each transaction must be examined in order to determine whether the expenditure relating to it is capital or revenue [332] However, the determination as to the capital or revenue nature of expenditure is not always a question of fact [333] The court must examine all the facts including the purpose of the expenditure After the factual situation has been established, the court must determine whether the payment is part of the income producing operations or equipping the income producing machine or structure [334] A recurring payment can still be of a capital nature [335] The purpose of the expenditure is an important factor [336] Generally, expenditure is of a capital nature if it is incurred in creating or acquiring an income producing concern, a source of profit or a capital asset [337] On the other hand expenditure is of a revenue nature if it is part of the cost incidental to the performance of the income producing

In the former type of case, where a person borrows a sum of money and applies it for a purpose which does not produce income, and it is not directly connected with the income earning part of his business, the interest relating to the loan will not have been incurred in the production of income

The approach is different where, for example, B acquires a post-dated promissory note made by A with a face value of R100 for R94 and negotiates it for R96 to C who presents it to A for payment at maturity date The transactions between B and C and C and A are, in effect, sales [119] Thus the R2 profit earned by B in respect of his sale of the note to C, and the R4 profit earned by C on his sale of the note to A, do not constitute interest earned [120] The issue whether the expenditure incurred by B and C is incurred in the production of income is dependent upon the nature of the profit earned by both of them.[121] If the receipts from the disposals of the note by B and C are of a capital nature, then obviously the expenditure incurred by them in acquiring the note does not constitute expenses incurred in the production of income [122] On the other hand, if the receipts are of a revenue nature, then the costs of acquiring the note are expenses incurred in the production of income [123]

## 7 6 NOT OF A CAPITAL NATURE

In order to be deductible under the general deduction formula, expenditure or losses must not be of a capital nature [124] It is both impossible and impractical

In approaching this issue, it must be appreciated that one is concerned with the situation where a person borrows a specific sum of money and applies it to an identifiable purpose which subsequently changes The original purpose of the application of the loan is to produce taxable income whereas the latter purpose does not result in the earning of taxable income

Where a loan is repayable at the instance of the borrower, it can be argued that the interest is not deductible after the change in the original purpose of the loan on the basis that the interest is no longer incurred in the production of income One would have to accept the reasoning of Melamet J in ITC 1500 and the decisions in ITC 953 and ITC 1171 One would, therefore, take the view that the decision in ITC 1013 was incorrect

A similar argument could be advanced where the loan is for a fixed period The position is, however, not certain as there is no direct authority on this question.[318]

It is submitted that the principles applicable to the issue whether interest is incurred in the production of income apply to discount expenses It should be appreciated that original issue discount transactions generally relate to fixed periods The analogous situation with regard to interest would be a loan for a fixed period of time Thus the decisions in ITC 953, ITC 1171 and ITC 1501 would have limited application to original issue discounting transactions

so The taxpayer sought to deduct rental paid by him in the calculation of his taxable income. The Commissioner of Taxes disallowed the deduction and the taxpayer took the matter on appeal to the Special Court [15]

The main issue before the court was whether the termination of the partnership precluded the rental from being an allowable deduction As a partnership is not a legal persona and the taxpayer continued to carry on his profession of accountant, the court held that a dissolution of the partnership did not, per se, affect the deductibility of the rental The court was of the view that rental would not have constituted expenditure incurred wholly and exclusively for the purpose of trade or in the production of income had the taxpayer ceased practising as an accountant upon dissolution of the partnership However, the court held that as the taxpayer continued his profession after the partnership was dissolved, there was a continuity of action sufficient to warrant the statement that the obligations were incurred for the purpose of trade Accordingly, the taxpayer's appeal was allowed [16]

A loan and a lease can have similar income tax consequences in that the borrower and lessee normally have the obligations to pay interest and rents respectively on a regular basis [17] Thus, it is appropriate to compare the decision in ITC 1013 with those in ITC 953 and ITC 1500 and to accept that they are in conflict

ITC 1013[114] which could be referred to support the argument that the original purpose of the expenditure should prevail

Financier and Producer could be distinguished on the basis that they fall with the latter type of case discussed above, namely, the funds were borrowed generally in order to fund the taxpayer's floating capital ITC 729 could be distinguished on the grounds that the court was primarily concerned with whether the taxpayer was carrying on a trade and the specific provision in the Income Tax Act covering the deduction of the payment of annuities to former employees ITC 1029 could be distinguished on the basis that the liability for the expenditure arose prior to the cessation by the taxpayer of his practice

However, ITC 1013 is authority against the proposition advanced by Melamet J The facts of the case were that the taxpayer had carried on an accounting practice n partnership with another person During the existence of the partnership, the partners signed a five-year lease in terms of which they rented certain rooms The rooms which were surplus to their requirements were sublet at a profit

When the partnership dissolved the taxpayer moved out of the premises and joined another firm The taxpayer's former partner remained on the premises and used as much of the accommodation as he required The taxpayer and his former partner remained liable to the lessor of the premises They were able to sublet the vacant room for a few months Thereafter they were unable to do

He took the proposition further

> 'Even where a loan is fixed for a certain period a change in the application of the proceeds of the loan may alter the deductibility of the interest expenditure attaching to that loan '[405]

He referred to ITC 953[406] in support of this latter proposition

The decision in ITC 1500 was set aside by the Appellate Division in CIR v Guiseppe Brollo Properties (Pty) Ltd [407] In that case, Nicholas AJA stated that the enquiry relates mainly to the purpose of the borrowing The ultimate use of the funds may sometimes be relevant On the facts, the court found that the funds were not borrowed in order to produce income nor did the loan increase the taxpayer's capacity to produce income The court found that there was not a variation of the original loan and that there was a connection between the interest expenditure and the original dividend debt

The Appellate Division did not specifically refer to ITC 1171[408] and ITC 1135.[409] ITC 1135 was primarily concerned with the fact that the taxpayer had ceased trading and is not direct authority for the proposition propounded by Melamet J ITC 1171 is more supportive of the approach adopted by Melamet J as it was concerned with the results of the cessation of trade and the incurring of expenditure in the production of income Melamet J omitted to refer to cases such as Financier,[410] Producer,[411] ITC 729,[412] ITC 1029[413] and

This situation should be distinguished from that in which there is a cessation of trade. Whilst it is beyond the scope of this thesis to discuss this matter in detail, it should be noted that the interest will not be deductible where a trade has ceased unless it can be established that the person has continued his trade or profession or that the expenditure was incurred prior to cessation of the trade and there is a link between the business and the expenditure incurred [401]

It has been argued that, in the case of interest, where there is a change in the original purpose of the borrowing the ultimate purpose may determine whether the interest has been incurred in order to produce income [402]

This approach was taken further in ITC 1500[403] in which Melamet J applied principles applicable to the cessation of a trade to those relating to the production of income and stated

> 'Where a loan is raised for one specific purpose but, subsequently, the proceeds of the loan are diverted to another use then, when the loan is not for a fixed period, but is repayable on demand, the deductibility of the interest expenditure must be tested by reference to the purpose of minimising the interest expenditure, day by day, as the liability to pay interest is incurred. The original purpose of the borrowing does not continue to govern the question of the deductibility of the interest expenditure.'[404]

borrowing effects.[294] In doing so, one must assess the closeness of the connection between the borrowing and the income earning operations.[295]

It may be necessary to distinguish between the situation where a person borrows a specific sum of money and applies it to an identifiable purpose and that where a person borrows money generally and on a large scale in order to fund the floating capital of his business.[296]

In the former type of case it is possible to identify a clear causal connection between the purpose of the borrowing and what it actually effects. In the latter type of case it is not possible to determine exactly what a specific borrowing effects. It is only possible to state that the borrowing was effected in order to provide the person with money to run his business. It is not possible to link the borrowing with specific ways in which the capital is employed in the business.[297]

Conversely, where a person borrows a sum of money for use in his business in order to produce income, the interest relating to the loan will have been incurred in the production of income.[298] If, subsequently, in pursuing a legitimate business purpose he invests the money in an investment which does not yield viable income, the interest relating to the loan will still be deductible for income tax purposes.[299] The test applied is the purpose for which the money was borrowed.[300]

Tax Act [287] Thus, if A issues the bill, note or bond, he should do so with the intention of utilizing the proceeds thereof in his income-earning operations [288] In this situation it is clear that the act entailing the expenditure is incurred for the purpose of earning income Therefore, the expenses attendant upon the issue of the bill, note or bond are deductible

The question which then arises is whether the discounting expenses are deductible If it is established that it is necessary for A to issue the bill, note or bond at a discount on its face value and if the issue of a bill, note or bond at a discount is a necessary concomitant of A's business operation, the discounting expense should be deductible, provided the other requirements of the general deduction formula are met [289]

The situation should be no different, in principle, from that in which interest is incurred in respect of money borrowed [290] Where the money borrowed is used for the purposes of a business, the discounting expenses should constitute expenditure actually incurred in the production of the income of the business [291] This should be the case whether the money was borrowed for the acquisition of fixed or floating capital [292]

Thus, it is clear that in applying the purpose test to expenditure on interest one must determine the purpose of the borrowing to which the interest relates [293] If the loan is obtained in the production of income, this test in the general deduction formula will be satisfied It is also important to determine what the

business.[280] Where a sum is borrowed for a specific purpose, there will be a close causal connection between the purpose of the expenditure and what it effects.[281] On the other hand, where money is borrowed generally in order to raise floating capital one cannot say that expenditure was incurred in order to achieve a particular effect. This applies particularly in the case of an institution such as a bank. In this situation it is only possible to state that funds are borrowed to provide capital for the business. It is not possible to link particular funds with certain specific types of expenditure.[282]

In order to determine whether expenditure has been incurred in respect of receipts or accruals which do not constitute income as defined in s 1 of the Income Tax Act, the court must assess the closeness of the connection between the expenditure incurred and the income concerned.[283] In doing so, the court must take into account the purpose of the expenditure and what it actually effects.[284] Where this approach leads to the finding that expenditure was incurred for a dual purpose, the one to produce income as defined in the Income Tax Act, and the other to produce income which is exempt from tax, the expenditure should be apportioned.[285]

Where A issues a bill, note or bond to B at a discount on its face value he is, in effect, incurring a discounting expense in order to obtain the consideration received by him from B. The act entailing the expenditure is the issuing of the bill, note or bond at a discount.[286] In order to be deductible, the instrument must have been issued in order to earn income as defined in s 1 of the Income

exercise of the taxpayer's energy and ability. Thus interest paid on moneys borrowed to acquire the shares was not deductible as the shares had not produced income. There must be a close link between the expenditure and the production of income.[274]

However, where expenditure is incurred for two purposes, the dominant purpose will be the main factor.[275] If the dominant purpose is to produce income and the incidental purpose is not to produce income, the latter purpose will be too remote from the expenditure to affect its allowance.[276] Thus in CIR v Drakensberg Garden Hotel (Pty) Ltd[277] the income from rent and business profits was held to be closely connected with the interest expenditure. The interest was incurred for the main purpose of producing the income. The interest was also incurred for the incidental purpose of producing dividend income. This did not affect the deductibility of the interest.

The purpose for which expenditure is incurred and the closeness of the connection between the expenditure and the income earning operations are both interrelated.[278] Therefore in examining the closeness of the connection between expenditure and income earning operations one should have regard to the purpose and effect of the expenditure.[279]

In certain circumstances it is necessary to distinguish between the case where a person borrows a specific sum of money for a specified purpose and the case where money is borrowed generally in order to raise floating capital for the

Difficulties may arise where money is borrowed for the purpose of earning income and, subsequently, when profits have been accumulated, such profits are utilized for a purpose that does not earn income.[266] The purpose of the expenditure should be the main factor[267] although, where the non-productive income is material, the courts have permitted the deduction of only a portion of the expenditure.[268]

Once it has been established that an act is performed with the purpose of earning income, it is necessary to decide what expenditure is attendant upon it and is therefore deductible.[269] There are three types of expenses which deductible.[270] The first is expenses which are necessary for the performance of the business operation. The second is expenses which are attached to the performance of the business operation by chance. The final type of expenses is those which are bona fide incurred for the more efficient performance of such business operations. These types of expenditure are deductible provided they are so closely connected with the performance of the business operation that it would be reasonable to regard them as part of the cost performing the operation[271] or a necessary concomitant of the operation.[272]

The 'closeness of connection' test is strictly applied by the courts.[273] In CIR v Shapiro the taxpayer was required to hold certain shares in order to hold office as a director. The shares did not produce income. The court held that although the shareholding was a sine qua non to his directorship, it was not the shareholding that produced the income. The income was earned by the

capital employed ceases to be fixed capital and becomes circulating capital or stock in trade [414]

The court referred to Ammonia Soda [415] In this case it was held that fixed capital is that which a company retains in the form of assets. The assets either themselves produce income or are retained by the company and made use of to produce income. Circulating capital is a portion of the subscribed capital used by being temporarily parted with and circulated in the business. It may take the form of money, goods or other assets. It is intended that this form of capital return to the company with an increment and that it is used in this way on a continuous basis. Thus, where a banker lends money to a customer he parts with it. The money circulates and the banker hopes to receive it back with interest.[416]

The court in Salisbury Board of Executors held that the appellant company had not established that it had changed its intention to carry on the business of a lender of money. The loss sustained by it was therefore a loss of a capital nature and was not deductible [417]

This type of situation is different from that in which B and C have acquired claims against third parties and have disposed of them for a profit. In cases like Salisbury Board of Executors money was lent to third parties in order to earn interest. The money represented fixed capital retained by the taxpayer in order to earn interest. In the case of B and C, the capital was utilized by them

The first contention of the appellant company was that the company had one business, that of administering estates and general agency, and that the lending of money was an adjunct and ancillary to the business [409] The court found that the facts did not show this to be the case [410]

The court found that it was part of the business of the company to invest its capital However, any losses incurred in respect of such investments would not necessarily be deductible [411] Losses of capital would not be deductible, whereas a loss in a business of banking or moneylending would be of a revenue nature and therefore deductible

The court stated that the fact that investments changed from time to time did not necessarily show that losses incurred were not of a capital nature In this respect, the intention of the company was an important factor The appellant company's memorandum was fairly restrictive and indicated that the company's object was to deal with the capital by way of investment in the strict sense [412]

The court then considered whether any other factor had intervened to change the company's intention [413] The court found that the system of the company's receiving its money back in instalments enabled it to invest in fresh securities Whilst this indicated a system of moneylending it was not in itself sufficient to establish that such a system existed Where a loan or part of a loan is repaid in a relatively short time, a moneylending business can only be established if the

which time he presented it to A for payment C made a profit on the transaction Although these situations are different, they will be dealt with together.

Essentially B had a claim against A which he sold to C C purchased the claim from B and recovered the amount of the claim from A when it became due [404] Cases which have dealt with the deductibility of claims[405] have generally involved taxpayers lending money to debtors in circumstances in which the debts became irrecoverable The taxpayers sought to deduct the losses on the basis that they fell within the requirements of the general deduction formula.[406]

A good example of this type of case is that of Salisbury Board of Executors Ltd v COT [407] In this case the main business of the appellant company was the administration of estates, representation of absentees and general agency It earned commissions and other revenue from the remainder of its business Most of its issued capital was raised for the purpose of investment or loan

The capital was lent and the appellant company earned raising fees and interest in respect of the loans This part of the appellant company's business brought in work for other parts of its business In the course of its business the appellant company advanced a sum of money to a debtor who died insolvent The appellant company suffered a loss as a result and sought to write it off as a bad debt [408]

He argued that he had incurred a loss of circulating capital which he employed in the production of his income.[401]

The main issue was whether the promissory note formed part of the taxpayer's trading stock. The court examined the difference between fixed and circulating capital. There was no evidence before the court showing that the taxpayer traded in promissory notes. Accordingly, the court found that the transaction was an ordinary loan of money on the security of an interest-bearing promissory note. Thus, the capital invested by the taxpayer constituted fixed capital and the loss was of a capital nature.[402]

This should apply, it is submitted, even though the funds are used to acquire a capital asset.

Having examined the situation where A issues a post-dated note with a face value of, say, R100 to B for R94, it is now necessary to consider the other circumstances relating to the discounting of a negotiable instrument.[403] The transactions to be considered are those in which B acquires the note from A for R94 and negotiates it for R96 to C who presents it to A for payment at its face value of R100.

The positions of B and C are slightly different. B lent money to A and received a promissory note from A. He then sold the promissory note to C at a profit. C acquired the note from B. He held it until the maturity date at

found that the interest was not so closely connected with the capital assets that it was of a capital nature [496]

If one accepts the reasoning in ITC 1124, it is difficult to conceive of a situation in which interest can be expenditure of a capital nature

In view of the fact that interest is of a revenue nature and is deductible if the other requirements laid down in the general deduction formula are met, it has been argued that interest is sui generis and therefore warrants special treatment [497] The question then arises whether the position is different if the acquisition of the capital asset is funded out of the issue of a bill, note or bond at a discount on its face value. There is, in principle, no reason why original issue discount expenses should be treated differently to interest payment [498] In the circumstances, where funds are raised by the issue of a bill, note or bond at a discount and used for the purposes of trade and in the production of income, the discounting expenses should be allowed as a deduction in the calculation of the borrower's taxable income [499]

This approach is supported by the judgment in ITC 257 [500] In that case the taxpayer, who had retired from business, earned income from director's fees, interest and rentals One of the ways in which he earned income was by lending money by issuing short-term post-dated promissory notes The taxpayer suffered a loss on a loan made by way of the issue of a promissory note He sought to deduct this loss in the determination of his taxable income

have been borrowed and used for business purposes constitute expenditure incurred in the production of income [90] The court raised, but did not decide, the question whether interest could be capital expenditure because of its association with the fixed capital into which the loan is converted [91]

In ITC 1124[92] the appellant company had borrowed monies in order to acquire shares in two companies which owned timber plantations The purpose of acquiring the shares was to hold them as capital investments and to ensure a continued supply of timber to a saw milling company in the group to which it belonged The effect of the purchase was that the appellant company would receive dividend income from the two subsidiary companies Such dividend income would be exempt from tax in its hands The appellant company sought to deduct from its income the interest incurred by it on the loan which it took out to acquire the shares of the two companies [93]

The court found that the interest expenditure was not incurred in the production of income and judgment was given in favour of the Commissioner [94] However, the court stated that where money is borrowed for a capital purpose it does not necessarily follow that the interest paid on the loan is also of a capital nature [95] The court held that, on the facts, the interest was not intended to and did not improve, augment or preserve capital assets Nor did the interest form part of or add to the cost of acquiring capital assets Neither did the interest enhance the value of the capital assets Thus, the court

Because each case should be treated on its merits, it is possible that a certain type of expenditure could be capital in the hands of one person and revenue in the hands of another.[185] Whilst the tests have been set out clearly and precisely, the main difficulty remains in endeavouring to apply the tests to the facts of particular cases.[186]

It is necessary to examine all the circumstances surrounding the transaction where A issues a bill, note or bond to B at a discount on its face value

If one applies the purpose test, then if the expenditure is part of the costs incidental to the performance of the income producing operations, it is of a revenue nature and is deductible.[187] This would apply where, for example, the funds raised by A were used to fund work, service, activities or operations of a business

However, the position is not so clear where the funds were used to acquire a capital asset used in a business. If loan capital were used to fund the acquisition, the interest paid on the loan would probably be an allowable deduction if all the other requirements of the general deduction formula were met.[188] If the purpose test were strictly applied, it could be argued that the interest payment was capital expenditure and not deductible.[189]

The question whether interest payments are capital or revenue expenditure is by no means clear. In Genn the court held that interest paid on monies which

a mine was held to have been an enduring benefit.[176] It should be appreciated that phrases such as 'enduring benefit' are essentially descriptive rather than definitive.[177] In addition, there have been cases in the United Kingdom where lump-sum payments have been held to be revenue expenditure in circumstances where they were securing lasting benefits.[178]

For example, the enduring benefit test did not apply to advances paid against anticipated commissions.[179] Expenditure on the improvement of knowledge and technical expertise has been held to be of enduring benefit and, therefore, of a capital nature.[180] However, where expenditure is incurred in acquiring knowledge and product knowledge which is short-lived and continually changing, it cannot be stated that the expenditure is of an enduring or lasting character. In these circumstances it may be possible to establish that the expenditure is closely and directly related to the taxpayer's income earning operations and is, therefore, of a revenue nature.[181] Legal expenses incurred in unsuccessfully opposing an application for an interdict preventing the taxpayer from infringing a copyright have been held to be of a revenue nature.[182]

The test is of limited application. It only applies where a payment is made 'once and for all'. It does not cover the situation where recurrent payments are of a capital nature.[183] The real test is between expenditure which is made to meet a continuous demand rather than a payment made once and for all.[184]

Examples of circulating capital are the trading stock of a trading company and money lent to a customer by a banker during the normal course of banking business.[165] An example of fixed capital is a loan or loans made by a person who is not carrying on the business of a moneylender.[166]

Tests derived from United Kingdom authorities have been used to assist in determining whether expenditure is capital or revenue.[167] One such test is where a payment is made once and for all it is capital expenditure and where it is recurrent it is revenue expenditure.[168] This test applies only to the form and not the substance of a transaction.[169] Thus, it is of no assistance where a capital asset is paid in instalments or where revenue expenditure is commuted and paid in one lump sum.[170] This test was not, however, intended to be decisive in every case and it has not been generally applied in South Africa.[171]

A further test derived from United Kingdom authorities is that expenditure is capital where it is made not only once and for all but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade.[172] By 'enduring' is meant enduring in the way that fixed capital endures.[173] There is a certain amount of difficulty in applying this test because it is not clear how long an asset or advantage should endure in order to constitute capital expenditure.[174] It has been held that phrases such as 'enduring benefit' were only introduced in order to make it clear that the 'asset' or 'right' acquired had enough durability in order to justify its being regarded as a capital asset.[175] Thus, for example, a payment to secure an advantage for the productive life of

has been lost, the loss is of a capital nature, and if floating capital has been lost, the loss is of a revenue nature [458]

When the capital employed in a business changes frequently, from money to goods and vice versa, and this is done in order to make a profit, the capital employed in this manner is floating capital [459]

The distinction between fixed and floating capital is that floating capital is consumed or disappears in the process of production whereas fixed capital remains intact.[460] Fixed capital constitutes assets which produce income.[461] The assets may produce income without further action by the company or they may be made use of by the company to produce income [462] Fixed capital is not consumed in the process of producing income In a situation where a loan of money constitutes fixed capital the lender does not retain ownership of the actual money lent However, in an economic and accounting sense, it remains his capital. The money returns to the lender upon termination of the loan The interest paid to the lender by the borrower for the use of the capital is the lender's consideration The interest is not the augmented proceeds of the capital lent and the capital has not disappeared in the process [463] Where a person carries on the business of banking or moneylending, loan losses resulting from the carrying on of his business are of a revenue nature and therefore deductible [464]

with the taxpayer's income earning operations that the court regarded it as part of the cost of earning the profits.[349] In the circumstances, the expenditure was found to be of a revenue nature.[350]

Where an amount is paid for the cancellation of an agreement, the question which must be asked is whether the cancellation results in the reduction or avoidance of a financial disability or whether it results in the establishment of a new income producing structure.[351] Examples of cancellation payments made which did not affect the income earning structure are a payment by a landlord to a tenant for the early termination of a lease;[352] and a payment by a principal to an agent in order to terminate an onerous agency contract because of the size of commissions paid to agents.[353] Examples of cancellation payments which affected the income earning structure are a termination payment made to a tenant in order for the landlord to obtain occupation of the leased premises and an adjoining premises which provided a new income producing structure;[354] a payment made in order to secure the earlier completion of a building which would result in the earlier receipt of rent;[355] and a payment by a franchiser to a franchisee to cancel the franchise agreement and take over the franchisee's business for its own account.[356]

Where a taxpayer is carrying on a business, such as a moneylending business and where the capital advanced by it has become irrecoverable, it is necessary to determine whether fixed or floating capital has been lost.[357] If fixed capital

operation.[138] Thus, money spent in acquiring a source of profit is capital expenditure whereas money spent in operating it is revenue expenditure.[139] In ascertaining the nature of expenditure, the court must assess the closeness of the connection between the expense and the income earning operations.[140] The closeness of the connection is not defined.[141] The court must consider whether it would be proper, natural or reasonable to regard the expenses as so linked in the circumstances being considered.[142] It must consider the purpose and effect of the expense.[143]

Expenditure incurred in protecting the income earning structure would be treated as capital as there is not a sufficiently close link between the expenditure and the income earning operation.[144]

Payments made in terms of an agreement whereby the taxpayer acquired the right to prevent a competitor from competing with its main business for a number of years were held to be capital.[145] The taxpayer's income-producing structure included its goodwill. The agreement not only preserved the goodwill but enhanced the possibility of its increase. The agreement conferred upon the taxpayer the advantage of eliminating a competitor.[146] This case can be distinguished from another case where expenditure was incurred in order to prevent the registration by a competitor of a trade label which was similar to that of the taxpayer.[147] The court found that the validity of the taxpayer's own label was not in issue.[148] The main purpose of the expenditure was to protect and increase the taxpayer's profits. The expenditure was so closely connected

35 ITC 169 (1930) 5 SATC 162, Port Elizabeth Electric Tramway Co Ltd v CIR, ITC 380 (1937) 9 SATC 347, ITC 542 (1941) 13 SATC 116, ITC 674 (1949) 16 SATC 235, ITC 1218 (1974) 36 SATC 212, ITC 1495 (1991) 53 SATC 216, ITC 1516 (1992) 54 SATC 101, ITC 1531 (1992) 54 SATC 323, ITC 1545 (1992) 54 SATC 464

36 ibid

37 ITC 380 (1937) 9 SATC 347 at 348 It will be noted that this test was laid down in an unreported case no 1877 It was also referred to with approval in ITC 542 (1941) 13 SATC 116 at 118

38 ITC 380 (1937) 9 SATC 347 at 348

39 ITC 169 (1930) 5 SATC 162, ITC 380 (1937) 9 SATC 347, ITC 505 (1941) 12 SATC 160, Pyott Ltd v CIR (1945) 13 SATC 121, ITC 969 (1961) 24 SATC 777, ITC 1545 (1992) 54 SATC 464 In ITC 674 (1949) 16 SATC 235 it was held that a liability to pay expenditure had been actually incurred See also ITC 1094 (1966) 28 SATC 275

40 See ITC 1075 (1965) 28 SATC 17, ITC 1117 (1968) 30 SATC 130, ITC 1121 (1968) 30 SATC 171

41 ITC 1218 (1974) 36 SATC 212 at 215

24 ITC 328 (1935) 8 SATC 258

25 ITC 13 (1924) 1 SATC 118, ITC 286 (1933) 7 SATC 322, Arenson v CIR (1948) 15 SATC 144, ITC 1195 (1973) 35 SATC 231, ITC 1483 (1990) 52 SATC 306

26 Joffe & Co (Pty) Ltd v CIR at 360

27 C Divaris 'The Caltex Case Part I' (1975) 14 ITR 11 at 12-14

28 Caltex Oil (SA) Ltd v SIR (1975) 37 SATC 1, Divaris at 12-14 In Caltex a liability to pay for trading stock was incurred in pounds sterling which is not legal tender in South Africa

29 ITC 1218 (1974) 36 SATC 212 at 214

30 ITC 169 (1930) 5 SATC 162, COT v BSA Co Investments Ltd (1966) 28 SATC 1, ITC 1218 Joffe & Co (Pty) Ltd v CIR

31 Discount expenses involve a voluntary payment of money which falls within the meaning of expenditure See n 3 above

32 ibid

33 s 11(*a*) of the Income Tax Act 58 of 1962

34 Port Elizabeth Electric Tramway Co Ltd v CIR (1936) 8 SATC 13

14 ITC 902 (1960) 23 SATC 511, ITC 1056 (1964) 26 SATC 270, T Co Ltd v COT (1966) 28 SATC 67, ITC 1109 (1967) 29 SATC 161, ITC 1204 (1973) 36 SATC 49, ITC 1232 (1975) 37 SATC 145, ITC 1308 (1978) 42 SATC 154, ITC 1499 (1989) 53 SATC 266

15 ITC 27 (1924) 1 SATC 218, ITC 207 (1931) 6 SATC 54, ITC 223 (1931) 6 SATC 150, ITC 303 (1934) 8 SATC 72

16 ITC 289 (1933) 7 SATC 331, ITC 686 (1949) 16 SATC 490, ITC 1030 (1963) 26 SATC 59, ITC 1268 (1977) 40 SATC 57

17 ITC 249 (1932) 7 SATC 49

18 ITC 185 (1930) 5 SATC 273

19 ITC 359 (1936) 9 SATC 182, ITC 904 (1959) 24 SATC 84

20 ITC 114 (1928) 4 SATC 64, Anglo American Corporation of SA Ltd v COT (1975) 37 SATC 45, Plate Glass & Shatterprufe Industries (Finance Co) (Pty) Ltd v SIR (1979) 41 SATC 103, ITC 1460 (1989) 51 SATC 152, ITC 1531 (1991) 54 SATC 323

21 ITC 44 (1925) 2 SATC 116, ITC 1082 (1966) 28 SATC 151, Stone v SIR (1974) 36 SATC 117, Platt v CIR (1922) 32 SATC 1

22 ITC 278 (1933) 7 SATC 246, ITC 405 (1938) 10 SATC 133

23 ITC 332 (1935) 8 SATC 269

7 ITC 870 (1959) 23 SATC 79

8 Lockie Bros Ltd v CIR (1922) 32 SATC 150, ITC 184 (1930) 5 SATC 268, ITC 289 (1933) 7 SATC 331, ITC 686 (1949) 16 SATC 490, ITC 733 (1951) 18 SATC 111, ITC 815 (1955) 20 SATC 487, ITC 894 (1959) 23 SATC 475, ITC 1221 (1974) 36 SATC 233, ITC 1242 (1975) 37 SATC 306, ITC 1383 (1978) 46 SATC 90

9 COT v BSA Co Investments Ltd (1966) 28 SATC 1

10 ITC 1361 (1981) 44 SATC 176

11 ITC 331 (1935) 8 SATC 266, Salisbury Board of Executors Ltd v COT, Southern Rhodesia (1941) 12 SATC 1, Atlantic Refining Co of Africa (Pty) Ltd v CIR (1957) 21 SATC 203, ITC 999 (1962) 25 SATC 183, ITC 1003 (1963) 25 SATC 237, ITC 1009 (1963) 25 SATC 277, ITC 1219 (1974) 36 SATC 218, ITC 1270 (1977) 40 SATC 65, ITC 1284 (1978) 41 SATC 45, COT v A Co (1979) 41 SATC 59, ITC 1321 (1980) 42 SATC 269, ITC 1327 (1980) 43 SATC 47, ITC 1344 (1981) 44 SATC 19, ITC 1363 (1982) 45 SATC 17, Solaglass Finance Co (Pty) Ltd v CIR (1991) 53 SATC 1, Burman v CIR (1991) 53 SATC 63

12 Palabora Mining Co Ltd v SIR (1973) 35 SATC 159

13 ITC 881 (1959) 23 SATC 237, ITC 1013 (1963) 25 SATC 321, ITC 1292 (1979) 41 SATC 163, ITC 1367 (1982) 45 SATC 39, ITC 1404 (1985) 48 SATC 1

## FOOTNOTES

1 58 of 1962

2 (1946) 13 SATC 354

3 Joffe & Co (Pty) Ltd v CIR at 360 This meaning has been referred to with approval in Stone v SIR (1974) 36 SATC 117, ITC 1218 (1974) 36 SATC 212, Solaglass Finance Co (Pty) Ltd v CIR (1991) 53 SATC 1 at 22-3, 1991 (2) SA 257 (A) at 279, CIR v Felix Schub (SA) (Pty) Ltd (1994) 56 SATC 57 at 68-9, 1994 (2) SA 801 (A) at 812, Sentra-Oes Kooperatief Bpk v KBI (1995) 57 SATC 109 at 115 See also A S Silke 'Exchange Losses on Foreign Currency Borrowings' (1975) 14 ITR 213 at 217 A similar approach was adopted in the United Kingdom in Allen (HM Inspector of Taxes) v Farquharson Bros & Co 17 TC 59

4 Joffe & Co (Pty) Ltd v CIR at 360

5 ITC 1060 (1963) 26 SATC 313

6 ITC 1300 (1979) 42 SATC 52

actually incurred when there is an absolute liability to pay for the instrument. The issue whether the expenditure is incurred in the production of income will depend upon the nature of the profit earned on the disposal of the instrument. If the profit is of a revenue nature then, clearly, the expenditure will have been incurred in the production of income. If a person acquires a negotiable instrument and the instrument forms part of his trading stock and if the proceeds from its sale will be of a revenue nature, then the cost of acquiring it will also be of a revenue nature

of the issue in the issuer's income earning operations In these circumstances the act entailing the expenditure will have been incurred in order to earn income Therefore, the expenses attendant upon the issue of the instrument, such as discounting expenses, are incurred in the production of income.

The discounting expenses will be of a revenue nature where the money raised by the issuer is used as part of his working capital or to fund working capital The position is not so clear where the money raised from the issue of the instrument is used to acquire a capital asset used in a business. If the purpose test is strictly applied it could be argued that the expense is of a capital nature and not deductible It can, however, be strongly argued that discounting expenses, like interest, are not intended to and do not improve, augment or preserve capital assets Nor do they form part of or add to the cost of acquiring capital assets Thus, it can be argued that discounting expenses, like interest, are not so closely connected with capital assets that they are of a capital nature If one accepts this argument then, effectively, discounting expenses and interest are treated in a similar manner to rental paid

In the case of the sale of a negotiable instrument, where the transaction is part of a profit-making business operation it will clearly involve expenditure incurred in the carrying on of a trade The cost of acquiring an instrument will constitute expenditure and the expenditure will have been

maturity basis of valuation It is not clear what would constitute a significant difference

There are a number of issues which arise as a result of applying an alternative basis of calculation The first issue is whether one basis of calculation is acceptable in some circumstances and not acceptable in other circumstances The second issue is that it is not clear how high the percentage variation should be before it becomes unacceptable to the Commissioner It is clear from the examples 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 in certain circumstances This raises the question whether the straight-line basis of valuation is acceptable in this situation It is submitted that, referring to some of the examples, 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

The discounting expenses will be incurred in the production of income where the instrument is issued with the intention of utilizing the proceeds

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

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

$$\frac{\text{Total interest} \times \text{Monthly balances}}{\text{Total monthly balances}}$$

The straight-line method of calculating the accruals involves an equal allocation of the interest over the period involved The actual interest calculation and the calculation based on the yield to maturity have the same results. 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. 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

liability to pay its face value on maturity date. This liability will therefore be absolute provided no conditions are attached to it

There were two decisions of the Special Court in which it was held that discounting expenditure is akin to interest It was held further that interest accrues from day to day and that therefore the discount expenses were not incurred when the bill, note or bond was issued These decisions are open to criticism Subsequently, there were two further decisions of the Special Court which dealt with the same issue These decisions were that the discounting expenses were incurred when the instruments were issued It is respectfully submitted that these decisions were correct

As a result of these conflicting decisions, s 24J was enacted In effect, s 24J provides that discounting expenses should be deducted on an annual basis The annual deductions are calculated on the amount incurred annually on the basis of the yield to maturity The second basis is to calculate the interest by applying an alternative method 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 In the Explanatory Memorandum three alternative methods are referred to These are those based on the weighted

In both types of transactions the deductibility of expenditure incurred is governed by the general deduction formula The provisions of s 22 also apply in the case of the purchase and sale of a negotiable instrument

In the case of the issue of a negotiable instrument at a discount, the discount is akin to interest Thus, where such a transaction takes place prior to the issuer's commencing trade, the discounting expenses will be deductible in terms of s 11(δA) of the Income Tax Act The discounting expenses clearly constitute expenditure incurred by the issuer of the instrument

The stage at which the discounting expenditure is incurred by the person issuing the instrument is a fairly complicated issue There are advantages to the issuer if the expenses are incurred at the time of the making of the instrument, particularly in the case of a deep discount bond If the expenses are incurred at this stage then the financing costs which may relate to the use of the money borrowed for a number of years may be deductible at the outset The issue is dependent upon whether the making of a deep discount bond has the effect of creating an absolute liability to pay the face value of the bond at maturity If so the liability to pay is incurred at the outset If not, then a mere contingent liability is created and it cannot be said that the liability has been actually incurred for the purposes of the general deduction formula As a deep discount bond is a form of promissory note, it constitutes, by definition, an unconditional

to acquire claims against third parties [418] The claims were acquired for resale at a profit.[419] They therefore constituted stock in trade [420] Thus, the capital was utilized by B and C as circulating capital [421]

In the circumstances it is clear that if B and C utilize the promissory notes acquired by them as part of their trading stock and if the proceeds from the sale of the notes constitute income in their hands, the cost of acquiring the notes should be of a revenue nature [422] If the other requirements of the general deduction formula are met, the cost of the note will be deductible. [23]

7 7 CONCLUSION

In examining the deduction of expenditure incurred in discounting transactions, two basic types of transactions must be examined The first is essentially a transaction of loan. This arises where a post-dated bill, note or bond is issued at a discount on its face value The person to whom the instrument is issued is, in effect, lending money to the issuer of the instrument The discount constitutes the expenditure incurred by the issuer of the instrument The second type of transaction is where the holder of a bill, note or bond negotiates it to a third party This transaction is one purchase and sale The expenditure incurred by the holder is the cost of the instrument and the sale proceeds should constitute gross income

166 1943 AD 595

167 at 602

168 See also Bennett v Ogston (Inspector of Taxes) 15 TC 374 and Riches v Westminster Bank Ltd 28 TC 159

169 This arises by virtue of the different wording of these sections of the Income Tax Act 58 of 1962

170 See n 168 above

171 Pyott Ltd v CIR (1945) 13 SATC 121 This Appellate Division decision is authority for the proposition that English cases based on the concept of profits and gains in English taxing statutes are not of assistance in interpreting the definition of taxable income in the Income Tax Act 58 of 1962

172 See C Divaris and M L Stein Silke on South African Income Tax 11 ed (1994) at para 25 4

173 See 'Interest The Time Factor in Accruals and Deductions' 39 The Taxpayer 181

174 9 TC 577

175 577-9

176 at 579

177 at 580-1

154 Halsbury The Laws of England 32 at para 106, and Halsbury The Laws of England 33 at para 524

155 Words and Phrases Legally Defined s v 'Interest' at 564

156 The South African Law of Obligations at para 174

157 Lee & Honore

158 R W Lee & A M Honoré The South African Law of Obligations 2 ed (1978) (E Newmann & D J McQuoid-Mason)

159 See, for example, Kelly v Holmes Bros 1927 OPD 29, McCabe v Burisch 1929 TPD 261, Bernitz v Euvrard 1943 AD 595

160 Van Leeuwen Censura Forensis 1 4 4 31

161 Voet Commentarius ad Pandectas 12 1 20

162 Voet 22 1 9

163 Van der Keessel Theses Selectae 542 De Villiers JP in Kelly v Holmes Bros at 32 was of the opinion that Van der Keessel could have been right in distinguishing between loans of money on interest and money debts His reason for this view was that a loan on interest in normally an investment by a creditor for a fixed period

164 Kelly v Holmes Bros at 31-3

165 at 32 This passage was quoted with approval in McCabe v Burisch at 265

141 ibid

142 ibid

143 A holder in due course is defined in s 27(1) of the Bills of Exchange Act 34 of 1964 as a holder who has taken a bill, which is complete and regular on the face of it, under certain circumstances First, he must have become the holder of the bill before it becomes overdue and, if it had previously been dishonoured, without notice of it Second, he must have taken the bill in good faith and for value At the time the bill was negotiated to him, he must have had no notice of any defect in the title of the person who negotiated it

144 s 36(b) of the Bills of Exchange Act 34 of 1964

145 s 92

146 (1991) 53 SATC 229

147 ibid

148 ibid

149 Adams v SA Motor Industry Employers Association

150 (1975) 37 SATC 1

151 at 15

152 (1990) 52 SATC 337

153 (1991) 53 SATC 229

131 Akbar Khan v Attar Singh at 549-50

132 An instrument may rank as a negotiable instrument despite the fact that the obligation is not unconditional This definition arises by virtue of mercantile usage The requirement of a bill of exchange or promissory note containing an unconditional undertaking or promise, as the case may be, is laid down in ss 2 and s 7(1) of the Bills of Exchange Act 34 or 1964 See Cowen & Gerring at 153

133 Hill v The Colonial Banking & Trust Co 1937 TPD 138 at 148

134 ibid

135 See s 87(1) of the Bills of Exchange Act 34 of 1964

136 The three conditions being that the loan was in existence, the interest remained unpaid at the date of payment and the holder of the instrument was able to establish title to it

137 See L Tager Negotiable Instruments (1984) at para 2

138 Tager at para 4

139 ibid See also Saambou-Nasionale Bouvereniging v Friedman 1979 (3) SA 978 (A), Froman v Robertson 1971 (1) SA 115 (A), Adams v SA Motor Industry Employers Association 1981 (3) SA 1189 (A) at 1199-1200

140 Adams v SA Motor Industry Employers Association

121 ITC 1485 (1990) 52 SATC 337 at 342, ITC 1496 (1991) 53 SATC 229 at 248

122 Words and Phrases Legally Defined 3 ed s v 'Interest' at 564

123 R W Lee & A M Honore The South African Law of Obligations (1950) at para 174

124 ITC 1485 (1990) 52 SATC 337 at 341 and ITC 1496 (1991) 53 SATC 229 at 249

125 ITC 1485 (1990) 52 SATC 337 at 342 - 3

126 ITC 1485 (1990) 52 SATC 337 at 343, ITC 1496 (1991) 53 SATC 229 at 249

127 ITC 1485 (1990) 52 SATC 337 at 342 and ITC 1496 (1991) 53 SATC 229 at 248

128 South African NCDs sometimes restrict the type of person who may own the certificate. For example, ownership of the certificate may be restricted to companies and corporate bodies or residents of South Africa. See Cowen & Gerring at 291-5

129 Customs & Excise Commissioners v Guy Butler (International) Ltd (1976) 2 All ER 700 (CA) at 702 and 711

130 ibid

108 ITC 1496 (1991) 53 SATC 229

109 ITC 1485 (1990) 52 SATC 337 at 341-3, ITC 1496 (1991) 53 SATC 229 at 248 - 9

110 ITC 1485 (1990) 52 SATC 337, and ITC 1496 (1991) 53 SATC 229 at 248

111 ibid

112 (1975) 37 SATC 1at 12

113 (1986) 48 SATC 55 at 65

114 (1988) 50 SATC 81

115 ITC 1485 (1990) 52 SATC 337 at 341-2, ITC 1496 (1991) 53 SATC 229 at 248

116 ITC 1485 (1990) 52 SATC 337 at 342, ITC 1496 (1991) 53 SATC 229 at 248

117 ibid

118 ibid

119 ibid

120 See Halsbury The Laws of England 4 ed 32 at para 106, and Halsbury The Laws of England 4 ed 33 at para 524

93 ITC 1485 (1990) 52 SATC 337, ITC 1496 (1991) 53 SATC 229

94 The deduction of such expenditure is claimed under s 11(*a*) of the Income Tax Act 58 of 1962

95 (1990) 52 SATC 337

96 at 340

97 ibid

98 (1991) 53 SATC 229

99 at 246-7

100 at 248-9

101 ITC 1485 (1990) 52 SATC 337at 343, and ITC 1496 (1991) 53 SATC 229 at 2?4

102 ITC 1485 (1990) 52 SATC 337 at 340

103 ITC 1496 (1991) 53 SATC 229 at 247

104 See H B Falkena, L J Fourie & W J Kok at 236

105 ibid

106 ITC 1485 (1990) 52 SATC 337 at 340 - 1

107 See s 87(1) of the Bills of Exchange Act 34 of 1964

79 ibid

80 at 72-3

81 at 69

82 (1988) 50 SATC 81

83 at 93-4

84 at 94

85 at 93

86 at 89-93. The minority judgment was delivered by Nicholas AJA at 93-8

87 at 90

88 ibid

89 at 93

90 Caltex Oil (SA) Ltd v SIR, Nasionale Pers Bpk v KBI, CIR v Edgars Stores Ltd

91 ITC 326 (1935) 8 SATC 252, Concentra (Pty) Ltd v CIR, ITC 608 (1945) 14 SATC 370, Sub-Nigel Ltd v CIR (1948) 15 SATC 381, Caltex Oil (SA) Ltd v SIR

92 Nasionale Pers Bpk v KBI, H Vorster 'Unquantified and Defeasible Expenses Incurred in the Production of Income' (1985) 1 SATJ 1 at 8-9

Nasionale Pers Bpk v KBI (1986) 48 SATC 55, CIR v Edgars Stores Ltd (1988) 50 SATC 8, ITC 1495 (1991) 53 SATC 216, ITC 1516 (1992) 54 SATC 101

68 ibid

69 See Pyott Ltd v CIR. , Nasionale Pers Bpk v KBI, CIR v Edgars Stores Ltd

70 See n 67 above

71 ITC 380 (1937) 9 SATC 347 and ITC 969 (1961) 24 SATC 777

72 (1937) 9 SATC 347

73 at 348

74 ibid It could, possibly, be argued that the deduction in respect of the commission actually paid to the agent had not been incurred by the company until the sales had been completed This argument assumes that a liability is not actually incurred when payment is made As the issue of a bond at a discount does not involve payment prior to the incurring of the liability to pay, this question is beyond the scope of this thesis

75 (1961) 24 SATC 777

76 at 786-7

77 (1986) 48 SATC 55

78 at 68

59 See the definition of a bill of exchange in s 2 of the Bills of Exchange Act 34 of 1964

60 Akbar Khan v Attar Singh (1936) 2 All ER 545 (PC) See also D V Cowen & L Gerring Cowen on the Law of Negotiable Instruments in South Africa 5 ed (1985) at 225-30

61 ibid

62 This follows if one has regard to the definition of a promissory note in s 87(1) of the Bills of Exchange Act 34 of 1964

63 ibid.

64 See ITC 969 (1961) 24 SATC 777

65 ibid.

66 ibid

67 ITC 169 (1930) 5 SATC 162, ITC 183 (1930) 5 SATC 262, ITC 326 (1935) 8 SATC 252, ITC 380 (1937) 9 SATC 347, ITC 423 (1939) 10 SATC 335, ITC 505 (1941) 12 SATC 160, ITC 508 (1941) 12 SATC 238, ITC 537 (1942) 13 SATC 104, ITC 542 (1942) 13 SATC 116, ITC 545 (1943) 13 SATC 193, Pyott Ltd v CIR (1945) 13 SATC 121, ITC 608 (1945) 14 SATC 370, ITC 674 (1949) 16 SATC 235, ITC 684 (1949) 16 SATC 368, ITC 711 (1950) 17 SATC 332, ITC 840 (1957) 21 SATC 424, ITC 969 (1961) 24 SATC 777, ITC 1094 (1966) 28 SATC 275, ITC 1117 (1968) 30 SATC 130, ITC 1120 (1968) 30 SATC 171, ITC 1346 (1981) 44 SATC 31,

50 ITC 564 (1944) 13 SATC 326, ITC 666 (1948) 16 SATC 130, ITC 696 (1950) 17 SATC 86, ITC 786 (1954) 19 SATC 421, ITC 1150 (1970) 33 SATC 131; ITC 1332 (1980) 43 SATC 87

51 See ss 11(*a*), 11(*h*) and 23(*g*) of the Income Tax Act 58 of 1962

52 ITC 169 (1930) 5 SATC 162, Port Elizabeth Electric Tramway Co Ltd v CIR, ITC 380 (1937) 9 SATC 347, ITC 542 (1941) 13 SATC 116, ITC 674(1949) 16 SATC 235, ITC 1218(1974) 36 SATC 212.

53 ibid. For an overview of money market instruments see H G Falkena, L J Fourie & W J Kok The Mechanics of the South African Financial System 3 ed (1989) at 209 - 245

54 A promissory note is defined in s 87 of the Bills of Exchange Act 34 of 1964 as an unconditional promise in writing, made by one person to another, signed by the maker, and engaging to pay on demand or at a fixed or determined future time, a sum certain in money to a specified person or his order, or to bearer

55 ibid

56 See chapter 6 section 6 5 above

57 Particularly if one has regard to the definition of a promissory note see n 54 above

58 See n 54 above

42 ITC 47 (1925) 2 SATC 120, Baxter v COT (1937) 9 SATC 1, Concentra (Pty) Ltd v CIR (1942) 12 SATC 95, Caltex Oil (SA) Ltd v SIR This applies in respect of the general deduction formula There are provisions in the Income Tax Act which, in effect, constitute exceptions to this rule See, for example, s 22

43 ITC 508 (1941) 12 SATC 238, Concentra (Pty) Ltd v CIR, Caltex Oil (SA) Ltd v SIR

44 ibid

45 Concentra (Pty) Ltd v CIR, ITC 1499 (1989) 53 SATC 266

46 Sub-Nigel Ltd v CIR (1948) 15 SATC 381, ITC 1094 (1966) 28 SATC 275

47 ITC 329 (1935) 8 SATC 252, Concentra (Pty) Ltd v CIR, ITC 608 (1945) 14 SATC 370

48 Caltex Oil (SA) Ltd v SIR In Palabora Mining Co Ltd v SIR the court allowed the deduction of expenditure, part of which had been incurred in previous years of assessment This factor was not, however, an issue raised before the court

49 See for example ITC 1332 (1980) 43 SATC 87 where, inter alia, the factual position was examined

329 Smith v SIR (1968) 30 SATC 35 at 40, ITC 1401 (1985) 47 SATC 171 at 174, ITC 1539 (1990) 54 SATC 394 at 397, ITC 1528 (1991) 54 SATC 243

330 Smith v SIR at 37, ITC 1401 (1985) 47 SATC 171at 174

331 New State Areas Ltd v CIR, ITC 1195 (1973) 35 SATC 231, Solaglass Finance Co (Pty) Ltd v CIR

332 New State Areas Ltd v CIR, ITC 946 (1961) 24 SATC 459 at 462, Harry S Hopkins (Pvt) Ltd v COT (1961) 24 SATC 594, SIR v Cadac Engineering Works (Pty) Ltd, ITC 1401 (1985) 47 SATC 171, ITC 1154 (1970) 33 SATC 159 at 160, ITC 1528 (1991) 54 SATC 243 at 247

333 SIR v Cadac Engineering Works (Pty) Ltd at 70

334 at 72, ITC 1370 (1982) 45 SATC 55 at 56-7

335 ITC 98 (1927) 33 SATC 247, ITC 353 (1936) 9 SATC 82

336 See n 331 above

337 CIR v George Forest Timber Co Ltd, New State Areas Ltd v CIR, CIR v African Oxygen Ltd, COT v Rhodesia Congo Border Timber Co Ltd (1961) 24 SATC 602, Nchanga Consolidated Copper Mines Ltd v COT (1962) 24 SATC 462, (1964) 26 SATC 37, Van Leer Packaging (Rhodesia) (Pvt) Ltd v COT (1971) 33 SATC 19, ITC 1066 (1964) 27 SATC 114, Atlantic Refining Co of Africa (Pty) Ltd v CIR, ITC 1063 (1964) 27 SATC 57, ITC 1154 (1970) 33 SATC 159, ITC 1224 (1974) 37 SATC 30 at 31-2

315 ITC 1013 (1963) 25 SATC 321 at 321 - 2

316 at 324

317 Tager (1976) 93 SALJ 12 at 23-4

318 ibid

319 See chapter 2

320 ibid

321 Port Elizabeth Electric Tramways Co Ltd v CIR

322 s 11(*a*) of the Income Tax Act

323 ibid

324 ibid

325 Sub-Nigel Ltd v CIR. SIR v Cadac Engineering Works (Pty) Ltd (1965) 27 SATC 61. CIR v African Oxygen Ltd

326 (1924) 1 SATC 20 See also TI Ltd v COT (1961) 24 SATC 136. Lambson v CIR (1945) 14 SATC 57. ITC 359 (1936) 9 SATC 182. ITC 1063 (1964) 27 SATC 57. Atlantic Refining Co of Africa (Pty) Ltd v CIR (1957) 21 SATC 203 at 208

327 (1946) 14 SATC 155

328 CIR v African Oxygen Ltd

301 ITC 19 (1924) 1 SATC 130, ITC 411 (1938) 10 SATC 238, ITC 490 (1941) 12 SATC 72, Producer v COT, ITC 729 (1951) 18 SATC 96, ITC 1013 (1963) 25 SATC 321, ITC 1029 (1964) 26 SATC 54, ITC 1135 (1969) 31 SATC 228, ITC 1171 (1971) 34 SATC 80

302 L Tager 'The Deduction of Interest Payments for Income Tax Purposes' (1976) 93 SALJ 12 at 20

303 (1990) 53 SATC 272

304 at 280

305 ibid

306 (1961) 24 SATC 552

307 (1992) 55 SATC 47

308 (1971) 34 SATC 80

309 (1969) 31 SATC 228

310 (1950) 17 SATC 34

311 (1948) 15 SATC 405

312 (1951) 18 SATC 96

313 (1964) 26 SATC 54

314 (1963) 25 SATC 321

288 This arises from an application of the principles enunciated in Port Elizabeth Electric Tramway Co Ltd v CIR

289 Port Elizabeth Electric Tramway Co Ltd v CIR

290 The reason for this is that, in South African law, the issue of a bill, note or bond at a discount on its face value is akin to a loan See chapter 2

291 Port Elizabeth Electric Tramway Co Ltd v CIR

292 ITC 174 (1930) 5 SATC 177, CIR v Genn & Co (Pty) Ltd

293 Port Elizabeth Electric Tramways Co Ltd v CIR, CIR v Nemojim (Pty) Ltd at 266, CIR v Standard Bank of SA Ltd at 194

294 CIR v Nemojim (Pty) Ltd at 194, CIR v Standard Bank of SA Ltd at 193-4, ITC 1603 (1996) SATC 212 at 215

295 ibid

296 CIR v Standard Bank of SA Ltd at 196 See also Financier v CGT, CIR v Allied Building Society

297 ibid

298 ITC 1135 (1969) 31 SATC 228 at 229, ITC 1171 (1971) 34 SATC 80 at 82, ITC 1500 (1990) 53 SATC 272 at 280

299 ibid

300 ibid

275 In ITC 873 (1959) 23 SATC 89 there was more than one purpose, but none was dominant One of the purposes was to produce tax-free income The court accordingly disallowed the expenditure

276 CIR v Allied Building Society, ITC 1310 (1979) 42 SATC 177

277 (1960) 23 SATC 251 See also ITC 1089 (1966) 28 SATC 208

278 CIR v Genn & Co (Pty) Ltd, ITC 1604 (1996) 58 SATC 263 at 269

279 ibid

280 CIR v Standard Bank of SA (Pty) Ltd at 196-7

281 ibid

282 ibid

283 CIR v Nemojim (Pty) Ltd. CIR v De Beers Holdings (Pty) Ltd (1986) 47 SATC 229

284 ibid

285 ibid

286 See Port Elizabeth Electric Tramway Co Ltd v CIR for a discussion on the process of determining expenditure incurred in the production of income

287 ibid

264 Producer v COT

265 CIR v Genn & Co (Pty) Ltd

266 ITC 572 (1944) 13 SATC 461, ITC 953 (1961) 24 SATC 552, CIR v Nemojim (Pty) Ltd (1983) 48 SATC 241 at 256

267 ITC 572 (1944) 13 SATC 461

268 Producer v COT, Financier v COT In CIR v Allied Building Society the court found that the ultimate use or destination of the money borrowed was relevant but not decisive See also ITC 1133 (1969) 31 SATC 204, ITC 1116 (1968) 30 SATC 98

269 Port Elizabeth Electric Tramway Co Ltd v CIR

270 Port Elizabeth Electric Tramway Co Ltd v CIR, CIR v Genn & Co (Pty) Ltd, African Greyhound Association (Pty) Ltd v CIR, CIR v Allied Building Society

271 ibid

272 Joffe & Co (Pty) Ltd v CIR, ITC 1221 (1974) 36 SATC 233

273 CIR v Shapiro (1928) 4 SATC 29 See also ITC 128 (1928) 4 SATC 127, ITC 277 (1933) 7 SATC 244, ITC 1126 (1968) 31 SATC 111

274 CIR v Shapiro See also ITC 296 (1934) 7 SATC 353, ITC 484 (1941) 11 SATC 351, ITC 1602 (1996) 58 SATC 205 at 209

254 ibid. See also ITC 345 (1935) 9 SATC 46, ITC 390 (1937) 9 SATC 472, ITC 409 (1938) 10 SATC 226, ITC 428 (1938) 10 SATC 350, ITC 569 (1944) 13 SATC 447, ITC 583 (1945) 14 SATC 111, ITC 735 (1951) 18 SATC 204, CIR v Stellenbosch Farmers' Winery (1945) 13 SATC 381, ITC 781 (1953) 19 SATC 407

255 Port Elizabeth Electric Tramway Co Ltd v CIR, African Greyhound Racing Association (Pty) Ltd v CIR (1945) 13 SATC 259 at 262, Producer v COT (1948) 15 SATC 405 at 408, Financier v COT (1950) 17 SATC 34 at 36, CIR v Genn & Co (Pty) Ltd (1955) 20 SATC 113, CIR v African Oxygen Ltd (1963) 25 SATC 67, COT v Rendle (1965) 26 SATC 326, CIR v Allied Building Society (1963) 25 SATC 343, CIR v Standard Bank of SA Ltd (1985) 45 SATC 179

256 ibid

257 CIR v Genn & Co (Pty) Ltd

258 Port Elizabeth Electric Tramway Co Ltd v CIR

259 Sub-Nigel Ltd v CIR

260 ITC 832 (1956) 21 SATC 320

261 ITC 786 (1954) 19 SATC 421

262 ITC 1079 (1965) 28 SATC 46

263 ITC 224 (1931) 6 SATC 156

242 SA Crushers (Pty) Ltd v Ramdass 1951 (2) SA 543 (N) at 546, Arnold v Viljoen at 331, Kamaludin v Gihwala 1956 (2) SA 323 (C) at 326

243 (1989) 51 SATC 35

244 at 36-7

245 at 37

246 at 39

247 1973 (2) SA 805 (C) at 808-9

248 ITC 1444 (1989) 51 SATC 35 at 39 - 40

249 at 40

250 s 11(*a*) of the Income Tax Act 58 of 1962

251 See ITC 590 (1945) 14 SATC 133, ITC 1521 (1992) 54 SATC 175

252 s 11(*a*). See also ITC 1595 (1995) 57 SATC 321 at 329

253 Lockie Bros Ltd v CIR at 151, Sub-Nigel Ltd v CIR. The expenditure must be made bona fide in the normal course of business to produce income. See ITC 1600 (1996) 58 SATC 131 at 138-9

226 Explanatory Memorandum on the Income Tax Bill, 1995 at 12

227 s 24J(4)

228 s 24J(1) s v 'adjusted gain on transfer or redemption of an instrument'

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

230 s 24J(1) s v 'adjusted loss on transfer or redemption of an instrument'

231 s 24J(5)

232 s 24J(6)

233 section 5.3 1.5 of the Budget Review issued by the Department of Finance on 13 March 1996 and s 14 of Act 36 of 1996

234 s 24J(7)

235 s 24J(8)

236 s 24J(9)

237 ibid

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

239 ibid

240 Hauman v Nortjie 1914 AD 293 at 296

241 Arnold v Viljoen 1934 (3) SA 322 (C) at 331

209 at 150-1

210 at 151.

211 at 151-3

212 s 24J(1) s v 'interest'.

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

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

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

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

217 See s 24J(1) s v 'yield to maturity'

218 ibid

219 ibid

220 ibid.

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

222 s 24J(1) s v 'instrument'

223 s 24J(2)

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

225 Explanatory Memorandum on the Income Tax Bill', 1995 at 17

194 at 99-101.

195 at 101

196 at 101-2.

197 at 102.

198 at 102-3. The learned judge referred to the cases of Tucker v Ginsberg 1962 (2) SA 58 (W); Moser v Meiring 1931 OPD 74, Naidoo v Von Gerard and Chapman 1931 AD 374, and ITC 968 (1962) 24 SATC 725

199 ITC 1587 (1995) 57 SATC 97at 103

200 ibid

201 at 103-4.

202 at 105

203 at 105-6

204 at 106.

205 at 107

206 ibid

207 ibid.

208 (1995) 57 SATC 148

178 at 581

179 1980 STC 650

180 at 650-1

181 ibid

182 at 651-5

183 at 653-4

184 at 653

185 at 655

186 See Willingale v International Bank Ltd 1978 STC 75

187 ibid

188 (1991) 53 SATC 229

189 (1990) 52 SATC 337 at 343

190 (1975) 37 SATC 1

191 (1990) 52 SATC 337 at 341

192 Caltex Oil (SA) Ltd v SIR at 341 See also Joffe & Co Ltd v CIR, Sub-Nigel Ltd v CIR, SIR v Eaton Hall (Pty) Ltd (1975) 37 SATC 343

193 (1995) 57 SATC 97

Third, there was indirect advertising obtained from general publicity The taxpayer was always concerned about its public image As a main board member, Mr Ackerman helped to conceive the idea of raising money from the private sector by way of a self-imposed levy It was then agreed that the taxpayer would make the donation provided there was extensive publicity relating to the donation.[10]

The majority judgment in the Appellate Division was given by Nicholas AJA After considering the facts, he examined the various issues The issue relevant to this chapter related to the wholly and exclusive requirement contained in s 23(g) He referred to three English cases, Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes),[11] Bowden (HM Inspector of Taxes) v Russell & Russell[12] and Mallalieu v Drummond (Inspector of Taxes).[13] He quoted the following passage from the judgment of Romer LJ in the case of Bentleys:

> 'The relevant words ... -"wholly and exclusively laid out or expended for the purposes of the ... profession" - appear straight forward enough It is conceded that the first adverb - "wholly" - is in reference to the quantum of the money expended and has no relevance to the present case The sole question is whether the expenditure in question was "exclusively laid out for business purposes, that is What was the motive or objec , in the mind of the

## 8.2 WHOLLY AND EXCLUSIVE REQUIREMENT IN SOUTH AFRICA

The Appellate Division was required to interpret the provisions contained in s 23(*g*) of the Income Tax Act in Pick 'n Pay[6] and Solaglass.[7] The approach adopted in these cases is open to criticism.[8] In this section there will be a discussion of these two cases

In Pick 'n Pay the taxpayer pledged to donate to the Urban Foundation five equal annual instalments totalling R500 000. The taxpayer sought to deduct the sum of R100 000 in each of the first two years of assessment to which the instalments related in respect of the donations. The deductions were claimed as advertising expenses. The Commissioner disallowed the taxpayer's claim and the matter was considered by the Special Court where the taxpayer's appeal was allowed. The case was then considered by the Appellate Division.[9]

The taxpayer carried on business operating supermarkets. Mr Ackerman was its chairman and managing director. At the relevant time he held 30% of the issued share capital of the taxpayer. He was also a main board member of the Urban Foundation. The taxpayer's advertising fell into three broad categories. First, there was the day-to-day advertising listing goods and their prices. Second, there was the advertising of special events such as the launching of new products

Section 23(*g*) was amended to its present wording in 1992.[3] Prior to that, s 23(*g*) prohibited the deduction of monies not wholly or exclusively laid out or expended for the purposes of trade. Thus, the amendment in 1992 eliminated the wholly and exclusive requirement. The main reason for this was that it had been the practice of Inland Revenue to allow an apportionment of expenditure partly for purposes of trade and partly for purposes other than trade. The Appellate Division of the Supreme Court, however, held that the provisions of s 23(*g*) should be applied strictly and that no deduction should be granted where expenditure was incurred for a dual purpose. The amendment was therefore intended to restore the previous practice of Inland Revenue in allowing an apportionment of such expenditure.[4] The Appellate Division cases which presumably resulted in the amendment were Solaglass Finance Co (Pty) Ltd v CIR[5] and CIR v Pick 'n Pay Wholesalers (Pty) Ltd.[6]

The approach which will be adopted in discussing the meaning of trade in s 11(a) and s 23(*g*) will be to discuss the decisions in Pick'n Pay and Solaglass and the legislative response to these cases. This will be followed by a discussion on the meaning of trade in South Africa. This will involve a brief review of cases in South Africa, Zimbabwe and the United Kingdom which covered trade and the profit motive and trading for a fiscal advantage

# 8 TRADE

## 8.1 INTRODUCTION

Section 11 of the Income Tax Act 58 of 1962 provides that, in order to determine the taxable income of a person carrying on a trade within the Republic of South Africa, certain specified deductions are allowable from the income of that person. In other words, it is a requirement of s 11 that a person carry on a trade in order for that person to claim a deduction in terms of that section. Furthermore, s 23(*g*) of the Act stipulates that no deduction shall be made in respect of any monies claimed as a deduction from income derived from trade to the extent to which such monies were not laid out or expended for the purposes of trade. Thus s 23(*g*) contains a negative requirement to the effect that monies will only be deductible to the extent that they have been laid out or expended for the purposes of trade.

Thus, the final aspect of the general deduction formula that requires consideration is the question whether expenditure or losses have been incurred in the carrying on of a trade. This aspect of s 11(*a*) is considered together with s 23(*g*) of the Income Tax Act. The test in s 11(*a*) provides for positive requirements whilst the test in s 23(*g*) lays down negative requirements.[1]

418 See chapter 2

419 ibid

420 See s 1 of the Income Tax Act s v 'trading stock'

421 Ammonia Soda Co Ltd v Chamberlain

422 See s 11(*a*) of the Income Tax Act

423 ibid

405 See, for example, Ammonia Soda Co Ltd v Chamberlain, Salisbury Board of Executors Ltd v COT, Atlantic Refining Co of Africa (Pty) Ltd v CIR, Weinstock v COT (1962) 24 SATC 756, COT v BSA Co Investments Ltd, Stone v SIR, SIR v Crane (1977) 39 SATC 191, ITC 1270 (1977) 40 SATC 65, ITC 1321 (1980) 42 SATC 269, ITC 1344 (1981) 44 SATC 19, ITC 1327 (1980) 43 SATC 47

406 ibid

407 (1941) 12 SATC 1

408 at 1-2

409 at 2-3

410 at 3-4

411 at 4-5

412 at 5-6

413 at 6

414 ibid

415 (1918) 1 ChD 266 This case was also referred to in SIR v Crane

416 Ammonia Soda Co Ltd v Chamberlain at 286

417 Salisbury Board of Executors Ltd v COT at 7-8 and 10

390 CIR v Genn & Co (Pty) Ltd

391 ibid

392 (1968) 31 SATC 53

393 at 53-4

394 at 56-7

395 at 55-6

396 ibid

397 Tager (1976) 93 SALJ 12 at 38

398 The reason for this is that, in South African law, original issue discount expenses are similar in nature to interest See chapter 2

399 This follows from the application of the principles enunciated in ITC 1124 (1968) 31 SATC 53

400 (1932) 7 SATC 65

401 at 65-6

402 at 66

403 There is discussion on the nature of discounting in chapter 2

404 ibid

384 Ounsworth v Vickers Ltd, quoted with approval CIR v Stellenbosch Farmers' Winery at 393 In applying this approach to the deductibility of interest, Trollip J in ITC 1124 (1969) 31 SATC 31 at 55 referred to CIR v Genn & Co (Pty) Ltd and stated that

> 'Such interest was not intended to nor calculated to, nor did it in fact, improve, augment or preserve those aforementioned capital assets, or form part of or add to the costs of acquiring them or enhance their value Consequently, we do not think that in the circumstances of this case the interest was so closely identified or associated with those capital assets that it might itself be regarded as being of a capital nature'

This approach was approved in Burgess v CIR at 197 and ITC 1604 (1996) 58 SATC 263 at 270

385 New State Areas Ltd v CIR. One must examine the true nature of each transaction. Its true nature is a matter of fact The purpose of the expenditure is an important factor See also Solaglass Finance Co (Pty) Ltd v CIR, ITC 946 (1961) 24 SATC 459 at 462, Henry S Hopkins (Pvt) Ltd v COT

386 Atlantic Refining, ITC 946 at 462, Henry S Hopkins

387 See n 337 above

388 ITC 1124 (1968) 31 SATC 53

389 The purpose test is discussed in New State Areas Ltd v CIR

373 New State Areas Ltd v CIR

374 ibid

375 Henriksen v Grafton Hotel Ltd (1942) 2 KB 184 at 195. See, also, Ounsworth v Vickers (1915) 3 KB 267

376 ITC 1110 (1967) 29 SATC 169 at 172.

377 Nchanga Consolidated Copper Mines Ltd v COT (1964) 26 SATC 37 at 42, SIR v Cadac Engineering Works (Pty) Ltd at 72

378 See, for example, Mitchell v B W Noble Ltd (1927) 1 KB 719, ITC 353 (1936) 9 SATC 82

379 ITC 870 (1959) 23 SATC 79

380 ITC 666 (1948) 16 SATC 130, ITC 825 (1956) 21 SATC 188, ITC 1210 (1973) 36 SATC 99

381 ITC 1433 (1984) 50 SATC 243

382 ITC 1528 (1991) 54 SATC 243

383 Nchanga Consolidated Copper Mines Ltd v COT (1962) 24 SATC 469 at 477, (1964) 26 SATC 37

364 ITC 257 (1932) 7 SATC 65, Salisbury Board of Executors v COT, Southern Rhodesia (1941) 12 SATC 1, ITC 812 (1955) 20 SATC 469, ITC 933 (1960) 24 SATC 347, ITC 1003 (196[illegible]25 SATC 237, ITC 1138 (1969) 32 SATC 3

365 Reid's Brewery Co Ltd v Male (1891) 2 QB 1, Ammonia Soda Co Ltd v Chamberlain at 286-7, Stone v SIR at 129-130, Solaglass Finance Co (Pty) Ltd v CIR

366 Stone v SIR, Burman v CIR, ITC 1121 (1980) 42 SATC 269

367 New State Areas Ltd v CIR

368 Vallambrosa Rubber Co Ltd v Farmer 5 TC 529, ITC 33 (1925) 2 SATC 59, ITC 359 (1936) 9 SATC 182, New State Areas Ltd v CIR, Rhodesia Railways Ltd v COT (1933) 6 SATC 225, Port Elizabeth Electric Tramway Co Ltd v CIR

369 New State Areas Ltd v CIR

370 ibid

371 ibid

372 British Insulated & Helsby Cables Ltd v Atherton (HM Inspector of Taxes) 1926 AC 205, New State Areas Ltd v CIR, Atlantic Refining Co of Africa (Pty) Ltd v CIR, Heron Investments (Pty) Ltd v SIR at 189, CIR v African Oxygen Ltd at 76-7, ITC 1528 (1991) 54 SATC 243 at 248, SIR v John Cullum Construction Co (Pty) Ltd

352 ITC 1267 (1977) 39 SATC 146

353 Anglo Persian Oil Co Ltd v Dale (HM Inspector of Taxes) (1932) 16 TC 253 Certain passages were noted with approval in SIR v John Cullum Construction Co (Pty) Ltd (1965) 27 SATC 155 at 173-4

354 ITC 843 (1957) 21 SATC 431

355 ITC 924 (1960) 24 SATC 250

356 ITC 1539 (1990) 54 SATC 394

357 Solaglass Finance Co (Pty) Ltd v CIR at 13, Stone v SIR (1974) 36 SATC 117 at 130; ITC 1327 (1980) 43 SATC 47 at 52

358 Stone v SIR at 129-30, Solaglass Finance Co (Pty) Ltd v CIR at 13

359 New State Areas Ltd v CIR, Stone v SIR, Burman v CIR (1991) 53 SATC 63

360 CIR v George Forest Timber Co Ltd at 23, Solaglass Finance Co (Pty) Ltd v CIR at 13, Stone v SIR at 130

361 New State Areas Ltd v CIR at 163 - 4, Solaglass Finance Co (Pty) Ltd v CIR at 13 - 4

362 Ammonia Soda Co Ltd v Chamberlain (1918) 1 ChD 266 at 286, Solaglass Finance Co (Pty) Ltd v CIR at 14

363 Stone v SIR at 130

338 ibid

339 CIR v George Forest Timber Co Ltd. Solaglass Finance Co (Pty) Ltd v CIR

340 CIR v Genn & Co (Pty) Ltd. Palabora Mining Co Ltd v SIR (1973) 35 SATC 159; SIR v Cadac Engineering Works (Pty) Ltd at 76. ITC 1370 (1982) 45 SATC 55 at 56-7; ITC 1401 (1985) 47 SATC 171; Heron Investments (Pty) Ltd v SIR (1971) 33 SATC 181

341 ITC 1401 (1985) 47 SATC 171 at 174

342 CIR v Genn & Co (Pty) Ltd at 120, ITC 1401 (1985) 47 SATC 171 at 194

343 See n 340 above

344 SIR v Cadac Engineering Works (Pty) Ltd; ITC 1370 (1982) 45 SATC 55; ITC 1195 (1973) 35 SATC 231 at 234

345 CIR v African Oxygen Ltd

346 at 76

347 CIR v Stellenbosch Farmers' Winery

348 ibid. See also CIR v African Oxygen Ltd at 79

349 CIR v Stellenbosch Farmers' Winery

350 ibid

351 ITC 1539 (1990) 54 SATC 394 at 397

expenses being necessarily incurred in the performance of the taxpayer's duties, cases interpreting this provision are of limited assistance in interpreting s 23(*g*). The reason for this is that s 23(*g*) does not contain a test of necessity. However, it is interesting to note that the strict, objective approach adopted in Ricketts, particularly by Lord Blanesburgh, has been criticized.[44] It is submitted that the more liberal approach adopted by Lord Warrington in the Court of Appeal in Ricketts has merit. In addition, apart from Lord Pearce, all the judges in the House of Lords in the cases of Pook and Taylor accepted the approach adopted by the House of Lords in Ricketts.[45] It has been submitted that this is one of the reasons why the House of Lords had difficulty in reaching decisions in these cases. In the circumstances, it is submitted that where a decision of the highest court in a country is clearly incorrect, the court should not hesitate to adopt a different approach to the same issue in a later case. It is respectfully submitted that, in view of the fact that the wording of s 198(1) of the Income and Corporation Taxes Act of 1988 differs materially from that of s 23(*g*), the courts in Pick 'n Pay and Solaglass were correct in not referring to the decisions of Ricketts, Pook and Taylor.

The important decisions that have dealt with the issue of non-travelling expenses under schedule D are Bentleys, Mallalieu and Arthur Young. These cases considered the deductibility of expenses under the provisions of s 74 of the Income and Corporation Taxes Act of 1988 or its

subsidiary is the promotion of its business, the expenditure would not be disqualified because the activity involved another result or the furtherance of another object which is inherent in the act [39] Accordingly, he found that whilst the taxpayer's loans had an advantage to the group, that result did not constitute a purpose different from that of promoting the taxpayer's own business. Thus the losses were not disqualified by virtue of s 23(g) [40]

In considering the decisions in Pick'n Pay and Solaglass, it will be noted that reference is made to decisions in the United Kingdom. Accordingly, it is necessary to determine the principles established in the United Kingdom that should have been followed by the courts in South Africa.

The important cases in the United Kingdom that dealt with travel expenses under schedule E were Ricketts v Colquhoun (HM Inspector of Taxes).[41] Pook (HM Inspector of Taxes) v Owen[42] and Taylor v Provan (HM Inspector of Taxes).[43] The courts in these cases were required to interpret the provisions of the predecessors of s 198(1) of the Income and Corporation Taxes Act of 1988. This provision allows the holder of an office or employment to deduct certain travel expenses in certain circumstances. It is a specific requirement of this provision that the expenses should have been wholly, exclusively and necessarily incurred in the performance of the taxpayer's duties as holder of his office or employment. As this provision has the additional requirement of the travel

Where the connection between the expenditure and the group's interests were too remote, such expenditure would not fall within the prohibition of s 23(*g*) provided it was wholly and exclusively incurred for the purpose of the taxpayer's trade [16]

The minority judgment was given by Friedman AJA [17] After considering the facts and other issues, he examined the requirements of s 23(*g*) He stated that there were two questions to consider First, were monies laid out or expended within the meaning of s 23(*g*)? Second, if so, were they wholly or exclusively laid out or expended for the purposes of the taxpayer's trade? He referred to the judgment of Romer LJ in Bentleys and the decision of the House of Lords in Mallalieu In the case of Bentleys the learned judge stated that the expenses in question were deductible and that the element of hospitality did not constitute a dual purpose with the professional purpose involved With regard to Mallalieu, the learned judge stated that the case was concerned with the distinction between object and effect The taxpayer in Mallalieu was held to have two objects One was to serve the purposes of her profession and the other was to serve her own purposes [18]

Friedman AJA stated that it was not uncommon for businesses in large groups to be structured in such a way that the activities of each subsidiary took into account the interests of the group If the sole object of a

the facts of the case from those in COT v BSA Co Investments Ltd [43] where the benefit conferred upon the other person was only indirectly and remotely connected with the trading activities of the BSA Company. In Solaglass the promotion of the group interests was an integral part of the taxpayer's activities. Thus, the evidence did not support the proposition that the promotion of the group's interests was merely a motive and not a purpose.[44] Further arguments advanced on behalf of the taxpayer were that the promotion of the group's interests was the taxpayer's subjective intention and not the objective intention of the taxpayer's trading activities, and the promotion of the group was not a purpose of the taxpayer's trade, but an effect or result of it. The learned judge was in accord with the description of the taxpayer's business as being borrowing and lending money at a profit, subject to the self-imposed constraints of operating within the group structure. However, he was not in agreement with elevating the profit objective to a purpose and relegating the self-imposed constraints to the status of a result. He was of the opinion that the evidence indicated that the taxpayer conducted its business with a view to achieving two purposes, namely, the promotion of the group's interests and the making of a profit. The concept of a dominant objective had no role to play in this situation.[45]

The learned judge stated that not all the taxpayer's expenses would be treated in this manner when considering the requirements of s 23(g)

incapable of exact definition, and hence of little real use as a general test. And the same applies to the suggested distinction, urged upon us by counsel for the appellant, between "subjective intention" and "objective purpose". The truth is, in my judgment, that there are no hard and fast rules for deciding whether a taxpayer's expenditure falls within or outside the ambit of the section, it is not possible to devise a precise universal test for determining whether expenditure comprises moneys "exclusively laid out or expended for the purposes of trade." In general, one can say no more than that the issue is to be resolved by examining the particular facts of each individual case."[9]

The learned judge found, on the evidence, that the taxpayer's trading activities were aimed at achieving a dual purpose. One was furthering the interests of the group's subsidiary companies, and the other was making a profit for the taxpayer.[11] He then referred to the various arguments advanced on behalf of the taxpayer.

The first argument was that the taxpayer was brought into operation in order to further the group's interests. Thereafter, its sole objective was to earn profits for itself. Botha JA did not accept this argument on the basis that it was not supported by the evidence.[12] The second argument was that the promotion of the group's interests was merely a motive and not a purpose. The learned judge did not accept this argument. He distinguished

deduction of expenditure and losses while s 23(*g*) is concerned with 'monies laid out or expended' [28]

Botha JA then applied the views expressed by him to the facts of the case In applying the test of s 23(*g*) he stated that it must be shown that the loans made by the taxpayer were wholly and exclusively laid out or expended for the purposes of the taxpayer's trade He referred to various United Kingdom cases discussed by Friedman AJA in his judgment and the case of MacKinlay (Inspector of Taxes) v Arthur Young McClelland Moores & Co [29] He went on to state

> 'However, in none of the cases referred to in argument did the facts resemble, even remotely, the peculiar facts of the present matter To the extent that the reported judgments reflect the use of general criteria in applying the words of the statute concerned to the facts of a particular case, such criteria appear to me to furnish no more than vague and imprecise guidelines, fitting nicely perhaps the facts under consideration, but to be applied to other and different 'actual situations, if at all, only with caution and circumspection So, for instance, the distinction between "motive" and "purpose" in this context seems to me to be a nebulous one it may sometimes be found to be helpful, but at other times it may be conducive more to confusion than to clarity Again, the distinction between "object" and "effect" seems to me to be

The matter was considered by the Appellate Division One of the issues before the court was whether s 23(*g*) precluded the deductions claimed by the taxpayer. The majority judgment was given by Botha JA [26] He analysed the requirements of s 23(*g*) and dissected their requirements to its component parts These were the following deductions, in respect of, any monies, claimed as a deduction from income derived from trade, which are not wholly and exclusively laid out or expended for the purposes of trade He stated that the core of the prohibition was the requirement that the section related to 'any monies' This term is neutral with regard to 'losses' The wholly and exclusive requirement in the prohibition is also neutral with regard to 'losses'. The essence of the prohibition is that there must be monies which are laid out or expended and that this should be done in a particular manner, namely, for the purposes of the taxpayer's trade. There is nothing in the section which supports the proposition that the prohibition in s 23(*g*) does not apply when monies which are laid out or expended result in losses [27]

The learned judge referred to the requirements of s 11(*a*) This section applies to, inter alia, 'expenditure and losses' In the case of an irrecoverable loan, the claim under s 11(*a*) is based on the fact that a loss has been incurred Although s 11(*a*) provides positively for what may be deducted and s 23(*g*) contains the negative requirements, there is no direct correlation between the two sections Thus, s 11(*a*) is concerned with the

wholesaling and retailing of timberwood and glass products Each company in the group had responsibility for its own finances until 1973 In that year it was decided that the taxpayer would secure and arrange for the funding requirements of the group One of the taxpayer's objects was to lend money to any person or company and to borrow such money as it deemed fit. Companies in the group that required funding would have to apply to the taxpayer The taxpayer would have regard to the applicant's budget and, if it approved of the application, it would lend the subsidiary the funds requested. Whilst security for the loans was not required, interest was charged at varying rates which were generally one per cent higher than the cost to the taxpayer of the funding If a subsidiary had surplus funds, it was required to place these on daily call with the taxpayer The taxpayer obtained its funds partly from the surplus funds deposited with it by the subsidiaries, and partly from commercial banks by way of overdrafts and acceptance credit facilities Initially the taxpayer dealt with companies within the group Subsequently, it extended its activities to staff loans and discounting bills for customers of group companies [24]

The taxpayer sought to deduct certain amounts in respect of bad debts which were irrecoverable The loans which the taxpayer had written off as irrecoverable related primarily to loans to subsidiary companies within the group There were some smaller loans to employees of group companies which were irrecoverable [25]

the judgment of Lord Sumner in Usher's Wiltshire Brewery Ltd v Bruce[21] to the effect that where the taxpayer's sole purpose for incurring expenditure is the same as the object of the expenditure, the fact that, to some extent, the expenditure enures to the benefit of a third party cannot result in the fact that the purpose of the expenditure was not wholly and exclusively incurred for the purpose of the taxpayer's trade. The benefit to the third party would be a secondary consequence. Referring to the judgment of Romer LJ in Bentleys, the learned judge stated that the difficulty with this type of case is that there is the intention to benefit the donee. However, this should not preclude the expenditure from having been incurred solely in order to promote trade. He stated that a dual purpose exists where there is a deliberate and independent or distinct secondary motive to incur the expenditure.[22] After reviewing the evidence, the learned judge stated that whatever Mr Ackerman's motives were, the taxpayer had discharged the onus of proving that its purpose in benefiting the Urban Foundation was not an independent or distinct purpose. It benefited the Urban Foundation to gain favourable publicity and that this was a form of indirect advertising.[23]

In Solaglass the taxpayer was a wholly-owned subsidiary of Plate Glass Shatterprufe Industries Ltd (PGSI). PGSI was the holding company of the Plate Glass Group (the group). PGSI had approximately 200 subsidiary companies, and the group was involved in the manufacture, processing,

It was argued on behalf of the taxpayer in Pick'n Pay that the donation by the taxpayer enabled it to gain publicity and increase its profits. The benefit to the Urban Foundation was merely incidental. Whilst charity was an effect of the donation, it was not part of the taxpayer's purpose. On the other hand, it was argued on behalf of the Commissioner that the taxpayer had two purposes, one of which was philanthropy [17]

The learned judge stated that the question was one of fact, and the fact was the taxpayer's state of mind. He found that, in the circumstances of the case, the direct evidence of the taxpayer's purpose was not decisive. It was clear, on the evidence, that an object of the donation was to obtain publicity and thereby attract more customers to the taxpayer's stores. However, there was also a philanthropic purpose. Accordingly, on the probabilities, the taxpayer did not show that it did not have a philanthropic purpose as well as a business purpose in making the donation. Thus, the taxpayer's appeal was dismissed. Corbett JA and Botha JA concurred in the judgment.[18]

The minority judgment was delivered by Nestadt JA.[19] The learned judge considered the issue whether the so-called donation was made exclusively for the purposes of the taxpayer's trade. He stated that the test was subjective. He stated that the inquiry did not relate to the effect of the disbursement, and referred to Malialiem.[20] He referred to a passage from

since the latter result or objective is necessarily inherent in the act '[14]

Thereafter, he referred to the following quotation of Pennycuick J in Lawrenden

'As appears from that judgment it may often be difficult to determine whether the person incurring the expense has in mind two distinct purposes, or a single purpose which will or may produce some secondary consequences. But once it is found that the person has a distinct purpose other than of enabling him to carry on and earn profits in his trade or profession section 137(*a*) prohibits deduction of the expense '[15]

The learned judge's reference to Mallalieu related to the distinction that Lord Brightman made in his speech between the object of the expenditure and its effect. The quotation was as follows:

'The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure. An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes '[16]

two individuals responsible for the activities in question? It is well established that the question is one of fact: and again, therefore, the problem seems simple enough. The difficulty, however, arises, as we think, from the nature of the activity in question. Entertaining involves inevitably the characteristic of hospitality: giving to charity or subscribing to a staff pension fund involves inevitably the object of benefaction: an undertaking to guarantee to a limited amount a national exhibition involves inevitably supporting that exhibition and the purposes for which it has been organised. But the question in all such cases is: Was the entertaining, the charitable subscription, the guarantee, undertaken solely with the object of promoting the business or its profit-earning capacity? It is, as we have said, a question of fact. And it is quite clear that the purpose must be the sole purpose. The paragraph says so in clear terms. If the activity be undertaken with the object both of promoting business and also with some other purpose, for example, with the object of indulging an independent wish of entertaining a friend or stranger or of supporting a charitable or benevolent object, then the paragraph is not satisfied though in the mind of the actor the business motive may predominate. For the statute so prescribes. *Per contra*, if, in truth, the sole object is business promotion, the expenditure is not disqualified because the nature of the activity involves some other result, or the attainment or furtherance of some other objective,

In the case of Solaglass, the majority judgment has been criticized on the ground that, if it is accepted that the benefiting of the group was one of the taxpayer's purposes, it should have been regarded as still having been incurred as part of the taxpayer's trade. The reason for this is that the expenditure was directly linked to the trading activities of the group and the profitable well-being of the group. Therefore, in a broad sense, it formed part of the taxpayer's trading activities.[84]

In the case of both Pick 'n Pay and Solaglass there has been criticism to the effect that the majority judgments applied a profits test in determining whether the taxpayers involved incurred the expenditure as part of their trading activities. This issue will be discussed in the following section.

## 8.3 SECTION 23(g)

Section 23(*g*) was amended to its present wording in 1992.[85] Section 23(*g*) now prohibits the deduction of any monies to the extent that they have not been laid out or expended for the purposes of trade. The amendment in 1992 eliminated the wholly and exclusively requirement.

Thus, situations in which expenditure was previously disallowed because it did not satisfy the wholly and exclusive requirement may now have a different result. In addition, the courts will be faced with the difficult task of apportioning the expenditure in certain circumstances. The criteria for

contradictions This test clearly differed from the subjective test applied in Bentleys

In Arthur Young the decision confirmed the approach adopted in Mallalieu Lord Oliver seemed to stress the importance of the effect of the expenditure and did not take into account the conscious motives of the person incurring the expense.[41]

It is submitted that one of the main difficulties in Mallalieu was that Lord Brightman was endeavouring to apply 'exclusively' to an objective purpose It is easier to apply 'exclusively' to a subjective purpose and Lord Brightman in Mallalieu should have applied a subjective test It is respectfully submitted that the decision in Bentleys was correct. A solicitor entertaining a client for business purposes should be entitled to claim the cost of the expenses as deductible for tax purposes. The reason for this is that the expenses were incurred for the purposes of the taxpayer's profession The taxpayer's purpose was to further his practice The personal benefits were merely one of the effects of the entertaining. The personal benefits did not constitute a purpose. For the same reason, the taxpayer in Mallalieu should have been able to deduct the cost of her court robes and other garments as claimed by her The same reasoning would apply to other items of expenditure, for example, the furnishings and

accepted that such expenditure is incurred over the period between the date that the instrument is issued and the date of redemption.[94] In these circumstances, the interest should only be deductible if after the taxpayer's cessation of trade there is an acceptable link between the interest and the expenditure from which it is being deducted.[95]

Bearing in mind the meaning of trade as defined and determined by the case law, it is apparent that where a person issues a bill, note or bond at a discount in order to finance his income earning operations, he is carrying on a trade.[97] However, where an individual issues a bond in order to fund non-trading expenditure, such as the cost of purchasing a private residence, he is not carrying on a trade.[98] The purchase and sale of a negotiable instrument as part of a profit-making operation should generally constitute the carrying on of a trade.[99]

## 8.5 TRADE AND THE PROFIT MOTIVE

Trade is defined in s 1 of the Income Tax Act as including, inter alia, every profession, trade, business, calling, occupation or venture. It includes the letting of any property and the use or grant of permission to use any defined patent, trade mark or copyright or any other property of a similar nature. The definition is extremely wide and is not necessarily exhaustive.[100]

brought into account in terms of s 22 of the Income Tax Act when the instrument is sold

Once trading has closed, the general deduction formula does not permit the deduction of any further expenditure.[87] There have been a number of cases that have dealt with the deduction of expenditure apparently incurred after the cessation of a trade.[88] It is accepted that a taxpayer may carry on more than one trade at any time.[89] The point that needs to be considered is whether a taxpayer, who carries on more than one trade and ceases carrying on one of the trades, is entitled to deduct expenditure relating to the trade that he has ceased.

Whilst the authorities on this question appear to be contradictory,[90] the weight of authority seems to be that expenditure should be disallowed if it has been incurred after the cessation of a business.[91] This applies in spite of the fact that the taxpayer might be carrying on another trade.[92] However, if there is a link between the expenditure and the income from which such expenditure is being deducted, the expenditure will be deductible.[93] Thus, for example, expenditure incurred by an architect whilst in practice was allowed as a deduction after his retirement.[94] A question which arises in the case of a loan is whether a borrower is permitted to deduct the interest he pays on a fixed loan if the obligation continues after his trade has ceased. This enquiry is relevant in the case of original issue discount expenses if it is

been held that a company did not carry on a trade where its income was derived from loans to its shareholders and their relatives,[76] where a company made loans to a subsidiary company,[77] where a company had no intention of producing income,[78] where a company let a house to its major shareholders at a rental below market value,[79] where a company let property in circumstances in which the actual letting of property was incidental to the trade carried on[80] or where a company declared a dividend but did not pay the dividend to its shareholder and subsequently sought to deduct the interest accruing on the loan from the shareholder.[81]

Where expenditure is incurred prior to commencement of a trade it is not deductible unless covered by s 11(6A) of the Income Tax Act.[82] Where A issues a bill, note or bond to B at a discount on its face value, the discount is akin to interest.[83] Thus, where such a transaction takes place prior to A's commencing trade the discounting expenses are deductible under s 11(6A) of the Income Tax Act. Where B, who has acquired a bond at a discount on its face value, onsells it to C the transaction is one of purchase and sale.[84] Where the instrument is acquired for resale at a profit, the acquisition will be part of its trading activities.[85] Thus, provided the other requirements of the general deduction formula have been met,[86] the costs of it will be deductible. Where the instrument is not acquired for resale but its owner subsequently converts it into trading stock, the costs of it will be

Whether a person is carrying on a trade may be determined only after an enquiry into the facts. Certain guidance can, however, be obtained from cases which have considered the issue

A trade is clearly carried on where a person is carrying out a profit-making scheme of purchasing and selling shares.[67] It follows that where a company carries out share-dealing activities which are both of a jobbing and investment nature, it is carrying on a trade.[68] Where a company, which had as one of its objectives the carrying on of business as bankers and financiers and held an investment, the court found that it was carrying on business.[69] A trade may be carried on where a single moneylending transaction takes place.[70] It is, however, important that the person intends to make a profit, even if a loss ensues. Where a person has no intention of making a profit, for example, if money is borrowed at interest and re-lent interest free, then, in the absence of other material factors, he will not be carrying on a trade.[71] On the other hand, if a person enters into a venture and will make a loss for a short period, but it is anticipated that he will thereafter make a profit, he will be carrying on a trade.[72]

A trade is not carried on where an individual invests surplus funds in interest bearing investments,[73] or where a relationship of debtor and creditor is created.[74] Where an individual invests his savings in equities and other forms of secured investments, he does not carry on a trade.[75] It has

doing so will need to be developed For example, if one considers the facts in Mallalieu, the question which arises is whether Mallalieu would be able to deduct her expenditure under the present law It is submitted that her expenditure on her court garments would not be disallowed in terms of s 23(*g*) However, a portion of her expenditure could be disallowed as her expenditure could possibly only have been incurred for the purpose of her trade It is, therefore, possible that an apportionment could take place In addition, it is also necessary to consider some of the other prohibitions contained in s 23 For example, s 23(*f*) prohibits the deduction of expenditure incurred in respect of amounts received or accrued which do not constitute income as defined In South Africa this section was invoked by the Commissioner to disallow expenditure incurred in respect of dividend-stripping transactions. Another provision which must be considered is s 23(*b*) which, inter alia, prohibits the deduction of domestic or private expenses

## 8.4 APPLICATION OF TRADE IN SOUTH AFRICA

Trade is defined in s 1 of the Income Tax Act as including, inter alia, every profession, trade, business, calling, occupation or venture The definition is very wide and is intended to cover every profitable activity It should thus be given the widest possible interpretation [46]

Apart from the issue of the tests that should have been applied in Pick 'n Pay and Solaglass, the majority judgments in these cases have been criticized for other reasons

In the case of Pick 'n Pay, it has been pointed out that Mr Ackerman's state of mind should not have been the focus of the court's inquiry, but rather the intention of the taxpayer. As the taxpayer was an artificial entity, it was necessary to take into consideration the intentions of the directors acting in their capacities as such. It has, therefore, been submitted that there was sufficient evidence to indicate that the taxpayer envisaged a philanthropic effect, but not a philanthropic purpose.[59] In any event, it has been submitted that a seasoned businessman would regard the enhancement of his business as a prerequisite to any act of business generosity.[60] A further criticism of the majority judgment is that insufficient note was taken of the distinction of the purpose and the effect of the expenditure. Where expenditure is effected for a trading purpose and it has a non-business effect, it is not prohibited from being deductible in terms of s 23(*g*).[61] The court accepted this distinction, but in the majority judgment it was held that the philanthropic nature of the expenditure constituted a purpose and not an effect.[62] Where expenditure is incurred for a philanthropic purpose, but is motivated for business reasons, it can be argued that such expenditure could still have been incurred as part of the taxpayer's trade and should still be deductible.[63]

Mr Ackerman's state of mind and found on the facts that the taxpayer also had a philanthropic purpose in making the donation [56] One of the main differences between the majority and minority judgments appears to be their application of the facts to the subjective test

In Solaglass, Friedman AJA applied a subjective test After referring to Bentleys and Mallalieu, he stated that in order to determine the taxpayer's object in making the expenditure, one must look into the taxpayer's mind at the time when the expenditure is made [57] Botha JA, on the other hand, stated that it was not possible to formulate a general test He stated that there were no hard and fast rules for deciding whether expenditure fell within the ambit of the section He stated that one must examine the facts of each particular case [58] It is not clear whether Botha JA applied a subjective or objective test He referred to the taxpayer's evidence as to its aim It would appear that his approach was objective in that he also took into account the aims of the group and did not rely solely on the taxpayer's m in purpose, which was to make a profit In addition, Botha JA did not regard the promotion of the group's interests as an effect of the expenditure He regarded it as a second main purpose With respect, this finding is open to criticism

carpeting in a person's office, and the costs of travelling overseas either first or business class.

Having regard to these points, it would appear, with respect, that the references to Bentleys and Mallalieu in the judgments of Nicholas AJA in Pick 'n Pay[52] and Friedman AJA in Solaglass[53] are confusing. The reason for this is that the judgments in these cases conflicted in the approaches they adopted. Bentleys applied a subjective test whereas it is not entirely clear as to the approach adopted in Mallalieu. It would appear that in Mallalieu an objective approach was adopted. In addition, the judgment in Mallalieu is not clear on a number of issues. Therefore, reference to these two cases without highlighting their differences can lead to confusion. It is, therefore, possible to sympathize with Botha JA when he stated in his judgment in Solaglass that he found the various criteria confusing and that he did not apply general criteria.[54]

In Pick 'n Pay it would appear that the court applied a subjective test. Nestadt JA specifically stated that the test was subjective. After examining the facts, he found that benefiting the Urban Foundation was not an independent or distinct purpose.[55] It is respectfully submitted that the learned judge was correct in his finding. It would appear that Nicholas AJA applied a subjective test in his judgment. Whilst he did not specifically state that he was applying a subjective test, he examined the evidence and

In Mallalieu, Lord Brightman appears to have confused the concepts of purpose and intention and the approach that should have been adopted. He stated that the legislation required that one has regard to the purposes of the business and not the taxpayer. However, he went on to state that the purposes of the taxpayer were fundamental to the application of the section. He indicated that the words 'intention' and 'objects' were similar to the word 'purposes' in this context.[48] It would appear that Lord Brightman was applying a test of intention rather than a purpose test. In addition, it would appear that Lord Brightman was applying an objective test in that he was not having regard to the taxpayer's mind.[49] Clearly, this approach was different from the subjective approach adopted by Romer LJ in Bentleys. Lord Brightman drew a distinction between object and effect. He then referred to the taxpayer's unconscious motive. With respect, he appears to have confused the concepts of motive, purpose and intention. It appears that he in fact applied a test of intention rather than purpose.[50] His opinion is confusing in a number of respects. For example, his reference to unconscious motive and to objective purpose and effect. With regard to the latter point, he gave the example of the doctor who stayed in the South of France with a patient. Any enjoyment by the doctor would be merely an effect of the activity. Unfortunately, he did not apply this reasoning to the facts in Mallalieu. It would appear that Lord Brightman applied an objective test, although, as stated, his opinion contained apparent

predecessor. The wording of this provision is similar to s 23(*g*) in that in order to be deductible, one of the requirements is that the expenditure must be wholly and exclusively laid out or expended for the purposes of the taxpayer's trade, profession or vocation. It is, therefore, respectfully submitted that it was appropriate for the courts in Pick 'n Pay and Solaglass to refer to these cases.

The cases of Bentleys, Mallalieu and Arthur Young use terms such as motive, purpose and intention. It is important to understand the meaning of these terms when examining these cases. Motive must be distinguished from purpose and intention. It means an emotion which prompts an act. Purpose is what a person has in mind when he carries out an act. Intention indicates something more than contemplation. It indicates a state of affairs that a person wishes to bring about. Intention is wider than purpose. It includes the necessary consequences of an act. On the other hand, purpose is limited to what a person has in mind.[46]

In Bentleys, Romer LJ appears to have used the words purpose, object and motive interchangeably. The meaning of motive is clearly different from purpose and object. Nevertheless, it was laid down in Bentleys that one must look at the state of mind of the taxpayer. The court applied a subjective test.[47]

tax advantage and was not, therefore, a trading transaction. There were other cases dealing with the issue of tax avoidance, and note should be taken of the approach of Templeman J (as he then was) in Black Nominees Ltd v. Nicol (Inspector of Taxes); Nicol (Inspector of Taxes) v. Black Nominees Ltd.[131] and the dissenting judgment of Eveleigh LJ in Floor v Davis (Inspector of Taxes).[132] The approach of Lupton, Finsbury, Black and Davis was reinforced in IRC v. Plummer.[133] Lord Wilberforce in Plummer noted that the transaction in question was a tax avoidance scheme and stated that this -

> 'entitles and requires us to look at the plan as a whole. It does not entitle us to disregard the legal form and the nature of the transactions carried out.'[134]

In Plummer the scheme was simple. It was similar to Westminster in that it applied the notion that annual payments reduce a person's taxable income. The taxpayer undertook to make a series of annual payments in return for a lump-sum payment. The lump sum was not handed over to the taxpayer, but made available in a series of post-dated promissory notes. Each note corresponded to each of the annuity payments. The notes were retained as security for the taxpayer's undertaking to pay the annuity. Overdraft facilities were arranged so that when the taxpayer had to make an annuity payment, the cash required to effect the payment was borrowed by the taxpayer on the overdraft facility. The payment was effected and a

circumstances, the taxpayer was not able to establish that the deduction of the expenditure involved was not prohibited by s 23(g) [113]

Although the majority judgments in Pick'n Pay and Solaglass did not specifically discuss the issue whether profit-making is a prerequisite to trading, it would appear that a profit test was in fact applied in these cases.[114] In Pick'n Pay the decision of the majority was that the taxpayer had two purposes when incurring the expenditure, one of which was philanthropic. In the circumstances, it was found that the taxpayer did not incur the expenditure wholly and exclusively for the purposes of its trade. This clearly implies that as the philanthropic purpose did not directly result in an increase in the taxpayer's profits, the purpose was not solely to trade. Therefore, in effect the majority applied a profits test.[115] The same applies to the majority judgment in Solaglass. The fact that one of the purposes of the taxpayer's expenditure was the benefiting of the group resulted in the majority decidi that the expenditure was not incurred wholly and exclusively for the purposes of the taxpayer's trade. It can therefore be argued that as this purpose did not result in a direct increase in the taxpayer's profits, the expenditure did not comply with the test laid down in s 23(g) [116]

'It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade, and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of s 23(*g*). Such monies may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer's trade....Where, however, a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of no making a profit, or in fact registering a loss, must, in order to satisfy s 23(*g*) , be shown to have been so connected with the pursuit of the taxpayer's trade, eg on grounds of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the purposes of trade....Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer.'[113]

In De Beers the court found no satisfactory explanation of the transaction in question As it was not a normal share-dealing transaction it was not part of a profit-making scheme In the

'I am not suggesting the legal form of any transaction should be disregarded in favour of its supposed substance Nothing that I have said is in any way inconsistent with the decision in the Duke of Westminster's case where there was only one transaction the grant of an annuity and there was no question of its having formed part of any larger scheme '[145]

This statement would seem to indicate that Lord Fraser did not regard the decision as being in conflict with that in Westminster.[146]

Lord Wilberforce reiterated certain long-standing principles The first is that when a taxing Act has to be construed, the courts are not confined to a literal interpretation The second is that a taxpayer can still organize his affairs in order to minimize his liability for tax The third is that documents and transactions are either genuine or sham It is a question of fact as to which is the situation The fourth is that if a document or transaction is genuine, the court cannot look behind it to a supposed underlying substance However, if the transaction is part of a series of transactions, if the court regards the wider series of transactions as a whole, this does not mean that the court is preferring substance over form.[147]

It has been submitted that the basis for the doctrine in Ramsay is that of fiscal nullity which was developed in the courts in the United States of

Lord Wilberforce commented on the principles laid down in Westminster as follows

> 'It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or a combination of transactions intended to operate as such, it is that series or combination, which may be regarded '[143]

Lord Fraser commented on the schemes in Ramsay and Rawling as follows

> 'The essential feature of both schemes was that, when they were completely carried out, they did not result in any actual loss to the taxpayer. The apparently magic result of creating a tax loss that would not be a real loss was to be brought about by arranging that the scheme included a loss which was allowable for tax purposes and a matching gain which was not chargeable. In Ramsay the loss arose on the disposal of Ramsay's shares. In Rawling it arose on the disposal of the taxpayer's reversionary interest in the settlement.'[144]

Lord Fraser stated further

The facts were that the United Kingdom trustees resigned and were replaced by foreign trustees. The new trustees appointed the taxpayer a beneficiary of certain shares subject to his surviving by three days. The taxpayer sold his interest in the shares to another non-resident company. The taxpayer then purchased the shares from the latter company. The taxpayer therefore claimed that there was no liability for capital gains tax. The House of Lords held that all the transactions should be treated as one composite transaction. The documents should be read as a whole and the taxing statutes should be applied to the true legal effect of the transaction. Thus the House held that the taxpayer had acquired the shares as a beneficiary of the trust.[139] It has been submitted that in Chinn there were two separate issues. First, whether one must construe each transaction as part of the whole and, second, whether one can regard the only legal consequences arising as those that flow from all the transactions taken as an indivisible whole.[140] The House of Lords accepted the second proposition possibly using the first to justify this approach.[141]

In Ramsay, the taxpayer entered into two transactions in terms of which he made a loss for capital gains tax purposes, and this loss was matched by a non-chargeable gain which arose out of a second transaction into which the taxpayer entered. The taxpayer sought to set off the allowable loss against his liability for capital gains tax. The true legal effect of the transactions treated as a whole was that the taxpayer made neither a gain or a loss.[142]

promissory in a similar amount was released to the taxpayer. The taxpayer applied the proceeds of the promissory note to settle the overdraft. The main benefit to the taxpayer of the scheme was that he could claim to have made annual payments which reduced his total income for income tax purposes. The recipient of the annual payments was a charitable company which could recover tax on the annual payments received.[134]

In Plummer the House of Lords applied the principle laid down in Westminster. If a person signs a contract to make annual payments, effect must be given to that legal contract. The annuity payments that he makes pursuant to that contract must be regarded as annual payments. This should apply regardless of the arrangements that the person makes in order to discharge the payments.[136] In Ramsay Lord Wilberforce stated that it would have been legitimate in Plummer to regard all the arrangements as a whole. It was, however, concluded that the arrangements had a commercial reality and they should be upheld.[137]

Chinn v Collins (Inspector of Taxes)[138] was a case concerned with capital gains tax. Capital gains tax was payable on a distribution of a trust asset to a beneficiary by trustees of a trust. The tax was calculated on the difference between the original price paid by the trustees and the value of the asset at date of distribution. However, where a purchaser purchased an asset from a foreign company, there was no liability for capital gains tax

case, the fiscal consequences corresponded with these legal consequences of the transaction.[125]

The Ramsay/Dawson approach developed in cases that were heard prior to these cases. FA & AB Ltd v Lupton (Inspector of Taxes)[126] was a case concerned with dividend-stripping. The House of Lords refused to allow the taxpayer a fiscal result which differed from the financial result. The taxpayer was not allowed to deduct the loss on the sale of the shares because when one looked at the transaction as a whole, and taking into account the dividend received by the taxpayer, the taxpayer did not make a loss.[127] In commenting on this case, Lord Templeman stated:

> 'But in dividend-strip cases the tax avoidance scheme negatives trading because on a true analysis of the transaction the trader does not trade at all.'[128]

The approach adopted by the court in Lupton differed from the earlier dividend-stripping case of Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd[129] in which the majority view was arrived at by examining the component parts of the transaction. It was held that the activities of the dealer in the shares involved amounted to trading in the shares. In Finsbury Securities Ltd v Bishop[130] the House of Lords viewed the transaction as a whole and concluded that the transaction was an artificial device to secure a

In the United Kingdom, it is submitted that there are three broad stages in the development of the approach to tax avoidance and trading The first stage is the Westminster approach based on the decision in IRC v Duke of Westminster [118] The second stage is Ramsay/Dawson approach based on the decisions of W T Ramsay Ltd v IRC,[119] Eilbeck (Inspector of Taxes) v Rawling[120] and Furniss (Inspector of Taxes) v Dawson [121] The third stage is the Challenge/Ensign approach based on the decisions of IRC v Challenge Corp Ltd[122] and Ensign [123] There are, of course, many other decisions dealing with the issues raised at the various stages However, the cases mentioned as highlighting these three stages are referred to in order to identify the stages in an easily recognizable manner

The Westminster approach is illustrated by the following well-known extract from the judgment of Lord Tomlin

> 'Every man is entitled to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.'[124]

In Westminster the taxpayer covenanted to pay his gardener an annuity The gardener agreed to continue to work for the taxpayer for the annuity and such sum as was necessary to make up his wages The majority accepted that the gardener voluntarily worked full time for the taxpayer for half wages and enjoyed the annuity given to him by the taxpayer In this

## 8.6 TRADING IN ORDER TO OBTAIN A FISCAL ADVANTAGE IN THE UNITED KINGDOM

An issue which requires discussion is that relating to whether trade is carried on when a transaction is effected in order to obtain certain fiscal advantages. For example, assume a taxpayer carries out a series of transactions and each transaction on its own constitutes a trading transaction. However, the transactions, viewed as a whole, result in the taxpayer's avoiding income tax. In addition, the taxpayer has entered into the transactions in order to achieve that income tax saving. An example of this type of activity is that involving dividend-stripping. In a typical dividend-stripping case, a trader in shares purchases shares in a company in which there are divisible profits available for distribution. Assume that the shares are bought for R100. After the purchase, a dividend of R80 is declared and the dealer then sells the shares for R20. The dealer claims that he has made a loss R80 in his trade of purchasing and selling shares. This assertion ignores the fact that the trader has received a dividend of R80.[117] In this type of situation, the question is whether the acquisition and sale of the shares constitute a trading transaction by the trader. Whilst it is beyond the scope of this thesis to discuss the role of tax avoidance in trading transactions, it is necessary briefly to refer to some of the issues involved. These issues will not be discussed in any detail.

In ITC 1292[105] the taxpayer sought to deduct the costs relating to the letting of a holiday home. The court determined the issue as being whether the losses claimed by the taxpayer were incurred in the carrying on of a trade or business. The court concluded that if there was no possibility of earning a profit, the expenses were not deductible. The court relied on the decisions of ITC 112 and ITC 561 although in the instant case there was the possibility of the taxpayer's earning a profit in future years. The facts in ITC 1367[106] were similar to those in ITC 1292. The court found that there was no real prospect of letting the property in question at a profit and accordingly disallowed the taxpayer's claim for a deduction of the expenses. It has been submitted that the ratio decidendi of the judgment of the court was that the taxpayer failed to discharge the onus on him of showing that the expenses were incurred for the purposes of his trade.[107]

On the other hand, there have been a number of cases in which it has been held that, in order to carry on a trade, it is not essential to make a profit.[108] Examples of cases in which this has been held are where the taxpayer hired property and sub-let it for the same rental[109] and where shares were acquired with the purpose of selling them at a loss.[110] It has been held that profit-making is not an essential feature of trading.[111] In CIR v De Beers Holdings (Pty) Ltd, an Appellate Division case, Corbett JA stated

The issue whether a person is carrying on a trade may only be determined after an enquiry into the facts of the case. Certain guidelines can be obtained from cases which have considered the issue. An issue which should be determined at the outset is whether it is essential to make a profit in order to trade.

On a superficial level, two early cases seem to support the proposition that profit is an essential element in trading. In ITC 112[101] the taxpayer was a private company in which the two directors were also the only shareholders. The taxpayer borrowed money at an interest rate of 6% per annum and on-lent the funds to the shareholders at an interest rate of 1% per annum. The Special Court held that no gain could have arisen on the loans in question. If the taxpayer's purpose was not to secure a gain, any loss arising from the loans could not be regarded as income losses. In ITC 561[102] the taxpayer inherited certain properties. One of the properties was a residence and was not suitable for letting. The Special Court disallowed the taxpayer's claim for a deduction of the expenses relating to the property. The reason for the disallowance was that there was no prospect of any gain arising out of the taxpayer's ownership of the property. It has been suggested that the basis of the decision in ITC 561 was that the property was vacant and not lettable,[103] and that the court in ITC 112 could have reached the same decision on the grounds that the expenditure was not incurred in the production of income.[104]

Lord Oliver stated that Ramsay, as developed in Dawson, established that the fiscal consequences of a preordained series of transactions which are carried out to their planned conclusion are determined by looking at the planned and final result of the transactions The emphasis is on the unbroken and predestined chain from start to finish The two different views related to the meaning of 'preordained' and 'a composite transaction' The wider view interpreted 'preordained' as meaning 'preconceived' Thus, all events which occur sequentially as a result of the initial intent and in which there is a tax saving would form part of the scheme The effect of this is that where events or transactions form part of a single composite transaction, their actual nature could be distorted [178]

There were four reasons why Lord Oliver rejected this wider view of the effect of Dawson First, there is no precedent for this view Second, it would involve a rejection of Lord Brightman's meticulous analysis of the successive steps in Dawson Third, there was no authority for this proposition in Dawson Fourth, there was no rational basis for this proposition either in Dawson or which could be formulated in the House of Lords [179]

Lord Oliver stated

> 'As the law currently stands, the essentials emerging from Dawson appear to me to be four in number (1) that the series of transactions

adopted in Dawson can be applied to a linear as well as a self-cancelling transaction The necessary conditions must exist to enable the court realistically to regard the two transactions as one single, composite and indivisible whole In this situation, the transactions would be treated as a single disposal for tax purposes In discussing these two views, he referred to the decisions in Ramsay and Dawson The Ramsay principle involves looking at the result that the parties actually intended and produced One must apply to that result the ordinary fiscal consequences that flow from it Although Dawson purported to apply the Ramsay doctrine, it went further Dawson involved reconstituting the actual constituent transactions to something that they were not in fact Thus, an intended result was attributed to the parties that they did not, in fact, intend Fiscal consequences are applied to the reconstituted set of transactions In Dawson there was an exchange of shares This transaction had permanent fiscal and legal results He regarded as critical the determination of when the circumstances exist in which the principles laid down in Dawson apply Lord Oliver rejected the first view His reason for this was that if one accepted it, one would have to accept that where any transaction is entered into in order to avoid tax on a subsequent transaction, the first transaction would be treated as indistinguishable from the later transaction Thus the later transaction would have no independent legal effect even if the facts of the particular case indicated the contrary [77]

and O finally resulted in a subsidiary of O acquiring the shares in Q. M, having received the proceeds of the sale, later lent most of the proceeds to the taxpayers. The issue was whether the share exchange with M, the disposal of the shares in Q by M to O's subsidiary and the loans by M to the taxpayers constituted a single composite transaction. If so, whether this transaction had the effect that every time M lent money to any of the taxpayers, this was deemed to be a part disposal of the shares in Q for capital gains tax purposes.[173]

The House of Lords dismissed all three appeals by Inland Revenue.[174] The decisions in the cases of Bowater and Gregory were unanimous, while the decision in Craven was by majority. In Craven the main speech was by Lord Oliver, and Lords Keith and Jauncey gave speeches which also dismissed the appeal.[175] The dissenting speeches were given by Lords Templeman and Goff.[176]

Lord Oliver examined the decision in Dawson. He said that there were two different views as to what Dawson decided. The first was that any transaction entered into with the purpose of avoiding, minimizing or postponing tax in respect of another transaction which, at the time, was being contemplated and which subsequently takes place must be ignored for fiscal purposes. The reason for this is that the transaction formed part of a scheme for the avoidance of tax. The second view is that the approach

The facts in Gregory were that the taxpayers were negotiating the sale of shares in a family company to C. It was envisaged that the sale would be carried out through a company registered in the Isle of Man. The negotiations broke down. The taxpayers proceeded to incorporate an Isle of Man company, H. The taxpayers exchanged their shares in the family company for shares in H. At the time there were no negotiations taking place for the sale of the shares in the family company. Almost two years later H sold the shares in the family holding company to N, a new purchaser not connected to C. Assessments to capital gains tax were raised on the taxpayers on the basis of a sale directly to N.[17]

The facts in Craven were that the taxpayers owned all the shares in a family company, Q. They were advised by their accountant that they should either sell Q or merge it with another company. They tried unsuccessfully for three years to sell or merge Q with another company. Finally they investigated a sale or merger with a company, C. Shortly thereafter another company, O, showed an interest in purchasing Q. When the negotiations with O waned, the taxpayers resumed negotiations with C. At this stage, the taxpayers arranged to acquire an off-the-shelf Isle of Man company, M. The object of this purchase was to use M as Q's holding company for a merger with C. O then made an offer to purchase Q. At this stage negotiations were proceeding with both C and O. Q's share capital was reorganized with a view to saving stamp duties. The negotiations with C

discrimination against the father as the mother could have obtained such an order. Whilst Inland Revenue has sought to confine the application of this decision to cases concerned with the Matrimonial Causes Act of 1973, the importance of this case is that the House of Lords agreed that an artificial tax device could be effective in spite of the Ramsay/Dawson approach [169]

A further development of the Ramsay doctrine took place in the cases of Craven (Inspector of Taxes) v White, IRC v Bowater Property Developments Ltd and Baylis (Inspector of Taxes) v Gregory which were considered together [170]

The facts in Bowater were that the taxpayer was a company. A sister company of the taxpayer had negotiated the sale of certain land to M. The negotiations for the sale fell through. In the meantime the sister company sold the land to the taxpayer. The taxpayer then sold the land to five associated companies in equal shares at its market value. The purpose of this was to take advantage of the development land tax exemption that was available to the five companies. Almost two years later M reopened negotiations and, consequently, it entered into agreements with the five companies in terms of which it acquired the land. Revenue sought to assess the taxpayer to development land tax on the basis of a sale directly from the taxpayer to M [171]

provisions However, Revenue succeeded with this argument in Dawson The question arises when a person enters into transactions which satisfy the relevant statutory requirements whether, if they have the fiscal effects, the transactions can be set aside on the basis of Ramsay In Nova Lord Templeman decided in favour of the taxpayer on the issue of the debts However, he offered no general principles which can be applied in deciding other cases It has been submitted that in Nova the transactions had a commercial purpose The Ramsay principles have the effect that the transactions can only be nullified if they do not have a commercial purpose Thus, if a statutory provision requires, either explicitly or by implication, a commercial purpose, the Ramsay doctrine cannot be applied in respect of transactions that comply with that provision [106] As a result, Nova has been referred to as a statutory avoidance scheme [107]

An interesting case which subsequently came before the courts and was decided in favour of the taxpayer was Sheridley v Sheridley [108] In this case a custodial parent sought a court order for the payment of school fees The issue was whether the court had jurisdiction to make an order where there was no issue before it The House of Lords held that a parent could obtain a court order against himself or herself even if his sole object was to obtain a tax advantage Thus the House held that the Ramsay doctrine did not apply in this situation The reason for this approach was that the House of Lords held that if the order was not granted, there would be fiscal

the group's overall financial position The profit made by the taxpayer was merely a disguise to conceal the fact that the lease was not being traded If the taxpayer had acquired the lease and sold it on an arm's length basis to an associated company, the transaction would still have involved book entries and the group's overall financial position would have remained unchanged [162]

In Nova, Lord Templeman in the House of Lords found that property could only be acquired as trading stock if it was acquired for the purpose of being used in the course of trade. He stated that in order to constitute trading stock, an asset must be acquired with a view to resale at a profit [163] This latter statement has been criticized as being erroneous It is generally recognized that every trading transaction does not presuppose a profit purpose An example is the sale of a loss leader aimed at attracting customers to a retail outlet [164] Lord Templeman found that as far as the debts were concerned, the House could not infer that the only reasonable conclusion was that they were acquired by the taxpayer solely for the purpose of acquiring a fiscal advantage for the group However, he found that the shares were worthless and were not acquired as trading stock [165]
In considering the application of the Ramsay principles in Arndale and Nova, Lord Templeman did not consider it necessary to consider them in Arndale In Nova he stated that Revenue could not complain that L had secured a fiscal advantage by taking advantage of the relevant statutory

part of L.'s trading stock and had been acquired by L. at a price considerably in excess of the price at which they were sold to the taxpayer. Thus, L. had incurred certain capital losses in respect of the assets. The relevant legislation in the United Kingdom provided, in effect, that group relief could be made available by converting a capital loss sustained by one company in the group into a trading loss sustained by another member of the group provided certain conditions were fulfilled. One of the conditions was that an asset pregnant with a loss had to be transferred to a trading company in the group which acquired the asset as trading stock. For corporation tax purposes the shares were deemed to have been sold to the taxpayer for a consideration equivalent to their cost to L. and not the nominal amount attributed to them in the sale documentation. The same applied to the debts sold to the taxpayer by L. In the circumstances, the taxpayer claimed to have incurred an allowable loss being the difference between the cost to L of the assets and the price paid for the assets by the taxpayer.[160]

In Arndale, Lord Templeman in the House of Lords found that the taxpayer did not trade and did not intend trading with the lease. Thus the taxpayer did not acquire the lease as trading stock.[161] His decision has been criticized on the ground that he did not provide sufficient reasons for this conclusion. He stated that since the companies involved were all part of the same group, the transaction was a book entry which had no effect on

However, Lord Fraser said

> 'The true principle of the decision in Ramsay was that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.'[156]

There are two decisions on trading which are also of relevance, namely, Coates (Inspector of Taxes) v Arndale Properties Ltd[157] and Reed (Inspector of Taxes) v Nova Securities Ltd.[158] The facts in Arndale were, briefly, that the taxpayer was a property dealing company and was part of a group of companies. The taxpayer acquired a lease from A, an associated company, and, on the same day assigned it at its market value to B, another associated company. A's expenditure on the lease prior to its sale amounted to more than the market value of the lease. The taxpayer, being a trading company, elected to bring the lease into its trading account at a value equivalent to the amount that A had expended on it. The taxpayer entered into the transaction in order to obtain favourable tax consequences for companies in the group.[159] The facts in Nova were, briefly, that the taxpayer was a trader in shares and securities. The taxpayer was acquired by another company, L. L sold certain shares and debts to the taxpayer at their market value. The shares were valued at a nominal value, and the balance of the sale price related to the debts. These assets did not form

scheme The change must, however, be regarded as a mere change of form with no enduring legal consequences In Burmah the change of the taxpayer's position from that of creditor of a subsidiary to that of a shareholder with a greater equity investment in the subsidiary could have had no enduring legal consequence as the subsidiary was liquidated as part of the scheme.[153]

In Dawson the taxpayers wished to sell their shares to a purchaser In order to avoid capital gains tax, they exchanged their shares for shares in a company incorporated in the Channel Isles Capital gains tax was not chargeable on this transaction Thereafter, they arranged for the Isle of Man company to sell the shares to the purchaser. The House of Lords held that capital gains tax was chargeable on the sale of the shares.[154]

The taxpayers argued that, applying the principles enunciated in Ramsay and Burmah, and analysing the legal and practical effects of the scheme, both the exchange of shares and the sale agreement had enduring legal consequences. There was no preordained intention or arrangement for the scheme to terminate. The House of Lords did not accept this submission on the basis that it resulted in too restrictive an interpretation of the principles laid down in Ramsay and Burmah The main difference between Ramsay and Burmah on the one hand and Dawson on the other was that in the latter case the taxpayers sought to defer, not save, tax.[155]

financial statements. At the end of this series of transactions the taxpayer was in the same financial position as it was at the outset. However, whereas previously it had a valueless debt, after the series of transactions it owned valueless shares in a subsidiary which had an allowable loss of a similar amount. The House of Lords disregarded the series of transactions on the basis that they were artificial.[151]

The decision of the House of Lords in Burmah has been questioned. The basis of this is that the rules relating to groups of companies can, in certain circumstances, operate to the disadvantage of taxpayers and, in other circumstances, they can result in benefits to the taxpayers involved. In Burmah the taxpayer was able to manipulate the rules to the advantage of its group. Had there been a profit on liquidation, such profit would presumably have been taxed. It has been submitted that there is a big difference between the situation in Burmah and that in Ramsay.[152]

Vinelott J in Furniss (Inspector of Taxes) v Dawson attempted to reconcile these decisions. In Ramsay there was no real loss. In Burmah there was a potential loss to the taxpayer of the debt that was owed to it by its subsidiary. Vinelott J stated that the Ramsay approach should not be confined to cases where the steps taken to further a single composite scheme are circular or self-cancelling. The court may disregard a transaction even if the legal position of the parties changes during the

America However, whilst this doctrine has not been accepted in the higher courts in the United States, it is accepted in the courts in the United Kingdom.[148]

In IRC v Burmah Oil Co Ltd.[149] Lord Diplock stated

> 'It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay's case did not mark a significant change in the approach adopted by this House in its judicial role to a preordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable '[150]

In Burmah a similar approach was adopted to that in Ramsay The facts were that the taxpayer owned a subsidiary which was indebted to it The prospects of the taxpayer's recovering the amount owed were minimal The taxpayer capitalized the subsidiary by taking up a rights issue in respect of shares The subsidiary used the funds raised from the capitalization to repay its indebtedness to the taxpayer Subsequently the subsidiar was liquidated At the date of liquidation the subsidiary reflected a loss in its

portfolio. Included in the loans which it acquired as part of the portfolio was a loan to the government of the Federation of Rhodesia and Nyasaland in order to assist in the building of the Kariba hydro-electric project. At the date of acquisition, slightly more than half of the agreed amount to be loaned had actually been advanced. The taxpayer acquired this loan at a discount on the amount already advanced. The taxpayer agreed to advance the balance of the agreed amount to the government in terms of the loan agreement. Subsequently, the taxpayer sold the loan to another investment company which has been formed by the British South Africa Co Ltd. At that stage, the taxpayer had advanced to the government the balance of the amount which it was obligated to advance in terms of the loan agreement. The loan was sold to the purchaser at a discount on the total amount paid and advanced by the taxpayer in respect of the loan. The price that the taxpayer paid for part of the loan and the consideration received by the taxpayer for the sale of the loan were fair. The taxpayer acquired the portfolio, including the loan, as a packaged deal in order to confer a tax benefit on the British South Africa Co Ltd. The reason why the taxpayer sold the loan was, partly, for the group to straighten up its books by reflecting the loan at its then value and, partly, so that the taxpayer could avoid the payment of United Kingdom tax on the interest earned in respect of the loan."[11]

dismissed.[208] Briggs FJ referred to Harrison as authority for the fact that to seek to recover a tax refund was an attempt to make a profit.[209]

Whilst it is appreciated that Winstock was concerned with the taxation of receipts rather than the deduction of expenditure, it is interesting to note that the court held that the taxpayers were carrying on a trade although one of their purposes was to minimize their liability for tax. The reference by Briggs FJ to Harrison is also interesting. It has already been noted that the approach adopted in Harrison to dividend-stripping was subsequently changed in later cases that were considered by the House of Lords. In Harrison the House, in effect, applied the Westminster approach. If one applies the Ramsay/Dawson principles to the facts in Winstock, the single, composite, transaction which would be treated as a whole would probably be the distribution of the dividend by A to the taxpayers. That would be the true effect of the transactions. The sale by the taxpayers of A to Z, the distribution of the dividend by A to Z and the part repayment of the loan by Z to the taxpayers would probably be regarded as self-cancelling transactions.

In COT v BSA Co Investments Ltd[210] the taxpayer was formed in order to take over the investment dealing business which had been carried on previously by the British South Africa Co Ltd. After its formation, the taxpayer acquired from the British South Africa Co Ltd its investment

Winstock & another v COT[206] is a case in which it had to be determined whether the taxpayers were carrying on a trade. Whilst the issue was whether certain receipts constituted taxable income in the hands of the taxpayers, the case is relevant because the taxpayers entered into the transactions with fiscal objectives. The facts were, briefly, that the taxpayers were the sole shareholders of a company, A. They bought the issued shares in, and the outstanding loan account due by another company, Z, which had an assessed loss. The taxpayers then sold their equity shares in A to Z. Thereafter, A declared a dividend from its accumulated profits. The dividend accrued to Z. Z became entitled to a refund of tax paid by A. This entitlement arose by virtue of certain provisions of the relevant taxing Act which were in effect at the time and which applied because of Z's assessed loss. The amounts received by Z by way of dividend and refund of tax were utilized partly to repay Z's indebtedness to the taxpayers. The Commissioner sought to tax the taxpayers on the net profit made by them from these transactions. The taxpayers argued that the transaction should be viewed as a whole. It was not a profit-making scheme. The purpose was to obtain tax relief and not to make a profit. In addition, the taxpayers argued that the money received by the taxpayers represented a repayment of their loan accounts and constituted a return of their capital.[207]

The court found that the taxpayers were engaged in an operation of a business to carry out a scheme of profit-making, and their appeal was

stock-in-trade shares that produced the income, the dividends and the refund."[202]

In the circumstances, the court allowed the taxpayer to deduct the cost of the shares in the calculation of its taxable income.[203] This decision is interesting in that it referred to early United Kingdom cases as authority for following the Westminster principle. It has been seen that subsequent House of Lords cases dealing with dividend-stripping applied the Ramsay/Dawson principles and disallowed the claims by the taxpayers to deduct the cost of the shares involved. In view of this, the approach adopted by Forrest and Harrison was incorrect and, therefore, the basis of the court's decision in Umtali Finance was incorrect. Furthermore, it will be noted that the Appellate Division in South Africa did not follow the decision in Umtali Finance. In this regard, it is interesting to note that in Nemojim, the Appellate Division did not agree with the decision in Umtali Finance insofar as it dealt with issues similar to those in Nemojim.[204] In addition, the Appellate Division in Nemojim was not convinced of the view of Clayden CJ in Umtali Finance with regard to the decision in Rand Selections. Clayden CJ was of the opinion that the basis of the majority decision in Rand Selections was wholly tied up with the definition of a liquidation dividend.[205] Thus, in the context of subsequent South African cases, the decision in Umtali Finance was also incorrect.

It is interesting to note that the court did not consider the question whether the taxpayer was trading in respect of the tax exempt dividends received by it. It would appear that the court accepted that the taxpayer was trading. The reason for this is that it was accepted that the taxpayer traded in shares and dividends. In addition, it was accepted that the taxpaye could deduct a portion of its expenditure insofar as it related to the acquisition of the portion of the liquidation dividend which represented a return of its capital.[197]

Umtali Finance (Pty) Ltd v COT[198] was a Zimbabwean case that had to consider the issue of dividend-stripping. The case was heard by the Federal Supreme Court, and the judgment was given by Clayden CJ. The court referred to early English cases such as Griffiths (Inspector of Taxes) v J P Harrison (Watford) Ltd[199] and CIR v Forrest[200] which adopted the Westminster approach. The court also referred to Rand Selections but distinguished the majority decision on the basis that it was tied up with the special definition of liquidation dividend and the majority relied upon the definition in determining the purpose of the expenditure apart from the simple purchase of the shares.[201] After reviewing all the facts and authorities, Clayden CJ stated:

> 'Applying what was said in those cases, one starts with the fact that the business of the appellant was to deal in shares. The deductions which are claimed are not the expenses of obtaining a dividend or a tax refund, the tax free income, but the expenses of obtaining the

In CIR v Rand Selections Corp Ltd[195] the taxpayer was a finance company which derived its income partly from share-dealing and dividends. It owned shares in a company, L. Knowing that L was about to go into liquidation, the taxpayer bought further shares in L. Shortly thereafter, L was placed into voluntary liquidation, and liquidation dividends were paid to the taxpayer in respect of its shares in L. The dividends were represented by cash and shares in another company. Part of the dividend represented a return of the taxpayer's floating capital, and the remainder was a dividend as defined. This latter part of the liquidation dividend was exempt from tax. In the circumstances, as the exempt portion of the dividend did not constitute income in the taxpayer's hands, the company could not deduct any expenses incurred in respect of that dividend. The issue before the court was whether the taxpayer was entitled to deduct the whole amount or a portion of its cost of its shares in L. The taxpayer argued in the Appellate Division that as the Income Tax Act did not direct an apportionment of expenditure or give guidance as to what portion of the expenditure was deductible, the whole of the expenditure was deductible. Centlivres CJ, who delivered the majority judgment, did not agree with this contention. He apportioned the expenditure on the basis of the expenditure multiplied by the income. This amount is divided by the sum of the income and the dividend. He held that the resulting figure was the deductible expenditure. The matter was referred to the Commissioner to issue a revised assessment on the basis of this formula.[196]

trading. He stated that in Ensign there was no difficulty because a trading transaction was clearly identifiable. He did not say how it was identified. He left unanswered certain issues. For example, is it necessary for there to be a risk of profit or loss in order to carry on a trade? Must the transaction be of a type that is generally regarded as being part of the carrying on of a trade? In the latter event, is the taxpayer still trading if he only entered into the transaction for fiscal advantage and that it was irrelevant if a profit was made? It could be argued that these are the effects of the decision in Ensign. It has been submitted that there are two implications of the decision in Ensign. First, the taxpayer's subjective intention is irrelevant and the court must apply an objective test to the transaction in order to determine the taxpayer's intention. Second, a transaction entered into for fiscal advantage but which is designed to make a loss is not a trading transaction. However, where the transaction may make a profit or loss, it will not lose its trading status by virtue of the fact that the taxpayer entered into it in order to reduce his liability for income tax.

## 8.7 TRADING IN ORDER TO OBTAIN A FISCAL ADVANTAGE IN SOUTHERN AFRICA

The early cases in South Africa and Zimbabwe covering the issue of trading in order to obtain a fiscal advantage adopted the Westminster approach to the problem.

trading. However, in the House of Lords, the decision was mainly concerned with the principle enunciated in the Ramsay/Dawson approach. Thus, the House examined the true effect in law of a single composite transaction and regarded the transaction as a whole. Lord Templeman distinguished between tax mitigation and tax avoidance. Income tax is mitigated when the taxpayer reduces his net income in circumstances in which he is entitled to reduce his liability for income tax. Tax avoidance takes place where the taxpayer's tax liability is reduced without the loss or expenditure having been incurred. The new dimension which was added in the approach of the House in Ensign was that the series of transactions were analysed and the true effect of the transactions was determined. The parties were taxed according to the true effect of these transactions. The self-cancelling intermediate steps were ignored. Thus, the taxpayer was not deprived of the beneficial effects of a scheme merely because it was entered into with fiscal motives.[192]

The House of Lords in Ensign did not cast doubt on and nor did it endorse the decision in Lupton and the other cases dealing with the question of trade.[193] Lord Templeman removed the requirement of distinguishing between sole and paramount intention and to balance fiscal intention against commercial elements. The question is how does one establish whether a trade is being carried on? Lord Templeman did not state the principles that must be applied in order to determine whether a person is

Accordingly, he found that although the partnership entered into the film trade for a fiscal purpose, this did not alter the purpose of the expenditure. The partnership expended capital for a trading purpose, which was the production and exploitation of a film.[139] The case was therefore remitted to the Special Commissioners to determine the taxpayer's deduction based on expenditure by the partnership of 25% of the estimated costs of production of the film.[140]

Lord Jauncey considered whether the trading characteristics were eclipsed by the non-trading activities so that they formed part of an overall non-trading transaction. He stated:

> 'I do not consider that FA & AB Lupton requires that the trading transaction be denatured because the taxpayer has incorporated it within a tax avoidance scheme which seeks to obtain for him greater fiscal advantages than the trading transaction if standing alone would produce...the proper approach is to disregard the steps in this scheme which have no commercial purpose rather than to treat those steps as somehow affecting or denaturing other steps in the scheme having such a purpose.'[141]

The decisions in Ensign in the lower courts were mainly concerned with whether the transactions were trading transactions and the taxpayer's intention in securing a fiscal advantage and thus whether the taxpayer was

Special Commissioners.[182] Ultimately, the case was considered by the House of Lords.[183] The main speech was delivered by Lord Templeman.[184] Lord Templeman distinguished the facts from those in Westminster on the basis that in Westminster the fiscal consequences of the transaction corresponded with the legal consequences. In Ensign this was not the case when one reads the documents as a whole.[185] He found that the loan by the production company to the partnership, the deposit of these funds into the bank account and the payment of these funds to the production company were self-cancelling operations. The true legal effect of the transaction as a whole was that the partnership expended 25% of the estimated costs and no more.[186] The scheme had the apparently magical result of creating for tax purposes expenditure of the full production costs whereas the partnership in fact incurred a real expenditure of only 25% of the estimated costs of production.[187]

Lord Templeman referred to the principles of the Ramsay/Dawson approach and stated that they -

> 'do not compel or authorise the court to disregard all the fiscal consequences of a single composite transaction read as a whole on the grounds that it appears that the transaction is a tax avoidance scheme.'[188]

are disregarded. These issues are best illustrated by examining the facts and speeches in Ensign.

In Ensign the facts were, briefly, that the taxpayer became a partner in a limited partnership which was established in order to finance the production and exploitation of a commercial film. The partnership and the other companies involved in the film embarked on a series of transactions in respect of the film in order to claim certain income tax allowances in respect of the film. The negative of the film vested in the partnership. A production company bought the right to produce the film. Associated companies of the production company had the exclusive distribution rights in respect of the film. The partnership contributed 25 per cent of the estimated costs of making the film. The production company lent to the partnership the balance of the production costs, including all costs exceeding the estimated costs. The production costs were deposited in a bank account by the partnership. This amount was paid to the production company to cover the costs of finance of the film. The partnership was entitled to 25% of the net profits of the film. The taxpayer claimed a deduction of its portion of the first year allowances in respect of its investment in the film. The taxpayer's claim was based on the assertion that the partnership had incurred the total costs of production of the film and not 25% of the estimated costs of production. The Inspector of Taxes refused to allow the taxpayer's claim and his decision was upheld by the

was, at the time when the intermediate transaction was entered into, preordained in order to produce a given result, (2) that that transaction had no other purpose than tax mitigation, (3) that there was at that time no practical likelihood that the preplanned events would not take place in the order ordained, so that the intermediate transaction was not even contemplated practically as having an independent life, and (4) that the preordained events did in fact take place. In these circumstances the court can be justified in linking the beginning with the end so as to make a single composite whole to which the fiscal results of the single composite whole are to be applied."[180]

It is clear from these three appeals that the House of Lords was prepared to put some limits on the Ramsay doctrine. It is, however, also clear that it is unlikely that this doctrine will be overturned. One of the issues which was not entirely resolved was when a series of transactions will be regarded as preordained. There was a difference of opinion amongst the judges and the question was still not resolved. A further issue which was not clarified was the possibility of double taxation where two transactions are linked.[181]

The Challenge/Ensign approach raise ' two further issues. The first was the distinction between tax mitigation and tax avoidance. The second was the extent to which the fiscal consequences of a single composite transaction

and is an important consideration in many transactions. Therefore, if a taxpayer structures the transaction so as to minimize the effects of taxation, that fact should not, by itself, result in the setting aside of the transaction for fiscal purposes. As Grosskopf JA stated, if the tax considerations so affect and alter the nature of the transaction that the taxpayer is not in fact trading, then the position is different and the court may ignore the transaction for fiscal purposes.

The Appellate Division recently considered the issue of disguised transactions in Erf 3183/1 Ladysmith (Pty) Ltd and another v CIR.[230] Whilst this case did not deal specifically with the issue of when a person is carrying on a trade, the principles covered in the case are relevant. Therefore, this case will be discussed briefly.

The facts of the case were that the directors of Pioneer Seed Company (Pty) Ltd ('Pioneer') and its subsidiary Pioneer Seed Holdings (Pty) Ltd ('Holdings') wished to establish a factory in Ladysmith. The taxpayers each purchased a piece of immovable property and subsequently Holdings acquired the entire shareholding in the taxpayer companies. Thereafter both of the taxpayers executed a series of simultaneous and interrelated agreements which were intended to achieve a similar purpose. Each of the taxpayers entered into an agreement of lease with a pension fund ('the Fund'). In each case the Fund leased the immovable property acquire by

"If a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not, in my view, cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage. If he carries on a trade, his motive for doing so is irrelevant. Of course the position might be different if a transaction "is so affected or inspired by fiscal considerations that the shape and character of the transaction is no longer that of a trading transaction." "[235]

The learned judge found that the taxpayer's transactions were inspired by commercial considerations and he did not accept the argument advanced by counsel for the Commissioner on this point.[236]

The second ground advanced by counsel for the Commissioner was that the taxpayer was not carrying on a trade. It was contended that an investment of the nature of the taxpayer's in the scheme did not amount to the carrying on of a trade. The learned judge stated that the definition of trade should be interpreted widely, and that the taxpayer did carry on a trade.[237] Accordingly, the Commissioner's appeal was dismissed.[238]

The approach of the Appellate Division in Burgess is, with respect, the correct approach to this issue. Liability for tax is a factor that must be taken into consideration in many business transactions. It is a cash outflow

The first was that the taxpayer entered into the scheme for fiscal purposes, and the second was that the taxpayer was not carrying on a trade."[1]

Insofar as the Commissioner's first argument is concerned, it was argued that the taxpayer's purpose in making the investment was to obtain the fiscal benefits flowing from the scheme. The possibility of commercial profits was merely incidental. Counsel for the Commissioner relied mainly on the authority of Lupton, Ramsay and Ensign Tankers. Grosskopf JA, who gave the judgment of the court, stated that he was in agreement with the approach adopted in Lupton which was to determine whether the transaction, viewed fairly and rationally, was a trading transaction. However the learned judge was of the opinion that the English authorities to which counsel for the Commissioner referred were not of direct relevance. The reason for this was that the structures of the Fenton scheme were aimed at achieving commercial results. These results were a short-term gain with a limitation on the possible losses. The scheme did not create artificial structures. The argument of counsel for the Commissioner was based on the premise that, if the taxpayer's purpose was not to secure a tax advantage, he would have been carrying on a trade. In other words, the taxpayer's purpose in seeking to secure a tax advantage had the result that he was not carrying on a trade. The learned judge stated that this argument was not sound in law."[2] He went on to state

at which he was primarily at risk This amount was the difference between the investor's interest liability to the bank and the guaranteed income payable by the insurance company in respect of the policy The policy was a non-standard policy in terms of the sixth schedule to the Income Tax Act and the proceeds from the policy were taxable in the investors' hands The proposers of the scheme assumed that the interest liability to the bank would be deductible As the income in respect of the policy would only be received at the end of the first year, the proposers assumed that the interest would be deductible in the first year and that there would be a one year deferral of income in the hands of the investors [231] The taxpayer entered into the scheme and, whilst he was still involved in it there was a crash on the Johannesburg stock exchange Consequently, on the first anniversary of the policy the insurance company paid the minimum amount guaranteed by it. The taxpayer liquidated his investment in the scheme and, as a result, he suffered a loss in respect of his bank guarantee Although the loss was suffered by the partnership, the taxpayer was entitled to deduct his share of the loss from his personal income [232]

The Special Court held that the Commissioner was correct in disallowing the deduction of interest because the taxpayer had not shown that the expenditure was incurred by him in the carrying on of a trade Counsel for the Commissioner argued that there were two main reasons why the taxpayer's activities could not be regarded as the carrying on of a trade

Insofar as the merits of the taxpayer's case were concerned, the taxpayer's appeal was dismissed.[228]

An important case heard by the Appellate Division recently is that of Burgess v CIR.[229] The case involved facts arising from the so-called Fenton scheme. The essence of the scheme was that an investor would borrow money from a bank and enter into a single premium endowment policy. The insurance company would issue a policy with a surrender value which was guaranteed if the policy was surrendered within a period of two years. Obviously the surrender value reflected a lower return on the policy than the investor's interest rate for which he was liable to the bank in respect of the amount borrowed by him. The difference between these two rates represented the investor's main risk if the returns on the policy were not as anticipated.[230]

The transaction was entered into by way of an en commandite partnership in which the investors were partners. The reason for this was to limit the liability of the investors in the event of the insurance company being liquidated. The investors were not liable for the partnership's debts except to the extent of the bank guarantee. The bank lent the money to the partnership for a year and the partnership paid this amount to the insurance company as a single premium on an endowment policy. Each individual investor provided the bank with a bank guarantee in respect of the amount

the interposition of the various subsidiary companies. The approach of the Appellate Division is, perhaps, a more practical approach because it involves an examination of the taxpayer's reasons for entering into a particular trading transaction where it is not a part of the taxpayer's normal trading activities. Thus, adopting this approach the taxpayer in BSA Co would be entitled to the losses because the explanation would be that the loan was acquired as part of a package deal and was subsequently sold in order to tidy up the taxpayer's books and avoid liability for tax in the United Kingdom.

The Appellate Division considered a dividend-stripping case in Gerber v CIR.[22b] The essential facts were similar to those in Nemojim. The taxpayer's evidence was that he intended to make a commercial profit from his dividend-stripping operations. He assumed that in the determination of his taxable income the cost of the shares in question would be deductible. If he had misconceived the position, s 8D of the Income Tax Act could have rendered the scheme unprofitable. However, the court was of the opinion that even if the taxpayer's after-tax position was not profitable, this did not necessarily mean that he had not intended to make a commercial profit. On the facts of the case, the court found that the taxpayer's dividend-stripping operations constituted the carrying on of a trade within the meaning of the definition of trade in s 1 of the Income Tax Act.[22c]

purposes of trade Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer ' [224]

As there was no satisfactory explanation by the taxpayer of the EHSA share transaction, the court did not treat it as a normal share-dealing transaction [225] The quotation from the judgment of Corbett JA clearly sets out the position of the Appellate Division with regard to the issue of the carrying on of a trade. Clearly, the court's approach is indicative of the fact that it has not adopted a Westminster approach to this issue. The court went further than the court in Westminster but not as far as the courts that adopted the Ramsay/Dawson approach. If the court had adopted the Westminster approach, each transaction would have been looked at in isolation and the taxpayer would probably have succeeded in its claim. If the court had adopted the Ramsay/Dawson approach, it would not have applied the Westminster approach on the grounds that the Westminster approach only related to single transactions and not to a series of transactions as was the case in De Beers. It is difficult to envisage how a court would apply the Ramsay/Dawson approach to the facts in De Beers. The reason for this is that there were a number of transactions that took place over a number of years. In the latter stages of the transactions it was necessary to restructure EHSA as a result of legislative changes. Clearly these changes could not have been envisaged at the outset of the series of transactions. Some of the transactions were self-cancelling, for example,

Approximately four years later the taxpayer sold its shares in EHSA for a nominal amount to an associated company and EHSA was deregistered approximately one year later [223]

One of the issues that the court had to consider was whether the purchase price paid by the taxpayer for the EHSA shares was monies wholly or exclusively laid out or expended for the purposes of the taxpayer's trade After considering the various authorities, Corbett JA stated:

> 'It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer's trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of s 23(*g*) Such moneys may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer's trade. Where, however, a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s 23(*g*), be shown to have been so connected with the pursuit of the taxpayer's trade, eg on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the

companies. Approximately two years later there was a reduction in the authorized and issued share capital of EHSA and the distribution of a capital dividend to the shareholders. This was followed by a further restructure which resulted in the original 'A' ordinary shareholders owning the whole of the issued share capital of EHSA. At this stage it was still intended that EHSA would be liquidated and its assets distributed to the shareholders. The liquidation dividend would be exempt in the hands of the taxpayer. The law changed and it became possible for EHSA to convert its share capital to shares with a no par value. This could be achieved by the shareholders passing a special resolution to increase EHSA's share capital constituted by shares of no par value by, inter alia, transferring reserves to the stated capital account without a distribution of shares. There was an amendment to the definition of a dividend in the Income Tax Act. The effect of the amendment was that where there had been a transfer of capital reserves to share capital, a distribution of this amount to the shareholders by way of a reduction of share capital would, in effect, be regarded as a distribution of a dividend. A result of these legislative changes, it became possible for the capital reserves of EHSA to be transferred to stated capital without the issue of shares thereby resulting in a saving of stamp duty. The capital could then be distributed to the shareholders by way of a reduction of share capital. This distribution would be treated as a dividend and would be tax-free in the taxpayer's hands. The shareholders implemented this scheme and, in due course, they received a tax-free dividend

23(*f*) on the basis that the expenditure was incurred in order to acquire dividend income which did not constitute income as defined in the Income Tax Act. The court found that the expenditure was not wholly incurred in the production of income and was partly incurred in the production of exempt income.[220] The decision of the court settled a difference of opinion as to the application of the decision of the majority in Rand Selections. In Rand Selections the court found that part of the expenditure related to the exempt liquidation dividend. Therefore this portion of the expenses was not deductible. In Umtali Finance the court distinguished the decision in Rand Selections on the ground that the decision in Rand Selections was tied up with the definition of liquidation dividend. The Appellate Division in Nemojim did not agree with this view.[221]

De Beers Holdings (Pty) Ltd v CIR[222] was a case which was considered by the Appellate Division. The facts were fairly complicated and involved the taxpayer's direct and indirect shareholding in a company known as Engelhard Hanovia of Southern Africa (Pty) Ltd (EHSA). Initially the taxpayer acquired 40% of the 'A' ordinary shares in EHSA. The ordinary and preference shares in EHSA were held by the founder of EHSA. The intention was to liquidate EHSA and distribute its assets as a liquidation dividend. This did not take place for various reasons, and approximately four years later there was a restructure after which the holders of the 'A' ordinary shares held their shares in EHSA indirectly through two subsidiary

taxpayer's trade. It was argued by the Commissioner that the loan was purchased with a dual purpose. One purpose was to further the taxpayer's trade and the other purpose was to confer a tax benefit on the British South Africa Co Ltd. The learned judge drew a distinction between motive and purpose and stated.

> 'So long as the goods purchased are goods which form part of a trader's normal stock-in-trade and are purchased for the purposes of being disposed of in the course of his normal trade, the motives which prompted the trader to purchase that stock-in-trade are irrelevant.'[214]

Accordingly, the Commissioner's appeal was dismissed.[216] The facts of this case are distinguishable from those in many situations by virtue of the fact that the Kariba loan was purchased as part of a package deal. Accordingly, the value of this case as a general authority is reduced.[217]

The Appellate Division in South Africa considered the issue of dividend-stripping in the case of CIR v Nemojim (Pty) Ltd.[218] On appeal it was conceded by the Commissioner's counsel that the taxpayer at all material times carried on a trade and that the share-dealing transactions carried on by the taxpayer were part of the taxpayer's trade.[219] Thus the court did not consider the question whether dividend-stripping transactions constitute trading transactions. The court considered the purpose of the expenditure and whether the deduction of the expenditure was prohibited in terms of s

One of the arguments advanced by the Commissioner was that the loan was of a capital nature and did not constitute stock-in-trade in the taxpayer's hands. Alternatively, he argued that if the loan was part of the taxpayer's stock-in-trade, the expenditure on the loan had not been wholly and exclusively incurred for the purposes of the taxpayer's trade.[212]

The judgment in the Appellate Division of the High Court of Zimbabwe was delivered by Beadle CJ.[213] With regard to the Commissioner's first argument, he found that the purchase and sale of the loan were genuine transactions. The situation was similar to that in which a trader purchases the stocks of a fellow trader in order to assist the latter. The trader's intention would be to sell as much of the stock at a profit as he was able. He would cut his losses as far as possible on that part of the stock that he could not sell at a profit. Nevertheless, he would hope to make a profit on the transaction as a whole. In other words, the learned judge placed emphasis on the fact that the transaction was a packaged deal. He went on to state that in this type of transaction it was not possible to distinguish between two types of stock, the profitable stock being stock-in-trade and the non-profitable stock being assets held as capital assets. Therefore, he found that the loan formed part of the taxpayer's stock-in-trade.[214]

The second issue related to whether the taxpayer's expenditure in acquiring the loan was wholly and exclusively incurred for the purposes of the

In Zandberg the court had to decide whether a transaction was a sale or a loan secured by a pledge. The second party was indebted to the first party. The latter required security for the loan. The second party owned a wagon which she needed for every day use. The first party did not want the wagon. If the second party retained possession of the wagon, it would not be possible to effect a valid pledge. In the circumstances the second party purported to enter into a sale of the wagon to the first party with a right of repurchase. The court held that the contract was a dishonest pretence and that it was entered into for the purpose of making it appear that ownership of the wagon had passed to the first party. Innes J A stated in his judgment that the court must be satisfied that the parties to the relevant contract have a real intention that differs from the simulated intention.[246]

In Randles Brothers the defendant company imported goods and transferred them to a registered manufacturer to be made up into shirts and pyjamas for the defendant. The goods were imported under rebate of customs duty. In 1930 new regulations were promulgated which only allowed the rebate of duty if the registered manufacturer to whom the importer transferred the goods declared that the goods were owned by him. Thus, in order to comply with the new regulations, the defendant purported to sell the goods to the manufacturer. At the same time the defendant agreed to purchase the garments from the manufacturer at an agreed price. The price was calculated by adding to the price at which the defendant had

their lease agreements with the Fund did not place an obligation on the Fund to effect the improvements. It should be noted that subsequent to the implementation of these transactions, there was an amendment to s 11(*f*) in terms of which no allowance in respect of a lease premium was deductible when the amount paid was received by a person who was exempt from income tax.[241]

The issue before the court was whether the improvements as envisaged by para (h) of the definition of gross income accrued to the taxpayers. In other words, the court had to consider whether the various agreements referred to above correctly reflected the intentions of the parties. If not, the court had to decide whether there was an unexpressed or tacit understanding between the taxpayers and Pioneer to the effect that the taxpayers would be entitled to require Pioneer or Pioneer and the Fund jointly to effect the improvements to the properties.[242]

The court found that the taxpayers had failed to discharge the onus on them to show that there was no right to have improvements effected on the properties which accrued to them in terms of para (h). In reaching its decision the court found that there was no satisfactory explanation of the need for the variation agreements and there was an air of unreality about the agreements. With regard to the latter point there were various factors and anomalies that contributed to this situation. First, the agreements could

monies paid out in terms of the transaction were wholly and exclusively expended for the purposes of trade.

An important case on the issue of trading with a fiscal intent was Burgess which was considered by the Appellate Division. The court held that if a taxpayer pursues a course of conduct which constitutes the carrying on of a trade, he does not cease carrying on the trade merely because one of his purposes, or even his main purpose, is to obtain a tax advantage. If he carries on a trade, his motive for doing so is irrelevant. This approach is, with respect, a correct and practical one.

A recent South African case which did not deal with trade but which was required to determine the true nature of a preordained series of agreements was Ladysmith. The court referred to earlier South African cases such as Zandberg and Randles Brothers. The court sought to apply the principles adopted in these cases. These involved an enquiry into the true intention of the parties to the transactions. This approach is different from the substance over form approach adopted in United Kingdom cases such as Ramsay. The application in Ladysmith of the principles enunciated in Zandberg and Randles Brothers is open to criticism. The effect of the approach of the court in Ladysmith was not dissimilar to that taken in Ramsay.

by looking at the planned and final result of the transactions. The emphasis is on the unbroken and predestined chain from start to finish.

The third approach was that developed in Challenge/Ensign. The new dimension which was added in the approach of the House in Ensign was that the series of transactions was analysed and the true effect of the transactions was determined. The parties were taxed according to the true effect of these transactions. The self-cancelling intermediate steps were ignored. Thus, the taxpayer was not deprived of the beneficial effects of a scheme merely because it was entered into with fiscal motives.

In South Africa earlier cases adopted the Westminster approach. These decisions were based on earlier United Kingdom decisions which also adopted this approach. The Appellate Division considered the issue of dividend-stripping in Nemojim. The court did not consider whether these types of transactions constituted trading transactions as the point was conceded by the Commissioner's counsel. In De Beers the Appellate Division held that, as a general rule, a transaction entered into with the purpose of not making a profit, or of making a loss, must, in order to satisfy s 23(*g*), be shown to have been connected with the taxpayer's trade. For example, the reason for entering into the transaction could be on the ground of commercial expediency or indirect facilitation of the trade. This could justify the conclusion that, despite the lack of profit motive, the

which will also need to be considered is s 23(*h*) which, inter alia, prohibits the deduction of domestic or private expenses

There have been a number of cases in the United Kingdom that have considered the issue of trading in order to obtain a fiscal advantage It is submitted that there are three broad stages in the development of tax avoidance and trading The first is the Westminster approach in which it is accepted that taxpayers are entitled to order their affairs so as to minimize their liability for tax. The second approach is that of Ramsay/Dawson This approach involves first, construing each transaction as part of the whole and, second, regarding the only legal consequences arising as those that flow from all the transactions taken as an indivisible whole This has the effect that transactions can only be nullified if they do not have a commercial purpose. Thus, if a statutory provision requires, either explicitly or by implication, a commercial purpose, the Ramsay/Dawson principles cannot be applied in respect of transactions that comply with that provision The main principle of the decision in Ramsay was that the fiscal consequences of a preordained series of transactions, intended to operate as such, should be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction on its own Dawson went further than Ramsay Dawson established that the fiscal consequences of a preordained series of transactions which is carried out to its planned conclusion are determined

cases the majority should have applied a subjective approach similar to that adopted in Bentleys In Pick'n Pay it is respectfully submitted that there was sufficient evidence to indicate that the taxpayer envisaged a philanthropic effect and not a philanthropic purpose In Solaglass, it is respectfully submitted that, the benefiting of the group should have been regarded as either an effect of the expenditure or as one of the taxpayer's trade purposes. In addition, both the judgments have been criticized in that they applied a profits test in determining whether the expenditure in question was part of the taxpayers' trading activities.

In applying the concept of trade in South Africa, it should be appreciated that the requirement that expenditure be wholly and exclusively incurred for the purposes of a taxpayer's trade has now been removed. Expenditure is deductible to the extent that it is incurred for this purpose. Thus, situations in which expenditure was previously disallowed because it did not satisfy the wholly and exclusive requirement may now have a different result. In addition, the courts will be faced with the difficult task of apportioning the expenditure in certain circumstances. The criteria for doing so will need to be developed In addition, it will also be necessary to consider some of the other prohibitions contained in s 23 For example, s 23(f) prohibits the deduction of expenditure incurred in respect of amounts received or accrued which do not constitute income as defined Another provision

tax or some other legislative provision, the enquiry should then be whether the transactions fall within the relevant legislative provisions."[94] Whilst the court in Ladysmith stated that the enquiry was to ascertain the true intention of the parties, the approach that it adopted in doing so was not substantially different from the approach to the enquiry in Ramsay

## 8.8 CONCLUSION

Section 11 of the Income Tax Act contains a positive requirement that in order for that section to apply, a person should carry on a trade and the expenditure in question should relate to the carrying on of that trade. Section 23(*g*) contains a negative requirement to the effect that monies will only be deductible to the extent that they have been laid out or expended for the purposes of trade. It should be noted that, for years of assessment ending prior to 1 January 1993 it was a requirement of s 23(*g*) that monies were only deductible if they were wholly and exclusively laid out or expended for the purposes of trade. The meaning of trade and its application to ss 11(*a*) and 23(*g*) are important

The two important cases which considered the wholly and exclusive requirement were Pick'n Pay and Solaglass. It would appear that in Pick n Pay Nicholas AJA applied a subjective test although he did not specifically state that he was doing so. In Solaglass Botha JA stated that one must examine the facts of each particular case. It is submitted that in both the

The distinction between the approach in the United Kingdom in cases such as Ramsay and that in South Africa in cases such as Randles Brothers has been highlighted. In Ramsay the court applied the doctrine of substance over form. In Randles Brothers the court did not apply this doctrine. The court determined the true intention of the parties to the agreements.[250] In Ladysmith the court found that the taxpayers had not discharged the onus on them of showing that they did not have the right to have the improvements effected to the properties.[251] Thus, whilst the court referred to certain anomalies in the agreements, it was not required to determine the rights and obligations which arose from the transactions. The court endeavoured to determine the true intention of the parties to the transactions. This determination was made by an examination of the various agreements and the purpose of the parties in entering into the agreements.[252] The finding of the court is open to criticism for the reasons set out above. The fact that the court determined the intention of the parties primarily by examining the agreements results in the determination of intention mainly by reference to the documentation. Unless there is a non-tax commercial rationale to agreements there is a danger that the agreements may be found to be a sham transaction.[253] With due respect this was not the approach adopted in Randles Brothers. The approach should be to determine from all the circumstances the true intention of the parties. If the intention is to enter into the agreements in question to avoid

there is an unexpressed agreement or tacit understanding between the parties. Otherwise there would be no ostensible agreement that is a pretence.[248]

Whilst the approach adopted and the principle applied in Zandberg and Randles Brothers is not open to criticism, the application of the principle in Ladysmith has been criticized. Although the taxpayers may have had an expectation that the improvements would be effected to the properties, this expectation did not necessarily constitute a legal right as envisaged in para (h). It has been argued that the fact that the parties were not at arm's length would indicate that the taxpayers did not have an enforceable right against either Pioneer or the Fund to have the improvements effected. The reason for this was that Pioneer was the holding company of the taxpayers. It had the right in terms of its lease agreement with the Fund to compel the Fund to effect the improvements. It would have acted against its own interests if it elected not to enforce its rights. Therefore there was no need for a tacit understanding or agreement that the taxpayers would be able to compel Pioneer to require the Fund to effect the improvements. The fact that the contracts were interdependent should not have counted against the taxpayers as this is often the case in transactions in which financing is involved.[249] It is respectfully submitted that this argument is correct and that the court did not correctly apply the principle enunciated in Zandberg and Randles Brothers.

sold the goods to the manufacturer the cost of making the garment Payments were only effected when the garments were sold to the defendant The Commissioner of Customs contended that at all times the defendant remained the owner of the goods at all times and was therefore liable to pay full duty on the goods The majority held that, on the facts, the Commissioner had not proved that the parties did not genuinely intend entering into contracts of sale and to transfer ownership of the goods as provided in the agreements.[247]

Watermeyer J A stated that a transaction is not necessarily a disguised transaction if it is entered into in order to evade the prohibition in an Act to avoid a tax imposed by the Act If the parties honestly intend the transaction to have the effect that it purports to have, the transaction will be interpreted by the courts according to its tenor Thereafter the only question is whether the transaction so interpreted falls within the prohibition or taxing provision of the Act On the other hand, the learned judge stated that a disguised transaction is a dishonest transaction in the sense that the parties do not intend it to have the legal effect between them that appears from its tenor The purpose of disguising the transaction is to create a deception by concealing the real transaction between the parties This type of transaction is regarded as in fraudem legis and is interpreted by the courts according to the real transaction between the parties In order to find that a transaction is in fraudem legis the court must be satisfied that

not be considered separately. They were signed simultaneously and were clearly interdependent. Second, there were a number of clauses in the main lease agreements that are normally contained in these types of agreements which were clearly inapplicable. For example, the Fund was not entitled to assign the leases or sub-let the premises without the consent of the taxpayers who could not withhold their consent unreasonably. As the sub-lease agreements were signed at the same time, the court found these provisions illusory. These factors were consistent with a wider and unexpressed agreement or tacit understanding which had not been disclosed. The court did not accept the agreements on their face value. In addition the court considered that there was insufficient evidence relating to the events after the acquisition of the land. Thus the court inferred that the decisions which eventually led to the finalization of the agreements were taken by the directors of Pioneer on their own or jointly with the directors of Holdings. Consequently, the court found that there was an unexpressed agreement or tacit understanding between the taxpayers and Pioneer that the taxpayers would be entitled to compel Pioneer or Pioneer and the Fund jointly to effect improvements to the properties.[241]

The legal principle that the court applied was that of determining the true intention of the parties. The court referred to the cases of Zandberg v Van Zyl[242] and Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd.[243]

the taxpayer. The agreements contained a clause which stipulated that the Fund was entitled to erect buildings and other improvements on the land and such improvements became the property of the taxpayers. At the same time the Fund sub-let the properties to Pioneer. These agreements imposed an obligation on the Fund to erect certain specified buildings and improvements on the pieces of land. The Fund entered into building contracts with a contractor to construct the factories. Finally the taxpayers entered into agreements with the Fund to vary the lease agreements. These agreements of variation provided that, inter alia, the Fund's liability for rent for the first four months of the lease agreements could only be discharged from rent received by the Fund in terms of the agreements of sub-lease. To the extent that it was necessary, the taxpayers waived their rights to recover from the Fund rent due in respect of this four month period.[240]

The transactions were concluded in order to procure the benefit of a deduction under s 11(*f*) of the Income Tax Act for Pioneer. The intended effect of the series of transactions was that Pioneer would be entitled to deduct the cost of the improvements effected by the Fund in terms of the agreements of sub-lease as the improvements were effected in terms of an obligation under the agreements. The Fund would not be taxable on the value of the improvements in terms of para (h) of the definition of gross income in s 1 of the Income Tax Act as it was exempt from income tax. The taxpayers would not be taxable on the value of the improvements as

by "An Understanding" ' 1979 BTR 301 See also Prendergast v Cameron 23 TC 122, John Cronk & Sons Ltd v Harrison 20 TC 612, Campbell v IRC 45 TC 427 These are examples of earlier cases in which a series of transactions was treated as an indivisible whole

140 Blom-Cooper at 306

141 'Current Notes. The Whole is Greater than the Sum of its Parts' 1981 BTR 65 at 66

142 W T Ramsay Ltd v IRC

143 at 180.

144 at 190.

145 at 191.

146 See 1981 BTR 65 at 67.

147 W T Ramsay Ltd v IRC. See also Monroe at 204-6

148 P Millett 'Artificial Tax Avoidance, the English and American Approach' 1986 BTR 327; J Tiley 'Judicial Anti-avoidance Doctrines The US Alternatives' 1987 BTR 180 and 220, P J Millett 'A New Approach to Tax Avoidance Schemes' (1982) 98 LQR 209, RK Ashton 'The Ramsay "Saga" - Is There Now Light at the End of the Tunnel?' 1988 BTR 482 at 484

149 (1982) STC 30

150 at 32

151 ibid

152 See Monroe at 208-9

121 (1984) 1 All ER 530 (AC).

122 1986 STC 548

123 (1992) 2 All ER 275 (HL)

124 IRC v Duke of Westminster at 19

125 Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) at 284-5

126 1972 AC 634

127 ibid

128 Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) at 286

129 40 TC 281.

130 43 TC 591.

131 1975 STC 372

132 1978 STC 436

133 1979 STC 793.

134 at 797.

135 ibid

136 See H H Monroe 'Fiscal Finesse' Tax Avoidance and the Duke of Westminster' 1982 BTR 200 at 202-4

137 See Monroe at 204.

138 1981 AC 533

139 ibid See also the comments of Lord Templeman in Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) at 287 For a discussion of the judgments of Templeman J (as he then was) and the Court of Appeal, see L. Blom-Cooper 'The Legal Effect of Transactions Infected

108 For example Modderfontein Deep Levels Ltd & another v Feinstein 1920 TPD 288, ITC 615 (1946) 14 SATC 399, ITC 697 (1930) 17 SATC 93, COT v BSA Co Investments Ltd (1966) 28 SATC 1, ITC 1274 (1977) 40 SATC 185, ITC 1300 (1980) 42 SATC 52, ITC 1318 (1980) 42 SATC 256, ITC 1371 (1981) 45 SATC 168, CIR v De Beers Holdings (Pty) Ltd (1986) 48 SATC 229; 'I' v COT (1993) 55 SATC 62.

109 ITC 615 (1946) 14 SATC 399. The court took into account the fact that the definition of trade in s 1 of the Income Tax Act specifically includes the letting of property

110 ITC 1274 (1977) 40 SATC 185

111 Modderfontein Deep Levels Ltd & another v Feinstein

112 CIR v De Beers Holdings (Pty) Ltd at 260

113 at 261

114 See 1992 The Taxpayer 181 at 182-3, D Davis 'Law of Taxation' 1991 Annual Survey of SA Law 550 at 572-4

115 See (1992) The Taxpayer 181 at 182-3

116 See (1992) The Taxpayer 181 at 182-3, D Davis at 572-4

117 Ensign Tankers (Leasing) Ltd v Stokes (Inspector of Taxes) (1992) 2 All ER 275 (HL) at 286

118 1936 AC 1

119 1981 STC 174

120 54 TC 101

95 This matter is discussed in chapter 7

96 ITC 1135 (1969) 31 SATC 228

97 This follows, for example, from the fact that it has been held in ITC 1222 (1974) 37 SATC 17 that a person purchasing and selling shares for profit is carrying on a trade.

98 See n 71 above

99 See n 97 above.

100 See ITC 770 (1953) 19 SATC 216 which was cited in Burgess v CIR 1993 (4) SA 161 (A). It was held in ITC 368 (1936) 9 SATC 411 that 'venture' is a transaction in which a person risks something with the object of making a profit. The business carried on need not be a lawful one. See, for example, CIR v Delagoa Bay Cigarette Co Ltd (1918) 32 SATC 47.

101 (1928) 4 SATC 61.

102 (1944) 13 SATC 313.

103 C Divaris & M L Stein Silke on South African Income Tax 10 ed (1982) at 309 n 26.

104 H Vorster 'Profit Prospects and Deductibility' (1986) 2 SATJ 115 at 118.

105 (1979) 41 SATC 163

106 (1982) 45 SATC 39

107 Vorster at 116-17

84 ibid

85 This follows, for example, an application of the principles enunciated in ITC 697 (1955) 17 SATC 93

86 See ss 11(*a*), (*h*) and 23(*g*)

87 See ss 11(*a*), (*h*) and 23(*g*), and L Tager 'The Deduction of Interest Payments for Income Tax Purposes' (1976) 93 SALJ 12 at 18

88 See, for example, ITC 19 (1924) 1 SATC 130, ITC 411 (1938) 10 SATC 238, ITC 490 (1941) 12 SATC 72, ITC 729 (1951) 18 SATC 96, ITC 1013 (1963) 25 SATC 321, ITC 1029 (1963) 26 SATC 54, ITC 1135 (1969) 31 SATC 228, ITC 1171 34 SATC 80, ITC 1573 (1994) 56 SATC 187

89 ITC 729 (1951) 18 SATC 96

90 See, for instance, ITC 19 (1924) 1 SATC 130, ITC 411 (1938) 10 SATC 238 and ITC 490 (1941) 12 SATC 72 which held that such expenditure is not deductible. On the other hand ITC 729 (1951) 18 SATC 96 and ITC 1013 (1963) 25 SATC 321 held that such expenditure was deductible on the basis, apparently, that there was a form of continuity in the business

91 See ITC 729 (1951) 18 SATC 96, ITC 1013 (1963) 25 SATC 321, ITC 1135 (1969) 31 SATC 228

92 ITC 1135 (1969) 31 SATC 228 at 233

93 ibid

94 ITC 1029 (1963) 26 SATC 54

69 See ITC 541 (1942) 13 SATC 113

70 See CIR v Stelt (1928' ' 'C 253

71 See ITC 953 (1961) 24 SATC 552, ITC 296 (1934) 7 SATC 353, CIR v Sunnyside Centre (Pty) Ltd (1996) 58 SATC 319 at 327

72 ITC 1429 (1988) 50 SATC 40 at 44

73 See ITC 512 (1941) 12 SATC 246

74 See Kirsch v CIR (1946) 14 SATC 72

75 See ITC 1275 (1978) 40 SATC 197

76 See ITC 957 (1960) 24 SATC 637

77 See ITC 496 (1941) 12 SATC 132. Both this case and ITC 957 (1960) 24 SATC 637are difficult to reconcile with ITC 541 (1942) 13 SATC 113. The reasoning in ITC 541 is persuasive in that if a company is carrying on an activity covered in its objects and is earning income from this activity, it is carrying on business

78 See ITC 112 (1928) 4 SATC 61; ITC 224 (1931) 6 SATC 156, ITC 352 (1936) 9 SATC 80

79 See ITC 881 (1959) 23 SATC 237

80 See Reef Estates Ltd v CIR (1954) 19 SATC 153

81 COT v AB (Pvt) Ltd (1963) 25 SATC 366, ITC 1466 (1990) 52 SATC 25, ITC 1517 (1992) 54 SATC 109

82 See ITC 607 (1945) 14 SATC 366 But see ITC 984 (1961) 25 SATC 59 and ITC 46 (1925) 2 SATC 119

83 See chapter 2

64 See 1992 The Taxpayer 181 at 182 It should be noted that in CIR v Sunnyside Centre (Pty) Ltd (1993) 55 SATC 150 at 157 the Transvaal Provincial Division distinguished the facts in that case from those in Solaglass Finance Co (Pty) Ltd v CIR. The bases for this were, first, that in Sunnyside the expenditure was incurred for a single business purpose The situation was not the same as that in Solaglass where the court found that there were two purposes for incurring the expenditure in question. The second basis for distinguishing Solaglass was that in Sunnyside the taxpayer was one of the operating companies Its function was directed solely towards maintaining and increasing its own profitability.

65 by the Finance Tax Act 141 of 1992 The amendment applied to years of assessment ending after 31 January 1992.

66 See ITC 770 (1953) 19 SATC 216. It was held in ITC 368 (1936) 9 SATC 411 that 'venture' is a transaction in which a person risks something with the object of making a profit The business carried on need not be a lawful one See, for example, CIR v Delagoa Bay Cigarette Co Ltd (1918) 32 SATC 47 It should be appreciated that it is not essential to make a profit in order to trade See, for example, COT v BSA Co Investments Ltd (1966) 28 SATC 1 and ITC 697 (1950) 17 SATC 93

67 See ITC 1222 (1974) 37 SATC 17

68 See ITC 770 (1953) 19 SATC 216

J F Avery Jones 'Nothing Either Good or Bad, but Thinking Makes it so - The Mental Element in Anti-avoidance Legislation - I' 1983 BTR 9 at 10-13; Hyam v DPP 1973 AL 55 at 73

47 Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes) at 504

48 Mallalieu v Drummond (Inspector of Taxes) at 1101

49 See Avery Jones 1983 BTR 199 at 199

50 ibid.

51 See J M S Christian 'MacKinlay v Arthur Young' 1990 BTR 319 at 324.

52 CIR v Pick 'n Pay Wholesalers (Pty) Ltd at 148.

53 Solaglass Finance Co (Pty) Ltd v CIR at 18-20

54 at 24-5.

55 CIR v Pick 'n Pay Wholesalers (Pty) Ltd at 152

56 at 145-7.

57 Solaglass Finance Co (Pty) Ltd v CIR at 20.

58 at 24-5.

59 See Emslie at 218.

60 ibid. See also 'Case Law' 1987 The Taxpayer 129 at 130

61 See Emslie at 219

62 'Tax Deductibility A Too Acid Test?' 1991 The Taxpayer 25

63 See Emslie at 221, 'Acquisition and Disposal of Assets The Unifying Characteristic of Trade' 1992 The Taxpayer 181 at 182

(ChD); Caillebotte (HM Inspector of Taxes) v Quinn (1975) 2 All ER 412 (ChD); Mallalieu v Drummond (Inspector of Taxes) (1983) 2 All ER 1095 (HL); Hillyer v Leeke (Inspector of Taxes) 1976 STC 490; Watkis (Inspector of Taxes) v Ashford Sparkes & Harward 1985 STC 451; MacKinlay (Inspector of Taxes) v Arthur Young McClelland Moores & Co (1990) 1 All ER 45 (HL). Some cases that have dealt with non-travelling expenses under Schedule E are Lomax (HM Inspector of Taxes) v Newton 34 TC 558; Sanderson (HM Inspector of Taxes) v Durbridge 36 TC 239; Brown v Bullock (HM Inspector of Taxes) 40 TC 1; McKie (HM Inspector of Taxes) v Warner 40 TC 65; Elward (HM Inspector of Taxes) v Utitz 42 TC 492; Lucas v Cattell (HM Inspector of Taxes) 48 TC 353; Woodcock v IRC 1977 STC 405; Ward (HM Inspector of Taxes) v Dunn 1979 STC 178.

42 45 TC 380.

43 49 TC 579.

44 See the speech of Lord Pearce in Pook (HM Inspector of Taxes) v Owen at 592. See also J Ward 'Subjective Objectivity: The Schedule E Expense Rule' 1988 BTR 6 at 15.

45 See Ricketts v Colquhoun (HM Inspector of Taxes); Pook (HM Inspector of Taxes) v Owen and Taylor v Provan (HM Inspector of Taxes).

46 See the opinion of Lord Brightman in Mallalieu v Drummond (Inspector of Taxes) (1983) 2 All ER 1095 (HL) at 1095-104. See also

34 Solaglass Finance Co (Pty) Ltd v CIR at 26-7

35 at 26-7.

36 at 27-8

37 at 9-21 Grosskopf JA concurred with the judgment of Friedman AJA.

38 at 19-20.

39 at 20-1.

40 at 21.

41 10 TC 118. Some other cases that have dealt with travel expenses under sch E are Nolder (HM Inspector of Taxes) v Walters 15 TC 380; Pook (HM Inspector of Taxes) v Owen 45 TC 380. Taylor v Provan (HM Inspector of Taxes) 49 TC 579 Some cases that have dealt with travel expenses under sch D are Newsom v Robertson (HM Inspector of Taxes) 33 TC 452, Edwards (HM Inspector of Taxes) v Warmsley, Henshall & Co 44 TC 431, Bowden (HM Inspector of Taxes) v Russell & Russell 42 TC 301; Horton v Young (HM Inspector of Taxes) 47 TC 60. Some cases that have dealt with non-travelling expenses under sch D are, Copeman (HM Inspector of Taxes) v William Flood & Sons Ltd 24 TC 53; Lochgelly Iron & Coal Co Ltd v Crawford (Surveyor of Taxes) 6 TC 267, Norman v Golder (HM Inspector of Taxes) 26 TC 293, Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes) 33 TC 491, Murgatroyd (HM Inspector of Taxes) v Evans-Jackson 43 TC 581, Edwards (HM Inspector of Taxes) v Warmsley, Henshall & Co 44 TC 431, Prince v Mapp (HM Inspector of Taxes) (1970) 1 All ER 519

13 (1983) 2 All ER 1095 (HL)

14 Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes) at 503-4.

15 Bowden (HM Inspector of Taxes) v Russell & Russell at 306

16 Mallalieu v Drummond (Inspector of Taxes) at 1100a-d

17 CIR v Pick 'n Pay Wholesalers (Pty) Ltd at 149.

18 at 150-1

19 at 152-5.

20 at 152.

21 6 TC 399.

22 CIR v Pick 'n Pay Wholesalers (Pty) Ltd at 152.

23 at 152-5.

24 Solaglass Finance Co (Pty) Ltd v CIR at 9-10.

25 at 10-11.

26 at 21-9. Nicholas AJA and Nienaber AJA concurred with the judgment of Botha JA.

27 at 21-2.

28 at 22-3

29 (1990) 1 All ER 45 (HL)

30 Solaglass Finance Co (Pty) Ltd v CIR at 24-5.

31 at 26

32 ibid

33 (1966) 28 SATC 1

## FOOTNOTES

1 CIR v Nemojim (Pty) Ltd (1983) 45 SATC 241 and Solaglass Finance Co (Pty) Ltd v CIR (1991) 53 SATC 1

2 by the Finance Tax Act 141 of 1992 The amendment applied to years of assessment ending after 31 January 1992.

3 Explanatory Memorandum on the Income Tax Bill, 1992 at 17

4 (1991) 53 SATC 1.

5 (1987) 49 SATC 132.

6 (1987) 49 SATC 132.

7 (1991) 5. SATC 1.

8 For example, see J Silke 'The "Negative Test" Still a Serious Threat?' (1994) 33 ITR 75. T S Emslie 'Is Generosity a Bar to Tax Deductibility?' (1988) 105 SATJ 214

9 CIR v Pick 'n Pay Wholesalers (Pty) Ltd at 144

10 at 145-6

11 33 TC 491

12 42 TC 301