COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v KNUTH AND INDUSTRIAL MOULDINGS (PTY) LTD
62 SATC 65

Division:	Eastern Cape Provincial Division
Judges:	LEACH J, JONES J and JANSEN J
Date:	24 May and 25 November 1999

Income tax - Capital and Revenue - Shares, sale of - Whether proceeds on sale of shares fell in taxpayer's 'gross income' as defined in s 1 of the Income Tax Act 58 of 1962 - Scheme implemented on behalf of taxpayer to enable him to purchase half share in a company of which he was the other shareholder - Valuation of company's plant and machinery far in excess of amount previously reflected in company's books as being its nett asset value - Scheme implemented through medium of another company which was appointed taxpayer's nominee to exercise option to purchase other half share - Taxpayer then selling his half share to other company and effecting further sale to another company - Commissioner seeking to tax taxpayer on proceeds of such sales as they were not 'receipts or accruals of a capital nature' as envisaged in the definition in s 1 - Held that taxpayer's shares had originally been acquired and held by him as fixed capital rather than as his stock-in-trade or 'floating capital' - Held that taxpayer's sale of his shares was not part of a profit-making scheme and that the accrual derived therefrom was therefore derived from the sale of his fixed capital and was not subject to tax - Held further that taxpayer had not acquired the new company for resale at a profit but rather he intended to derive an income from its productive use and it had therefore become part of his fixed capital which could be sold without attracting liability for tax.

Income tax - Tax Avoidance - Section 103(1) of the Income Tax Act 58 of 1962 - In terms of aforementioned scheme taxpayer-company claiming depreciation allowance in terms of s 12B of the Income Tax Act 58 of 1962 -Commissioner for SARS of the view that scheme in question was one envisaged by s 103(1) and therefore disallowed taxpayer-company's claim for deduction in terms of s 12B and assessed its liability to tax as if the scheme had not been entered into or carried out - Held that sole or main purpose of the scheme in question was to enable taxpayer to become sole owner of the business via becoming the sole shareholder in the new company and the fact that in carrying out this purpose an advantage could be taken of a provision in the Income Tax Act to reduce liability for tax was

immaterial - Held accordingly that Commissioner had erred in attempting to rely on s 103(1) of Act 58 of 1962.

Respondent and one Mattheus were equal shareholders in Oldco which they ran between them from 1983.

In 1988 respondent and Mattheus parted company and respondent undertook to purchase Mattheus's half share in the company and they agreed upon a purchase price of R225 000.

Respondent had most of his capital tied up in Oldco and was not able to raise sufficient money from his private funds in order to pay such a large sum and he therefore approached his bank manager to see if he could arrange a loan. His request was refused and Oldco was itself prohibited by s 38(1) of the Companies Act 61 of 1973 from providing financial assistance for the purpose of purchasing its own shares.

Respondent then approached his attorney for advice and he had suggested that respondent should obtain a formal option from Mattheus for the purchase of his share in Oldco at the price they had agreed upon which, in due course, he did.

Respondent was then introduced to 'Financial Associates Corporation' in order to arrange the necessary finance for the purchase of Mattheus's share. On their suggestion a valuation of Oldco's plant and machinery was obtained in order to determine the true value of the company's assets and the estimate, based on current market value, was a sum far in excess of the amount reflected in the company's books as being its nett asset value.

Financial Associates Corporation then proceeded to implement a scheme on behalf of respondent through the medium of a company known as 'Attest Finance (Pty) Ltd' whereby respondent appointed Attest as his nominee to exercise the option for the purchase of Mattheus's share and on 21 February 1989 Attest took up the option and bought out Mattheus for R225 000. Then, on 28 February 1989 respondent sold his share in Oldco to Attest for R941 929. On 1 March 1989 respondent invested the full proceeds of the sale in Newco, thereby raising a director's loan in his favour with the company. On 1 March 1989 Attest sold to Newco for R1 166 878 the business of Oldco comprising all its assets and liabilities. About a year later respondent sold his interest in Newco to another company, DAD Holdings (Pty) Ltd for the sum of R1 664 951 being R689 113 for his shareholding and R975 000 in respect of his loan account.

The Commissioner for SARS had sought to tax, in respect of the 1989 year of assessment, the sum of R958 345 being the amount that respondent had obtained from selling his share in Oldco to Attest and, in respect of the 1990 year of assessment, he sought to tax the full amount of R689 112 which had accrued to respondent arising out of the sale of Newco to DAD Holdings.

The Commissioner's decision to subject the aforementioned amounts to tax had formed the subject of the appeal to the court *a quo*, being the Special Court for Hearing Income Tax Appeals, under *case no 9990* (unreported).

The Special Court had upheld respondent's contention that the amounts in issue were not taxable and the Commissioner then appealed to the High Court against that decision.

The essential dispute between the Commissioner and respondent was whether the proceeds of the sale of the shares should be regarded as falling within respondent's 'gross income' as defined in s 1 of the Income Tax Act 58 of 1962 for the years of assessment in question.

There were further issues between the Commissioner and Newco (Industrial Mouldings (Pty) Ltd) which had formed the basis of the dispute in *case no 10176* (unreported) and in regard to which the Special Court had also found against the Commissioner who then appealed to the High Court.

Attest had sold the business of Oldco, including its assets and liabilities, to Newco on 1 March 1989. The price paid by Newco was based upon a valuation of the plant and machinery and for purposes of the year of assessment ending 31 December 1989 Newco submitted a return of income supported by financial statements wherein it claimed the sum of R553 625 as a depreciation allowance in terms of s 12B of the Income Tax Act 58 of 1962 as it then read which provided for a deduction calculated in a prescribed manner to be allowed in respect of certain plant, machinery, implements, utensils and articles brought into use by a taxpayer for the purposes of his trade and *in casu* the deduction claim was calculated at 50% of the value at which the plant and machinery purchased from Attest had been brought into Newco.

The Commissioner was of the view that the scheme in issue was one envisaged by s 103(1) of the Income Tax Act 58 of 1962 and although he allowed a deduction of 25% of the book value of Oldco's plant and equipment acquired from Attest, he therefore disallowed Newco's claim for a deduction in terms of s 12B and assessed its liability to tax as if the scheme had not been entered into or carried out.

Newco then lodged an objection against the assessment and when it was refused it appealed successfully to the Special Court (unreported *case no 10176*) on the ground that s 103(1) had not been applicable. The Commissioner, in turn, appealed to the High Court against the finding of the Special Court on this point.

Held

In regard to case no 9990 (proceeds on sale of shares)

(i) That there was no doubt that the shares held by respondent in Oldco had originally been acquired and held by him as fixed capital rather than as his stock-in-trade or 'floating capital' and there was no suggestion that respondent wished to acquire Mattheus's share for any other reason than to become the sole owner of the company and to hold it 'for keeps'.

(ii) That therefore respondent held his share in Oldco as fixed capital at the time his possible purchase of Mattheus's share first arose and, moreover, as he wished to acquire Mattheus's share for the same purpose, the option which he obtained should also be regarded as being of a 'capital' nature.

(iii) That the fact that respondent held his share in Oldco as fixed capital is something which was clearly in his favour as the mere sale of a capital asset which has been acquired and held as such does not, in itself, constitute a taxable trade and, before its sale renders the accrual derived therefrom subject to tax, there must be something else to show that it was in pursuance of the business of buying and selling in a profit-making scheme.

(iv) That what the court was called upon to decide was whether respondent had changed the intention with which he had held his share in Oldco in such a way as to render it part of his floating capital.

(v) That neither respondent nor Newco should be punished for implementing a scheme which resulted in them paying less tax than would otherwise have been the case had the scheme not been implemented: no obligation rests upon a taxpayer to pay greater tax than is legally due under the Income Tax Act and a taxpayer is not debarred from entering into a *bona fide* transaction which, when carried out, has the effect of avoiding or reducing liability for tax, provided his actions in doing so do not offend a provision in the law designed to prevent the avoidance or reduction of tax.

(vi) That, accordingly, apart from the argument in regard to s 103 of the Income Tax Act 58 of 1962 dealt with below, as the Commissioner does not allege that the scheme in itself offended any provision of the Act, he cannot complain if it reduced a taxpayer's tax burden.

(vii) That in the instant case no direct evidence was led to show that respondent had in fact been motivated by the tax implications of the scheme as suggested by the

Commissioner and indeed there were strong indications to the contrary which pointed towards the scheme having been implemented in order to enable respondent to become the sole owner of the company conducting the business, rather than to draw the tax benefits bound up therein.

(viii) That in considering whether the scheme amounted to one of profit-making it is useful to strip away its somewhat gaudy disguise - respondent made no 'profit' nor received any income out of the implementation of the scheme.

(ix) That the scheme was clearly one devised to enable respondent to be the sole shareholder in a company that carried on the business formally carried on by Oldco and was in no way designed to create profits for him.

(x) That, accordingly, respondent's sale of his shares in Oldco was not part of a profit-making scheme and that the accrual derived therefrom was therefore derived from the sale of his fixed capital and was not subject to tax.

(xi) That the Commissioner was clearly wrong in having sought to tax the accrual derived from the sale of respondent's shares in Newco to DAD holdings; there can be no question of respondent having acquired Newco for resale at a profit but rather he intended to derive an income from its productive use and it had therefore become part of his fixed capital which could be sold without attracting liability for tax.

In regard to case no 10176 (application of s 103(1) of Act 58 of 1962)

(xii) That it had been shown on a balance of probabilities that the sole or main purpose of the scheme was to enable respondent to become sole owner of the business *via* becoming the sole shareholder in Newco, and the fact that in carrying out this purpose an advantage can be taken of a provision in the Income Tax Act to reduce liability for tax, is immaterial and the Commissioner therefore erred in attempting to rely on s 103(1) of the Income Tax Act 58 of 1962.

(xiii) That, accordingly, Newco had discharged the onus which lay upon it in terms of s 103(4) to rebut the presumption that tax avoidance was its sole and main purpose of the scheme and the court *a quo* had therefore correctly set aside the Commissioner's assessment of Newco's tax liability for the year ending 31 December 1989.

Appeal in both cases *9990* and *10176* dismissed with costs.

LEACH J: In these two matters the Commissioner for the South African Revenue Service appeals to this court under s 86A(1) and (2)(*a*) of the Income Tax Act 58 of 1962 ('the Act') against the decision of the Income Tax Special Court (Erasmus J, President) delivered in Port Elizabeth on 6 November 1997 upholding the appeals brought by two taxpayers under the provisions of s 83(1) of the Act in *ITC 9990* and *ITC 10176*. As is apparent from what is set out below, the taxpayer in the latter case is a company which conducts the business formerly carried on by another company of the same name and, consequently, in order to avoid possible confusion, Erasmus J, in delivering the judgment in the court *a quo*, referred to the taxpayer as 'Newco' and to its predecessor as 'Oldco'. The same reference was used by counsel in the appeal and, for convenience, I shall do so as well for purposes of this judgment. Moreover, for convenience, I shall refer to the appellant in the appeals to this court as 'the Commissioner' and to the respondent taxpayer in case no *9990* as 'Knuth'.

As the facts of the two cases are intimately interwoven, the two appeals were heard together in the court *a quo* and a single judgment was delivered. The appeals to this court were similarly argued as if they were one, and as a result, it

is also my intention to give a single judgment although, at the end of the day, a separate order should be made in respect of each individual case.

Turning to the dispute, the basic facts are largely common cause. Knuth and one Mattheus were equal shareholders in Oldco which they ran between them from 1983. However in 1988 they decided to part their business ways, and Knuth undertook to purchase Mattheus' half share in the company. As they were satisfied that the nett asset value of Oldco at that time was R450 000 (the amount then reflected in its books of account) they agreed upon a purchase price of R225 000.

Knuth appears to have had most of his capital tied up in Oldco and was not able to raise sufficient money from his private funds in order to pay such a large sum. He therefore approached his bank manager to see if he could arrange a loan. However as banks are apparently generally reluctant to grant credit on the security of shares in a private company, his request was refused. Of course Oldco was itself prohibited by s 38(1) of the Companies Act 61 of 1973 from providing financial assistance for the purpose of purchasing its own shares, and so Knuth found himself in something of a quandary. He approached his attorney, one Kaplan, for advice. Kaplan suggested that he should obtain a formal option from Mattheus for the purchase of his share in Oldco at the price they had agreed upon which, in due course, he did.

Although Kaplan was unable to provide further assistance, he referred Knuth to an accountant, one Strelitz, who in turn introduced him to a concern operating in Johannesburg under the name of 'Financial Associates Corporation' in the hope that it could devise a scheme involving the sale of Oldco's assets in order to arrange the necessary finance for the purchase of Mattheus' share. On Financial Associates Corporation's suggestion, a valuation of Oldco's plant and machinery was obtained from one Snowball in order to determine the true value of the company's assets. Snowball's estimate, based on current market value, was that Oldco's assets were in fact worth R1 192 250 *viz* a sum far in excess of the amount of R450 000 then reflected in the company's books as being its nett asset value.

On the strength of Snowball's valuation, Financial Associates Corporation proceeded to implement a scheme on behalf of Knuth which, according to the evidence, is quite a commonplace. It did so through the medium of a company known as 'Attest Finance (Pty) Ltd' ('Attest'). No witnesses from either Financial Associates Corporation or Attest were called to testify in the court *a quo*. Strelitz, who did testify, had no further involvement in the implementation of the scheme and Knuth himself was unable to shed much light thereon as its workings seems to have really passed over his head. However, from the documents contained in the dossier submitted to the court under regulation B3 of the regulations promulgated under s 107 of the Act (of which use can be made in evidence in terms of regulation B7) the court *a quo* pieced together the following chronology of the implementation of the scheme (I quote from the judgment):

'(*a*) On 14 February 1989, Knuth (Pty) Ltd is incorporated, later to be renamed Industrial Mouldings (Pty) Ltd. (This is Newco, the appellant in case no 10176.)

(*b*) On, or some short time prior to 21 February 1989, Knuth appoints Attest as his nominee to exercise the option for the purchase of Mattheus's share.

(*c*) On 21 February 1989, Attest takes up the option and buys out Mattheus for R225 000.

(*d*) On 28 February 1989, Knuth sells his share in Oldco to Attest for R941 929.

(*e*) On 1 March 1989, Knuth invests the full proceeds of the sale in Newco, thereby raising a director's loan in his favour with the company.

(*f*) On 1 March 1989, Oldco declares a dividend *in specie* of its total distributable reserves in favour of its sole shareholder, Attest.

(*g*) On 1 March 1989, Attest sells to Newco for R1 166 878 the business of Oldco comprising all its assets and liabilities. (The purchase consideration is almost exactly the sum of the R941 929 and R225 000 paid by Attest to Knuth and Mattheus respectively for their shares in Oldco).

(*h*) Newco pays the purchase price out of Knuth's investment of R941 929 and a bank overdraft of at least R225 000.

At the end of the day, the net effect was that Knuth acquired the full shareholding of the company by means of a payment to Mattheus of R225 000 by Newco out of the loan obtained by it from its bank.'

I did not understand any of the parties to this appeal to dispute this synopsis of the scheme. They also accepted that about a year later Knuth sold his interest in Newco to another company, DAD Holdings (Pty) Ltd, for the sum of R1 664 951 being R689 113 for his shareholding and R975 000 in respect of his loan account.

Arising out of all of this, a dispute has arisen between the parties in regard to certain amounts which the Commissioner has sought to subject to tax. In respect of the 1989 tax year, he sought to tax the sum of R958 345 being the amount Knuth had obtained from selling his share in Oldco to Attest, less the initial cost of the share of R1,00. In respect of 1990 tax year, he sought to tax the full amount of R689 112 which accrued to Knuth arising out of the sale of Newco to DAD Holdings. It was the Commissioner's decision to subject these amounts to tax which formed the subject of the appeal to the court *a quo* in *ITC 9990*. The Special court upheld Knuth's contention that the amounts were not taxable and this court is now called upon to decide whether it was correct. I intend to deal with this aspect of the case before turning to deal with the issues between the Commissioner and Newco which formed the basis of the dispute in *ITC 10176*.

The essential dispute between the Commissioner and Knuth is whether the proceeds of the sale of the shares should be regarded as falling within Knuth's 'gross income' for the years in question. In s 1 of the Act, 'gross income' is defined as being:

'. . . the total amount, in cash or otherwise, received by or accrued to or in favour of (a taxpayer) . . . excluding receipts or accruals of a capital nature . . . '.

The Commissioner contends that the amount which accrued arising out of the sale of the shares in question were not 'receipts or accruals of a capital nature' as envisaged in this definition, and, were therefore taxable as gross income. The Act fails to define the phrase 'receipts or accruals of a capital nature'. Although there is no simple litmus test which can be applied to determine the issue, over the years various guidelines have been laid down which assist in the determination of the nature of a receipt or accrual.

In an elucidating and oft quoted exposition of this issue Corbett JA (as he then was), in his minority judgment in *Elandsheuwel Farming (Edms) Bpk v*

Sekretaris van Binnelandse Inkomste 1978 (1) SA 101(A) at 118A-F,1 said the following:

> 'Where the taxpayer sells property, the question as to whether the profits derived from the sale are taxable in his hands by reason of the proceeds constituting gross income or are not subject to tax because the proceeds constitute receipts or accruals of a capital nature, turns on the further enquiry as to whether the sale amounted to the realisation of a capital asset or whether it was the sale of an asset in the course of carrying on a business or in pursuance of a profit-making scheme. Where a single transaction is involved it is usually more appropriate to limit the enquiry to the simple alternatives of a capital realisation or a profit-making scheme. In its normal and most straightforward form, the latter connotes the acquisition of an asset for the purposes of reselling it at a profit. This profit is then the result of the productive turn-over of the capital represented by the asset and consequently falls into the category of income. The asset constitutes in effect the taxpayer's stock-in-trade or floating capital. In contrast to this the sale of an asset acquired with a view of holding it either in a non-productive state or in order to derive income from the productive use thereof, and in fact so held, constitutes a realisation of fixed capital and the proceeds an accrual of a capital nature.'

Of course it is well established that no single feature should be elevated to a position of decisive pre-eminence (see *Commissioner for Inland Revenue v Guardian Assurance Company South Africa Ltd* 1991 (3) SA 1(A) at 19B-C)2 but the intention with which the taxpayer acquired the property or asset in question is a particularly important consideration. Indeed, a taxpayer's intention has been described as being the most important 'test' employed to decide whether the profits arising from the disposal of an asset are in the nature of capital or income (see *Silke on South African Income Tax* Vol 1 paragraph 3. 2). Accordingly, if the object of the original acquisition was to resell the asset at a profit and that object is achieved, the profit obtained is the result of the productive use of capital employed for the purpose of making such profit and is, then, income - see *Lace Proprietary Mines Ltd v Commissioner for Inland Revenue* 1938 AD 267 at 277.3 On the other hand, if an asset is acquired with the intention to hold it 'for keeps' *ie* only to be disposed of if some unusual or unexpected circumstance should intervene, that 'is the usual badge of a fixed, capital investment' - *per* Trollip JA in *Barnato Holdings Ltd v Secretary for Inland Revenue* 1978 (2) SA 440 (A) at 454A.4

The distinction between capital, on the one hand, and revenue, on the other, may also be considered in terms of 'fixed' and 'floating' capital (as adverted to by Corbett JA in the passage from his judgment in the *Elandsheuwel Farming* case quoted above), fixed capital being that which a person wishes to keep in his possession as a means of earning continuous profits, with floating capital being the property a person means to turn into profit by resale. In *Commissioner for Inland Revenue v George Forest Timber Company Limited* 1924 AD 516 at 5245 Innes CJ, in dealing with these concepts, said the following:

> 'Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it

> remains intact. The distinction is relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed. But as pointed out by Mason J in *Stephan v Commissioner for Inland Revenue* (1919 WLD at p 5)6 the two phrases have an ascertained meaning in accountancy as well as in economics. Ordinary merchandise in the hands of a trader would be floating capital. Its use involves its disappearance; and the money obtained for it is received as part of the ordinary revenue of the business. It could never have been intended that money received by a merchant in the course, and as a result of his trading, should not form part of his gross income.
>
> The proceeds of fixed capital stand in a different position. The sale of such capital would, generally speaking, represent a mere realisation, which ought from its nature to be excluded, and which I think the section intended to exclude from the calculation of income.'

Although the difference between fixed and floating capital is not a distinction expressly mentioned in the Act, it is often referred to in tax cases and can now be regarded as entrenched in our law - see *Bourke's Estate v Commissioner for Inland Revenue* 1991 (1) SA 661 (A) at 672F.7 It is therefore clearly established that an asset held by a taxpayer, either in a non-productive state or in order to derive income from the productive use thereof, constitutes fixed capital and the proceeds derived from a realisation thereof are of a capital nature. But where an asset is acquired for reselling at a profit, it effectively constitutes the taxpayer's stock-in-trade or 'floating capital' and the proceeds derived therefrom are of a revenue nature - see the *Elandsheuwel Farming* case, *supra* and the *Bourke's Estate* case, *supra* at 673A-B.8

Of course, these various 'tests' are no more than guidelines and, ultimately, one is called upon to make a decision which is not contrary to sound commercial and good sense - *cf Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 56H-I.9 Bearing all the above in mind, I turn now to consider the accruals Knuth derived from firstly selling his share in Oldco to Attest and then, subsequently, selling his shareholding in Newco to DAD Holdings.

Dealing at the outset with the taxability of the accrual derived from the sale of Knuth's shares in Oldco, the argument advanced in this court on behalf of the Commissioner appears to have been the same advanced on his behalf, and rejected, in the court *a quo*. The Commissioner's contention, as I understand it, is that if it had been Knuth's intention to merely purchase Mattheus' share in Oldco, he could have obtained the necessary finance (R225 000) on the strength of Snowball's valuation of Oldco's assets at R1 192 250. The argument in that respect was that if the bank manager had known that the company's assets were worth what Snowball said they were and not the sum of R450 000 as reflected in the books, he would have been prepared to grant a loan. Moreover, as Oldco's balance sheet of 28 February 1989 reflects a distributable reserve of R247 244, it was argued that it could have declared it a potentially taxable 'dividend' sufficiently large to have enabled him to purchase Mattheus' share. However, the elaborate scheme that I have detailed instead resulted in Knuth obtaining a non-taxable loan account in Newco. The Commissioner therefore argued that the scheme had been designed specifically to offer Knuth the maximum financial

advantage with the least tax implications and that, as a result, the tax benefits which accrued from the scheme were its main objective and not merely incidental thereto. Bearing all of this in mind, it was therefore submitted that Knuth had embarked upon a scheme of profit-making which involved the sale of his shares in Oldco rendering the accrual derived therefrom subject to tax.

There does not seem to me to be any doubt that the shares that Knuth held in Oldco had originally been acquired and held by him as fixed capital rather than as his stock-in-trade or 'floating capital'. The company appears to have been successful and there is no suggestion that Knuth wished to acquire Mattheus' share for any other reason than to become the sole owner of the company and to hold it 'for keeps'. In my view, Knuth therefore held his share in Oldco as fixed capital at the time his possible purchase of Mattheus' share first arose. Moreover, as he wished to acquire Mattheus' share for the same purpose, the option which he obtained should also be regarded as being of a 'capital' nature - *cf ITC 962* (1960) 24 SATC 651, *ITC 1208* (1974) 36 SATC 80 and Meskin *op cit* at 3. 42 under the sub-heading 'Share Options'.

The fact that Knuth held his share in Oldco as fixed capital is, of course, something which is clearly in his favour as the mere sale of a capital asset which has been acquired and held as such does not, in itself, constitute a taxable trade and, before its sale renders the accrual derived therefrom subject to tax, there must be something else to show that it was in pursuance of the business of buying and selling in a profit-making scheme - see for example *John Bell & Co (Pty) Ltd v Secretary for Inland Revenue* 1976 (4) SA 415 (A) at 429C[10] and the judgment of Trollip JA in the *Elandsheuwel Farming* case (*supra*) at 114-115.[11] But one must also bear in mind that a taxpayer may change the intention with which he is holding an asset, and that an asset initially held as fixed capital may subsequently be used in a profit-making scheme. As a result, the intention a taxpayer has in regard to the use of an asset at the date of its acquisition is not necessarily conclusive - see *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A) at 202[12] and *Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A) at 607.[13] What we are called upon to decide is whether Knuth changed the intention with which he held his share in Oldco in such a way as to render it part of his floating capital.

In arguing that Knuth had changed his intention by deciding to sell his share in Oldco as part of a profit-making scheme, Mr *Lowe* SC, counsel for the Commissioner, laid particular emphasis on the tax implications flowing from the scheme, namely, the avoidance of a potentially taxable 'dividend' to be paid by Oldco to Knuth to enable him to finance the purchase of Mattheus' share and the deduction Newco claimed under s 12B of the Act (which I shall deal with in more detail below). He therefore contended that the tax implications of the scheme were such that the inference had to be drawn that the scheme was entered into either solely or primarily for the purposes of incurring the tax benefits it offered.

In considering this argument, I do not think one should punish either Knuth or Newco for implementing a scheme which resulted in them paying less tax than would otherwise have been the case had the scheme not been implemented. No obligation rests upon a taxpayer to pay greater tax than is legally due under the Act and a taxpayer is not debarred from entering into a *bona fide* transaction which, when carried out, has the effect of avoiding or reducing liability for tax, provided his actions in doing so do not offend a provision in the law designed to prevent the avoidance or reduction of tax - see for example *Silke on South African Income Tax* (Vol 3) at 19.1. Accordingly, apart from the argument in regard to s 103 of the Act mentioned below, as the Commissioner does not allege that the scheme in itself offended any provision of the Act, he cannot complain if it reduced a taxpayer's tax burden.

Moreover, Knuth was emphatic in his evidence that the tax implications had not motivated his decision to implement the scheme. The purpose with which a taxpayer deals with an asset or implements a scheme is a question of fact - see for *eg Bloch v Secretary for Inland Revenue* 1980 (2) SA 401 (C) at 407A.[14] In considering the factual enquiry which therefore has to be made, the *ipse dixit* of the taxpayer's intention is of course to be taken into account but does not necessarily dispose of the matter. As was observed by Miller J (as he then was) in *ITC*

1185, 35 SATC 122 at 123-4:

> 'It is very often difficult, however, to discover what his true intention was. It is necessary to bear in mind in that regard that the *ipse dixit* of the taxpayer as to his intent and purpose should not lightly be regarded as decisive. It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business or occupation and the frequency or otherwise of his past involvement or participation in similar transactions . . . This is not to say that the court will give little or no weight to what the taxpayer says his intention was, as is sometimes contended in argument on behalf of the Secretary in cases of this nature. The taxpayer's evidence under oath and that of his witnesses must necessarily be given full consideration and the credibility of the witnesses must be assessed as in any other case which comes before court. But direct evidence of intent and purpose must be weighed and tested against the probabilities and the inferences normally to be drawn from the established facts.'

That a court is not bound by a taxpayer's testimony but is to have regard to the evidence and the probabilities as a whole, is also evident from cases such as *ITC 1162*, 33 SATC 201 at 204 and *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A) at 202H.[15] But at the same time, where no evidence is led to rebut what a taxpayer says his intention had been, the more readily a court will accept his *ipse dixit*. As was remarked by Colman J in a judgment in the Special Court, in a passage apparently approved by the Appellate Division in *Secretary for Inland Revenue v Gallagher* 1978 (2) SA 463 (A) at 472-3[16]: 52 SATC 323 at 327:

> '. . . the sworn testimony of a witness, given with the appearance of truthfulness and candour, is not lightly to be discarded unless some reason appears for disbelieving the witness. What he says may be discarded if there is credible evidence to the contrary, or

> if there are such weighty probabilities against what he has deposed to that the court does not feel justified in accepting his evidence.'

In the instant case, no direct evidence was led to show that Knuth had in fact been motivated by the tax implications of the scheme as suggested by the Commissioner. Indeed there are strong indications to the contrary. Firstly, one knows that if his bank had been prepared to advance him the necessary funds, he would have purchased Mattheus' share without entering into the scheme. Secondly, as Erasmus J observed in the court *a quo* in a finding which I did not understand the Commissioner to seriously dispute in this court, Oldco at the time lacked the liquidity to pay out as substantial a cash dividend as would have been required to enable Knuth to purchase Mattheus' share. Both of these factors point towards the scheme having been implemented in order to enable Knuth to become the sole owner of the company conducting the business, rather than to draw the tax benefits bound up therein.

I also find myself unimpressed by the argument that, on the strength of Snowball's valuation, Knuth could have obtained a loan from his bank in order to purchase Mattheus' share in Newco. We know that he approached his bank unsuccessfully for a loan, albeit on the strength of Oldco's then current financial statements. There is no reason to think that the bank's attitude would have changed merely by reason of another valuation which it might not have accepted. One really cannot speculate on this issue, and no evidence was led by the Commissioner to the effect that the bank would probably have lent and advanced the required funds on the strength of Snowball's valuation. In any event, that valuation was obtained after the approach to the bank had proved unsuccessful, and it seems from Knuth's evidence that he never considered going back to the bank to again plead his case on the strength of this new information. I did not understand his evidence in that regard to be disputed and, consequently, he seems clearly to have embarked upon the scheme, not in order to avoid going back to the bank for a loan which might now be successful, but to obtain Mattheus' share in the business which had been conducted by Oldco up until then. That appears to me to have been the primary objective of the scheme which was therefore not designed specifically to offer Knuth the maximum advantage with the least tax implications to him, as was submitted on behalf of the Commissioner.

In considering whether the scheme amounted to one of profit-making it is, in my opinion, useful to strip away its somewhat gaudy disguise. Reduced to the bare essentials, Knuth wished to acquire Mattheus' share in the business of which they were the co-owners. Although the nett asset value of the company conducting that business was reflected in its books as being R450 000 the actual value was approximately almost R1,2 million of which Knuth's share was worth approximately R600 000. As a result of the prohibition contained in s 38 of the Companies Act, the scheme was implemented which resulted in Knuth becoming the sole shareholder in a company conducting the same business and which had the same assets, but which owed its bank an additional amount equivalent to the sum paid for Mattheus' share. As was pointed out by the court *a quo*, Knuth therefore made no 'profit' nor received any income out of the implementation of the scheme. Had he obtained a loan in order to pay Mattheus for his share in the company (either from the company itself in breach of s 38 of the Companies Act, or from a third party), his nett asset value would have been exactly the same as it was after implementation of the scheme. It may well be that Mattheus would have had something to grumble about had he known of the scheme (as he was being paid R225 000 for an asset which, on Snowball's valuation, was worth in the vicinity of R600 000) but that seems to me to be neither here nor there for purposes of this matter.

I am therefore satisfied that the scheme was clearly one devised to enable Knuth to be the sole shareholder in a company which carried on the business formally carried on by Oldco and was in no way designed to create profits for him. Had it not been for his desire to be the sole shareholder of the company conducting the business, the scheme would not have been embarked upon. Neither a desire to avoid a taxable dividend from Oldco, nor a deduction under s 12B of the Act appear to have been the main objective of the scheme. I am accordingly of the view that Knuth's sale of his shares in Oldco was not part of a profit-making scheme and that the accrual derived therefrom was therefore derived from the sale of his fixed capital and is not subject to tax. The Commissioner was therefore wrong to have regarded the accrual as revenue in nature and his assessment for the 1989 tax year, which was the subject of the appeal in *case no 9990*, was correctly set aside by the court *a quo.*

I turn now to the additional assessment for the 1990 tax year in which the Commissioner sought to tax the accrual Knuth derived from the sale of Newco to DAD Holdings. It was submitted on behalf of the Commissioner that this sale was the culmination of the scheme of profit-making devised by Financial Associates Corporation whereunder Knuth sold his shareholding in Oldco and ultimately became the sole shareholder of Newco. The immediate answer to the Commissioner's contention in that regard is that, for the reasons that I have just set out, the scheme was not one of profit-making. But even if I am incorrect in that regard, the Commissioner was clearly wrong in having sought to tax the accrual derived from the sale of Knuth's shares in Newco to DAD Holdings.

As I have said, Knuth clearly wished to become the sole shareholder in the company which conducted the business previously conducted by Oldco. There is no hint of any evidence that he wished to do so for any reason other than to keep Newco as an income-producing asset. It was only some time after Newco had come into existence that approaches were made to him to sell it. The facts were succinctly and correctly summarised by Erasmus J in the court *a quo* as follows:

> 'It is clear from all the evidence that DAD came onto the scene only after the scheme had been concluded and Knuth had acquired full control of Newco. That position was achieved on 1 March 1989. Mr White, who acted on behalf of the purchaser (DAD Holdings), testifies that he started investigating the possibility of acquiring a manufacturing concern such as Newco as late as August 1989, and that he entered into negotiations with Knuth sometime thereafter. The agreement of sale was signed on 11 April 1990 with an effective date of 1 January 1990. It is therefore clear that the DAD sale was not in the contemplation of the parties when they implemented the scheme.'

In my view there can therefore be no question of Knuth having acquired Newco for resale at a profit. On the contrary, he intended to derive an income from its productive use and it had therefore become part of his fixed capital which could be sold without attracting liability for tax. The court *a quo* was therefore correct in also setting aside the Commissioner's 1990 additional assessment of Knuth's tax liability in *case no 9990*.

That brings me to the dispute in *case no 10176*. As I have mentioned, Attest sold the business of Oldco, including its assets and liabilities, to Newco on

1 March 1989. The price Newco paid was based upon Snowball's valuation of the plant and machinery. For purposes of the year of assessment ending 31 December 1989, Newco then submitted a return of income supported by financial statements wherein it claimed the sum of R553 625 as a depreciation allowance under s 12B of the Act as it then read which provided for a deduction calculated in a prescribed manner to be allowed in respect of certain plant, machinery, implements, utensils and articles brought into use by a taxpayer for the purposes of his trade (*in casu* the deduction claim was calculated at 50% of the value at which the plant and machinery purchased from Attest had been brought into Newco).

Although subsequently amended, at the material time s 103(1) of the Act provided as follows:

> '103(1) Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property)-
>
> (*a*) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and
>
> (*b*) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out-
>
> (i) was entered into or carried out by means or in a manner which would not normally be employed in the

entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

(*c*) was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of any tax, duty or levy (whether imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner) or the reduction of the amount of such liability,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out or in such a manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'

As the Commissioner was of the view that the scheme in question was one envisaged by this section, and although he allowed a deduction of 25% of the book value of Oldco's plant and equipment acquired from Attest, he therefore disallowed Newco's claim for a deduction under s 12B and assessed its liability to tax as if the scheme had not been entered into or carried out *ie* as if the assets concerned which Newco had acquired from Attest could not be regarded as assets it had brought into use for the first time.

Newco then lodged an objection against this assessment. When such objection was refused, it then appealed successfully to the Special Court on the ground that s 103(1) of the Act had not been applicable. The Commissioner now, in turn, appeals against the finding of the Special Court on this point.

The provisions of s 103(4) of the Act are relevant to this aspect of the appeal.

Prior to its amendment by Act No 30 of 1998, the subsection read as follows:

'103(4) On any decision of the Commissioner under sub-section (1) . . . shall be subject to objection and appeal, and whenever in proceedings relating thereto it is proved that the transaction, operation, scheme, agreement . . . in question would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act or any other law administered by Commissioner or in the reduction of the amount thereof, it shall be presumed, until the contrary is proved-

(*a*) in the case of any such transaction, operation or scheme, that it was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of such liability or the reduction of the amount of such liability . . .'

In the light thereof, and although a major criterion prescribed by s 103(1) is the Commissioner being satisfied about the requisite state of affairs, his decision thereunder is rendered 'subject to objection and appeal' and the Special Court, on appeal to it by the taxpayer, may therefore re-hear the whole case and substitute its own decision for that of the Commissioner if it is shown that the Commissioner was wrong - see for example *Secretary for Inland Revenue v Geustyn, Forsyth and Joubert* 1971 (3) SA 567 (A) at 571-2[17] and *Commissioner for Inland Revenue v Louw* 1983 (3) SA 551 (A) at 569.[18] Similarly this court, while paying due deference to the factual and credibility findings of the Special Court, may also substitute its own decision for that of the Commissioner - *cf Commissioner for Inland Revenue v Louw*, *supra*.

To warrant the Commissioner being satisfied of the requisite state of affairs envisaged under s 103(1), four essentials have to be established, namely: (1) a transaction, operation or scheme entered into or carried out, which (2) has the effect of avoiding or postponing liability for the payment of any tax on income or reducing the amount thereof, and which (3) was entered into or carried out by means or in a manner which would not normally be employed in the entry into or carrying out of a transaction, operation or scheme of the nature of that in question, or has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of such a nature, and which (4) was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of any tax, or the reduction of the amount of such liability.

Each of these requirements must be present before s 103(1) can be applied - see the *Geustyn, Forsyth and Joubert* case, *supra*. Therefore if the scheme is not abnormal in the sense envisaged, s 103 cannot apply even if such scheme has the effect of tax avoidance and this was the taxpayer's main purpose - see *Smith v Commissioner for Inland Revenue* 1964 (1) SA 324 (A) at 332.[19] Similarly, if tax avoidance is not the sole or main purpose of the taxpayer, s 103 cannot be applied even if the scheme has the effect of tax avoidance and is abnormal as one of the essential requirements (*viz* tax avoidance being the sole or main purpose of the taxpayer) is absent.

This latter conclusion is really decisive of this aspect of the matter. It was argued on behalf of the Commissioner that the scheme in question was abnormal in the sense envisaged by s 103, but it does not seem to be necessary to reach a

decision on that issue as, even if the scheme was abnormal, the Commissioner cannot rely upon s 103 as the main purpose of the scheme was not to effect tax avoidance. Not only did Knuth deny it to have been the intention, but for the reasons that I have mentioned, there are objective factors which support him. As I am therefore satisfied that it has been shown on a balance of probabilities that the sole or main purpose of this scheme was to enable Knuth to become sole owner of the business *via* becoming the sole shareholder in Newco, the fact that in carrying out this purpose an advantage can be taken of a provision in the Act to reduce liability for tax is immaterial, and the Commissioner therefore erred in attempting to rely upon s 103(1) of the Act.

Accordingly, Newco discharged the *onus* which lay upon it under s 103(4) to rebut the presumption that tax avoidance was its sole and main purpose of the scheme. The court *a quo* therefore correctly set aside the Commissioner's assessment of Newco's tax liability for the year ending 31 December 1989 which was the subject of the dispute in *case no 10176*.

The Commissioner's appeal in both cases must therefore fail, and there is no reason for costs not to follow the event. I would therefore issue the following order:

1. The appeal of the Commissioner for the South African Revenue Services against the finding of the Special Court in *case no 9990* is dismissed, with costs.
2. The appeal of the Commissioner for the South African Revenue Services against the finding of the Special Court in *case no 10176* is dismissed, with costs.

(Jones and Jansen JJ concurred in the judgment of Leach J.)

____

Footnotes

1 39 SATC 163 at 180-1.
2 53 SATC 129 at 151.
3 9 SATC 349 at 358-9.
4 40 SATC 75 at 91.
5 1 SATC 20 at 23-4.
6 32 SATC 54 at 58-9.
7 53 SATC 86 at 94.
8 Ibid, at 94.
9 54 SATC 271 at 279.
10 38 SATC 87 at 103.
11 39 SATC (*supra*) at 177-8.
12 37 SATC 193 at 219-20.
13 20 SATC 355 at 361-2.
14 42 SATC 7 at 14.
15 37 SATC (*supra*) at 220.
16 40 SATC 39 at 50.
17 33 SATC 113 at 116-8.
18 45 SATC 113 at 132-3.
19 26 SATC 1 at 11-12.