IN THE TAX COURT OF SOUTH AFRICA

HELD AT CAPE TOWN

Case no 11156

In the matter between

Appellant

and

THE COMMISSIONER OF THE SOUTH AFRICAN REVENUE SERVICE Respondent

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JUDGMENT DELIVERED ON 7 APRIL 2004

BLIGNAULT J:

[1] Appellant is a South African citizen ordinarily residing in Panorama, Cape Town. He is employed on a full time basis by X. In his spare time he carries on the trade of a foreign exchange dealer. In his income tax return for the year of assessment 2002 appellant claimed to be entitled to set-off against his income, a loss of R158 964,00 which arose from his foreign exchange dealings. Respondent issued a revised assessment to appellant in which the set-off was disallowed on the grounds that appellant did not carry on such trade

in South Africa. Appellant objected to the assessment but respondent rejected the objection. Appellant then appealed to this court against the disallowance of the objection.

[2] In claiming set-off appellant relies on the provisions of section 20(1) of the Income Tax Act 58 of 1962 ("the Act"). The relevant part of this section reads as follows:

> *"**20. Set-off of assessed losses.**—(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be set off against the income so derived by such person—*
>
> *… …*
>
> *(b) any assessed loss incurred by the taxpayer during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares.*
>
> *Provided that there shall not be set off against any amount—*
>
> *… …*
>
> *(b) derived by any person from the carrying on within the Republic of any trade, any—*

(i) assessed loss incurred by such person during such year; or

(ii) any balance of assessed loss incurred in any previous year of assessment,

in carrying on any trade outside the Republic."

[3] Appellant testified that he was employed as an auditor by X during the 2002 year of assessment but after hours he carried on the trade of a foreign exchange dealer. The facility for carrying on this trade was provided by an entity named Global Forex Trading ("GFT") a division of a corporation based in Michigan in the United States of America. Before appellant could commence trading he had to attend a course in South Africa provided by Forextrader SA which held a franchise of GFT in South Africa. The facilities provided by Forextrader SA to appellant included appropriate computer software as well as a "dedicated" line for trading on the internet. Appellant's trading activities also required the use of a suitable computer. Before trading appellant acquired the necessary Reserve Bank approval for his activities. He transmitted from South Africa an obligatory amount of US$ 1 000,00 and an additional voluntary amount of US$ 2 000,00

to GFT. These amounts were intended as a form of security to settle any losses that he might incur from his dealings.

[4] The manner of appellant's trading was that he effected currency swaps with GFT. He would, for example, on day one sell US$ 100 000,00 for an equivalent amount of pounds sterling at the current exchange rate. This is known as a "short position". The procedure is that GFT would make an offer at a particular exchange rate which appellant could accept by conveying his decision electronically. Within two days he would effect a counter swop transaction in terms of which he would dispose of an amount of pounds sterling equal to US$ 100 000,00 at the rate of exchange ruling at the time of the second transaction. Appellant would then make a loss or profit on these transactions depending upon the movement of the US$ - pound sterling exchange rate. There were no actual transfers of the currencies involved. Appellant could also purchase US$ 100 000,00 on day one (a long position) and then effect a reverse transaction within two days. Any profit that he made was credited to his "foreign exchange trading account" with GFT and any loss was discharged from that account. In order to carry on this trade appellant had to

keep himself informed of political and economic events that might influence exchange rate movements and he had to study the trends and other information that was available to him through the software on his computer. Of vital importance was the decision-making as to which transactions to be entered into and the timing of those decisions. All of his trading took place from his home in Cape Town. During the course of the year of assessment he transferred US$ 10 500,00 to GFT in order to meet his obligations to it.

[5] The term "trade" is defined in section 1 of the Act as follows:

> *"'trade' includes every profession, trade, business, employment, calling, occupation or venture…"*

It is not in dispute that appellant's foreign exchange dealings constituted a "trade" as defined. Nor is the quantum of appellant's claim in dispute. The only issue is whether his trade as a foreign exchange dealer was carried on outside South Africa within the meaning of the proviso to section 20(1) of the Act.

[6] Counsel for appellant and respondent were in agreement that income tax cases dealing with the concept of income *"from any source within the Republic"* contain useful guidelines for considering the issue in this case. I propose to refer to a number of such cases.

[7] In **MILLIN v COMMISSIONER FOR INLAND REVENUE** 1928 AD 207 a question of law arose that related to income received by the wife of the appellant, in the form of royalties paid to her by publishers in respect of works of fiction composed and written by her in South Africa, and printed and published in England and the United States of America. Such royalties were payable to Mrs. Millin under contracts entered into by her with her publishers, and were remitted to her in South Africa through her London agents. The question was whether that income fell within the definition of "gross income" contained in sec. 7 of the Income Tax Act as income received or accrued from any source within South Africa. The Appellate Division held that the income did accrue to her from a source within South Africa. The following *dictum* of Solomon CJ, at 216, is pertinent:

"If we apply the same test here it would appear that the source of the whole amount received for royalties was in the Union. It is true that in this case no capital in the ordinary sense of that term was employed by Mrs. Millin. It was the exercise of her wits and labour that produced the royalties. They were employed in the Union, and it matters not, on the analogy of the Overseas Trust case, that the grant to her publishers of the right to publish her book was contained in a contract made in England. Her faculties were employed in the Union both in writing the book and in dealing with her publishers, and, therefore, on the test applied in the cases cited, the source of the whole of her income would be in the Union."

[8] In **COMMISSIONER FOR INLAND REVENUE v LEVER BROS AND ANOTHER** 1946 AD 441 the taxpayers were two English companies that were assessed in South Africa in respect of money received from a third company registered in South Africa. The special court held that the source of the income was not located in South Africa. This decision was upheld by the Appellate Division. The following passages in the judgment of Watermeyer CJ, at 449-450, are instructive:

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

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

[9] In **COMMISSIONER FOR INLAND REVENUE v EPSTEIN** 1954 (3) SA 689 (A) the facts were the following: Respondent, an agent in Johannesburg, had entered into an agreement with Hendrickse & Co., a partnership carrying on business in Argentina, in terms of which respondent undertook that he would, subject to certain reservations, import or export all commodities to or from Central and South America exclusively through Hendrickse & Co. The respondent had, in fact, made no imports, but the agreement was

carried out in relation to his exports of asbestos as follows: Hendrickse & Co. solicited orders for asbestos in the Argentine and concluded in their own name sales to such purchasers, whilst respondent made corresponding purchases from producers in South Africa. Hendrickse & Co. would then call upon a purchaser in the Argentine to open a letter of credit, in favour of respondent and payable at a bank in South Africa, for the full amount of the purchase price due by the purchaser plus the amount of the freight and insurance. Thereupon the respondent shipped the asbestos direct to such purchaser without having any communication with him, the letter of credit being payable on production of the bill of lading. On appeal, the Appellate Division held, as all respondent's activities in connection with his dealings in asbestos were carried on in South Africa, and as it was as a result of these activities that he earned the profits which the Commissioner sought to tax, that such profits were received from a source within South Africa. The appeal was accordingly allowed. The following *dictum,* at 699 C-E, is instructive:

> "*the source of the respondent's profits derived from his association with Hendrickse and Company was within the Union, whatever the source of the profits accruing to Hendrickse and Company may have*

been. In taxing the respondent the Legislature looks at his activities and ascertains whether those activities were exercised within the Union; if they were, then he is taxable in respect of any profits resulting from such activities. It may be said that when there is a partnership the members of which carry on their business activities in two different countries, the income of the partnership is derived from two sources and that when one of the partners carries on his business activities in the Union his income from the partnership is derived from a source within the Union while the income of the other partner is derived from a source in a foreign country. For the income which the partner, who carries on his business activities in the Union receives is the quid pro quo for the services he renders in the Union to the partnership.

[10] In **COMMISSIONER FOR INLAND REVENUE v BLACK** 1957 (3) SA 536 (A) the respondent was a stockbroker on the Johannesburg Stock Exchange. His firm carried on arbitrage business on joint account with a firm of London brokers. He bought and sold shares on speculative account in Johannesburg and made a profit in the tax year of £2,808. He had also sent £7,000 to the London firm to enable them to deal on his behalf in shares on the London Stock Exchange, with the intention of making a profit on the resale of shares. The respondent had authorised the London firm to act without reference to him but, as they were in daily telephone

communication, in practice this did not happen. From these London sharedealings the respondent had made a nett profit in the tax year of £1,694, which the Commissioner had included in his income. The respondent's objection having been overruled, the respondent had successfully appealed to the Special Income Tax Court, which held that the £1,694 had been derived from a source outside South Africa. An appeal by the Commissioner was dismissed by the Appellate Division. The following passages in the judgment of Schreiner ACJ, at 543 B-H, are relevant:

> *"But the Commissioner would be entitled to succeed in this appeal if he could show that the only true and reasonable conclusion on the facts found was that the dominant, or main or substantial or real and basic cause of the accrual of income was to be found in Johannesburg.*
>
> *… …*
>
> *A reasonable person could certainly reach the conclusion, as the Special Court in effect did, that there was a distinct business of buying and selling shares in London, and that the fact that the respondent was a stockbroker carrying on a similar business in Johannesburg was at most a factor which facilitated the carrying on of his London business.*
>
> *If there was a distinct business of buying and selling shares in London it cannot be said that because of the factor of authorisation*

or confirmation the true and only reasonable conclusion was that the cause of the accrual of the income was that factor. No doubt the element of control over the transactions may be of importance, depending on the circumstances of the particular case. Here the respondent had the right to terminate the authority of the London firm to buy and sell shares for him, but until he did so they could effectively deal on his behalf without reference to him. The fact that in practice this was only done in connection with the shares of the two companies mentioned above does not mean that there was any change in the terms on which the business was being conducted. I mention this factor, not in order to suggest that it must or should have carried decisive weight with the Special Court but as illustrating the difficulty, indeed the impossibility, of holding that the only true and reasonable conclusion is that the exercise of his control by the respondent in Johannesburg was the cause of the accrual of income. At least another reasonable conclusion which could not be said to be untrue was that the main, the real, the dominant, the substantial source of the income was the use of the respondent's capital in London and the making and executing of the contracts in London."

[11] In **TRANSVAAL ASSOCIATED HIDE AND SKIN MERCHANTS v COLLECTOR OF INCOME TAX, BOTSWANA** 19 SATC 97 the appellant was a South African company that carried on the business of the buying and selling of hides and skins of livestock. These articles were purchased at various abbatoirs and sold in South

Africa. One of the abbatoirs where hides and skins were purchased, was at Lobatsi in Botswana. After the appellant took possession of the hides and skins they were subjected to a process of curing which took from 11 to 21 days. Thereafter they were sorted, bundled and despatched to purchasers. In an income tax appeal the issue was whether the income in question was derived from a source in South Africa. The Court of Appeal of Botswana held that the processes carried out in Botswana in preparing the hides for sale and delivery were the dominant factors in the accrual of the income derived from the sales of the hides. The source of the income was therefore to be found in Botswana. Maisels JA said the following at 111:

> *"… the position is different when the activities of a person are performed in two or more countries. In such cases, it would appear that the locality of the source must be determined by reference to those of the activities which constitute 'the dominant or main or substantial or real and basic cause' of the accrual of the income."*

[12] Mr P J Koekemoer appeared on behalf of respondent. He submitted that the following facts show that appellant carried on his trade in the United States of America. The transactions in question were all effected with GFT which was based in the United States.

Any loss or profit was made in the United States. Appellant was obliged to keep funds in a bank account in the United States in order to meet his obligations to GFT and he had transferred US$10 500 to that account during the year of assessment. Mr Koekemoer also relied heavily on the judgment in **COMMISSIONER FOR INLAND REVENUE v BLACK,** supra.

[13] Mr T S Emslie appeared on behalf of appellant. He submitted that the activities which constituted appellant's trade were all performed by him in South Africa. Even the transfers of US dollars to GFT in the United States were activities performed by appellant in this country. The funds were deposited into GFT's own bank account and not in any account belonging to appellant. He also emphasised that appellant and GFT traded with each other as principals and that GFT at no stage acted as appellant's agent. He submitted, in the alternative, that even if appellant did to some extent carry on his trade outside the Republic, then his trade was nevertheless predominantly carried on in South Africa.

[14] IT seems to me that appellant is entitled to succeed in this appeal. I accept that certain elements of appellant's trading, such as the receipt of the funds that were required as security, the making of offers by GFT and the actual making of a profit or a loss, occurred in the United States of America. It seems to me however that, as in the case of Ms Millin referred to above, it was the exercise of appellant's wits and labour that played the essential role in his trading. There can be no doubt that these were exercised by him in the Republic when he made the crucial decisions as to the transactions to be entered into. The application of the "dominant" or "main' or "substantial" or "real and basic" cause tests that were referred to in the other cases cited above, would in my view lead to the same result. Appellant's activities in the Republic complied with such a criteria.

[13] In the result the appeal succeeds. Respondent's revised assessment in respect of appellant for the year of assessment 2002 is hereby set aside. Respondent is directed to allow appellant to set off against his income in terms of section 20(1)(b) of the Act, the loss

incurred by him in that year of assessment in his trade as a foreign exchange dealer.

A P BLIGNAULT