IN THE TAX COURT OF SOUTH AFRICA

(HELD AT THE EASTERN CAPE HIGH COURT, PORT ELIZABETH)

Case No: 13539/13673

In the matter between:

ABC (PTY) LTD **APPELLANT**

And

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICES **RESPONDENT**

JUDGMENT

SCHOEMAN J.

Background.

[1] The appellant, ABC (Pty) Ltd, received or accrued amounts under the Productive Asset Allowance scheme (PAA) for the years 2008 to 2010 years of assessment. The appellant submitted tax returns for the period 2008 to 2010 where the amounts it received under the PAA were reflected as 'gross income'. In 2010, due to a reassessment and after obtaining legal advice, it concluded that those amounts were actually receipts or accruals of a capital nature. The appellant and the respondent agreed that the only way to approach the issue was if the appellant objected to the assessment which course of action was condoned

by the respondent. This objection was dismissed, hence the instant appeal. This is a unanimous judgment by the court constituted by two assessors, who able assisted me, and I.

Issues

[2] There were disputes pertaining to the deduction of research and development expenditure, a dispute relating to the net realisable value of inventory, a dispute pertaining to fixed asset allowances and, as stated, the dispute whether the PAA was gross income or if it constituted receipts of a capital nature. The parties agreed that the trial in respect of the first two issues be separated from the other two issues and an order to that effect was made by agreement between the parties.

[3] The parties further resolved the issue pertaining to the fixed asset allowances and a draft order was made an order of court. Therefore, the only issue in dispute is whether the compensation of R83 651 677 (2008), R76 895 388 (2009) and R48 338 557 (2010) received by or accrued to the appellant under the PAA is gross income as defined in section 1 of the Income Tax Act No. 58 of 1962 (the Act) or of a capital nature and therefore excluded from the definition of gross income.

The evidence

[4] Ms X, a tax specialist and advisor, employed by the appellant, testified. A report of Mr K, an expert witness of the appellant, was handed in as evidence by agreement. From the evidence the following emerged. There were too many different models of motor vehicles in South Africa. The PAA was introduced as part of the Motor Industry Development Programme under the auspices of the Department of Trade and Industry (DTI). It was an incentive to the motor industry to encourage streamlining the production of light motor vehicle assembly plants into a limited number of models; improving international competitiveness; improving the contribution to the economy in terms of employment, investment and supporting the consumer; and reducing the net foreign currency usage.

[5] The PAA was in the form of a rebate certificate to the maximum of 20% of the total investment in qualifying productive assets and spread equally over five years. A PAA certificate reduced the amount of import duty payable on the import of motor vehicles tax to the extent of the certificate value, allowing that only the remaining amount of duty owing on clearing the imports would be payable in cash. These certificates could only be used to rebate duties on imported motor vehicles, within a stipulated time frame and were not tradable. This was done to ensure that the range of products offered to the consumer is sustained.

[6] In order to qualify for the PAA the appellant had to invest a minimum value in qualifying assets and submit a business plan to the DTI. The business plan had to be 'in respect of a project to invest in productive assets with a view to producing specified motor vehicles . . . of sufficient quality, quantity and competitive prices to supply to the common customs area and international markets in line with the guidelines issued by [DTI]'. The business plan had to demonstrate that the investment would result in the rationalisation of models produced; an increase in production of units within two years; increase international competitiveness; contribute to development of domestic manufacturing; a favourable effect on the long term balance of payments; and consumer interest supported.

[7] The productive assets, for purposes of the PAA, included 'Buildings erected for the sole purpose of manufacturing specified motor vehicles or automotive components, and new or unused plant, machinery, tooling, jigs, dies and moulds, in-plant logistics, testing, design and production IT equipment and supporting software.'[1]

[8] The benefits, for tax purposes, as set out in para 3 *supra*, constituted amounts received by, or accrued to, the appellant in the in the said years of assessment.

[1] *Government Gazette No 31716* dated 19 December 2008 p15.

[9] The PAA incentive rewarded automotive manufacturers for investing capital in qualifying productive assets. Manufacturers were incentivised to concentrate their efforts on platform rationalisation to ensure a smaller number of models and to import low volume niche models rather that manufacture these locally.

[10] The appellant rationalised its production reforms from six in 1998 to three in 2010. Furthermore, its total units sold had increased and it had invested an amount of R2.2 billion in productive assets.

[11] In its income returns for the 2008 to 2010 years of assessments, the appellant reflected the PAA certificates issued to it and employed it as rebate against customs duty as part of its gross income for tax purposes. As stated earlier there were belated objections but the respondent disallowed them. After an Interpretation Note pertaining to the taxability of government grants was issued in 2010, the appellant filed its income tax returns on the basis that the PAA certificates were receipts of a capital nature. The respondent did not query this and they were duly assessed as such.

Legal position

[12] The salient portion of the definition of 'gross income" as defined in s 1 of the Act is as follows.

'Gross income', in relation to any year or period of assessment, means

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

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

during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder. . . ,

[13] From this definition it is clear that gross income is any amount that is received by or accrues to a resident that is not of a capital nature. There is no definition of receipts or accruals of a 'capital nature':

'There is no definition in the Act of receipts and accruals 'of a capital nature'. No doubt the legislature has realized that it is impossible to define the qualities that render a receipt or an accrual either income or capital. From the large mass of judicial decisions on the question whether a receipt or an accrual is of an income or a capital nature, it is obvious that the expression 'of a capital nature' is not precise, and that there is no single infallible test for settling the question whether a particular receipt or accrual is income or capital. . . .

. . . the burden of proof regarding the rate of tax applicable to a transaction, event, or item rests upon the taxpayer.

. . . the inquiry whether an amount is of an income or a capital nature is a question of law, which has to be decided upon the facts of each case.'[2]

[2] AP de Koker *Silke on Income Tax* para 3.1.

[14] Usually the 'most important 'test' employed by the courts in deciding whether the proceeds arising upon the disposal of an asset are in the nature of income or capital is the test of 'intention': with what intention did the taxpayer acquire and hold the asset?'[3] This would not be helpful in the instant matter as it is common cause that initially the appellant held and acquired the asset as income.

[15] On 10 December 2010 Income Tax Interpretation Notes No 59 (the Interpretation Notes) was issued in respect of the tax implications of, *inter alia*, the receipt or accrual of government grants. The weight that should be given to an interpretation note has been set out as follows by Zulman J.

'Departmental practice is not necessarily, of course, an indication of what the law means. However, it seems to me that the departmental practice is a very sensible approach to what should be done in this type of case. Plainly the procedure and the practice laid down by the Commissioner in that regard, is, if nothing else, commercial wisdom and good sense.'[4]

[16] In the Interpretation notes the following is said:

'In the *Oxford Dictionary Thesaurus, and Wordpower Guide*1 the term "grant" is defined as –

"a sum of money given by a government or public body for a particular purpose".'[5]

This definition accords with the PAA and it is common cause that the PAA is a grant.

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[3] De Koker op cit para 3.2.
[4] ITC 1572 (1993) 56 SATC 175 at 186.
[5] Interpretation Note para 2.

[17] The Interpretation Note states that 'Whether an amount received or accrued is of a capital or revenue nature depends on its character in the hands of the recipient'[6] and:

'The nature of the grant received and the relationship which exists between the grant received and the recipient's activities needs to be examined.

A government grant will be a trading receipt when it is paid in order to assist in meeting a person's trading obligations or in order to assist in carrying on trading operations. A grant of this nature results in trading receipts being supplemented and accordingly is itself a trading receipt.'[7]

[18] The appellant referred the court to *Moolman v Commisioner for Inland Revenue*[8] and *ITC 1435*[9] arguing that in those decided cases the court asked the question, when determining whether the grant was of a capital or revenue nature, 'why was the grant made? In none of the decided cases, referred to by the appellant, the court paid any attention to the use the grants were put after their receipt.

[19] Silke[10] dealing with subsidies states as follows.

'Subsidies or similar payments made by the government in terms of an Act of Parliament to local merchants or producers for the production or export of certain commodities are, it is submitted, on income account if they are paid to supplement the trading receipts derived from the sale of such commodities.

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[6] Interpretation note 3.1.
[7] Interpretation Note 3.2.3.
[8] 1954 (2) SA 560 (A).
[9] 50 SATC 117.
[10] Silke op cit 3.43.

In *Moolman v CIR [footnote 4 supra]* it was held that an amount received by a wool producer from the South African government in terms of an Act of Parliament, the payment being based on the amount of wool sold to the United Kingdom government during a defined six-year period, could not be regarded as a receipt of a capital nature but was an addition to the purchase price which the farmer obtained for the wool that he sold during the six years and was therefore of an income nature.

'If a subsidy takes the form of a contribution towards the producer's cost of production of a certain commodity, it is submitted that it is of an income nature. On the other hand, if the subsidy is paid as a contribution towards the cost of fixed capital assets – for example, the government may contribute towards the cost of a new factory or plant and machinery – it is submitted that it partakes of the nature of capital and is not taxable.' (my emphasis)

[20] Another way to approach the question whether income is capital or revenue is to ask: which hole does it fill? In *Burmah Steamship Company Ltd v The Commissioners of Inland Revenue* [11] the company, having acquired a half-share in a second-hand motor vessel, contracted with a firm of ship builders for repairs. A significant delay occurred in the completion of these repairs. The company instituted a claim for £ 3000, an amount approximately equal to the profit the company would have earned had the repairs been affected in time, against the repairers for breach of contract. The issue was whether the £1500 the appellant received from the repairers was a capital assets or part of profit and therefore income. It was the late delivery of a capital asset (the vessel) which

[11] *Burmah Steamship Company Ltd v The Commissioners of Inland Revenue* 1931 S.C. 156.

led to the claim, but the loss to the appellant was the loss of trading opportunities, not the loss of fixed capital. Therefore, if the damages 'was inflicted on the Appellant's trading, making (so to speak) a hole in the Appellant's profits, and the damages fill a 'hole' in profit the receipt is of a revenue nature, whereas if they fill a hole in a person's capital assets, then the receipt is of a capital nature.'

[21] It is the appellant's case that to determine whether the grant is revenue or capital, the predominant focus is on the purpose or cause of the grant. The appellant referred us to three cases [12] where the courts asked 'What was the origin of the claim?' [13], that the grant was to assist appellant with the capital expenditure involved and was therefore the grant was of a capital nature[14], and why the grant was paid to the appellant.[15]

[22] In the instant matter the grant was made due to capital expenditure. However, if the PAA certificate was not utilised, within a stipulated period, as payment for customs duties on imported motor vehicles, the PAA certificate would lapse. The certificate was not tradable. The certificate was conditional and did not accrue until there were imports. If there were no imports within the necessary time frame, the condition had not been fulfilled and the certificate could not be used. The certificates only had value upon import of motor vehicles and not when the capital expenditure was incurred. The grant was to

[12] *ITC 402* 10 SATC 111; *Moolman (supra)*; *ITC1435* 50 SATC 117.
[13] *ITC 402.*
[14] *ITC 1435.*
[15] *Moolman.*

assist the appellant with the revenue expenditure, customs duty payable on imports.

[23] The incentive with the PAA was to have fewer locally produced models and to invest in infrastructure. But that was not the sole motivation for the grant. It was also to see to it that with the importation of motor vehicles the range of products available to the consumers is sustained. The investment in infrastructure was a pre-requisite for the grant, but the PAA certificates can only be redeemed by payment of customs duties, that is, against revenue. I am of the view that it is clear that the certificate and grant cannot be utilised to fill the capital 'hole', but only the revenue and income 'hole'. The diminished payment of customs duty is clearly related to the gross income of the appellant. In our view the PAA certificates are not of a capital nature, but is included in the definition of gross income in terms of section 1 of the Act.

[24] The following order is made.

The appeal is dismissed.

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Irma Schoeman

(Judge of the High Court)