REPUBLIC OF SOUTH AFRICA

IN THE SUPREME COURT OF APPEAL

Reportable
Case No: 153/99

In the matter between:

The Commissioner of SA Revenue Services **Appellant**

and

Volkswagen of South Africa (Proprietary) Limited **Respondent**

Coram: **Hefer ADCJ, Nienaber, Scott JJA, Melunsky, Mpati AJJA**

Date of hearing: **13 November 2000**

Date of delivery: **24 November 2000**

Income Tax - Capital receipts or accruals - vehicles used by the manufacturer in conducting its business and then sold.

JUDGMENT

HEFER ADCJ:

[1] The exclusion of receipts or accruals of a capital nature from a taxpayer's taxable income which now appears in the definition of "gross income" in s 1 of the Income Tax Act 58 of 1962, as amended, has long been a feature of our income tax legislation. But the concept of capital receipts and accruals has never been defined in the legislation or in the judgments of the courts. All that we have is a number of judicial guidelines for the determination of the nature of a particular receipt or accrual on the facts of each case. In performing this exercise we must bear in mind what Innes CJ said in *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 453 *viz* that

> "[w]here an asset is realised at a profit as a mere change of investment there is no difference in character between the amount of enhancement and the balance of the proceeds. But where the profit is, in the words of an eminent Scotch Judge see *Californian Copper Syndicate v Inland* Revenue (41 Sc.L.R. p 694) 'a gain made by an operation of business in carrying out a scheme for profit making,' then it is revenue derived from capital productively employed, and must be income."

A full discussion of the guidelines that have emerged from the cases will not serve any useful purpose. We are concerned in the present case with what is alleged by the taxpayer to be the sale of capital assets and it is sufficient to refer to the following exposition in Corbett JA's judgment in *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste* 1978(1) SA 101 (A) at 118 A-E:

> "Where a 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 ... In the determination of the question into which of these two classes a particular transaction falls, the intention of the taxpayer, both at the time of acquiring the asset and at the time of its sale, is of great, and sometimes decisive, importance. Other significant factors include, *inter alia*, the actual activities of the taxpayer in relation to the asset in question, the manner of its realisation, the taxpayer's other business operations (if any) ..."

[2] The respondent is a well-known manufacturer of motor vehicles. By far the largest part of its production is destined for sale to the public. But it also manufactures vehicles for the company's own use. Having been used for some time these vehicles were sold and the question is whether the proceeds constituted revenue for income tax purposes. An Income Tax Special Court found that they did not because the receipts were of a capital nature. And so did the Eastern Cape Provincial Division of the High Court in an appeal to it by the Commissioner. With the necessary leave the Commissioner has now appealed to this court.

[3] The dispute arose from the claim in the respondent's income tax returns for the 1986 to 1992 years of assessment that the profits derived from the sales constituted receipts or accruals of a capital nature. The Receiver of Revenue did not agree. He assessed the respondent to tax on the basis that the profits were taxable and dismissed an objection to the assessments. Then followed the appeals already referred to.

[4] The vehicles in question fall broadly into four categories: lease vehicles, test vehicles, promotion vehicles and transport vehicles. Since the Commissioner has conceded the correctness of the Special Court's findings in respect of the test and transport vehicles the enquiry will be confined to the remaining two categories. They are described as follows in the Special Court's judgment:

Lease vehicles.

> "In an effort to provide a benefit to its employees and to attract suitable persons to its

> employment, the [company] operates a vehicle lease scheme whereunder employees of certain grades are provided with the benefit of leasing a company car at an extremely favourable rental and which the [company] ... maintains and services at its expense ... The employees are required to return the vehicles after they have travelled 15 000 kilometres or when the lease has run for a period of 11 months, whichever event occurs first. This was imposed as a minimum period of the lease in terms of an agreement with the major trade union and is also regarded in economic terms as being the optimum duration of a motor car lease. On termination of the lease, the employee is given the option of purchasing the leased vehicle although, in practice, only some 20% of the employees avail themselves of the opportunity to do so. Those not purchased by the employees are then sold out of hand by the [company] to its franchised dealers."
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> **Promotional vehicles.**
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> "[Promotional vehicles are] used for promotional purposes to enhance the public image of the [company] and its products. Vehicles typically included in this category are press vehicles, vehicles used for motor sport, vehicles provided to schools for driver education, vehicles provided to Nocsa and Ithuba as well as vehicles used in special market demonstrations. In respect of these vehicles the [company] had a set of rules as to when they were to be sold but, generally, when they had travelled some 10 000 to 15000 kilometres they were passed on to the used vehicle department for disposal in the same way as the leased vehicles."

[5] It is necessary to deal at the outset with an argument on behalf of the Commissioner to the effect that the lease and promotional schemes should not be treated as separate enterprises but as part of the respondent's entire business operation. The schemes, it is submitted, are designed to render the entire operation more profitable by attracting a better calibre of employee and advertising the company's products; and it matters not whether either scheme, viewed independently, is or is not profit orientated.

The submission must be rejected. We are dealing with the disposal of specific assets and the income generated in that way. The income is taxable or non-taxable depending on the nature of the receipts and we must determine whether their disposal constituted transactions in the course of a profit-

making scheme or whether it amounted to the realization of capital assets. The object of the acquisition and disposal of the assets is plainly relevant both in regard to the respondent's entire business and in regard to the schemes in terms of which it occurred. Indeed, bearing in mind that profit-making is obviously the ultimate aim of any business venture, it would be impossible to separate capital assets from trading stock if only the overall purpose of the entire enterprise were to count.

[6] It is beyond dispute that the purpose of the lease scheme is not to derive a profit. The undisputed evidence is that it is intended entirely as a benefit to the respondent's employees which in effect forms part of the latter's remuneration packages. The Commissioner's counsel frankly conceded as much. He conceded moreover that the lease scheme as such does not and cannot yield a profit from the way in which it operates. The President of the Special Court said in this regard:

> "It is obvious from this that the leasing scheme was never regarded by the [company] as a profit-making operation planned along sound commercial lines. Indeed monthly management accounting reports reflect ongoing losses caused by the scheme, and it is clear that the [company] viewed the scheme not as one having a profit motive, but, indeed, the direct opposite. As a result the [company's] management attempted to do away with or curtail the scheme but their proposals in that regard met with substantial resistance from the labour unions. The [company] therefore persisted with the scheme only as an exercise in labour relations."

[7] The way in which the respondent deals with the lease vehicles points the same way. The following emerges from the evidence:

(a) The company manufactures vehicles for sale to the public strictly on order. Vehicles for its own use in all four categories mentioned earlier are produced according to available construction capacity only. The latter are identified and earmarked at an early stage of the construction process. Thereafter, as a rule, they are treated separately in the company's recording and accounting system. It would not be wrong to

say that the company at all times manufactures and (until delivery) keeps two sets of vehicles, one of which is for sale and the other for its own use.

(b) Although there is supposed to be a fixed time when or a mileage at which lessees are required to return their hired vehicles the operation of the scheme is not monitored. The result is that the time and mileage are regularly exceeded and that a large percentage of the lease vehicles are returned and sold - obviously to the company's detriment - after up to two years of use.

(c) The company does not concern itself with the condition in which hired vehicles are kept and when it comes to selling returned ones it takes no real interest to ensure that the best prices are realized. The process is described as follows in the Special Court's judgment:

> "In determining the price the [company] uses the Autodealers Digest, a publication used in the motor trade to provide the average value of sales of particular models of used motor vehicles, adjustments being made inter alia, for kilometres travelled, condition of the vehicle and optional extras with which it is fitted. The list of cars available for sale and the fixed prices thereof are simply made available to the [company's] franchised dealers without any bargaining as to price ... In the event of no order being received at the list price of the vehicle, the price of the car is reduced in the next list and the process repeated until such time as the vehicle is sold ... the [company's] attitude in disposing of these vehicles at the end of the lease is to involve itself in the least time, effort and cost".

[8] Counsel for the Commissioner relies heavily on the fact that the use of the vehicles for relatively short periods lacks an element of permanency. As authority he cites Rabie JA's observation in *Sekretaris van Binnelandse Inkomste v Aveling* 1978(1) SA 862 (A) at 880E-F to the effect that there is an element of permanency in fixed capital. But the remark must be understood in the context in which it was made. It refers to the distinction

between fixed and floating capital drawn in *Commissioner for Inland Revenue v George Forest Timber Co Ltd* 1924 AD 516 at 524 where it was said that

> "... floating capital is consumed or disappears in the very process of production, while fixed capital does not."

But, as Innes CJ proceeded to say,

> "[t]he distinction is relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed."

This is true of the vehicles with which we are concerned too. Admittedly they are sold, not because they have reached a state of disrepair where their replacement has become imperative, but (apart from the agreement with the trade unions) because it is considered in economic terms that the time for replacement has arrived. But this holds good for any piece of equipment used for the production of income: no factory owner will use his machinery until it becomes worthless; he will replace it when it is most economical to do so.

I do not share the Commissioner's view that the position changes where the equipment is the very commodity in which the taxpayer trades. Like the manufacturer of computers who needs computers to conduct his business so the manufacturer of motor vehicles needs motor vehicles to conduct his business. In both cases the equipment used for the production of income has to be replaced from time to time. In the absence of a change of intention a computer in the first case and a motor vehicle in the second cannot be converted from capital assets into trading stock whenever it has to be replaced and is sold.

[9] Counsel for the Commissioner also relies on the regularity and extent of the sales. That the sale of returned vehicles takes place on a regular

basis cannot be gainsaid but, for the reasons listed in the previous paragraphs, it is an entirely neutral factor. And so is the extent of the sales. The evidence is in any event clear and uncontradicted that, compared with the respondent's total turnover, the sale of used vehicles is insignificant.

[10] For these reasons I agree with the finding of the two lower courts that the income from the sale of lease vehicles constituted capital receipts or accruals.

[11] In arriving at this conclusion I have assumed that the costs and expenses contained in the "capital profits" returns, have not otherwise been deducted as expenditure or losses in terms of s 11 of the Act. This matter was raised with the respondents' counsel during argument and he, quite correctly, pointed out that the aforesaid costs and expenditure were not queried by the Commissioner and were not in issue at the hearing before the Special Court.

[12] Counsel for the Commissioner elected not to address us on the correctness of the finding relating to the promotional vehicles. It was a wise decision for one needs but a glance at the description of the use of these vehicles in par **[4]** above to realize that the income derived from their disposal also constituted capital receipts or accruals.

The appeal is dismissed with costs.

JJF HEFER

Concur:
Nienaber JA
Scott JA
Melunsky JA
Mpati JA