REPORTABLE
CASE NO: 563/2001

IN THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

In the matter between:

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

and

C J SMITH **RESPONDENT**

CORAM: HEFER AP, SCHUTZ, SCOTT, BRAND JJA and HEHER AJA

DATE OF HEARING: 9 SEPTEMBER 2002

DELIVERY DATE: 26 SEPTEMBER 2002

Summary: Income tax - s 26(1) of Act 58 of 1962 - "farming operations" - requires genuine intention to carry out such operations profitably - reasonable prospect of profit not independent requirement.

JUDGMENT

HEHER AJA

HEHER AJA:

[1] This appeal is brought with leave granted in terms of s 86A(5) of the Income Tax Act, 58 of 1962 ("the Act"). The issue is whether farming operations can be carried on as contemplated in s 26(1) of the Act in the absence of a reasonable prospect that profit will be derived from such operations.

[2] The judgment of the special court (Erasmus J), which sets out the facts, is reported as ITC 1698 (63 SATC 161). It is unnecessary to do more than summarise them.

[3] The respondent is a medical practitioner at Uitenhage. About 1982 he purchased a farm in the Steytlerville district some 1040 hectares in extent for about R130 000. He intended to farm stock and, particularly, angora goats, mainly devoting his weekends to the project. About 1987 he decided to convert to game farming. He testified that he envisaged deriving a viable income from hunting after eight to ten years of development of the farm and the animals on it. During 1990/1 he sold a

portion of the farm, having found that it was unsatisfactory for running game, on account of its inaccessibility and lack of water. In 1993 he sold the remainder of the farm because of the pressures of ill-health and the opportunity offered by an unsolicited buyer.

[4] Within a few weeks the respondent was introduced to a farm in the Jansenville district. His health had improved. He was greatly taken with its potential for running game. The land was already well-stocked with trophy animals. He acquired the farm. He purchased springbok and improved the roads, dams, kraals and accommodation. Unfortunately he became involved in a dispute with a neighbour which threatened the viability of the farm. So he sold it in March 1996.

[5] The sad fact is that, throughout, both farms ran at a substantial loss. In his income tax returns the respondent set off the losses against the profits derived from his medical practice as permitted by s 20(1)(b) of the Act. The appellant countenanced the set-off until 1996.

[6] On 22 July 1996 he notified the respondent that he would not allow the losses for the years 1992, 1993, 1994 and 1995 "[a]angesien boerdery net soos enige ander onderneming 'n moontlikheid van winsgewendheid moet toon, en in die geval nie moontlik blyk nie". He subsequently amplified his refusal, adding that the respondent had not at the relevant times been carrying on *bona fide* farming operations within the terms of s 26(1) of the Act.

[7] The respondent appealed successfully to the South Eastern Cape Special Court ("the special court"). That court upheld his contention that the requirement of s 26(1) was proof of "activity in the nature of farming undertaken with the genuine intention of ultimately realising profit in the endeavour". It rejected the appellant's assertion that the section required proof that the activity should be carried on with a reasonable prospect of profit (albeit not generated in the tax year in which the loss arose) as an element independent of the taxpayer's intention.

[8] The special court found that the respondent had no reasonable prospect of

turning a profit during any of the relevant periods. Nevertheless it was satisfied on the totality of the evidence that the respondent had at all material times engaged in activities which were properly described as farming with a genuine intention to produce a profit at a future time. In reaching that conclusion the court held that a proper assessment of the respondent's *bona fides* took account of his *ipse dixit* and objective elements against which his word could be tested, the last-mentioned including aspects such as the size of the property, its suitability for the undertaking, the time and effort expended on the operations, its management and the prospect of profitability, no one factor being of itself decisive.

[9] On appeal the sole issue argued was the correctness of the approach of the court *a quo* to the interpretation of s 26(1). Counsel for the appellant at the outset disavowed any reliance on facts not appearing in the judgment and although, finding himself in difficulty, he attempted to escape that limitation, he referred to nothing which has the effect of expanding the dispute beyond the question of law.

[10] Section 26(1) provides

"The taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as it is derived from such operations, be determined in accordance with the provisions of this Act but subject to the provisions of the First Schedule."

The First Schedule deals with the "Computation of Taxable Income derived from Pastoral, Agricultural or other Farming Operations". It makes available to farmers benefits of which the ordinary taxpayer does not have the advantage. For that reason counsel for the appellant submitted that s 26(1) should be construed in such a manner as to restrict access to the Schedule. Whether that is correct it is unnecessary to decide, since, it seems to me, the gloss which he is seeking to place upon the meaning of farming operations has nothing to do with and does not derive from any possible restrictive interpretation.

[11] It is clear that s 26(1) does no more than establish a basic framework for a taxpayer who carries on farming operations by affirming the right and obligation of such a person to be taxed on a basis common to all taxpayers except in so far as the

First Schedule expressly or by necessary implication overrides or supplements the general provisions of the Act.

[12] In ordinary parlance the phrase "carrying on farming operations" is capable of several meanings. In the context of s 26(1) it could mean simply "a particular form or kind of activity" or it could bear a more commercial nuance, "a business activity or enterprise". (The Oxford English Dictionary 2 ed *sub nom* "operation" 4a and 5b) That the difference may be material was pointed out in ITC 1135 (31 SATC 228 at 231) in the context of Act 5 of 1967 (Rhodesia). See also ITC 1258 (39 SATC 58 at 61) to the same effect.

[13] The Act is directed to the taxation of profit-making activities. There is no apparent reason why the legislature should have intended a taxpayer who farms as a hobby or who dabbles in farming for his own satisfaction to receive the benefits conferred by the First Schedule.

[14] Both counsel relied upon the authority of judgments in the special courts. The

earliest statement appears in ITC 208 (6 SATC 55) in which the court, dealing with what it described as the "subsidiary occupation of farming" held that the statute required a "genuine intention to develop . . . a farming operation in the hope that it will ultimately pay". See also ITC 937 (24 SATC 374) and ITC 1258 (39 SATC 58). There was no mention of the reasonable prospect of making a profit. Nor was the problem considered in the light of the carrying on of a business.

[15] In ITC 1319 (42 SATC 263), however, Smalberger J was faced with a medical practitioner who claimed an entitlement to set off farming losses against professional and other income. The learned judge expressly rejected a statement in the 9th Edition of *Silke on South African Income Tax* based on the decision in ITC 208 (*supra*) saying (at 264)

"In so far as the test propounded by Silke purports to be an entirely subjective one, I do not agree with it. It seems to me that before a person can be said to be carrying on farming operations there must be a genuine intention to farm, coupled with a reasonable prospect that an ultimate profit will be derived, thereby incorporating an objective element into the test. To hold otherwise would make it well-nigh impossible for the Commissioner to determine whether or not to allow farming losses as

a deduction from other income, for he must needs adopt an objective approach when doing so."

That the learned Judge had in mind an independent criterion is clear from the following passage in his judgment (at 265):

"In all the circumstances the indications are that in 1976 and 1977 the appellant, despite his *ipse dixit* to the contrary, had no genuine intention of farming and was, at best, merely marking time until he could subdivide and dispose of the bulk of his property. It is, however, not necessary to come to any firm decision on this point as it appears in any event that at the relevant time . . . the appellant had no reasonable prospects of ultimately farming on a profitable basis. . ."

[16] There are two judgments of relevance in the Zimbabwean Special Court. In ITC 1424 (49 SATC 99) Smith J considered the judgment in ITC 1319 (*supra*). Having referred to an Australian case (25 CTBR/NS Case 80) in which it was held that

"A view to profit is merely one of the *indicia*, and not conclusive. It is enough to travel hopefully even if one is never destined to arrive",

the learned Judge said (at 106 - 7)

"In my view the proper test to be applied is that put forward in Silke on *South African Income Tax 9 ed.* As long as there is a genuine intention to develop land as a farming proposition in the hope that an ultimate profit will be derived then the taxpayer can be said to be a farmer who is carrying on farming operations or incurring expenditure for the purposes of his trade. This hope of course must be based on reasonable grounds. If the area used for farming operations or the means used are such

that there could never possibly be any chance of an ultimate profit then it could not be said that the hope of an ultimate profit is a reasonable one.
If the objective element suggested by Smalberger J in ITC 319, (*supra*), were to be accepted many so-called commercial farmers in this country would cease to qualify for treatment as farmers under the Income Tax Act [Chapter 181] as they appear to be travelling hopefully but are never destined to arrive . . . It would appear that [the taxpayer and his wife] are putting a lot of hard work into the venture and providing employment for a number of workers. In my view the appellant is still 'travelling hopefully' and there is a reasonable foundation on which that hope is based. Only time will tell whether he will arive."

It seems, with respect, that the learned judge was attempting to straddle the divide by his insistence on a 'reasonable hope'.

In *J v COT*, 55 SATC 62 Smith J (perhaps not the judge responsible for ITC 1424) put the test thus (at 67 - 8)

"It seems to me that a similar test [to that in ITC 1424 supra] must be applied in trying to determine the question of the secondary object - to make a profit. Applying such a test in this case, the court must decide whether there existed a genuine intention to make a profit based on reasonable grounds that an ultimate profit would be derived."

There seems little difference between the views expressed in that case and the conclusion of Smalberger J.

[17] In ITC 1644 (61 SATC 23) Southwood J considered the spectrum of approaches

to which I have referred and concluded (at 28)

"Maar die bedoeling om 'n wins te maak uit daardie bedrywighede moet 'n egte bedoeling wees. Omdat bedoeling altyd subjektief is, is dit moeilik om te bepaal of dit eg is of nie. Dit kan slegs aan die hand van die objektiewe feite bepaal word. Die persoon se *ipse dixit* kan nie deurslaggewend wees nie. Indien sy bedrywighede geensins versoenbaar is met sy *ipse dixit* kan sy *ipse dixit* nie aanvaar word nie. Indien dit deur die objektiewe feite gestaaf word, word sy bedoeling as eg beskou. In daardie verband is die aard, omvang en beheer van sy bedrywighede belangrik.
Die appellant se advokaat kan derhalwe nie gelyk gegee word nie dat die korrekte toets 'n egte verwagting om 'n wins te maak is nie. Die korrekte toets is soos deur Smalberger R en Smith R geformuleer, maar die vooruitsig om 'n wins te maak is nie beperk tot 'n besondere belastingjaar nie."

[18] Finally, in ITC 1701 (63 SATC 214) Kirk-Cohen J followed the judgment of Smalberger J in applying the dual test of a genuine intention to farm and a reasonable prospect of making a profit.

[19] Before us Mr. Marais for the appellant espoused a line of argument which in general terms relied on the line of reasoning propounded by Smalberger J. though he seemed to suggest that the test for genuine intention could be a holistic one in which the reasonable prospect of making a profit should operate as the decisive element. How are we to cut the gordian knot of this frequently confusing and sometimes self-

contradictory melange of approaches?

[20] Reference to the tax reports of other jurisdictions shows that the problem of how to treat taxpayers who carry on farming operations as a second sphere of interest is by no means a South African phenomenon. It is therefore not surprising that despite differences in legislation the question which faces this Court has been squarely addressed in both Australia and New Zealand. See E.F. Mannix and D.W. Harris, *Australian Income Tax Law and Practice*, Vol 1, 6/78. One of the cases which the authors cite is *Tweddle v FCT* (1942) 2 AITR 360. Of this authority the Court of Appeal of New Zealand had the following to say in *Grieve v CIR* [1984] 1 NZLR 101 (at 109):

"The definition of 'business' in the Australian legislation does not contain any reference to 'for pecuniary profit' or any such expression and for that reason the Australian authorities must be read with some care. But there is one passage in the judgment of Williams J in *Tweddle* to which Quilliam J referred in relation to the philosophy underlying the income tax legislation which it is helpful to set out in order to compare it with Quilliam J's response. At p 364 Williams J said:

> 'It is not suggested that it is the function of income tax Acts, or of those who administer them, to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. The Act must operate upon the result of a

taxpayer's activities as it finds them. If a taxpayer is in fact engaged in two businesses, one profitable and the other showing a loss, the Commissioner is not entitled to say he must close down the unprofitable business and cut his losses even if it might be better in his own interests and although it certainly would be better in the interests of the Commissioner if he did so (*Toohey's Ltd v Commissioner of Taxation for NSW* (1922) 22 SR (NSW) 432 at pp 440-1). If the appellant succeeds and makes a profit it will plainly be taxable, and it is difficult to see how his activities could at that moment of time be transmogrified from an indulgence in a somewhat unusual form of recreation into the carrying on of a business. I am satisfied that the appellant is seeking to establish himself at Winlaton as a recognized breeder of high-class stud stock, and that while he is prepared to make losses to achieve this ambition he has a genuine belief that he will be able eventually to make the business pay. Indeed, unless he can do so, his experience will hardly be an encouragement to others to emulate his example.'

Quilliam J found himself unable to agree with Williams J and went on to say at p 375:

'I do not consider that our statute entitles a taxpayer to create or persist in an entirely unrealistic venture and then, because it has the outward semblance of a business, to be able to assert that it is one. If that is the principle to be derived from *Tweddle's Case* then I respectfully decline to follow it.'

In the present case, and after citing a long extract from *Prosser* including both those passages and referring to the facts of the present case, Sinclair J observed that 'there is no justifiable reason why the general run of taxpayers ought, in these circumstances, to in reality subsidise the Objectors in what I term an unrealistic venture'.

With the greatest respect I prefer the view taken by Williams J. Just as it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income but only how much he has spent - a proposition derived from Australian authorities and confirmed in relation to our s 111 by the Privy Council in both the *Europa* cases (*Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641, 649; and *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546,556) - so too, while the Courts are justified in viewing circumspectly a claim that a taxpayer genuinely intended to carry on a business for pecuniary profit when looked at realistically there seems no real prospect of profit, an actual intention once established is sufficient.

The legislation sensibly allows for deductions and allowances to be claimed even where the overall result is a trading loss. It is not for the Courts or the Commissioner to confine the recognition of businesses to those that are always profitable or to do so only so long as they operate at a profit".

(per Richardson J)

McMullin J, while expressing himself in complete agreement with Richardson J, added

(at 114)

"Lack of reasonable prospect is only relevant as a factor by which the genuineness of the taxpayer's proclaimed profit-making intention is to be judged. In the result the prospect of profit-making should have been regarded in the present case as no more than an objective index against which the appellants' stated intention to carry on their farming operation for pecuniary profits could have been tested."

[21] It seems to me that the philosophy underlying the Act is, in respect of taxpayers who carry on farming operations, no different from that which was recognised in New Zealand. Nor should our conclusion be different. Neither the words of our statute nor the context of s 26 provide a discernible reason for introducing a reasonable prospect of profit as a requirement independent of the taxpayer's genuine intention to make a profit. As far as the contention that such an objective element is necessary to facilitate

the Commissioner's evaluation is concerned, it is commonplace in our law to refer to objective criteria in order to determine a subjective intention (eg in relation to *mens rea* in criminal prosecutions). That is, however, no reason to elevate the objective facts above the subjective element (which is the true object of the enquiry) as counsel would have us hold. In this regard we should approve the *dictum* of Miller J in ITC 1185 (35 SATC 122 at 123 - 4):

"It is no difficult matter to say that an important factor is: what was the taxpayer's intention when he bought the property? It is often very difficult, however, to discover what his true intention was. It is necessary to bear in mind in that regard that the *ipse dixit* 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. . . . 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 the court. But direct evidence of intent and purpose must we weighed and tested against the probabilities and the inferences normally to be drawn from the established facts."

[22] In the result I conclude that a taxpayer who relies on s 26(1) is (over and above proof that he is engaged in an activity in the nature of farming) only required to show

that he possesses at the relevant time a genuine intention to carry on farming operations profitably. All considerations which bear on that question including the prospect of making a profit will contribute to the answer, none of itself being decisive.

[23] The appeal is dismissed with costs.

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J A HEHER
ACTING JUDGE OF APPEAL

HEFER AP)Concur
SCHUTZ JA)
SCOTT JA)
BRAND JA)