THE SUPREME COURT OF APPEAL
REPUBLIC OF SOUTH AFRICA

JUDGMENT

Case No: 168/08

W J FOURIE BELEGGINGS **Appellant**

And

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE **Respondent**

Neutral citation: ***Fourie Beleggings v CSARS*** **(168/08) [2009] ZASCA 37 (31 March 2009)**

Coram: ***STREICHER, FARLAM, NUGENT JJA, LEACH and BOSIELO AJJA***

Heard: **13 March 2009**

Delivered: **31 March 2009**

Summary: **Income tax – amount paid to appellant, a hotelier, to compensate it for the cancellation of a contract to accommodate a number of people in its hotel for more than two years – such contract not forming part of the appellant's income- producing structure – payment not of a capital nature and subject to tax.**

ORDER

On appeal from: High Court, Bloemfontein (CJ Musi J, Hattingh and Van Der Merwe JJ concurring, sitting as a court of appeal).

The appeal is dismissed with costs.

JUDGMENT

LEACH AJA (STREICHER, FARLAM, NUGENT JJA and BOSIELO AJJA concurring):

[1] The so-called "9/11" attack upon the World Trade Centre in New York in September 2001 caused shockwaves which reverberated around the world, reaching as far afield as Potchefstroom in the North West Province of this country where the appellant conducted business as a hotelier, and leading to the cancellation of a lucrative trading contract the appellant had concluded a few months earlier. Subsequently, in full and final settlement of all claims arising from the cancellation of this contract, the appellant received a payment of almost R1,3 million.

[2] In assessing the appellant's tax liability for the 2002 tax year the respondent, the Commissioner of the South African Revenue Service, regarded this payment as forming part of the appellant's gross taxable income. The appellant objected to this under s 81 of the Income Tax Act, 58 of 1962 ("the Act"), contending that the payment

was an accrual or receipt of a capital nature, not subject to tax. When this objection was disallowed, the appellant appealed to the Tax Court. The appeal was also unsuccessful, as was a further appeal under s 86A(2)(a) to the Full Bench of the High Court, Bloemfontein which dismissed the appeal on 27 September 2007.[1] With leave of the High Court, the appellant appeals now to this court.

[3] At all material times the appellant conducted business at the Elgro Hotel in Potchefstroom which it had leased from a company known as Bultfontein Property Investments (Pty) Ltd. The appellant had previously done business with a company known as Naschem, a division of Denel (Pty) Ltd and a manufacturer of munitions, for whom it had provided accommodation for people referred to as 'students' but who appear to have been members of the military forces of the United Arab Emirates, while they received training in South Africa. In doing so, the appellant had made special arrangements to meet the dietary needs of the students as well as a number of their special needs. In April 2001, this led to the appellant concluding a further agreement with Naschem in which it agreed to accommodate and provide meals to substantial numbers of such students from April 2001 to 30 May 2003. Although the number of people to be accommodated was to vary from time to time during that period, the majority of the hotel's rooms had to be set aside for this purpose - which the appellant was prepared to do as it anticipated earning approximately R8,7 million from the contract.

[1] Its judgment has been reported as *WJ Fourie Beleggings CC v Commissioner for South African Revenue Service* (2008) 70 SATC 8.

[4] The conclusion of this agreement led to the appellant accommodating students from the Emirates from April to September 2001, during which period it earned some R4 million for doing so. And then news of the '9/11' attack reached Potchefstroom. Immediately thereafter, without offering any explanation, the students residing in the hotel at the time packed up and left, and it soon became apparent that they would not return. In the light of this unforeseen development, Naschem repudiated its contract with the appellant.

[5] The appellant thus found itself in a quandary. The vast majority of its clientele had absconded. Many of the rooms had been left in a state of considerable disrepair as not only had many of the students kept pets in their rooms but they had also smoked hookahs (described in evidence by the appellant's director, Mr Fourie, as 'hubbly bubbly pipes') which had burned carpets, bedding and curtains. While Fourie stated that if the contract had run its full course the appellant would have shrugged off this damage as an inevitable expense of a profitable contract, it suddenly found itself faced with a considerable repair bill in order to return the rooms to a condition in which they could be hired out. And of course, the appellant also had to meet its normal, on-going running costs which were substantial. All this it had to do with an extremely compromised client base.

[6] In these circumstances the appellant felt that it had no option but to look to Naschem for compensation, and threatened to bring legal proceedings. However, although the balance of the cancelled contract was worth an estimated R4,7 million,

the appellant was wary of attempting to recover this entire amount from Naschem with whom it had always enjoyed good business relations and hoped to continue to do so in the future. As a result, instead of issuing summons it entered into settlement negotiations with Naschem which initially offered to pay R600 000 in order to settle the dispute. This offer was was rejected, but the appellant subsequently accepted an increased offer of R1 292 760 which was paid in settlement of all claims it might have arising from the early termination of the contract. It was the payment of this sum which precipitated the current dispute as to whether the payment is to be regarded as capital or revenue.

[7] Whether a receipt or an accrual should be regarded as capital or revenue is probably the most common issue which arises in income tax litigation. A taxpayer's gross income is defined in s 1 of the Act as 'the total amount, in cash or otherwise, received by or accrued to or in favour of (the taxpayer) . . . excluding receipts or accruals of a capital nature'. Accordingly, if a receipt or accrual was not of a capital nature, it must have been of an income or revenue nature. But the phrase 'receipts or accruals of a capital nature' is not defined in the Act and although it has been held that the ordinary economic meaning should be attached to the word 'capital'[2] it has not been possible to devise a definitive or all embracing test to determine whether a receipt or accrual is of a capital nature, despite the regularity with which the issue has arisen. At the same time, and although common sense has been described as 'that

[2] *Commissioner of Taxes v Booysens Estates, Ltd* 1918 AD 576 at 582

most blunt of intellectual instruments',[3] it remains the most useful tool to use in deciding the issue.[4]

[8] The settlement agreement under which the amount in issue was paid recorded that as Naschem had unilaterally cancelled its agreement with the appellant who viewed this as a breach of contract which would cause severe financial loss and give rise to a valid claim for damages, the parties had agreed that Naschem would pay the appellant R1 292 760 in full and final settlement of all claims it might have, whether arising from the law of contract or the common law. The only realistic claim the appellant would have had against Naschem would have been in respect of its loss of profit suffered through the early termination of the agreement which, on payment, would clearly have been revenue.[5] In this respect the matter is similar to *ITC 312.*[6] In that case the appellant, whose business consisted of letting property, had let a portion of a building it owned for five years. When the lease still had more than two years to run, the tenant sought to cancel. After negotiations, it was agreed that the appellant would be paid a lump sum less than two-thirds of the total of the remaining rentals. In holding that this payment was income and not capital, the court said:[7]

'The contract was a contract of lease, and it seems to me that a lump sum paid in lieu of, and as compensation for, the balance of rent due for the period stipulated, is a sum paid under and by virtue of the letting of property."

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[3] Henry Hitchings *Doctor Johnson's Dictionary* John Murray Publishers (UK) (2005) at 132
[4] *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* case at 56I.

[5] Compare *ITC 724* (1952) 17 SATC 496 at 498 and *ITC 1761*(2004) 66 SATC 33 at 39.
[6] (1937) 8 SATC 154.
[7] At 156.

[9] The appellant, however, argued that in the present case the contract itself amounted to an asset that formed part of the its income-producing structure. Accordingly, so the argument went, the amount paid by Naschem had been paid for the loss or 'sterilisation' of an income earning asset and should be regarded as capital. In the light of this, the enquiry becomes, as was classically put by Lord Macmillan in *Van den Berghs, Ltd v Clark (Inspector of Taxes)*[8], 'whether the congeries of the rights which the recipient enjoyed under the contract and which for a price he surrendered was a capital asset'.

[10] In arguing that the contract it had with Naschem had been a capital asset, the appellant placed particular emphasis on the decision in this court in *Taeuber and Corssen (Pty) Ltd v Secretary for Inland Revenue*.[9] In that case, the appellant taxpayer had for many years acted as the sole agent in South Africa of a German producer. Its agency agreement provided that, on termination, the principal (the producer) would be entitled to require the agent (the taxpayer) not to sell or assist in the sale of any products in competition with the principal for a period of two years. In return for this undertaking, the principal undertook to pay the agent an amount calculated with reference to the commission the agent had previously earned. The agency agreement was subsequently cancelled and the principal duly paid the agent the amount it had undertaken to do on that event. This court found the payment to be of a capital nature, with Rumpff CJ holding that the agent had established 'an income-

[8] [1935] AC 431 (HL) at 443.
[9] 1975 (3) SA 649 (A).

producing structure' consisting in part of the contractual obligations 'that flowed from the contract with (the principal)'. The learned Chief Justice then went on to say:[10]

"What the parties intended . . . was a payment of a sum of money to restrain the [agent], for a period of two years, from earning income by the sale of all products competing with those of [the principal]. In the result, in my view, that part of [the agent's] income-producing structure which had sold only [the principal's] products was not only permanently prevented from selling [the principal's] products by the termination of the agreement, but also effectively closed for two years to the extent that it was prevented, for that period, from selling all such products as would compete with [the principal's] products, and the amount payable in terms of [the agency agreement] was intended to be, and must be construed as, compensation for this closure.'

[11] The appellant also relied on the decision in *ITC 134I*[11] in support of its contention that its contract with Naschem had been part of its income-producing structure. In that matter the appellant company had conducted business by registering the transfer of shares although it also despatched dividend warrants, sent out notices to members of companies and handled the issue of new shares in companies, including rights issues. The appellant had been formed when its shareholders, two other companies (A and B) had decided to merge their respective share transfer departments. In an effort to attract business from other companies as well, the appellant was given a neutral name not linked to either A or B, although at no time did outside business form a large part of its business. However, virtually all A and B's subsidiary companies made separate contracts with the appellant in which they bound themselves to employ the appellant for the services it offered. This state of

[10] At 663H-664A.
[11] (1981) 43 SATC 215.

affairs endured for some twenty years until company B acquired control over another financial institution, company C, and decided that it and its group of companies would withdraw from the existing arrangement with the appellant in order to use C's share-transfer department. They paid the appellant R260 048 in four equal instalments as compensation for doing so. It was argued by the tax authority that this amounted to no more that a *surrogatum* for future profits surrendered. The court however concluded that the withdrawal of the B group of companies undermined the whole basic structure of the appellant, that it resulted in an important 'limb of the fruit-bearing tree (being) chopped off'[12] and that it impaired the appellant's income-producing structure. The payment received in respect of the termination of the contracts with the appellant was accordingly treated as capital.

[12] A third decision upon which the appellant placed particular emphasis was that in *ITC 1259.*[13] In that case the taxpayer had concluded a management agreement with a large company, C, which had several subsidiaries and extensive holdings in fixed property. In terms of the agreement the taxpayer undertook not only to manage all C's properties but also to act as the secretary and accountant of all C's subsidiaries; to be the sole selling agent of the properties owned by C and its subsidiaries; and to act as an agent for an insurance company associated with C. The agreement was to last for a minimum of three years. However, a public company subsequently acquired a controlling interest in C and cancelled the taxpayer's contract after only 20 months. In consideration for the early termination of the agreement, the taxpayer was paid the

[12] At 223.
[13] (1977) 39 SATC 65.

sum of R30 000 which the Secretary for Inland Revenue sought to tax as income. The Transvaal Special Court found that the contract had been out of the ordinary course of the business earlier conducted by the appellant, and had resulted in a considerable disruption of the appellant's existing business structure which had been obliged to employ senior executives and experts as well as additional clerical staff. When implemented, the contract had constituted by far the major part of the appellant's property management business. Having regard to these facts, the court concluded that the contract had constituted a substantial part of the appellant's income-producing structure and, relying heavily on the judgment in *Taeuber* as authority for the conclusion that compensation paid for parting with a portion of a firm's business is to be regarded as capital, held the payment of R30 000 to be of a capital nature and not taxable.

[13] I accept that depending on the circumstances a sum paid to a taxpayer as compensation for the cancellation of a trading contract may be regarded as being of a capital nature.[14] But in considering whether that is here the case, it is of importance to note that in each of the cases relied on by the appellant the contract in issue, or more properly the rights and obligations flowing therefrom, were used by the taxpayers for the purpose of generating income. Thus in *Taeuber*, the taxpayer had used his right to freely trade and his business skills (which were sterilised by the restraint) to produce income. In *ITC 1341* the various companies were contractually bound to use the taxpayer's services when required; the contract thus channelled work to the taxpayer from which it earned an income. Similarly, in *ITC 1259*, the management agreement

[14] See eg *ITC 1279* (1997) 40 SATC 254 at 258.

and the other contracts provided the structure through which income earning activity was channelled to the taxpayer. The hallmark of each case is the fact that the contract created income-earning opportunities for the taxpayer. The contract was therefore a means used to produce income and was correctly found to have been part of the taxpayer's income-producing structure.

[14] There is of course a fundamental distinction between a contract which is a means of producing income and a contract directed by its performance towards making a profit.[15] This is graphically illustrated by the Australian decision in *Heavy Minerals Pty Ltd v Federal Commissioner of Taxation*,[16] a case regularly followed in that country which has striking similarities to the present case. In that matter the taxpayer was a party to contracts with both German and American buyers to which it sold rutile it had mined under a mining lease. When the rutile market collapsed, the taxpayer agreed to the cancellation of these contracts in consideration for the payment of monetary compensation. Its argument that this compensation was of a capital nature was rejected by Windeyer J who, in finding the amounts paid to be revenue, said:[17]

'Even if these contracts were such that they seemed to ensure that the taxpayer would have a secure market and some regular customers, that would not of itself make them part of the capital of its business.'

[15] See the speech of Lord Moncrieff in *Kelsall, Parsons & Co v IRC* 21 TC 608 at 623.
[16] (1966) 115 CLR 512; 10 AITR 140
[17] At CLR 517; AITR 143.

After then referring to the well known remark of Lord Ratcliffe in *Commissioner of Taxes v Nchanga Consolidated Copper Mines*[18] that phrases such as 'capital structure' were 'essentially descriptive rather than definitive', His Honour continued thus:

'The appellant sought to liken the moneys which the buyers paid to be released from their contracts to a price received as a consideration for going out of business . . . . But there is no analogy. The taxpayer's business was mining rutile and dealing in rutile. Its capital assets were the mining lease and the plant. After the contracts were cancelled it still had these. It was free to mine its rutile and to sell it if it could find buyers: and it tried to do so. The taxpayer was not put out of business by the cancellation of its overseas contracts. It did not go out of business when they were cancelled.'

[15] In the present case, the appellant traded as a hotelier before the contract and continued to do so, both once it had commenced and after it had been cancelled. The contract did not operate as a means by which the appellant generated business or through which it acquired business or obtained opportunities from which to earn income. It was merely a memorial of business the appellant had concluded, in which the number of persons it had agreed to accommodate, when that would take place and the rate that would be charged, were recorded. It may be that the appellant stood to earn a great deal from the contract which was to form the major source of its income during the period it lasted but that, and its anticipated duration of more than two years, did not transform it into part of the appellant's income-producing structure. That structure was made up of its lease of the hotel and the use to which the hotel

[18] [1964] AC 948 at 959.

was put. The contract the appellant agreed with Naschem was concluded as part of its business of providing accommodation. It was therefore a product of the appellant's income earning activities, not the means by which it earned income.

[16] In the light of these considerations, I conclude that the appellant's contract with Naschem cannot be construed as being an asset of a capital nature forming part of the appellant's income-producing structure. That being so, the amount paid to the appellant on termination of the contract is not in the nature of capital and must, by definition, be regarded as part of the appellant's gross income. The conclusions of both the Tax Court and the High Court in that regard were correct.

[17] The appeal is therefore dismissed with costs.

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L E LEACH
ACTING JUDGE OF APPEAL

Appearances:

For appellant:	C Van Breda
Instructed by:	Weavind & Weavind, Pretoria Matsepes Attorneys, Bloemfontein
For respondent:	G Stevens
Instructed by:	State Attorney, Bloemfontein