Tax & Exchange Control

ALERT

7 SEPTEMBER 2023

CLIFFE DEKKER HOFMEYR

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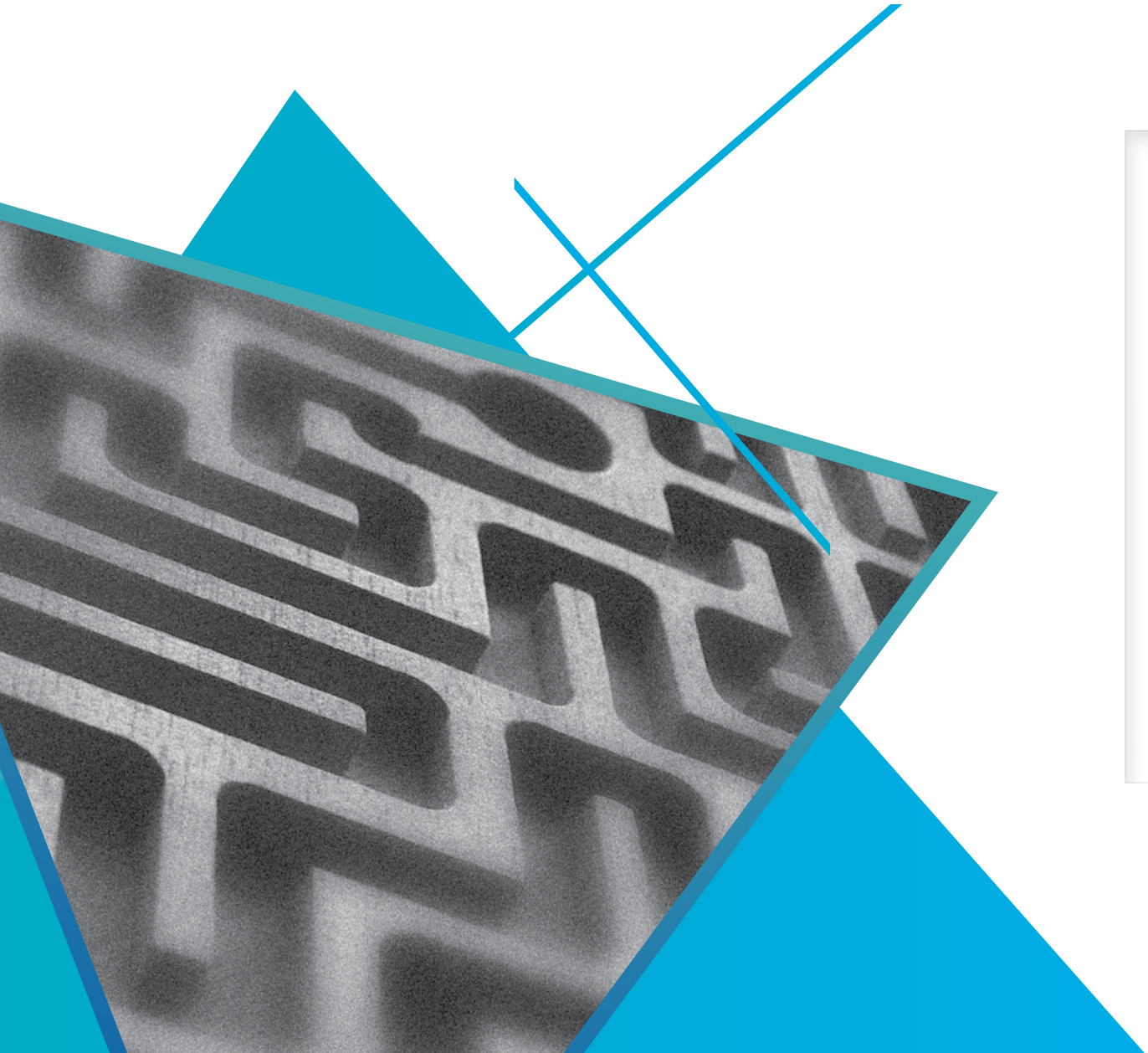

IN THIS ISSUE

At it again: Capital v revenue

The capital versus revenue debate is as old as tax law itself. The benefits, advantages or consequences of an amount being considered capital or revenue in nature has motivated taxpayers and the South African Revenue Service (SARS) alike to characterise amounts as one or the other. More often than not, the task of distinguishing between the two has fallen to the courts, as it did once again in the case of *A Taxpayer v Commissioner for the South African Revenue Service* (IT45638) [2023] ZATC 13, where judgment was handed down on 19 July 2023 (*IT 45638*).

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Background

In *IT 45638*, the taxpayer formed part of a group of companies that produced and exported fruit. The taxpayer undertook the marketing for the group, but also, to a very limited extent, exported fruit as well.

In 2014, the taxpayer entered into an agreement with a sustainable trade initiative and a European retail chain with which the taxpayer had an existing export relationship. This agreement had been concluded on the suggestion of the retail chain, which was cognisant that its customer base was prepared to pay a premium for produce that was sourced in an environmentally and socially sustainable manner. The purpose of the agreement was therefore to source table grapes from the taxpayer and other companies in the taxpayer's group that would produce these grapes in a sustainable manner with the assistance of the sustainable trade initiative.

In this, the taxpayer was the implementing partner and was tasked with managing the new company, NewCo, which was set up for the purpose of supplying the European retail chain. This NewCo was 40% held by a socio-economic empowerment trust, and 60% held by the taxpayer's holding company. The European retail chain and the sustainable trade initiative committed 40% of the funding necessary to capitalise NewCo, while the taxpayer committed 60% of the funding.

The funding from the taxpayer was extended to NewCo by way of a grant totalling more than R15 million. Following an opinion by its tax advisors, the taxpayer claimed the expenditure it incurred on the grant as a deduction against its income in terms of section 11(a) of the Income Tax Act 58 of 1962 (ITA). SARS took exception to this, stating that the expenditure incurred by the taxpayer was capital in nature, and therefore SARS disallowed the deduction. The taxpayer objected, and after the objection was also disallowed, it appealed to the Tax Court.

At it again: Capital v revenue

CONTINUED

Decision

The taxpayer's advisors argued that, in their opinion, the taxpayer's business relied on foreign customer satisfaction. Therefore, they reasoned, the grant to NewCo would enable NewCo to supply produce to the European retail chain, thereby resulting in the taxpayer being able to satisfy its European customer base. In light of this, they concluded that the expenditure incurred by the taxpayer on the grant would be in the production of its income and for the purpose of its trade.

This line of reasoning was maintained by the taxpayer in the Tax Court. In support of this, the taxpayer relied on the case of *CIR v VRD Investments (Pty) Ltd* [1993] (4) SA 330 (C) (*VRD*), concluding that the expenditure on the grant made the taxpayer's business more profitable, but did not result in the taxpayer acquiring a permanent asset or right (i.e. its income earning structure did not change).

The Tax Court began by admitting that the question of whether expenditure is capital or revenue in nature is never cut and dried. Rather, the character of expenditure must be determined with regard to the particular facts in question.

Turning to *IT 45638*, the Tax Court found that there were two pivotal facts. Firstly, the European retail chain sourced its table grapes from South Africa through the taxpayer. Secondly, the taxpayer's expenditure on the grant amounted to more than double the taxpayer's net profits before tax.

Looking at *CIR v George Forrest Timber Co Ltd* [1924] AD 516, the Tax Court concluded that capital amounts are invested to earn future profits, the outlay not recurring, but the income recurring. Although admitting that it is not an essential feature of capital expenditure to be once off, the Tax Court then referenced the English case of *British Insulated and Helsby Cables Ltd v Atherton* 1926 AC 205 (*Atherton*) where the point was made that expenditure incurred for the purpose of bringing an asset or advantage into existence for the enduring benefit of a trade is capital in nature.

In light of this, the Tax Court concluded that the agreement entered into by the taxpayer was not intended to create only a hope of NewCo exporting grapes to the European retail chain via the taxpayer. Rather, it was the intention of the parties that this agreement would establish a trading relationship between the parties from which the taxpayer would benefit as an exporter.

In reaching this conclusion, the Tax Court placed reliance on the fact that it would not have been commercially viable for the taxpayer to outlay the grant expenditure if it did not foresee an enduring benefit of this. Further, this enduring benefit was made more certain by the fact that the European retail chain had an existing trade relationship with the taxpayer.

At it again: Capital v revenue

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Therefore, the Tax Court concluded that the expenditure incurred by the taxpayer in extending the grant to NewCo was capital in nature as it secured an enduring advantage for the taxpayer.

Efficiency or Income

In coming to its conclusion, the Tax Court distinguished the *VRD* case relied on by the taxpayer from the cases relied on by the Tax Court. In *VRD*, the expenditure was found to be revenue in nature as it merely improved the income earning efficiency of a business, but did not establish an additional source of income. Here, however, the Tax Court found that NewCo exporting grapes to the European retail chain through the taxpayer was not a mere enhancement of the taxpayer's existing business, but was an entirely new income stream. In distinguishing *VRD* from the present matter, the Tax Court also referred to the well-known judgment in *Palabora Mining Co Ltd v Secretary for Inland Revenue* 1973 (3) SA 819 (A), which it held was equally distinguishable from the present case.

In effect, the Tax Court managed to potentially bring some clarity to a particularly muddy area of an already murky subject – it attempted to clarify when a lump sum (i.e. non-recurring expenditure) should be considered revenue or capital in nature. According to the Tax Court, the key is to examine the effect of the expenditure, and distinguish between new income streams and the enhancement of existing income streams. On the Tax Court's own admission, this distinction is drawn from the enduring benefit test as set out in *Atherton*, but the Tax Court highlighted its application in the present instance. The enduring benefit test has also formed part of our law for some time, having been stated by the Appellate Division (as it then was) in *New State Areas v Commissioner for Inland Revenue* 1946 AD 610.

As a result, taxpayers must be mindful of the effect of their expenditure before deciding whether it qualifies as an income tax deduction, or whether it is capital in nature. While the capital or revenue nature of a deduction will always depend on the facts, the judgment in *IT 46538* reflects that to claim a deduction on revenue account, even if the expenditure is once-off, it must serve to enhance an already existing business structure, and not add to that structure.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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