THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

JUDGMENT

Case no**: 509/10**

In the matter between:

THE COMMISSIONER FOR THE SOUTH AFRICAN

REVENUE SERVICE **Appellant**

and

FOUNDERS HILL (PTY) LTD **Respondent**

Neutral citation: ***CSARS v Founders Hill*** **(509/10) [2011] ZASCA 66 (10 May 2011)**

Coram: **HARMS DP, NUGENT, LEWIS and MALAN JJA and PLASKET AJA**

Heard: **17 MARCH 2011**

Delivered: **10 May 2011**

ORDER

On appeal from: Tax Court (Johannesburg) (Joffe J sitting with two assessors):

1 The appeal is upheld with costs, including those of two counsel, but excluding 50 per cent of the costs of preparing, perusing and lodging the appeal record.

2 The order of the Tax Court, Johannesburg is set aside. It is replaced with the following order:

'The appeal is upheld to the extent only that the appellant is not liable for the payment of interest in terms of s 89 quat of the Income Tax Act 58 of 1962.'

JUDGMENT

LEWIS JA (HARMS DP, NUGENT and MALAN JJA and PLASKET AJA concurring)

[1] In 49 BC when Julius Caesar crossed the Rubicon – a small river dividing Cisalpine Gaul (a province of Rome) from Italy – committing an act of treason in so doing (for no Roman general was allowed to enter Italy with his army without the consent of the Roman Senate), he intended to defy the Senate and in effect to declare civil war in Rome.[1] Little did he foresee (I suspect) that his act would come to be a symbol of passing a point of no return in the general sense, and that it has, in South Africa, become a tax mantra in cases that attempt to discern the distinction between capital gains and taxable income upon a disposal of property.

[2] In *Natal Estates Ltd v Secretary for Inland Revenue*[2] this court decided (in simplified terms – I shall return to the decision later) that where a landowner which had held land for some time as a capital asset, but then embarked on a project of selling off the land on a large scale, it had 'crossed the Rubicon' and had not merely sold an investment, the profit in respect of which would be regarded as capital: it had become a trader in land such that any profits it made amounted to taxable income.

[3] The respondent, Founders Hill (Pty) Ltd (Founders Hill), is described as a 'realization company' since it was formed for the avowed purpose of realizing land formerly owned as a

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[1] C Suetonius Tranquillus 'The Lives of the Twelve Caesars' XXXI and XXXII (trans Alexander Thomson).
[2] *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A).

capital asset by its holding company, AECI Ltd (AECI). A realization company, in the present context, is one formed for the purpose of facilitating the realization of property and the company does no more than act as the means by which the interests of its shareholders in the property may be properly realized. Surpluses made from sales of the property are supposedly not taxable as trading profits since such surpluses are capital receipts. But it is accepted that such a company, too, might cross the Rubicon and the appellant, the Commissioner for the South African Revenue Service, contended that Founders Hill had indeed crossed the Rubicon when it sold erven on which it realized profits. (I shall refer to the erven as such, or to property or land interchangeably.) Founders Hill maintained that it had done no more than realize a capital asset advantageously. The parties (and the tax court) thus both approached the matter on the supposition that the property was a capital asset in the hands of Founders Hill upon its acquisition, and that the question for determination was whether Founders Hill subsequently 'crossed the Rubicon' by starting to trade in the property.

[4] But approaching the matter in that way begs the question whether the property was a capital asset in the hands of Founders Hill in the first place. As will be seen, Founders Hill purchased the property from AECI for the very purpose of developing and reselling it. And so the initial question, in my view, is whether the property was acquired by it as stock-in-trade, or whether it was acquired as a capital asset. It is only if the property was acquired at the outset as a capital asset that a second question arises – the question that was considered by the court below – which is whether it thereafter 'crossed the Rubicon' by commencing to engage in the business of trading in the property. The distinction between realizing an investment. on the one hand, and carrying on the business of trading, on the other, is one long recognized. In *Commissioner of Taxes v Booysens Estates Ltd*[3] Innes CJ, referring to and quoting from *Californian Copper Syndicate v Internal Revenue,*[4] said that it was well established that where an investment was realized at a profit, the enhanced value was not taxable, but that 'where what is done is not merely a realisation or change of investment, but an act done in what is

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[3] *Commissioner of Taxes v Booysens Estates Ltd* 1918 AD 576 at 580. See also *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 452-3, and *Commissioner for Inland Revenue* v *Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 46A-52B, where there is a comprehensive analysis of the cases dealing with the distinction.

[4] *Californian Copper Syndicate v Internal Revenue* (1904) Sc (Court of Session) LR 691 at 694.

truly the carrying on or carrying out of a business', the profit made is regarded as taxable income.

[5] The Commissioner, while initially not assessing the profits made on sales of land by Founders Hill as income, issued a revised assessment in September 2003 for the 2000 and 2001 income tax years, claiming that the profits were in the nature of income on which Founders Hill was liable to pay tax. The Commissioner also assessed Founders Hill for interest in terms of s 89 quat of the Income Tax Act 58 of 1962.

[6] Founders Hill objected to the assessment on the ground that the proceeds of the sales were capital in nature. The objection was disallowed on the basis that Founders Hill was a trader in land. It appealed against the Commissioner's ruling. The Johannesburg Tax Court (Joffe J and two assessors) upheld the appeal. Starting from the supposition that Founders Hill had acquired the land as a capital asset, it held that the property had remained a capital asset at the time it was sold, with the result that the profit was a capital gain and not taxable income. It referred the matter back to the Commissioner to revise the relevant assessments on the basis that no tax was payable on the transactions in issue. It granted leave to appeal to this court. The total amount in issue is some R1 303 588, including the interest.

The history of the property

[7] There is no dispute about the circumstances under which the sales alleged to attract liability for income tax occurred. AECI was formed in 1924 following a merger between the British South Africa Explosives Company and Cape Explosive Works. AECI acquired vast tracts of land in the process, including land at Modderfontein in Johannesburg. The area of the land was some 4 100 hectares in extent.

[8] An explosives factory had been built on this land in 1896, and was extended in 1937. Much of the land was vacant, and constituted a buffer between the factory and other occupied land. On portions houses for employees were erected, and there were also storage facilities.

The land did not form part of any municipality and was effectively managed by employees of AECI.

[9] By the mid-eighties the legal and technological environment had changed significantly. Local government had been decentralized, town planning responsibilities had devolved on AECI and the manufacture of explosives had changed such that the buffer around the factory was not required to be as extensive as it had once been. The need for greater urban density in Johannesburg had become pressing as had the need for housing in the area. Accordingly, the Johannesburg City Council and AECI engaged in a planning process to address these changes. A number of professionals were asked to produce a strategic plan to deal with future development of the land, including proposals as to different land use.

[10] In a memorandum to the AECI board dated 2 March 1989, Mr J C von Solms recommended that the strategic plan that had been developed be accepted: that AECI take the decision to sell or develop the land, and commence the process step by step. The proposal was accepted.

The formation of Founders Hill

[11] One of the first steps was the formation of Founders Hill – a wholly owned subsidiary of AECI. It was incorporated at the beginning of 1993 and its main business was:

‘To acquire from AECI Limited certain properties situate at Modderfontein, Johannesburg which are held by AECI Limited as a capital asset and which have become surplus to its needs, *for the sole purpose of realising same to best advantage* and within a period of one year of completion of such realisation to be voluntarily wound up’ (my emphasis).

The main object of the company was in identical terms.

Sales by AECI to Founders Hill and by Founders Hill to third parties

[12] On 21 June 1994 AECI sold to Founders Hill erven 283, 301, 302 and 303 Modderfontein Extension 2, and erven 2, 17, 18, 19, 22, 23, 24, 25, 26 and 28 Founders Hill Township. The total price was R14 229 106, including VAT. Transfer was effected more than two years later, on 25 October 1996. Erven 301 and 302 Modderfontein were subdivided and sold to third parties in the years of assessment in question. They constituted part of a township development named Thornhill. Erven 25 and 28 in Founders Hill Township (known as Founders View North and South) were also subdivided. Some of the subdivided erven in the township were sold in the years of assessment to third parties and some to the Edenvale/Modderfontein Metropolitan Substructure, the local authority in place at the time.

The properties in Founders View

[13] Erven 25 and 28 Founders View were zoned for industrial use. Before the transfer by AECI to Founders Hill, AECI had already applied to rezone the area for light industrial use, and had subdivided the land for the purpose of that zoning. Founders Hill itself engaged professionals to develop these erven and incurred expenditure in ensuring that each subdivided stand could be sold with services such as the supply of water, electricity and sewerage by the local authority. Most of the erven were sold to third parties in 1996 and 1997. The last was sold in 2004. Some R11 million was spent by Founders Hill in developing and marketing these properties.

The properties in Modderfontein Extension 2: Thornhill

[14] Erven 301 and 302 formed part of what became the Thornhill development, forming its southern boundary. As indicated the erven had been subdivided by AECI before the transfer to Founders Hill. Apart from holding costs no expenditure was incurred by Founders Hill, and the subdivisions were sold from 2000 to 2002.

[15] A marketing company, Heartland Properties (Pty) Ltd (Heartland), was introduced into the property selling activities of AECI in 1998. It too was a wholly owned subsidiary of AECI. Its purpose was to promote the selling of the Thornhill properties. At that stage, Mr L Van

Vugt was appointed as the new managing director of AECI. He took the view that the surplus properties owned by AECI should be sold more aggressively: that if they were marketed more professionally and extensively they would achieve higher prices and that although income tax would be payable on profits the gains would probably be greater.[5] The remaining surplus land at Modderfontein was thus transferred to Heartland, at market value, and Heartland could deal with it as it chose.

[16] Much of the land transferred to Heartland formed part of the Thornhill Estate – an area designed to provide a secure residential environment. Heartland developed, marketed and sold its property, acquired from AECI, on a grand scale. It also marketed and acted as agent for Founders Hill in selling its erven in the Thornhill Estate. A third entity, Sable Homes, was also tasked with marketing the Thornhill property, including the erven that Founders Hill owned.

Activities of Founders Hill in selling its property

[17] Founders Hill had no employees. Its sole shareholder was AECI, and its directors were those of AECI. The erven in Founders View were, as I have said, subdivided and developed by AECI before the transfer to Founders Hill although the profits accrued to Founders Hill. And in Thornhill, Founders Hill did not, in fact, undertake any development or selling itself. Heartland acted on its behalf. The witnesses for Founders Hill did not attempt to suggest that there was any difference between Heartland's conduct in respect of the land it had acquired from AECI and which was sold, in effect, as stock-in-trade, thereby realizing profits that were declared as taxable income, on the one hand, and its activities for Founders Hill, where the profit was assumed to be in respect of a capital asset on the other.

Were the profits made on the sale of Founders Hill's property capital or income?

[18] As I have said, the Commissioner impliedly accepted that Founders Hill acquired the properties as capital assets, but contended that having regard to the extent of its activities, it

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[5] The transactions in question did not attract capital gains tax, introduced by the Taxation Laws Amendment Act 5 of 2001.

had crossed the Rubicon because it had started to trade in the land that it acquired from AECI, and that its profits were accordingly income, and taxable as such. He argued that Founders Hill's intention was that of AECI since the latter was the controlling mind of Founders Hill. Although its initial intention may have been different, it changed, he argued, as was manifest from the activities of Founders Hill over the years when the erven were sold. The sales during the years of assessment in question could not be viewed in isolation from those preceding and following that time. The realization programme of AECI was vast, and Founders Hill was but one of six companies formed by AECI to sell its surplus land throughout South Africa.

[19] Founders Hill argued, on the other hand, that its intention at all times was to realize the land held as a capital asset. That was the purpose of the company from inception. That is evident, it contended, from the memorandum of association, set out earlier. A taxpayer is entitled to realize an asset to best advantage, a principle recognized for nearly a century in South African law. Founders Hill cited in support of this proposition the cases of *Commissioner of Taxes v Booysens Estates Ltd*[6] and *Commissioner for Inland Revenue v Stott*[7] where Sir John Wessels JA said:

'Every person who invests his surplus funds in land . . . is entitled to realize such asset to the best advantage and to accommodate the asset to the exigencies of the market in which he is selling. The fact that he does so cannot alter what is an investment of capital into a trade or business for earning profits.'

[20] And similarly in *John Bell and Co (Pty) Ltd v Secretary for Inland Revenue*,[8] P J Wessels JA, after referring to the passage in *Stott* cited said:

'The mere fact, therefore, that a person deliberately delays the disposal of a capital asset because, upon his "reading" of the property market, "the hand of time" is needed in order to realise the asset to best advantage cannot, in my opinion, result in a change in the character of the asset so as to alter it from a capital asset, held for the purpose of advantageous disposal, to stock-in-trade, held for the purpose of earning income in the course "of an operation of business in carrying out a scheme for profit-making" [*Natal Estates* at 199A-B].'

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[6] *Commissioner of Taxes v Booysens Estates Ltd* 1918 AD 576 at 595.
[7] *Commissioner for Inland Revenue v Stott* 1928 AD 252 at 263. See also *Commissioner for Inland Revenue v Malcomess Properties (Isando) Pty Ltd* 1991 (2) SA 27 (A) at 34H-I.
[8] *John Bell and Co (Pty) Ltd v Secretary for Inland Revenue* 1976 (4) SA 415 (A) at 428E-F.

[21] This court invoked in support of the proposition that a taxpayer is entitled to realize property 'to best advantage' the decision in *Californian Copper Syndicate v Internal Revenue*[9] where Clerk LJ said that it was a settled principle that if the owner of an investment chooses to realize it, and makes a profit, the profit is not taxable as income. But he also said:

'But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or a change in investment, but an act done in what is truly the carrying on, or carrying out of a business.'

As I have said, on the parties' formulation of the issue in this case, the question was whether Founders Hill realized the erven to best advantage or whether it embarked upon the *business* of selling land.

[22] The Commissioner relied extensively on *Natal Estates Ltd v Secretary for Inland Revenue*[10] to which I now turn. In *Natal Estates* the taxpayer owned vast tracts of land (initially some 21 000 acres, some of which was expropriated from time to time, but to which it also added from time to time) along the coast north of Durban. For decades it had cultivated sugar cane on the land. In the late 1950s the board of directors had contemplated developing townships in the areas of La Lucia and Umhlanga Rocks. By 1963 the company that originally owned the land was taken over by Natal Estates, which established the townships of La Lucia and Umhlanga Rocks. Tracts of land were sold to various developers for township development. Between 1965 and 1970 Natal Estates sold nearly 5 000 acres. The Secretary for Inland Revenue issued an assessment in 1972 for the years from 1965 to 1972 on the basis that the profits realized were taxable as income.

[23] The Special Income Tax Court, to which Natal Estates appealed, found that it had traded in land and dismissed the appeal against the assessment. Holmes JA, on appeal to this court, after stating that it was clear that a taxpayer may realize an asset once owned as capital to best advantage, held that in this matter there had been a change in the intention of the

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[9] *Californian Copper Syndicate v Internal Revenue* (1904) Sc (Court of Session) LR 691 at 694.
[10] *Natal Estates Ltd v Secretary for Inland Revenue* 1975 (4) SA 177 (A).

taxpayer: it had become a dealer in land and was taxable on the income that it made from trading. The court rejected the contention that its business operations in regard to the sales of land in Umhlanga Rocks and La Lucia amounted only to the realization of a capital asset to best advantage and that it was not using its land as stock-in-trade in a profit-making business. Holmes JA said:[11]

'In deciding whether a case is one of realising a capital asset or of carrying on a business or embarking upon a scheme of selling land for profit, one must think one's way through all of the particular facts of each case. Important considerations include, *inter alia*, the intention of the owner, both at the time of buying the land and when selling it (for his intention may have changed in the interim); the objects of the owner, if a company; the activities of the owner in relation to his land up to the time of deciding to sell it in whole or in part; the light which such activities throw on the owner's *ipse dixit* as to intention; where the owner sub-divides the land, the planning, extent, duration, nature, degree, organisation and marketing operations of the enterprise; and the relationship of all this to the ordinary commercial concept of carrying on a business or embarking on a scheme for profit. Those considerations are not individually decisive and the list is not exhaustive. From the totality of the facts one enquires whether it can be said that the owner had crossed the Rubicon and gone over to the business, or embarked upon a scheme, of selling such land for profit, *using the land as his stock-in-trade*.'

[24] But even looking at the totality of facts, and the taxpayer's intention, discerning where the Rubicon lies gives rise to difficulty. As E B Broomberg said of *Natal Estates*:[12]

'The uncertainty created by the judgment is manifest in the use of the picturesque "crossing the Rubicon", which has become the trade-mark, so to speak, of this judgment. But to what "Rubicon" are we directed? Is it the objective conduct of the taxpayer which converts what was a mere realization into an observable trade? Or is it a purely mental turning point relating to the attitude of the taxpayer to his asset?'

[25] Assuming that a taxpayer acquires an asset with the intention to hold it as capital, a change in that intention (if such be proved) on the part of the owner who realizes it, should not be the only determinant of the nature of the profits made. Were it to be otherwise a number of difficulties arise. Whose intention is relevant? And at what stage? If the taxpayer is a

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[11] At 202G-203B.
[12] 1975 *Annual Survey of South African Law* p 517.
[13] *Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd* 1956 (1) SA 602 (A) at 610C-D.

realization company wholly owned by the original owner of the asset in question, is it the intention of the subsidiary or its controlling mind that counts? In my view, although this need not be decided at this point, the question should be whether the taxpayer is actually trading, or carrying on a business, at the time of assessment, and not merely whether or not it has changed its mind. Of course the intention of all concerned must be considered, but intention cannot be conclusive in the enquiry. As Schreiner JA said in *Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd*:[13]

'The decisions of this Court have recognised the importance of the intention with which property was acquired and have taken account of the possibility that a change of intention or policy may also affect the result. But they have not laid down that a possibility that a change of policy or intention by itself effects a change in the character of the assets.'

[26] The difficulties attendant on invoking the intention of a taxpayer as the litmus test which determines whether the proceeds of an asset sold are of a capital or income nature are made plain too in *Malan v Kommissaris van Binnelandse Inkomste*[14] where E M Grosskopf J said that intentions by their nature are changeable and often not fully formulated; and evidence after the event, however honest, is not always reliable, sometimes being reconstructed.[15] And of course in *Natal Estates*, in the passage cited, Holmes JA said clearly that one must 'think one's way though all the facts'[16] and thus not rely only upon what the taxpayer claimed had been its original and continuing intention.

[27] Naturally the Commissioner in this matter contended that Founders Hill had crossed the Rubicon. And Founders Hill maintained that it was still in Gaul, having realized capital assets it held for that sole purpose. Joffe J in the tax court, starting on the supposition that the land had been acquired by Founders Hill as a capital asset, found that the Rubicon had indeed not

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[14] *Malan v Kommissaris van Binnelandse Inkomste* 1981 (2) SA 91 (C) at 96E-G.
[15] See also ITC 1185 35 SATC 122 at 123-4, where Miller J said much the same: his dicta were relied on by E M Grosskopf J in *Malan.*
[16] For criticism of reliance on intention alone see Gavin Urquhart 'Capital v Revenue: Some Light in the Darkness?' 1979 *Acta Juridica* p 299.

been crossed. But he did not explain why. Founders Hill, on appeal, relied chiefly on the fact that its sole purpose was to sell off the land which AECI had held for decades: its intention, it said, was to realize capital assets to best advantage. That, as I have said, begs the question whether it acquired capital assets or stock-in-trade in the first place. The tax court apparently concluded (and before us Founders Hill contended) that because AECI had transferred surplus land in Modderfontein to a subsidiary company, Founders Hill, in order for the latter to realize the land, there was an intention to realize what was a capital asset to best advantage. Founders Hill bought no additional land, and it did not become a trader in property. The interposition of the realization company was thus of great significance. I shall deal with realization entities and their purpose in due course. But I shall deal first with the question of intention.

The intention of Founders Hill

[28] Founders Hill was formed as a 'realization company' on legal advice. Its witnesses were very conscious of two principles: that it was entitled to 'realize the property to best advantage'; and that in so doing it should not 'cross the Rubicon'. The problem lies in the fact that they had failed to appreciate that the realization of property to best advantage applies to the realization of a capital asset only and the fact that a taxpayer refers to an asset as a capital asset does not make it one. It had acquired the erven with the express intention of selling them – carrying on the business of selling land. The view taken that the interposition of a realization company would in some way enhance the intention to realize capital assets, rather than to trade, requires greater scrutiny.

Realization entities

[29] The principal progenitor of cases in South Africa dealing with realization companies[17] is *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue*,[18] also a judgment of Holmes JA in this court, where the profit on the sale of land by a company formed for the purpose of realizing land held for many years by different family members, was found to be capital in

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[17] There are earlier decisions in the Southern Africa tax courts, most notably *Realisation Company v Commissioner of Taxes* 1951 (1) SA 177 (SR), referred to by this court in B*erea West*, below.
[18] *Berea West Estates (Pty) Ltd v Secretary for Inland Revenue* 1976 (2) SA 614 (A).

nature. The Special Income Tax Court had held that the company had traded in land, a finding reversed on appeal. Holmes JA held that a court, when determining whether a company was merely selling the property as an asset held as capital, or was trading for profit, was entitled to look at the facts leading to its incorporation, to its memorandum and articles of association, and to its subsequent conduct.

[30] The facts of *Berea West*, in summary, were these. Hermann Konigkramer (K) married his wife, Elise, in community of property. In 1890 they entered into a postnuptial contract excluding the community. K owned a farm in Berea West, in the Durban area. It was some 620 acres in extent. Elise died in 1912, leaving her rather small estate (since community was excluded) to their 13 children, subject to a usufruct in favour of K. The validity of the postnuptial agreement was contested by some of the children. In order to settle the litigation that might ensue K formed an inter vivos trust, the children being the beneficiaries.

[31] In terms of the trust deed, executed notarially in 1922, an undivided half share of the farm was donated in trust for his 13 children and was transferred to the trustees after K’s death in 1927. In terms of K’s will, the remaining undivided half share of the property was also left to his 13 children. The administration of the trust and K's estate proved to be difficult and protracted and it took some ten years before the estate liabilities were fully paid. In the meantime some of the beneficiaries of the trust, who were also heirs, had died, with the result that others became beneficiaries and heirs by representation.

[32] The beneficiaries and other interested parties agreed that a company be formed to acquire the assets of the deceased estate and of the trust, and that shares be issued as consideration for the interests of the heirs and beneficiaries in the company in proportion to their respective entitlements. An agreement to this effect was executed in 1950. In the preamble to the agreement it was stated that its object was that in due course the company might complete the realization of the property and from time to time distribute the net profits from such realization among the shareholders, thus relieving the executors and the trustees of

their obligations. The Master of the Durban and Coast Local Division, and the court itself, approved the creation of the company which was registered in March 1950.

[33] The land, valued then at £120 000, was transferred to the company. Prior to the company's acquisition of the land, K's estate had received approval for the conditions of establishment of various townships, and these were proclaimed after the company had acquired the land. The conditions of establishment of the townships included stipulations that the owner was responsible for road making, water supply and certain physical surveys. The conditions had to be complied with before lots in the townships could be marketed. From 1950 to 1970 the company spent R95 496 in developing the land, being expenditure on roads, water supply and surveys. The company carried out no other development of the land. The directors of the company considered that the only way in which the company would ever be able to repay its share and debenture holders would be by selling building sites or lots in an established township and not land in blocks. The company disposed of the land by first developing and selling lots in one area and then, using the funds so acquired, developing and selling lots in another area.

[34] The amounts due in respect of debentures were fully paid in 1968 and dividends were paid to shareholders for the first time in 1969. Throughout its existence the company had rendered annual returns of income to the Receiver of Revenue in the same manner as an ordinary commercial company but received an assessment in respect of taxable income for the first time for the year ended 30 June 1965. For the year ended 30 June 1967 the company was assessed on a taxable income of R43077. Its objection to the assessment was rejected. It appealed to a special income tax court which held that the profits from the sale of its land by the company constituted taxable income and not a capital accrual.

[35] On a further appeal to this court Holmes JA concluded that the special court's finding of a changed intention was based on the objects in the company's memorandum; the similarity of the directors' approach to that of a trading company; the method of operation in the disposing of the property; the long period over which the farm was subdivided and realized; the fact that it was realized gradually in different areas; the expenditure of a substantial sum in developing the property over 20 years; the failure by the company to object to an assessment that it was

liable to pay tax on profits of the sale of land in one year of assessment; the fact that the heirs and beneficiaries realized their interests in the estate and the trust when shares and debentures were issued to them; the separate identity of the company, which was not the alter ego of the beneficiaries; and the view that the events leading to the formation of the company were only remotely relevant.

[36] Holmes JA concluded[19] that the basis of the finding that the company had become an ordinary company, trading for profit, was that after inception it had deviated from its original intention. He held otherwise:[20]

'The corner-stone of the argument on behalf of the respondent [the Secretary] was that, basically, if a company buys land with the object of selling it, and does so at a profit, the latter is regarded as income. Counsel for the appellant did not collide with this proposition: he sought to turn its flank by contending that it did not apply because the appellant acted merely as a realisation company and therefore any profit was of a capital nature. It is accordingly necessary to refer to the concept of a realisation company in relation to income tax. As will appear later, in general the authorities sanction a proposition which may be illustrated along the following lines:

Suppose, for example, A and B and C own a tract of land, *not having acquired it with a view to sale*, and they wish to realise this capital asset; and they promote a company and become the exclusive shareholders; and they transfer the land to the company for the purpose of realising the asset; and, when it has been sold, the company is to be wound up and its assets distributed among the shareholders. The company would be regarded as a realisation company, and not a company trading for profits, and the surplus would be regarded as a capital receipt; unless, of course, the company conducted itself as a business trading for profits, using the land as its stock-in-trade.

The position is well put in Simon's Taxes, 3rd ed at p B 1. 214 -

"If a company is formed for the purpose of facilitating the realisation of property and the company does no more than act as the means whereby the interests of its shareholders may be properly realised in the property, surpluses made from sales of the property are not taxable as trading profits since such surpluses are capital receipts."'

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[19] At 627H.
[20] At 628A-E.

[37] Holmes JA discussed the cases on which the editors of *Simon's Taxes* had relied, and concluded that they were authority for the proposition that where a company was formed solely for the purpose of *facilitating the realization of property which could not otherwise be dealt with satisfactorily*, then the profit achieved on sale would be of a capital nature and not taxable. In none of the cases discussed in *Simon's Taxes* and evaluated by this court was there but a single owner who interposed a 'realization company' where it could satisfactorily have realized the capital asset itself.

[38] The court concluded that Berea West had not traded in land and was not taxable on the profits that it made on its sales over time. Holmes JA held that the beneficiaries had set up the company 'for the purpose of facilitating the realisation of the land, and that the company, in which they became the shareholders, was merely the machinery for realising their interest in the land'.[21] On the special court's reasoning, he said, all realization companies would be taxable on their profits.

[39] What, then, is the difference between *Natal Estates*, on the one hand, and *Berea West* on the other? Some writers have assumed that the mere interposition of a realization company makes the difference. *Silke on South African Income Tax*[22] states:

'An important exception to the general rule that if a company acquires an asset with the express object of reselling it the proceeds are income is to be found in the concept of a realization company, which is applied when the transaction is not undertaken as a scheme of profit-making.'

[40] Similarly, R C Williams *Income Tax in South Africa: Law and Practice*[23] states that 'it is well established that . . . realisation to best advantage may be effected by means of a company or trust (a so-called "realisation company" or "realisation trust")'. Both *Silke* and Williams cite *Berea West* as authority for the proposition. It is possible that counsel who advised AECI took the same view, hence the transfer of the erven in question to Founders Hill.

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[21] At 634F.
[22] Para 3.16.
[23] Page 176.

Yet Holmes JA in *Berea West*[24] made it quite clear that if a realization company 'so conducts its affairs that it can be said to be carrying on the trade or business of making profits from the sale of land, using the latter as its stock-in-trade, the profits will be "revenue derived from capital productively employed" [25].'

[41] Founders Hill relied also on ITC 1481[26] where a company had been formed for the sole purpose of acquiring land, subdividing and selling it. The court found that the company had not embarked on the business of township development and selling land for profit. The court held that *Natal Estates* was distinguishable because of the extent of the development, the marketing, and construction of houses. In my view, the test whether the taxpayer is engaged in the business of selling, and therefore taxable on profits, cannot depend only on the degree of its activities. The case is not in line with the cases on realization entities discussed in *Berea West* and below, and was based on the supposition that the land was capital in the hands of the realization company. It is thus of no assistance in determining the matter before us.

Where the interposition of realization entities does not change the capital nature of the property sold

[42] Calling an entity a 'realization company' (and limiting its objects and restricting its selling activities in respect of the assets transferred to it), is not itself a magical act that inevitably makes the profits derived from the sale of the assets of a capital nature. *Silke* recognizes this when it states that it is conceivable that a realization company can change its intention and start trading in the assets. But this assumption begs the question whether, in circumstances where the original holder of the assets could, without the interposition of a subsidiary company (the sole purpose of which is to realize what was in the former owner's hands a capital asset), realize the assets itself, there could ever be an intention on the part of the interposed entity to realize the property it has acquired as a capital asset. If the sole purpose of

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[24] At 631E-G.
[25] A quotation from *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 453.
[26] ITC 1481 52 SATC 285 (Eastern Cape Special Court).

the transfer to the realization company is so that it can realize the property, on what basis can it be said that it ever held it as capital?

[43] Referring to companies formed for the purpose of realizing property Clerk LJ stated the general rule in *Californian Copper Syndicate*:[27] in such cases 'it is not doubtful that where they make a gain by a realisation, the gain they make is liable to be assessed for income tax'.[28] The import of this statement is that when an entity is formed for the sole purpose of realizing property, profits achieved amount to income made from trading.

[44] In my view an interposed realization company (or other entity) will stand in the shoes of the entity that has transferred assets to it, and hold them in turn as capital assets, only in special circumstances, exemplified in Holmes JA's judgment in *Berea West* (where A, B and C hold shares in property and require a vehicle to sell them as advantageously as possible, as was the case in *Berea West*), or where there is a need to protect the assets from the original holder. *Malone Trust v Secretary for Inland Revenue*[29] is an illustration of the latter situation.

[45] In 1917 Mrs J F Malone acquired a farm in Beacon Bay, East London. She lived there with her family for many years. The land was not suitable for farming. From time to time small portions of it were sold off to provide for the maintenance of her family. She died in 1933 and her husband inherited the property and continued to live on it. He died in 1948, and their son, Joseph Malone, acquired the farm and also lived on it. In 1952 he sold off some ten morgen, on which the purchaser established a township. When he was fifty he married a younger woman and they had three children. His wife, in the words of Trollip JA, was 'financially irresponsible' and his money was rapidly dissipated.

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[27] Above at 694.
[28] See the analysis of the passage by Nicholas AJA in *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 49E-I.
[29] *Malone Trust v Secretary for Inland Revenue* 1977 (2) SA 819 (A).

[46] In 1962 Joseph Malone and his wife executed a joint will, bequeathing their joint estate to their children, subject to a usufruct in Mrs Malone's favour. Their attorney and financial adviser, Mr Orsmond, was the executor of the estate. Some years later, on Orsmond's advice, Malone decided to establish a township on what remained of the land. Orsmond took the steps necessary to do so. But before this was finalized Mrs Malone had spent all the family money and had taken up with a younger man. Again on Orsmond's advice, Malone established a trust, the purpose of which was not only to establish a township but also to ensure that the proceeds from any sales would go to the trust and not to Mrs Malone.

[47] Malone died in June 1968. As executor of the estate, Orsmond had considerable difficulty in dealing with the property and proceeding with the establishment of a township. He thus transferred the land to the trust so that he could see to the establishment of the township in his capacity as a trustee. For the tax years 1970 and 1971, sales of erven in the township achieved profits which the Secretary taxed as income. An appeal against the assessment to a special income tax court failed.

[48] On a further appeal to this court, Trollip JA held that Malone, had he established the township himself, would have been doing no more than realizing his property to best advantage. When his executor transferred the land to the trust it did not engage in land trading. In forming the trust Malone merely 'set up the necessary machinery to implement that intention [to realize to best advantage] on his behalf more efficiently in order to protect the interests of himself, his wife, and more especially his children.'[30] Trollip JA, also relying on *Simon's Taxes*[31] and on *Berea West* said that the principle to be distilled was that:[32]

'[I]f a trust is formed for the purpose of facilitating the realization of property and the trust does no more than act as the means whereby the interests of its beneficiaries may be properly realized in the property, surpluses made from sales of the property are not taxable as trading profits since such surpluses are capital receipts. That statement is particularly apposite to the present case. In other words

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[30] At 828A-C.
[31] Third edition pB1.214.
[32] At 828B-D.

the trust here was purely a realization trust to which the principles expounded in the *Berea West* case are applicable.'

[49] The distinction between cases where an asset is transferred to a company from a single source for the sole purpose of realizing it, on the one hand, and *Berea West* and *Malone* on the other, is that in each of the latter cases there was a real justification for the formation of the company or trust (in addition to the purpose of realizing the assets). First, more than one person transferred the assets to the interposed entity (as in Holmes JA's example of A, B and C); and second, without the interposition of a company or trust, realization would have been difficult if not impossible.

[50] So too, the cases discussed in *Simon's Taxes,* referred to by Holmes JA in *Berea West*[33] are instances of interposition of another entity in order to achieve a purpose over and above the realization of property. In *Rand v Alberni Land Co Ltd*[34] a new entity was required to facilitate the sale of property previously held by different people. In *Inland Revenue Commissioners v Westleigh Estates Co Ltd*[35] the purpose was to consolidate and conveniently administer the interests of beneficiaries under different wills. In *Commissioner of Taxes v The Melbourne Trust Ltd*[36] a company was formed to facilitate the sale of assets belonging to three banks for the benefit of their respective creditors. These are but examples.

[51] In a more recent case in the Supreme Court of Canada, *Balstone Farms Limited v Minister of National Revenue*,[37] an elderly couple had owned farm land, let under crop leases, for many years. They decided to sell the land, at a profit, to a company for the purpose of selling it, though it was anticipated that it would continue to be farmed for a period and this object was set out in the letters patent of the company. The court held that on the evidence, the

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[33] At 628D-629H.
[34] *Rand v Alberni Land Co Ltd* (1920) TC 629 (KB).
[35] *Inland Revenue Commissioners v Westleigh Estates Co Ltd* [1924] KB 390.
[36] *Commissioner of Taxes v The Melbourne Trust Ltd* 1914 AC 1001 (PC).
[37] *Balstone Farms Limited v Minister of National Revenue* [1968] SCR 205.

real purpose in incorporating the company was to acquire the farm land with a view to selling it.

[52] The company gave several options on the lands to prospective purchasers: when these were not exercised the company retained option payments. In due course the property was sold. The Minister assessed both the receipts of option payments and the proceeds of sale for tax. The company, on appeal to the Supreme Court, relied inter alia on *Rand v Alberni Land Co Ltd*,[38] arguing that it had been formed as a realization company for the purpose of disposing of capital assets. The court rejected the argument.[39] That case, it said, quoting from the judgment of Rowlatt J, had 'done no more than provide the machinery by which the private landowners were enabled under the peculiar circumstances of their divided title, to properly realise the capital of the property . . . and that is not income or proceeds of trade'.

Judson J in *Balstone*[40] added:

'In none of these realization cases was there an out and out transfer by former owners for a cash consideration. . . . [Balstone] was not "realizing" or selling these properties for the benefit of prior owners or the creditors of prior owners. The facts speak for themselves and fully justify the finding of fact of the learned trial judge. The company was selling on its own behalf to make a profit . . . .'

Did Founders Hill acquire capital assets or stock-in-trade?

[53] Founders Hill was not merely AECI's alter ego. It was formed solely for the purpose of acquiring the property and then developing and selling it at a profit and I see no reason then why the property was not stock-in-trade. This is apparent from the terms of the memorandum of association and was confirmed by the minutes of the board of directors and the witnesses as well as the manner in which it dealt with the properties. As I have said, the mere fact that Founders Hill said that it acquired the properties as capital assets did not make them such. Founders Hill was no different, I think, from Balstone. Its business was to develop the erven and sell them. Its intention in acquiring was different from that which AECI had had, at least

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[38] Above.
[39] The Chief Justice, Cartwright CJ, dissented.
[40] At 212-213.

originally, to hold its surplus land as a capital investment. Founders Hill's profits were gains 'made by an operation of business in carrying out a scheme for profit-making' and therefore revenue derived from capital productively employed and must be taxable income. Counsel for Founders Hill could not explain why it was formed, and AECI assets sold to it, other than on the basis that AECI had taken legal advice to this end. That is not an explanation. And the case does not fall within the exception recognised on the special facts of *Berea West* where the realization of the property was not the main purpose of the interposition of the trust but a subsidiary one, or where, in the example of Holmes JA, three parties form a company to enable them to realize their properties to their best advantage. Special cases do not create general rules.

[54] I therefore consider that Founders Hill acquired the property as stock-in-trade and then conducted business in trading in the property and that the profits made were taxable as income. The Commissioner's assessments in the tax years 2000 and 2001 were thus correct. I see no reason, however, to impose penalty interest in terms of s 89 quat of the Act. Founders Hill acted on legal advice and in the mistaken belief that as a realization company it was doing no more than selling its property to best advantage. It disclosed all the facts in its tax returns. And in previous tax years the Commissioner had not assessed it for tax on the profits made on sales of erven.

Costs

[55] The appeal record did not comply with the rules of this court, and at least half of it was not necessary for the determination of the appeal. The Commissioner may not, therefore, recover 50 per cent of the costs of preparing, perusing and lodging the record.

Order

[56] 1 The appeal is upheld with costs, including those of two counsel, but excluding 50 per cent of the costs of preparing, perusing and lodging the appeal record.

2 The order of the Tax Court, Johannesburg is set aside. It is replaced with the following order:

‘The appeal is upheld to the extent only that the appellant is not liable for the payment of interest in terms of s 89 quat of the Income Tax Act 58 of 1962.’

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C H Lewis

Judge of Appeal

APPEARANCES:

APPELLANTS:	A R BHANA SC (with him C DREYER) Instructed by The State Attorney Johannesburg The State Attorney Bloemfontein
RESPONDENTS:	S F DU TOIT SC (with him H V VORSTER) Instructed by Vorster Perreira Attorneys Sandton Naude’s Attorneys Bloemfontein