

41/96

NOT REPORTABLE

Case number 337/94

IN THE SUPREME COURT OF SOUTH AFRICA

(APPELLATE DIVISION)

In the matter between:

THE COMMISSIONER FOR INLAND REVENUE

Appellant

and

ROLF-STEPHAN ARTHUR WILHELM NUSSBAUM

Respondent

CORAM : CORBETT CJ, NESTADT,
NIENABER, HOWIE JJA, et
ZULMAN AJA

DATE OF HEARING : 1 MARCH 1996

DATE OF JUDGMENT : 29 MARCH 1996

J U D G M E N T

HOWIE JA/.....

HOWIE JA :

Respondent is a retired schoolteacher. In 1946 he inherited certain shares quoted on the Johannesburg Stock Exchange. Upon that foundation, with active and careful investment, he built a substantial portfolio of quoted shares during the ensuing years. Changes in his shareholdings were reflected in documentation accompanying his yearly income tax returns. In the tax years 1982, 1983 and 1984 he disclosed share sales of a quantity and profitability that prompted appellant, in an additional assessment for each of those years, to subject the proceeds to tax. Respondent objected, contending that the proceeds were accruals of a capital nature. His objection having been disallowed, respondent appealed to the Cape Income Tax Special Court. That appeal failed. However, his further appeal to the Full Bench of the Cape of Good Hope Provincial Division was allowed and the assessments in question were set aside. Appellant then sought leave to

appeal. It was refused by the Full Bench but granted by this Court. Hence the present appeal.

Respondent was the only witness in the case. The salient evidence he gave may be summarised as follows. Dealing first with share acquisitions, he said that during his working life his annual income from investments and salary had always more than covered his living expenses. His surplus income therefore enabled him over the years consistently to add to the share portfolio he had inherited in 1946. In addition, he from time to time acquired shares by way of rights issues and he inherited shares on two further occasions.

Respondent said his investment decisions were always based on a pattern of expectations that a share would pay "adequate" dividends in the near term or "more than adequate" dividends later on. When he bought shares he did so with the intention to produce a sound and increasing dividend income and to protect the capital thus invested

from erosion by inflation. He had never bought a share for profitable resale. His holdings represented investment in all the major sectors of the share market and also comprised a good spread within each sector. This diversity was reflected in the fact that at the close of the 1982 tax year he held shares in over 140 companies.

As far as share disposals were concerned, respondent distinguished the period prior to 1982 from the three tax years thereafter. Up till 1982 he tended to sell his shareholding in a company, either partially or entirely, if he considered that a better dividend income could be achieved by acquiring shares in some other company, or when the level of dividend he had anticipated when buying the share was, for whatever reason, not achieved subsequently. He also sold shares when he felt that his holdings in a particular company distorted the overall balance which he aimed to achieve within the portfolio as a whole and within each individual sector or when rights issues had landed him

with what he referred to as "odds and ends".

Respondent endorsed in evidence comments he had made in an annexure to his 1978 income return in which he said that successful share investment necessitated "a constant watch ... on the portfolio" and "changes ... all the time to protect and enhance the quality and quantity of earnings as conditions change".

Referring to the three tax years in question, respondent said that his approach became decidedly different. He turned 60 during 1981 and resolved to build up some readily available cash resources with which to meet expected future medical expenditure (he had suffered a heart attack in 1976 and had no medical aid) and to cover the cost of buying himself a home, which he then contemplated doing (he had lived for many years in a rented flat). By this time interest rates in the money market were unprecedentedly high. This not only rendered fixed interest investment especially attractive but led him to

think that dividend payments would decrease as companies got into financial difficulties. Aiming to have about 15% of his investment capital in fixed interest, he set about raising the necessary cash by selling shares "bit by bit" over the next three years. Having disinvested from the share market and having invested savings, he achieved this aim by the end of the 1984 tax year. By that stage his holding of cash and stock in the money market totalled some R750 000,00. This enabled him to earn twice as much from interest in the 1985 tax year compared with his interest income in the 1984 tax year.

Respondent's nett disinvestment from the share market over the three tax years now in issue amounted to R307 000,00. This, he said, was the only time he had deliberately embarked upon share selling in order to realise nett surpluses. What did remain the same as in previous years, however, was the criterion on which he based his decisions to sell during these three years. That

was the consideration that a share was producing a poor dividend yield. If the yield was poor he sold regardless of profit or loss. As he put it -

"When selling a share I think it is a big mistake to look at cost because it is the future that counts and not the past."

Referred by his representative in the Special Court (a professional tax consultant) to the fact that the bulk of these sales had resulted in profits, respondent said that as most of the shares sold had been held for much longer than five years, profits were "inevitable". He added that in the prevailing inflationary economic climate it was "almost impossible to make losses". Asked if it was his policy to sell where the price of a share rose but its dividend did not, respondent replied in the negative.

That outline recounts the essence of respondent's evidence-in-chief.

Under cross-examination respondent revealed that he was keenly competitive by nature and that his share

portfolio was his predominant interest in life. He said he enjoyed increasing his income from it. He kept a close watch on his portfolio and never let it "sleep" in his efforts to effect that increase. However, he reiterated that he would sell, not for the profit to be made, but because the shares concerned were giving a lower than warranted dividend return. It was always his purpose to aim for the highest possible yield together with a good spread of investments. And by yield - it is clear - he meant not merely the amount of the dividend but that amount expressed as a percentage return not upon historic cost but upon current market value. However, there were certain instances where disposal was unavoidable. This occurred where a company in which he held shares was taken over and the shares were paid for in cash without an offer of fresh shares in substitution.

From the reasons which respondent gave for certain of the sales about which appellant's representative in the

Special Court questioned him, it is plain that he kept an active watch not only on his portfolio as a whole but also on the performance of individual shares seen both in isolation and in the context of a particular sector. He cited the example of staying in platinum shares but switching holdings from one company to its subsidiary because of the latter's higher dividend yield.

Respondent said that had he been bent on profit-making he could have realised far more than he did. For example, where a profit was to be had by selling low-yielding shares he often sold only part of his holding, retaining the balance because he considered that these shares had good future prospects.

Questioned by the President (Conradie J) about the dividend rate at which he aimed, respondent said that he usually bought at a yield of about 8% to 10%. Asked whether there was a particular rate at which he would think of selling, he said he would do so if the rate were

"ridiculously low" or "competitively low".

Although low yield had always been a criterion according to which he sold shares, respondent said he was more influenced by low yield during the tax years in question than at any other time, the reason being that he wanted to switch into interest-bearing investments but without reducing his dividend income.

Respondent's evidence must be considered in conjunction with the relevant figures which emerge, firstly, from an analysis of schedules which he compiled and annexed to his income returns for the tax years in question and, secondly, from correspondence conducted on his behalf with the Receiver of Revenue, Cape Town. In the schedules respondent set out full details of each year's share transactions and his shareholdings. He also appended comment explaining his investment strategy and his reasons for changing certain holdings. The schedules constitute clear evidence of very careful portfolio management and a

propensity for meticulous attention to detail.

Of the figures referred to, the essential ones may be tabulated as follows (stocks having been valued by respondent or his advisers at cost on a first in, first out basis and inherited shares having been given an estimated market value):

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>3-year Total</u>
<u>PROFIT</u>				
Share Sales	R 280 672	R 363 000	R 455 600	R1 099 272
Closing Stock	<u>R1 095 065</u>	<u>R1 211 350</u>	<u>R1 304 074</u>	
	R1 375 737	R1 574 350	R1 759 674	
Less Share Purchases	(R269 098)	(R265 668)	(R254 200)	R 788 966
Opening Stock	(<u>R904 156</u>)	(<u>R1 095 065</u>)	(<u>R1 211 350</u>)	
Profit	<u>R 202 483</u>	<u>R 213 617</u>	<u>R 294 124</u>	R 710 224
<u>DISINVESTMENT</u>				
Nett Share Disinvestment	R 11 574	R 97 332	R 201 400	R 310 306
<u>INCOME</u>				
Dividends (quoted shares)	R 154 840	R 153 280	R 152 268	R 460 388
Tax-free interest	R 11 302	-	-	
Interest	R 9 818	R 47 639	R 62 129	
<u>TRANSACTIONS</u>				
Sales	47	75	61	
Purchases	120	159	118	

As at the close of the 1984 tax year the portfolio comprised shares in 150 companies and its market value was approximately R2,9 million. It was not established, however, what the market value was at the start of the 1982 tax year. Of the shares held at the start of that year 82% were still held at the end of the 1984 year.

Counsel for respondent attached to their heads of argument a breakdown (also said to be extracted from respondent's income returns) of the sales effected and profits achieved in each of the tax years under consideration. The annual totals thus reflected differ from the sales and profit figures in the table set out above, being less in respect of each year. However, accepting the figures in these attachments as correct, they reveal that while many of the shares sold had been held for a long time, a substantial number had been held for five years or less. The significant details in the attachments may be tabulated as follows:

	<u>1982</u>	<u>1983</u>	<u>1984</u>
<u>SALES OF SHARES</u>			
<u>HELD FOR FIVE</u>			
<u>YEARS OR LESS</u>			
Sales	R 68 553	R 239 962	R 94 985
Cost	<u>R 18 969</u>	<u>R 112 900</u>	<u>R 47 514</u>
Profit	R 49 584	R 127 062	R 47 471
This profit expressed as percentage of total profit for the year	27%	60%	17%
<u>PROFITS IN</u>			
<u>CASES OF TAKE-OVERS</u>			
Number of take- overs	7	1	6
Profit	R48 598	R2 342	R85 965
<u>NUMBER OF SALES</u>			
<u>EXCLUDING CASES</u>			
<u>OF TAKE-OVERS</u>			
	31	42	24

On the evidence presented, the Special Court held that respondent had failed to discharge the onus of showing that in the years in question he was not engaged in a scheme of profit-making. A finding that respondent's evidence was not believed was not expressed but seems implicit in the Special Court's reasons.

In the judgment of the Court below (Foxcroft J, with whom Tebbutt J and Selikowitz J concurred) it was found

that no reasons existed for disbelieving respondent's assertions that he had not sold shares pursuant to a profit-making strategy. It was accordingly held that the profits he made were but incidental to his "primary object or dominant purpose of increasing his dividend income".

Before this Court counsel for appellant accepted that prior to the tax years in question respondent had bought shares solely for the purpose of investment and had held them as such. However, so it was argued, by the start of the 1982 tax year he had changed his intention and had gone over to holding them, if not also buying them, with a dual purpose. Although his main aim was still investment, his secondary purpose was to use his portfolio as stock-in-trade and to sell shares for profit whenever he felt it appropriate to do so.

For respondent it was contended that his purpose throughout was to buy and hold for investment purposes and that he only disposed of shares when forced by takeovers to

do so or when it was prudent to alter the nature of his investment by reason, for example, of the need to secure a better dividend yield or to switch into fixed-interest investments.

The legal principles to be applied in resolving the present dispute are settled. The broad question to be answered is whether the sales effected by respondent during the three years under discussion amounted to the realisation of capital assets or the disposal of trading stock in the course of carrying on a business: Cf. *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste 1978 (1) SA 101 (A)* at 118 B-C. However, because appellant contended for respondent's having had, contemporaneously with his main investment purpose, a secondary profit-making purpose, the enquiry becomes more specific. It is then whether respondent indeed had such a secondary purpose. And in the light of the onus resting upon him to establish that the proceeds of

the sales were accruals of a capital nature, the enquiry even further defined is whether it was shown that he did not have the secondary purpose contended for.

The concept of a twofold object consisting of a primary or main purpose and a secondary purpose was first mooted in *Commissioner of Taxes v Booysens Estates Ltd 1918 AD 576 at 604*. That was in relation to a corporate taxpayer but the principle would be the same, in the present context, in the case of an individual taxpayer. The difference usually highlighted is that continuity is a necessary element in the carrying on of a business in the case of an individual but not of a company: *Commissioner for Inland Revenue v Leydenberg Platinum Ltd 1929 AD 137 at 145*. (That the frequency of respondent's transactions, viewing them purely in isolation at this stage, provides evidence of such continuity is beyond doubt.)

The concept of a main and a secondary purpose was fully examined, defined and applied in *African Life Investment*

Corporation (Pty) Ltd v Secretary for Inland Revenue 1969

(4) SA 259 (A) at 269E - 270B. It was applied again in

Barnato Holdings Ltd v Secretary for Inland Revenue 1978

(2) SA 440 (A) at 453G. The question in both cases was

whether an investment share-holding company had carried on

a secondary business of sharedealing for profit.

In *African Life*, at the cited pages, Steyn CJ said the following:

"Whether or not a purpose is dominant in the sense that another co-existing purpose may be effected at a profit without attracting liability for tax, is a matter of degree depending on the circumstances of the case. A purpose may be a main purpose without being dominant in this sense. I shall not attempt a precise definition of the distinction, but there would, I consider, be such a main purpose where there is a further purpose simultaneously pursued by way of an additional, albeit subsidiary, activity calculated and intended to yield a profit. Where, for instance, a company whose main concern as an investor is an income from dividends, confines its purchases to sound equities with the highest dividend yield, but, at the same time, intends, in order to increase its income, to sell whenever it is able to do so at a substantial profit, that intention, although so closely connected with its main object that it may be said to be inseparable from it, would not ordinarily rank as merely incidental to such a dominant

purpose. As far back as in *Commissioner of Taxes v. Booysens's Estates Ltd.*, 1918 A.D. 576 at p. 602 and 604, it was pointed out that, whatever the primary objects of a company may be, it is quite possible that it may derive income in the ordinary course of business from carrying out its secondary objects. Where the sale of shares held as an investment is in fact contemplated as an alternative method of dealing with them for the purpose of making a profit out of them, or, in the case of a company, where it is one of the 'appointed means of the company's gains' (Cf. *Overseas Trust Corporation Ltd. v. Commissioner for Inland Revenue*, 1926 A.D. 444 at p. 456 i.f.; *L.H.C. Corporation of S.A. (Pty.) Ltd. v. Commissioner for Inland Revenue*, 1950 (4) S.A. 640 (A.D.) at p. 646), it can make no difference, I consider, that it is a secondary or subsidiary purpose of their acquisition. It would nevertheless be part of the business operations contemplated for the production of income, and the profit gained would be 'revenue derived from capital productively employed'. In such a case it could not be said that the pursuit of an overriding main objective of securing a dividend income merely provides the occasion for what is no more than a purely incidental change of investment, even though it be a profitable one. There would be no absolving dominant purpose."

Apart from the fact that in the case of a company its declared objects and its manifestly being in business to make profits will generally make it easier to infer the secondary purpose under consideration than it would be in

the case of an individual, there is no reason why the dictum in *African Life* should not apply in principle also to an individual taxpayer.

Before proceeding to the conclusion to be drawn from the facts of the present case it is apposite to refer again to the matter of *Barnato Holdings*, this time in connection with the onus.

In that matter the taxpayer, in the 1967, 1968 and 1969 tax years, sold its shares in one or more of three situations. The first was where the performance of the company in which the shares were held failed to reach or maintain the minimum expectations required of a satisfactory investment. The second was where the capital value of the shares had become such in relation to the return on the shares that it was more economical to replace the investment with another from which such capital would produce a substantially better return, for example, where the market value had increased appreciably without a

corresponding increase in dividend yield. And the third was where, in the same field of investment, the performance of another company indicated the desirability of a switch to that company to achieve a substantially better dividend yield. The shares thus sold were acquired in and after 1962 with the intention that their retention would be constantly and fairly often reviewed and that they would be disposed of in any of the above-mentioned or similar circumstances. Having related these facts, the judgment proceeds (at 453 in fine):

"That such circumstances were likely to supervene from time to time - shares being given to fluctuations in both fortune and value - must have been foreseen. Indeed appellant conceded that the switching out of such share investments from time to time for any of those reasons was unavoidable and always contemplated as being part of its business ... That would tend to indicate *prima facie* that those shares were not acquired for better or for worse, or, relatively speaking, for 'keeps' (i.e. only to be disposed of if some unusual, unexpected or special circumstance, warranting or inducing disposal, supervened), which is the usual badge of a fixed, capital investment ... Hence a formidable and difficult *onus* rested on appellant to convince the Court *a quo* that the shares

disposed of ... were nevertheless originally acquired and held as fixed capital or, putting it another way, that those shares were not disposed of in the course of appellant's conducting an additional, secondary business of dealing in those shares for profit."

It is clear from the evidence summarised earlier that all three above mentioned considerations which motivated the taxpayer in *Barnato Holdings* motivated respondent in the present case. He was therefore saddled with a "formidable and difficult onus".

Reverting to the facts, one is struck forcibly by the scale and frequency of respondent's share transactions. Those considerations are, of course, not conclusive but they are of major importance. Cf. *London Australia Investment Co Ltd. v Federal Commissioner of Taxation* 7 ATR 757 at 770 and 772. There is also the fact that the sales were almost without exception profitable. Indeed, respondent's annual profits substantially exceeded his annual dividend income. And the profits increased every year and markedly so in the 1984 tax year.

Respondent attributed the profits he made to an inflationary climate and the fact that he had held the shares concerned for many years. That explanation is unacceptable for two reasons. It takes no account of the considerable number and frequency of those sales which concerned shares held for only five years or less. The statistics set out above reveal the details. The profits realised by way of those sales represent a significant, and in 1983 a telling, percentage of the total profit for each year. Secondly, respondent's having sold shares where their dividend yield had become unacceptably low carries the following significance. Because dividend yield is dependent inter alia on market value, dividend yield can only decline if the market value of the share concerned goes up or if, without a fall in market value, the dividends themselves decrease. In none of the instances with which respondent dealt in his evidence concerning the sale of low-yielding shares did he allege that the fall in

yield had been due to a decrease in the quantum of the dividends as such. It is, moreover, inherently improbable - commercially speaking - that a decline in dividends would not be accompanied by a fall in market value. Moreover, respondent invariably invested with the expectation of growth and thus anticipated a rising market. He did not suggest in evidence that there was a falling market at any time relevant to this litigation. On the evidence, therefore, one must conclude that the reason for the decreases in dividend yield to which respondent referred was the fact that the market value of the shares had increased. It was essentially this factor, irrespective of the length of time for which the shares had been held, which occasioned profit.

Given the close watch which respondent kept on his portfolio and on every shareholding within it, and bearing in mind his meticulous attention to detail, it is most unlikely that he was unaware of the profit implications in

selling when dividend yield had fallen. Apart from merely being asked whether, as a matter of policy, he sold when dividends failed to increase consequent upon an increase in market value, respondent was not required by his representative to deal in detail with this aspect in evidence. Nor was he invited to explain the reason for selling so many shares that had been held for only comparatively few years.

Respondent's counsel argued, with reference to *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust 1992 (4) SA 39 (A)*, that the profits he made were merely incidental and not worked for. In that case, however, as explained in the judgment at 58H - 59B, the evidence established that had the scheme involved there operated ideally and to its full potential there would have been no profits. There were also other factors which showed that profits were not inevitable. Apart from profits not having been intended, they were not worked for

and were purely fortuitous in the sense of being an incidental by-product. The same conclusion cannot be drawn in the present case. Not only was profit inherent in the sale of shares whose dividend yield had dropped but respondent manifestly worked for it. He "farmed" his portfolio assiduously. The number, frequency and profitability of sales, especially of short-term shares, bears clear enough testimony to that.

It was then said that respondent could have achieved far greater profits had he really intended to employ his portfolio for profit-making. For example, so ran the argument, he often did not sell his entire holding of a low-yielding share, he merely trimmed it, explaining in his evidence that the balance was retained because he considered the shares in question to have good future prospects. The answer to this submission is that respondent was primarily an investor and it was wholly consistent with his investment motive that he did not sell

certain holdings entirely (cf. *Barnato Holdings* at 455G) and that 82% of the shares held at the beginning of the 1982 tax year were still held at the end of the 1984 tax year. The share retention factor therefore detracts in no measure from the force of all those circumstances which point to a subsidiary profit-making purpose.

Nor, in my view, can respondent derive support from the fact that he sold in some instances in order to take advantage of the high rates of return attainable in fixed-interest investments. Although it is clear that he did switch to a large extent to interest-bearing investments he devoted a far greater sum to shares. Of the approximately R1,1 million realised over the period in question approximately R310 000 went into the money market whilst just short of R790 000 was reinvested in the sharemarket.

Finally, it does not assist respondent that sizeable profits were made from forced disposals on take-overs. From the frequency of take-overs during the period in

question one may justifiably infer that they were part and parcel at that time of large-scale share-owning. Once the other factors in the case point, as I think they do, to respondent's having had a profit-making purpose, albeit a secondary one, then one may simply regard take-overs as "one of the methods available to a share-dealer for turning a shareholding to profitable account" (*Barnato Holdings* at 456C).

One may conclude by saying that whilst an investor buys shares "for keeps" and, generally, adds to his portfolio by employing surplus existing income, respondent's share transactions enlarged the value of his portfolio (at cost) from some R904 000 at the start of 1982 to just over R1,3 million by the end of 1984 and at the same time generated very considerable, annually increasing funds over and above his existing income. Indeed, employment of his capital in this way constituted an additional method of earning income.

For all these reasons it follows that the Court a quo erred in holding that the profits in question were merely incidental to respondent's investment activities and that the onus was discharged. That view is not defensible once one looks beyond his *ipse dixit* to all the facts in the case as the Special Court rightly did. In my opinion respondent had a secondary, profit-making purpose. At best for him he failed to discharge the onus of showing the contrary.

The appeal must therefore succeed.

The following order is made:

1. The appeal is allowed, with costs.
2. Save in regard to the costs of the application for leave to appeal in the Court a quo, the costs shall include the costs of two counsel.

3. The order of the Court a quo is set aside and substituted therefore is the following:

"The appeal is dismissed, with costs."

C.T. HOWIE

JUDGE OF APPEAL

CORBETT CJ] CONCUR

NESTADT JA]

NIENABER JA]

ZULMAN AJA]

CTH/al