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SOLOMON MARTIN GERBER

and

THE COMMISSIONER FOR INLAND REVENUE

Case No. 24/88 - mp

IN THE SUPREME COURT OF SOUTH AFRICA

APPELLATE DIVISION

In the matter between:

SOLOMON MARTIN GERBER Appellant

and

THE COMMISSIONER FOR INLAND REVENUE Respondent

CORAM: CORBETT, CJ, HOEXTER, NESTADT, VIVIER, JJA et NICHOLAS, AJA

HEARD: 23 May 1989

DELIVERED: 29 August 1989

JUDGMENT

HOEXTER, JA .....

HOEXTER, JA

In respect of assessments to normal tax raised by the respondent upon the appellant taxpayer for the years of assessment ended 28 February 1982 and 28 February 1983 the appellant lodged objections which were disallowed by the respondent. Thereafter the appellant appealed to the Transvaal Income Tax Special Court. In the course of the proceedings in the Court a quo the respondent's representative requested that the assessments be set aside and be referred back to the respondent. The Special Court dismissed the appeal and confirmed the assessments; and in so doing impliedly rejected the request made on behalf of the respondent. Against the whole of the judgment of the Special Court the appellant appeals and the respondent cross-appeals. In terms of sec 86A(5) of the Income Tax Act, No 58 of 1962 ("the Act") the President of the

Special ....

Special Court granted leave to appeal direct to this Court.

The appellant is a chartered accountant. He is a partner in a firm of chartered accountants based primarily in Johannesburg. The appellant is in charge of his firm's tax department and he is well-versed in the intricacies of tax law. The appellant appeared in person before this Court and argued the matter with ability. At the hearing before the Special Court the appellant gave evidence. He said that in the course of his professional practice he had in the past often been consulted with regard to those financial operations which are commonly known as "dividend-stripping"; and that in 1982 he decided to embark thereon for his own account.

The basic concept of dividend-stripping and the essential techniques in carrying it out were examined by this Court in Commissioner for Inland Revenue v Nemojim

(Pty) Ltd 1983(4) SA 935(A). That was a case in which the taxpayer indulging in dividend-stripping was a company; and, by reason of the provision of sec 10(1)(k) of the Act, the dividends declared by the companies stripped which were received by the taxpayer were exempt from tax in its hands. (See 943D). In the case of a natural person, however, dividends received by an individual are not exempt from tax and such dividends therefore form part of his "gross income", "income" and, subject to the deductions provided by sec 19, "taxable income" as defined in the Act.

The appeal and the cross-appeal relate to the manner in which deductions from income derived from dividends are, in a case of this kind, to be calculated in terms of the Act. Although the appellant's objections are confined to assessments raised in respect of the 1982 and 1983 tax years, an appreciation of the thrust of the

appellant's ....

appellant's argument requires a brief exposition of the appellant's dividend-stripping operations over a longer period, namely 1981 to 1986. For present purposes these may be summarised as follows:-

(a) On 10 November 1981 the appellant bought the whole of the issued shares of a private company called Walt and Bild (Pty) Ltd ("W & B") for R770 452.

(b) On 26 November 1981 W & B declared a dividend of R789 890 in favour of the appellant.

(c) The declaration of the dividend mentioned in (b) above reduced the value of the W & B shares which were valued, as at 28 February 1982, at R561.

(d) On 7 February 1982 the appellant bought the whole of the issued shares of a private company called Amalgamated Granite Industries (Pty) Ltd ("Anberg") for R213 081.

(e) On 20 September 1982 Anberg declared a dividend of R218 481 in favour of the appellant.

(f) The declaration of the dividend mentioned in (e) above reduced the value of the Anberg shares which were valued, as at 28 February 1983, at R4 498.

(g) On 1 February 1983 the appellant bought the whole of the issued shares of a private company called South Rand Pharmacy (Pty) Ltd ("SRP") for R304 007.

(h) On 25 February 1983 the appellant bought the whole of the issued shares of a private company called Osher Jewellers Wholesalers (Pty) Ltd ("OJW") for R104 514.

(j) On 28 February 1983 W & B declared a further dividend of R1 448 in favour of the appellant.

(k) During....

(k) During the 1984 tax year Anberg declared a further dividend of R4 296 in favour of the appellant.

(l) During the 1984 tax year SRP declared a dividend of R311 407 in favour of the appellant.

(m) During the 1984 tax year OJW declared a dividend of R107 077 in favour of the appellant.

(n) On 18 February 1985 W & B declared a further dividend of R5 945.38 in favour of the appellant.

(o) In the 1985 tax year the appellant sold the Anberg shares for R402.

(p) In the 1986 tax year the appellant sold the W & B shares for R200.

In the original assessment of the appellant's liability to normal tax for the 1982 tax year the respondent (1) allowed, in terms of sec 19(3) of the Act, a deduction of 33 1/3% in respect of the W & B dividend (see (b) above); and (2) allowed as expenditure a deduction of the full purchase price of the W & B shares (see (a) above). This resulted in an assessed loss of R179 411 and a consequent credit of R58 084 in favour of the appellant. In the additional assessment for the 1982 tax year and in the original assessment for the 1983 tax year the respondent adopted a different approach. He took the aggregate of the dividends and the value of the shares at the end of the tax year and deducted therefrom the cost of the shares acquired during the tax year or, in the case of shares acquired before the commencement of the tax year, their value at the beginning of the

tax.........

tax year. This net figure the respondent treated as a dividend and in respect thereof he allowed a deduction of $33^1/3$%. During the tax year ended 28 February 1982 the only dividend received was from W & B; and the respondent's calculation involved the addition of R789 890 (see (b) above) and R561 (see (c) above) which yielded a total of R790 451, from which he subtracted R770 452 (see (a) above) to produce a figure of R19 999; in respect whereof a deduction of $33^1/3$% in terms of sec 19(3) of the Act was allowed. Hence the respondent's statement, reflected in the remarks column of the 1982 additional assessment: "Income from dividend-stripping taxed R13 333". During the tax year ended 28 February 1983 both Anberg and W & B produced dividends. In the original assessment for the 1983 year the respondent's

calculations.......

calculations involved the addition of R218 481 (see (e) above), R4 498 (see (f) above) and R1 448 (see (j) above) which yielded a total of R224 427, from which he subtracted R213 081 (see (d) above) to produce a net figure of R11 346; in respect whereof a $33^1/3$% deduction in terms of sec 19(3) of the Act was allowed. Hence the respondent's statement in the remarks column of the 1983 original assessment: "Income from dividend-stripping taxed R7 564".

Before turning to a consideration of the appellant's main contentions it is convenient at this juncture to quote the provisions of sec 8D and of subsecs 19(1), (2) and (3) of the Act. Sec 8D was inserted by sec 7(1) of Act No 96 of 1981. As amended by sec 8 of Act 121 of 1984, the amendment being effective from the commencement of years of assessment ending on or after 1 January 1985, sec 8D provided as follows:-

"8D. For........

"8D. For the purposes of this Part, where the trading stock held by any person on or after 2 October 1981 includes or consists of any share, or any interest in any share, in a private company (other than a close corporation), there shall be included in the income derived by such person -

(a) during the year of assessment during which such share is disposed of by him;

or

(b) if the share is not disposed of by him, during the year of assessment during which such company is placed in liquidation or is deregistered or otherwise ceases to exist,

so much of the amounts of any dividends received by or accrued to him in respect of such share or interest during the period during which the share or interest was held by him as, by reason of the provisions of section 10(1)(k) or 19(3), were not includable in his taxable income for the current or any previous year of assessment, but excluding any portion of a dividend distributed more than four years prior to the year of assessment in question or out of profits derived by the company during the year of assessment of the company during which such dividend was distributed or during the immediately preceding year of assessment of the company."

During.......

During the 1982 tax year the special provisions of the Act applicable to dividends were subsections 19(1), (2) and (3). During the 1983 tax year they were subsections 19(1), (1A), (2) and (3). For purposes of the appeal nothing turns on sec 19(1A). As they read in the 1983 tax year subsections 19(1), (2) and (3) provided:-

> "19. (1) The provisions of section 11(a), (b), (i) and (j) and section 20 shall, subject to the provisions of sub-section (2) of this section, mutatis mutandis apply in relation to any income derived by any person in the form of dividends.
>
> (1A) ....
>
> (2) In respect of expenditure and losses not of a capital nature incurred by any person (other than a company) in the production of his income from dividends, the amounts to be deducted under section 11(a), (b), (i) and (j), as applied by sub-section (1) of this section, and the amount to be deducted

under..........

under sub-section (1A) of this section, shall in total be an amount which bears to the sum of the expenditure, losses and amount which but for this sub-section would have been allowed to be deducted under the said provisions the same ratio as the amount of such dividends as calculated after allowing the deduction under sub-section (3) of this section, bears to the amount of such dividends as calculated before allowing such deduction.

(3) In respect of income in the form of dividends (other than any portion of a dividend included in a taxpayer's income under section 8D and any dividends referred to in section 11(s)) derived by any person other than a company there shall be allowed as a deduction in the determination of the taxable income of such person an amount representing a percentage of such dividends calculated in accordance with the following scale:-

- Where.......

Where, but for the provisions of this sub-section, sub-section (2) and section twenty the taxable income of the taxpayer for the year of assessment in question -	Percentage of aforesaid dividends to be deducted
would not exceed R2,600.......	100 per cent
would exceed R2,600 but not R2,800	94 " "
....	
....	
....	
would exceed R4,600	$33^{1}/3$ per cent"

In framing his objections to the assessments in question the appellant contended that the respondent's original assessment for the 1982 tax year had been correctly determined; that it should be reinstated; and that the assessment for the 1983 tax year should have been determined in similar fashion. In a letter to the respondent dated 21 October 1985 the appellant advanced, <u>inter alia,</u> the

following.........

following contentions:-

"7. During the 1982 tax year the cost of the shares acquired by me amounted to R983 533 and the cost of the shares acquired by me during the 1983 tax year amounted to R408 521. These two amounts are therefore deductible in the 1982 and 1983 tax years respectively in terms of the provisions of Section 11(a).

8. During the 1982 tax year I received dividends of R769 891 which formed part of my 'gross income' for the year and as no portion of this amount is deductible this amount also forms part of my 'income' and 'taxable income' for the year. However, in terms of the provisions of Section 19(3) of the Act I am entitled to an allowance in respect of these dividends of an amount equal to one-third of the dividends ....

....

The total dividends .....received by me during the 1983 tax year in respect of private company shares in terms of private company share dealing operations amounted to R219 929. This amount once more forms part of my 'gross income' 'income' and 'taxable income' for the 1983 tax year. I am, however, furthermore entitled to the allowance in respect of this amount of one-third thereof in terms of the

provisions ....

provisions of Section 19(3) of the Act.

As the dividends derived in respect of shares held as trading stock the allowance in terms of Section 19(3) of the Act in respect of the years in question are subject to the provisions of Section 8D of the Act......

9. The shares acquired by me during the 1982 and 1983 tax years form part of my 'trading stock' which is defined in Section 1 of the Act to include 'anything produced, manufactured, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, sale or exchange by him or on his behalf, or the proceeds from the disposal of which forms or will form part of his gross income.' As has been set out above ...... the shares were acquired in order to receive dividends and thereafter to be disposed of for the maximum achievable consideration at the most appropriate time, but nevertheless as soon as possible ....
....

17. In the 1984 and 1985 tax years amounts of R526 950 and R51 851 are includable in my income in terms of Section 8D and in the 1986 and subsequent tax year the provisions of Section 8D will similarly apply to the shares in the companies of which I likewise dispose.

18. The ....

18. The additional 1982 and the original 1983 assessments have therefore been incorrectly issued as they do not grant the allowances and deductions which are recoupable by Section 8D. Clearly, the amounts on which I have been taxed together with the amounts includable in my income in future years in terms of Section 8D would result in a tax liability which would cripple me financially and possibly even lead to my sequestration. ...."

At the hearing of the appeal to the Special Court the appellant gave evidence. He was closely cross-examined as to the motives which had prompted him to engage in the dividend-stripping operations in question. The effect of the appellant's evidence was that he regarded the dividend-stripping operations as a profit-making scheme; and that he had, in fact, made substantial profits therefrom. He pointed out that over the period 1982 to 1985 his profits had amounted to nearly R100 000. In the course of cross-examination it was put

to ....

to the appellant that in undertaking the dividend-stripping operations his sole purpose had been "to claim a loss for tax purposes, namely the difference between the cost and selling price of the shares". The appellant firmly denied that this had been the case. No evidence was adduced on behalf of the respondent.

Having summarised the appellant's grounds of objection to the assessments in question the President of the Special Court (O'DONOVAN, J) in the course of his judgment remarked:-

> " It was contended by the Commissioner's representative, Mr Truter, that the cost of the shares in question is not allowable as a deduction in terms of section 11(a) read with section 23(g) of the Income Tax Act, because it was of a capital nature, or alternatively because the cost was not wholly or exclusively laid out or expended for the purpose of trade, and he requests that the assessments in question be referred back to the Commissioner for recalculation in accordance with a finding by the Court upholding this contention."

The contention so advanced on behalf of the respondent in the Court below was rejected. The learned Judge pointed out that in the Nemojim case (supra) -

> ".....in circumstances which were in principle similar to those in the present case, it was common cause, and was accepted by the Court, that Nemojim's operations constituted trading, and that the shares acquired by it constituted trading stock."

Proceeding to deal with the issue raised by the appellant's grounds of objection the President of the Special Court expressed the opinion that its determination depended entirely upon a construction of sec 19(1) of the Act; and that the provisions of sec 19(2) were irrelevant. On the wording of sec 19(1) the Court a quo was satisfied that expenditure and losses should, in the first instance, be set off against dividend income. The learned Judge concluded that the respondent had been

correct ....

correct in deducting expenditure and losses incurred in the production of dividends from the dividends, and in issuing assessments on that basis. The learned Judge further declined to revise or adjust the effect of sec 19(1) by reference to the provisions of sec 8D of the Act. In this connection he remarked in his judgment:-

> "It appears from the evidence led .....that an amount of R6 666 was allowed to the appellant as a deduction in terms of section 19(3) from net dividends received from Walt and Bild (Pty) Ltd in the 1982 year of assessment. The appellant's shares in this company were disposed of in the 1986 year of assessment and section 8D would accordingly apply thereto.
>
> A similar situation arises from the disposal by the appellant in the 1985 year of assessment of his shares in Anberg (Pty) Ltd, a one-third deduction, in the amount of R3 782, having been allowed in the 1983 year of assessment in terms of section 19(3).
>
> It is, however, difficult to see how the enactment of section 8D in 1981 can modify the effect of section 19(1) upon which, it seems to the Court, the appellant's appeal depends."

The .....

The Special Court's aforementioned rejection of the contentions by the respondent's representative that the appellant's dividend-stripping operations did not constitute the carrying on of a "trade" within the meaning of the Act, and that the cost price of the shares in question was a capital expense, forms the basis of the cross-appeal. In argument before us it was urged on the respondent's behalf that the cost of the shares was expenditure incurred not in the production of income but in the creation of an assessed loss; that, therefore, the deduction of such expenditure was not allowable under sec 11(a) of the Act; and that it was specifically precluded under sec 23(g).

The ground has now been cleared for a consideration of the merits of the appeal and the cross-appeal. It is convenient to begin with the question, material alike to the appeal and the cross-appeal, whether the appellant's dividend-stripping operations constituted the carrying on of a "trade" within the meaning of the Act. If that question is answered in the negative it will follow that the cost of the shares in question cannot be deductible in terms of sec 11(a) or sec 23(g). An affirmative answer to the question would, on the other hand, be fatal to the cross-appeal. For if the appellant's dividend-stripping amounted to a trading in shares their purchase price would represent expenditure not of a capital nature which was incurred in the production of income (thus qualifying for deduction in terms of sec 11(a)) and exclusively expended for the purposes of the appellant's trade (and thus not precluded from

deduction......

deduction under sec 23(g)).

Counsel for the respondent urged upon us that although the definition of "trade" in the Act is couched in wide terms, such definition would not embrace a financial operation whose object was to make a loss rather than a profit; and, so proceeded the argument, the sole object of the appellant's dividend-stripping was to produce a loss redounding to the appellant's fiscal advantage. For the reasons which follow this last submission cannot be sustained.

The facts of the instant case represent, I think, a classic example of "dividend-stripping"; and it is no less clear that the appellant made a business venture of such operations. Insofar as the nature of these operations is concerned, the essential facts of the present case bear a strong resemblance to those of the Nemojim case (supra), in which it was common cause (see 947D) that the Nemojim

company........