CASE NO 24/2000

In the matter between:

THE COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE Appellant

-and-

R.M.WOULIDGE Respondent

CORAM: HEFER ACJ, HARMS, OLIVIER, MTHIYANE, JJA AND FRONEMAN AJA

DATE OF HEARING: 28 AUGUST 2001

DATE OF JUDGMENT: 20 SEPTEMBER 2001

Section 7(3) of Income Tax Act 58 of 1962 – whether income resulting from sale of shares to children's trusts income in hands of parent – interest free credit to acquire shares – applicability of *in duplum* rule to tax payable under the section.

JUDGMENT

FRONEMAN AJA

[1] Section 7(3) of the Income Tax Act 58 of 1962 ("the Act") provides that:

"Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child –

(a) it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or

(b) it has been accumulated for the benefit of that child."

[2] The respondent in this appeal set up two similar trusts for his children Laura and Douglas in 1982. The children were income and capital beneficiaries under the terms of the trusts. Soon after the creation of the trusts the respondent sold shares in a group of four companies to the trusts. At the time the trusts had no assets to buy the shares. The respondent financed the purchase price by granting the trusts credit. Although the agreement of sale entitled the respondent to charge interest on the unpaid purchase price, he never did so. From 1982 to 1987 the companies declared no dividends and the trusts received no income. In 1988 a company, CTP Ltd (CTP), became interested in the business operation of the four companies in which the trusts held shares. As a result of this a restructuring of the group took place. A holding company was formed which held the

shares in the operating companies. Each trust acquired 50% of the shares in the holding company. In turn each trust sold half of its shareholding in the holding company to CTP for R1 642 500,00. This enabled the trusts not only to pay for the shares, but also to generate income that the appellant, in revised assessments for the years 1989,1990 and 1991, taxed in the hands of the respondent by relying on the provisions of section 7(3).

[3] The respondent's objection to the revised assessments was partially successful in the Cape Special Court for Income Tax Appeals. The appeal against the 1989 assessment was withdrawn. The court held that the respondent should be taxed in respect of the 1990 and 1991 tax years on the forsaken interest on the unpaid price of the shares sold to the trusts; but that such interest would not exceed an amount equal to the price of the shares. This limitation on interest was said to flow from the operation of the *in duplum* rule. On appeal the Full Court of the Cape High Court in a majority decision upheld that finding. Its decision is reported: *Commissioner for SA Revenue Service v Woulidge* 2000 (1) SA 600 (C). The facts of the matter are set out fully in the reported judgment and only those facts material to this judgment are referred to here.

[4] Counsel who appeared for the respondent conceded in his opening address before the Special Court that after 1988 the two trust beneficiaries received income that fell within the ambit of section 7(3). The concession, however, related only to the forsaken interest in respect of the purchase price. On that basis the matter proceeded.

[5] On appeal, in the court below and in this court the appellant contended, however, that the sale of the shares to the trust was a simulation or, at the very least, contained a considerable element of gratuitousness and that, accordingly, all the income received or accrued by reason of that sale should have been taxed in the hands of the respondent. There are a number of difficulties in this approach, both procedural and substantive in nature.

[6] Prior to the commencement of the hearing in the Special Court correspondence was exchanged between representatives of the appellant and the respondent. The respondent sought information under section 24(c) of the Constitution in order to prepare for the forthcoming hearing. He wanted to know, amongst other things, what act or payment the appellant contended constituted the donation, settlement or disposition under section 7(3) and what income under the section was received by reason of this. The

appellant's explicit response was that forsaking interest on the outstanding purchase price constituted the relevant conduct under the section and that all the income received by the trusts was causally related to this conduct. As already noted, respondent's counsel had conceded, at the outset of the hearing before the Special Court, that the forsaken interest fell within the provisions of the sub-section. The extent of the deemed income of the respondent in terms of the sub-section had to be determined, he said, by setting off the income actually received against the interest that should have been charged. Income up to the amount of the interest would not have accrued had it not been for the donation because the trusts would then have had to use that income to pay the interest. He indicated further that the interest that would have accrued could not legally exceed the capital by virtue of the operation of the *in duplum* rule. His exposition of the issues for determination by the Special Court fell squarely within the terms of the earlier correspondence between the parties and was never challenged by the appellant's representative at that hearing. The issues for determination were thus clearly defined. This did not include the broader issue, namely that the sale of the shares itself amounted to a sham or was a simulated transaction.

[7] Appellant's counsel sought to justify the attack on the sale of the shares

on this broad basis on appeal by reference to a passage in the record where the appellant's representative asked two perfunctory questions of the respondent, suggesting that the sale amounted to a donation of the respondent's capital and shares to the trusts. He conceded, however, that this questioning on its own could not have had the effect of broadening the issues if they had otherwise been limited in the earlier correspondence. In my view the earlier letters had exactly that effect.

[8] There is ample authority to the effect that it is not permissible to raise a new point on appeal in circumstances where one's opposing party did not have a proper opportunity to deal with the point at the earlier hearing. It is no answer for the Commissioner to call section 82 of the Act in aid. The onus placed on the taxpayer in that section only arises upon the identification of the issues to be adjudicated. Although there are no formal pleadings in tax appeals, the information sought and given under the right to information granted by the Constitution served the purpose of delineating the issues in the present case. The respondent's case might well have been conducted differently in the Special Court if the point about the whole transaction being a sham had been raised earlier. Considerations of fairness dictate that this Court should decline to entertain the point (*CIR v Conhage*

(Pty) Ltd (formerly Tycon (Pty) Ltd) 1999(4) SA 1149 (SCA) at 1157 E).

[9] In its alternative form counsel's argument was to the effect that the sale of the shares contained an appreciable element of bounty and that the respondent, who bore the onus, failed to show that the bountiful part could be separated from the part for which due consideration was given. He contended that the facts of this case were on a par with those in *Ovenstone v Secretary for Inland Revenue* 1980(2) SA 721 (A), and that *Joss v Secretary for Inland Revenue*1980(1) SA 674 (T) was wrongly decided insofar as it attempted to compartmentalise the inquiry into whether a disposition had been made under section 7(3) into two separate inquiries, and insofar as it held that an allocation *must* be made for tax purposes of the amount received by reason of a donation, settlement or disposition under the section. In my view these submissions are unsound.

[10] For its application section 7(3) requires a disposition made wholly or to an appreciable extent gratuitously out of liberality or generosity (*Ovenstone v Secretary for Inland Revenue,* above, at 737G-H;740A). Where the disposition contains both appreciable elements of gratuitousness and of proper consideration an apportionment may be made between the two

elements for the purpose of determining the income deemed to have accrued to, or received by, the parent under section 7(3). The taxpayer bears the burden of proof to show that such an apportionment is possible and how a court should give effect to the apportionment (*Ovenstone's* case, above, at 740 D-F). One of the ways in which such an apportionment may arise is where a loan is made (or credit granted) in terms of which capital is to be repaid at some later stage, on proper commercial or business grounds, but no interest is charged on the outstanding capital. As long as the capital remains unpaid the failure to charge interest represents a continuing donation (*Commissioner for Inland Revenue v Berold* 1962(3) SA 748 (A) at 753F). The interest that should have been charged (the extent of the donation) may then, depending on the circumstances, be regarded as that portion of the income deemed to be that of the parent within the meaning of section 7(3). That is what happened in *Joss v Secretary for Inland Revenue* 1980(1) SA 674 (T*)*. The passage (at 682 *in fine*-683A-B) which may be read as stating that the apportionment is a logical necessity and that an allocation must be made for tax purposes of the amount which was received by reason of the separate disposition, must be read in the context of the facts of that particular matter. In each case the possibility and extent of an apportionment for the purposes of section 7(3) is a matter of fact and the burden of proof in

relation thereto rests on the taxpayer by virtue of section 82 of the Act (*Ovenstone's* case, above, at 740 D-F). *Joss's* case is merely, in my view, a particular illustration of this general principle.

[11] Appellant's counsel submitted that in the present case the conduct of the parties to the sale of the shares (assuming that there was a valid sale) established that there was an appreciable element of gratuitousness to the transaction. Clause 8 of the agreement, he submitted, provided only in broad and undetermined terms what the amount of the purchase price would be and when it would be paid; the trusts possessed no assets to pay the purchase price; no actual amount was paid in respect of the purchase price for six years, the books merely reflected the credit for this as one for an indefinite period; and on such credit the trusts were never charged any interest. The submission may be sound as far as it goes, but it does not go far enough. There was indeed an appreciable degree of gratuitousness as far as the forbearance of interest was concerned (in the form of annual donations of the interest not charged), but the market-related purchase price, the terms of the deed of sale and the subsequent payment of that purchase price constituted due consideration in respect of the sale itself. That was indeed the respondent's case as advanced and presented before the Special Court.

Respondent conceded that forbearance of interest amounted to a donation under section 7(3); he quantified the extent of the donation by leading evidence on the applicable rate of interest that should have been charged on the capital over the period that no interest was in fact charged; and then he attempted to limit this quantification by relying on the *in duplum* rule in argument. The commissioner led no evidence in rebuttal. All this appears to me to be in conformity with the requirements relating to onus and proof set out in *Ovenstone's* case. Contrary to what happened in *Ovenstone's* case, however, the evidence in the present case established the case respondent sought to make out, namely that only the forbearance of interest was gratuitous (and thus a donation under the section) and not the sale itself, and what the applicable notional rate of interest should have been. What remained was really only a legal issue, namely whether the *in duplum* rule applied or not.

[12] It is clear that the *in duplum* rule can only be applied in the real world of commerce and economic activity where it serves considerations of public policy in the protection of borrowers against exploitation by lenders (*LTA Construction Bpk v Administrateur, Transvaal* 1992(1) SA 473 (A) at 482 F-G; *Standard Bank of South Africa v Oneanate Investments (Pty) Ltd (in*

liquidation) 1998(1)SA 811 (SCA) at 828 D). The present matter is not such a case (I agree with the views of Van Reenen J in this regard in his minority judgment in the court below, at 613I-614A). The respondent charged no interest on the loan that he advanced to the trusts. No actual interest thus ever accumulated. A notional commercial arms length transaction on interest would assume a lender who would insist on payment of the interest he charges and a borrower able to pay that interest. Here there is neither such a lender nor such a borrower. To the extent that either one is absent the result is a gratuitous disposition. I fail to see how that very element of gratuitousness can be said to trigger the working of the *in duplum* rule.

[13] The appeal must therefore be upheld to the extent that the application of the *in duplum* rule in the courts below was wrong. What remains is the question of costs. The major portion of the appellant's argument in this court and the High Court was directed at showing that the sale of the shares to the trusts was suspect in one way or another. In that he was unsuccessful. His success relates to the lesser aspect of the application of the *in duplum* rule. That does not, in the context of this matter, represent substantial success. In the circumstances I consider it just and practicable that no costs order be made in this court and in the High Court.

[14] The appeal thus succeeds to this extent and the following order is made:

1. The order of the Cape High Court is set aside and replaced with the following:

    "(a) The appeal succeeds to the extent that the Commissioner is directed to revise the assessments for the tax years 1990 and 1991 on the basis that the *in duplum* rule does not apply.

    (b) No order is made as to the costs of appeal."

2. No order is made as to the costs of appeal to this Court.

J.C.FRONEMAN

ACTING JUDGE OF APPEAL

HEFER ACJ)

HARMS JA) CONCUR

OLIVIER JA)

MTHIYANE JA)