THE HIGH COURT OF SOUTH AFRICA

(WESTERN CAPE DIVISION, CAPE TOWN)

Appeal Case No: A48/2014

Tax Court Case No: 13002

In the matter between:

KLUH INVESTMENTS (PTY) LTD **APPELLANT**

and

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE **RESPONDENT**

Coram: TRAVERSO DJP AND ALLIE ROGERS JJ

Heard: **8 AUGUST 2014**

Delivered: **9 SEPTEMBER 2014**

JUDGMENT

ROGERS J:

Introduction

[1] The is an appeal against the dismissal by the tax Court (Davis J sitting with two assessors) of an appeal brought in that court against an additional assessment levied by the respondent ('SARS') in respect of the appellant's year of assessment ended 30 June 2004. By way of the assessment an amount of R109 932 321 was added to the appellant's taxable income.[1]

[2] SARS issued the additional assessment on the basis that a gross amount giving rise to the said taxable income had accrued to the appellant upon the disposal, during its 2004 tax year, of a plantation as contemplated in para 14 of the First Schedule to the Income Tax Act 58 of 1962. The First Schedule applies in the circumstances contemplated in s 26(1) of the Act.

[3] It is common cause that the appellant disposed of a plantation during the course of its 2004 tax year for an amount which yielded, if the said statutory provisions are applicable, the taxable income forming the subject of the additional assessment. The dispute is, in essence, whether the amount accrued to the appellant as a person carrying on farming operations. SARS says yes, the appellant says no.

[4] Section 26(1) reads thus:

(1) The taxable income of any person carrying on pastoral, agricultural or other farming operations shall, in so far as it is derived from such operations, be determined in accordance with the provisions of this Act but subject to the provisions of the First Schedule.'

[5] The First Schedule uses the word 'farmer'. This is clearly a short-hand reference to the expression 'any person carrying on pastoral, agricultural or other

[1] The additional assessment was for R97 923 321 but the tax court recorded, and it is common cause, that to this must be added an amount of R12 million, because a deduction in that amount had already been allowed by SARS in the original assessment.

farming operations' in s 26(1). I shall for convenience use the phrase 'farming operations' to cover the expression used in s 26(1).

[6] Para 14 of the First Schedule provides as follows:

'14 (1) Any amount received by or accrued to a farmer in respect of the disposal of any plantation shall, whether such plantation is disposed of separately or with the land on which it is growing, be deemed not to be a receipt or accrual of a capital nature and shall form part of such farmer's gross income.

(2) Where any plantation is disposed of by a farmer with the land on which it is growing the amount to be included in such farmer's gross income in terms of sub-paragraph (1) shall –

(a) if the amount representing the consideration payable in respect of the disposal of the plantation is agreed to between the parties to the transaction, be the amount so agreed to; or

(b) failing such agreement, be such portion of the consideration payable in respect of the disposal of the land and the plantation as in the opinion of the Commissioner represents the consideration payable for the plantation.'

[7] Para 16 of the First Schedule defines 'plantation' as meaning

'any artificially established tree as ordinarily understood (not being a tree of the nature described in paragraph 12(1)(g)) or any forest of such trees and includes any natural extension of such trees.'

[8] Both sides, in their written argument, devoted considerable attention to the appropriate manner of assessing the evidence. The appellant, represented before us (as in the tax court) by Messrs Kuschke SC and Emslie SC, contended that the tax court had, without making adverse credibility findings against the appellant's witnesses, effectively discounted their evidence by attaching undue weight to recordals in various documents. In regard to the approach to the assessment of the taxpayer's *ipse dixit*, we were referred to *ITC 1185* 35 SATC 122 and *Malan v Kommissaris van Binnelandse Inkomste* 1983 (3) SA 1 (A) at 18B-19A. SARS, represented before us (as in the tax court) by Mr Sholto-Douglas SC leading Messrs Janisch and Cassim, reminded us of the well-known principle that an appellate court will not reverse a trial court's factual findings unless it finds that the trial court

committed a material misdirection or is convinced that the trial court's finding is wrong (see, for example, *S v Naidoo* [2002] 4 All SA 710 (SCA) para 26[2]).

[9] It appears to me, however, that the important facts for purposes of answering the question whether the appellant was carrying on farming operations were common cause. It has been said that the questions whether a person is carrying on farming operations and whether particular income has been derived from farming operations are questions of fact (*ITC 1630* 60 SATC 59 at 61), But the interpretation of s 26(1) and para 14 is a matter of law. Once all the facts relevant to determining whether the case does or does not fall within s 26(1) and para 14 have been ascertained, the question whether on those facts there has been a carrying on of farming operations seems to me to be a question of law. Even if it were regarded as a question of fact or a mixed question of fact and law, it is not the sort of matter in regard to which an appellate court would need to display the caution or deference mentioned in *Mkhize* and earlier cases to similar effect.

The facts

[10] Companies in the Thesen group (to which I shall refer collectively as Thesen) previously owned property in Knysna on which they conducted forestry, timber growing and plywood manufacturing businesses. The plantation at issue in the present case is a plantation which Thesen once owned and conducted.

[11] During May 2001 Thesen and Steinhoff Southern Cape (Pty) Ltd ('Steinhoff'), the latter represented by Mr D van der Merwe, concluded written agreements in terms whereof the latter was to purchase the former's Knysna assets as a going concern for R45 million. The Steinhoff group is involved in furniture manufacturing, here and abroad. However, the transaction was blocked by the board of Steinhoff's holding company because the group did not wish to own fixed property in South

[2] Statements in some of the earlier tax cases to the effect that a factual finding of the tax court cannot be reversed unless it is a finding to which no reasonable court could have come do not reflect the current position. That test was the one applied at a time when a tax court judgment could be appealed against only on a question of law. It was said to be a question of law whether the factual conclusion reached by the court was one to which no reasonable court could have come. The limitation of tax appeals to questions of law has fallen away so that the ordinary appellate test now applies.

Africa. (Van der Merwe said that the group had disposed of all or almost all of its African properties the previous year.)

[12] Van der Merwe wanted Steinhoff to have access to the plantation but needed to find a third party to acquire the fixed property. He had discussions with Mr GA Evans of Fihag Finanz und Handels AG ('Fihag'), a Swiss company. He had met Evans at the time Steinhoff's holding company was listed in September 1998. The Steinhoff group had at that time obtained options to buy certain furniture factories in Europe from Fihag, some of which were exercised in 2002 and 2003. Pursuant to discussions between Van der Merwe and Evans in mid-2001, agreement was reached that a special-purpose subsidiary of Fihag which Steinhoff would provide (in the event, the appellant[3]) would take Steinhoff's place as the purchaser of the bulk of Thesen's Knysna assets and that Steinhoff would recommend to Fihag a trusted local director for the subsidiary (in the event, a South African attorney, Mr J Pretorius). Steinhoff would still purchase Thesen's machinery and equipment (for about R15,7 million) but the appellant would buy the other assets, including the plantation and the land on which it stood, for R29,5 million. The appellant would keep the land and plantation but on-sell the other assets (a plywood business and certain trade marks) to a third party with Steinhoff's assistance.

[13] Thesen agreed to the cancellation of the contracts of May 2001. Although the substitute agreements were only executed in October 2001, oral agreement had been reached by June 2001. On 29 June 2001 Thesen permitted the appellant to take possession *inter alia* of the plantation and the land. The appellant paid an advance of R19,5 million on the purchase price.

[14] In terms of a written contract executed on 5 October 2001, Steinhoff purchased the machinery and equipment (including the sawmill) from Thesen for a price of R15 786 881. Thesen sold these assets to Steinhoff as a business conducted as a going concern as contemplated in s 11(1)(e) of the Value Added Tax Act 89 of 1991 ('the VAT Act'). The contract specified an effective date of 29 June 2001.

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[3] The appellant was, at earlier times relevant to this case, called Malenge Sawmills (Pty) Ltd and later Kota Sawmills (Pty) Ltd.

[15] The sale of the remaining Thesen assets to the appellant was recorded in a written contract executed on 3 October 2001. This contract likewise specified an effective date of 29 June 2001. The purchase price of R29,5 million was apportioned as follows: R11 956 121 to the plantation ('growing timber'), R12 528 459 to the plantation land and the balance to other assets. It was recorded that the appellant had already paid R19,5 million. (The remaining R10 million was lent to the appellant by the Steinhoff group.)

[16] The assets collectively were stated to comprise a business sold by Thesen to the appellant as a going concern (clause 5.1). For this reason, so it was recorded in clause 5.2, the sale would be zero-rated in terms of s 11(1)(e) of the VAT Act.

[17] Although nothing turns on this, prior to June 2001 the appellant was a subsidiary in the Steinhoff group and conducted a sawmilling business. According to the appellant's financial statements for the year ended 30 June 2001, the appellant during that year disposed of its pre-existing business as a going concern (presumably to another Steinhoff company) and Fihag became its holding company.

[18] The appellant retained the land and plantation but forthwith sold the remaining assets (a plywood business, certain trade marks and an erf) to third parties. (In fact, the on-sale of these residual assets had already been recorded in contracts concluded in July and August 2001.)

[19] Within less than two years Van der Merwe had persuaded Steinhoff's holding company's board that, because of escalating timber prices and the scarcity of plantation resources, it would be desirable for the group to obtain ownership of the plantation. This cleared the way for Steinhoff to acquire the plantation and land which the appellant had purchased from Thesen during 2001. Having regard to the price which Steinhoff was prepared to pay (reflecting in part that the price paid to Thesen had been a bargain for the purchaser and in part that timber prices were escalating), it is not surprising that the appellant agreed to sell.

[20] The sale was recorded in heads of agreement executed in February 2003 (the document was drawn up by Steinhoff's in-house lawyer). In clause 2 the parties

recorded that they had conducted research into 'the change of circumstances relating to the business of the [appellant]' and that Steinhoff had plans to erect a sawmill in the Southern Cape region. For these and other reasons, the parties had reached an agreement 'for the sale of the business of' the appellant to Steinhoff. The parties also recorded that Steinhoff had 'managed the business on behalf of' the appellant.

[21] The purchase price was to be determined by an independent valuer on the basis, however, that if for any reason the valuer failed or neglected to provide the parties with a valuation prior to 31 August 2003, the price would be R108,5 million.[4] The effective date was to be upon completion of the valuation but no later than 30 June 2003. By the time the heads were signed in February 2003 Steinhoff had already paid the appellant a 'deposit' of R42 660 425 towards the acquisition (this included, by way of set-off, the sum of R10 million which the Steinhoff group had lent the appellant in 2001 to fund the purchase of the assets from Thesen).

[22] The subject of the sale was described as being 'the plantation business', defined in clause 3.1 to mean 'the business of commercial forestry operations, which includes the plantation sale assets, machinery and equipment and plantation contracts carried on by the [appellant] at the plantations and the plantation immovable property as defined, as a going concern'. Clause 3.2 stated that the business was being sold as a going concern and that the sale would thus be zero-rated in terms of s 11(1)(e) of the VAT Act. In terms of clause 6 all benefit and risk in respect of the business was to pass from the appellant to Steinhoff with effect from the effective date.

[23] Disputes arose between the parties concerning the heads of agreement. One dispute was the valuation. Another was whether the sale had correctly been regarded as zero-rated in terms of s 11(1)(e) of the VAT Act. The appellant had

[4] See clause 4.3. Clause 4.2 stated that valuation was to be 'not more than' R98 million for the plantation and 'not less than' R10,5 million for the immovable property. There was a difference of opinion between the appellant's witnesses as to whether the 'not more than' phrase should have read 'not less than'. It is unnecessary to resolve this question, save to mention that in the event the parties settled on a price for the plantation of substantially more than R98 million, which rather indicates that the plantation price was to be 'not less than' R98 million.

received advice that the business was not, in its hands, a going concern and that VAT would thus be payable on the sale of the assets.

[24] These and other disputes were resolved by way of a settlement agreement concluded on 29 July 2004 (drafted by external attorneys). The settlement agreement stated that the new effective date would be 1 June 2004. The description in the heads of agreement of the subject of the sale as being a plantation business as a going concern was diluted in the settlement agreement. In terms of the settlement agreement, the subject of the sale was 'the Kota business' (the appellant's name at that time was Kota Sawmills (Pty) Ltd). The immovable properties were listed in an annexure. The 'Plantation' was defined as meaning

'the Standing Timber on the Immovable Property and, for the purposes of expressing the value thereof as part of the Purchase Price, includes the plantation business (ie the business of commercial forestry operations) including the Plantation sale assets, machinery and equipment and Plantation contracts, all as a going concern.'

[25] The purchase price of the combined assets was agreed at R159,7 million, with R144,7 million being in respect of the 'Plantation' as defined.

[26] Clause 6.1 recorded that the parties had, subsequent to the conclusion of the heads of agreement, received advice that VAT 'may be payable' at the standard rate of 14%. Steinhoff was to be liable for the payment of VAT on the purchase price. The appellant, which was a registered VAT vendor, was to issue VAT invoices to Steinhoff in respect of the purchase price.

[27] As part of the settlement agreement, the appellant was to pay Steinhoff an amount of R12 million as a 'Bonus Management Fee', defined in clause 2.5.12 as 'the bonus…which [the appellant] has agreed to pay Steinhoff for the exemplary manner in which Steinhoff managed the forestry business of [the appellant] in the period prior to Steinhoff acquiring the Kota Business.' Steinhoff was to issue a VAT invoice in respect of the fee. The fee was to be paid by the appellant by way of deduction against the purchase price (ie by set-off).

[28] In the additional assessment issued during 2010 in respect of the appellant's 2004 tax year, the amount of R144,7 million was treated as part of the appellant's gross income in terms of para 14 of the First Schedule. The taxable income adjustment arising from this treatment was R109 932 321, arrived at by deducting the initial cost of R11 956 121 and the capital gain of R22 811 558 already declared by the appellant. (The management fee of R12 million had already been allowed as a deduction in the original assessment.)

[29] Thus far I have described the sequence of events with reference to the contracts for the acquisition and disposal by the appellant of the assets in question. If those were the only sources of information, one might readily infer that the appellant purchased and later sold a plantation business as a going concern and must therefore in the interim have conducted the farming operation. There is no dispute between the parties that the cultivation, maintenance and harvesting of a plantation is a farming operation.

[30] However, there are important further facts which are not in dispute. At the time Thesen disposed of the plantation in 2001, it was already a 'mature plantation in rotation'. In other words, the plantation had reached the stage where it could annually yield a steady and sufficient number of mature trees for commercial felling, with younger trees taking their place year by year. The plantation thus comprised a range of trees ranging from the very young to the fully mature with a cycle of about 30 years. It had been very well managed by Thesen, which was regarded by Van der Merwe as having one of the best plantation teams in the country .

[31] Steinhoff and Fihag orally agreed during May/June 2001 that the former would be entitled to conduct the plantation business for its own profit and loss. The witnesses and counsel sought to place varying labels on the oral agreement but its actual substance does not seem to be in dispute. Steinhoff was to have access to the land on which the plantation stood. It was entitled to harvest timber for its own account. Steinhoff owned the equipment for conducting the plantation operations and employed the employees who worked on the plantation (mostly taken over from Thesen) and contracted with service providers. The appellant owned no equipment and had no employees. All operational income and expenditure were earned and

incurred by Steinhoff and reflected in its accounts. The appellant's financial records and financial statements for the period between acquisition and disposal reflected no operational income and expenditure.

[32] The arrangement was of indefinite duration though, in view of Steinhoff's policy as it existed in 2001, the arrangement was expected to endure for a lengthy period. It was accepted that in law either side could have terminated the arrangement on reasonable notice.

[33] Upon termination the plantation was to comprise trees of the same volume and quality as at commencement. This meant that Steinhoff, in conducting the plantation operations, had to keep the plantation in rotation and perform such other pruning, thinning and maintenance as would ensure that, upon termination, it could restore the plantation in the state it was in June 2001. Planting was not needed as seedlings grew naturally. The appellant's witnesses (who included Van der Merwe of Steinhoff and Evans of Fihag) said that Steinhoff was to manage the plantation using best practice and that FSC (Forest Stewardship Council) certification would be obtained. This was to ensure that the timber would qualify for export to Europe. Steinhoff was responsible for fire protection. Steinhoff insured the plantation against fire in the light of its obligation to restore the plantation to the appellant at the end of the arrangement (the premiums, according the Steinhoff's trial balances, exceeded R1 million annually). Steinhoff was not obliged to render reports to the appellant regarding the plantation operations.

[34] Prior to the Thesen transaction, Fihag had not conducted any operations in South Africa. It had interests in pine furniture manufacturing in Europe. It had no expertise in plantation operations. The appellant could not itself have taken over the operations without acquiring equipment and engaging staff. Although Evans could not speak of all matters from personal knowledge (his expertise and responsibilities were finance and investment and he had no involvement in the manufacturing businesses), he understood from Fihag colleagues that the investment in the Knysna plantation was viewed as strategically advantageous. The Knysna plantation in particular and Steinhoff more generally was a source or potential source of timber for Fihag's European interests. The Steinhoff group had options to buy some of

those European businesses, options it was likely to exercise if the European businesses were profitable.

[35] Evans testified that Fihag acquired the plantation and land as a long-term investment and without any intention of involving itself in plantation operations. The transaction was, by Fihag's standards, a small one (Evans said that the price of R29,5 million was probably less than 1% of its investments at the time).

[36] The indefinite transaction was terminated by agreement, ultimately with effect from 1 June 2004, after the Steinhoff group changed its policy and became willing to purchase the immovable property. Fihag and the appellant would not have been obliged to sell the land and plantation to Steinhoff. The appellant could notionally have taken over the operations or sold the plantation to someone else. However, there was a relationship of trust between the parties, reflected *inter alia* in the fact that Steinhoff's right to operate the plantation and its further rights and obligations in that regard were oral.

[37] Regarding the R12 million fee for which the settlement agreement provided, Van der Merwe said that from his point of view it was a 'rebate on the value of' the plantation, because the value of the plantation 'ran away from us'. In negotiation with Evans he said that Steinhoff had looked after the appellant's asset, which is why it was now worth so much, and Steinhoff wanted something for that. When asked why this was not simply reflected in a reduction in the price, he said Evans, who acted for investors, claimed he needed to stick to the valuation.

The disputed assessment

[38] In its 2004 tax return the appellant treated the disposal of the land and plantation as a capital transaction. In respect of the plantation, the appellants declared a capital gain of R45 623 115, being the difference between the disposal proceeds of R144,7 million and a CGT valuation of the plantation of R99 076 885 as at 1 October 2001. The appellant also claimed a s 11(a) deduction of R12 million in respect of the bonus management fee.

[39] In an additional assessment issued during August 2010, SARS rejected the treatment of the plantation disposal proceeds as a capital transaction, claiming that s 26(1) read with para 14 of the First Schedule deemed the disposal proceeds to be part of the appellant's gross income. SARS stated that the purchase price of R11 955 121 and the fee of R12 million were allowable deductions against the gross income. The appellant objected to this approach.

[40] In its grounds of assessment delivered in terms of rule 10, SARS persisted in its stance. In the alternative, SARS contended that, if the appellant had been correct in treating the transaction as being on capital account, the appellant's calculation of the capital gain was incorrect. One of the issues in that regard was whether the appellant had correctly treated the land and plantation as a so-called pre-valuation asset, ie an asset acquired prior to 1 October 2001, the date on which the CGT regime became operative. (The litigants agreed in the tax court that the CGT issue would stand over pending determination of the main issue. It is not before us.)

[41] In its grounds of appeal delivered in terms of rule 11, the appellant alleged that its intention had been to acquire and hold the land and the plantation as a long-term investment. In terms of an oral agreement, Steinhoff was engaged to manage the appellant's investment with a view to maintaining and enhancing its value, on the basis that Steinhoff would be entitled for its own benefit to conduct the plantation operations. The appellant conceded in its grounds of appeal that it should not have claimed the deduction of R12 million, given the capital nature of the acquisition and subsequent disposal of the plantation.

SARS' two bases for supporting the disputed assessment

[42] Although the onus was on the appellant to prove on a balance of probability that the proceeds from the disposal of the plantation in its 2004 year were not subject to tax (see s 82 of the Income Tax Act, subsequently substituted by s 102 of the Tax Administration Act 28 of 2011), it is convenient to consider the matter with reference to the two alternative bases on which SARS' counsel submitted that s 26(1) read with para 14 of the First Schedule applies to the proceeds.

[43] The first basis is that, even if the appellant conducted no other farming operations, the mere disposal of an operating plantation was itself sufficient to trigger the statutory provisions in question. It was not necessary, so it was submitted, to view s 26((1) as 'a separate jurisdictional fact that is required to be fulfilled before the deeming provision of para 14(1) can apply'.

[44] The alternative basis is that, although Steinhoff may have functioned as an independent contractor rather than an agent in performing plantation operations, such operations were nevertheless physically being conducted on land which belonged to the appellant. The appellant retained a direct interest in such operations, because Steinhoff was required to conduct the operations in accordance with agreed standards and to restore the plantation with the same volume of timber upon termination of the arrangement. The appellant would not have acquired the assets unless it expected that, upon termination, the plantation would be worth more than the purchase price paid and that it could then (if it so wished) sell the plantation at a profit. There was, thus, a 'sufficiently close connection' between the disposal proceeds and the conducting of the plantation operations over the intervening two-year period to trigger the operation of s 26(1) and para 14 of the First Schedule.

[45] Both bases require, as a key element for triggering the relevant statutory provisions, that the appellant had a commercial interest in the condition and value of the plantation upon termination (whenever that might be) of the arrangement between the appellant and Steinhoff. SARS' first basis is that this interest in itself is sufficient. SARS' alternative basis is that this interest, coupled with the performance of operations in the intervening period by an independent contractor for its own profit and loss but in accordance with agreed standards and with an obligation to restore an equivalent plantation at the end of the arrangement, gives rise to the operation of the relevant statutory provisions.

The tax court's findings

[46] The tax court, according to SARS' counsel, found in its favour on the alternative basis and thus did not need to consider the first basis. Whether the tax court understood there to be two distinct bases does not clearly appear from its

judgment. It is certainly so, however, that the tax court accepted as correct SARS' proposition that the key question was whether there was 'a sufficiently close or direct connection to the owner between the income generated and the farming activities conducted on the property' (para 37).

[47] The tax court did not find persuasive the oral testimony of the witnesses who said that the appellant was not conducting and did not intend to conduct a plantation business. The tax court placed considerable emphasis (i) on references in contractual documentation and resolutions of the appellant's directors and shareholders to the appointment of Steinhoff to manage the plantation for the appellant and to the effect that what was sold to Steinhoff in 2003 was a plantation business as a going concern; (ii) on the provision in the settlement agreement for a 'plantation management fee'; and (iii) on the invoice issued by Steinhoff to the appellant in that regard.

[48] The tax court also referred (i) to a note in the appellant's financial statements for the year ended 30 June 2002 to the effect that no plantation sales were being recognised in the current year and that 'sales will be recognised when the plantation is sold'; and (ii) to a note in the same financial statements on 'inventory', which stated that 'the plantation is still growing and will be sold in the future' and that 'growing of timber is one of the main objectives of the company'. As pointed out the appellant's counsel in their written argument, the financial statements to which the tax court referred were drafts sent in November 2002 by Steinhoff to the appellant's Mr Pretorius. The financial statements as adopted by the appellant's board on 15 March 2004 did not contain notes in the same form. The alterations appear specifically to have been directed at removing statements and entries which would suggest that the appellant had been conducting a plantation business.

[49] As foreshadowed earlier in this judgment, I regard the critical question as being essentially a legal one which arises from the undisputed facts as to the oral arrangement by which Steinhoff was permitted to conduct the plantation operations and the further undisputed fact that the appellant retained the ownership of the land and had a commercial interest in the plantation's being restored to it in good condition and with the same volume of trees as in June 2001. If the facts concerning

the oral arrangement were disputed, the recordals in the heads of agreement of February 2003 and the settlement agreement of July 2004 and the contents of the resolutions, invoice and draft financial statements might have been relevant in assessing the credibility of the witnesses. However, SARS accepts, and apparently accepted in the tax court, what the appellant's witnesses said about the oral arrangement, at least in the respects I have identified earlier. The appellant, for its part, cannot dispute that it retained ownership of the land on which the plantation stood (Van der Merwe and Pretorius referred to it as bare *dominium*) and had a vital commercial interest in the restoration of the plantation to it in due course in good condition and with the same volume of trees. The appellant would not have paid R29,5 million for the assets unless it expected that they would increase in value to an extent sufficient to justify an investment in that amount.

[50] These being the undisputed facts, I do not see how the answer to the problem can lie in the parties' characterisation of what was sold in 2003 any more than in what the appellant's witnesses claimed their understanding on that question to be. If, on the undisputed facts I have summarised, the appellant is found to have been a person 'carrying on pastoral, agricultural or other farming operations', it is irrelevant that the appellant and Steinhoff may have thought otherwise. Conversely, if the undisputed facts I have summarised lead to the conclusion that the appellant was not a person 'carrying on pastoral, agricultural or other farming operations', the fact that the parties characterised the subject matter of the sale in 2003 as the sale of a business as a going concern cannot justify a different conclusion.

[51] I nevertheless make the following observation in regard to the characterisation contained in the heads of agreement concluded in February 2003. The final agreement between the parties is reflected in the settlement agreement of July 2004. By then the appellant, it seems, had taken advice on the matter. If the credibility of the witnesses concerning the oral arrangement were in dispute, one might take a jaundiced view of the changes made in the settlement agreement. But if an analysis of the undisputed facts points to the conclusion that the settlement agreement stated the matter more accurately than the heads of agreement, there would be no reason to question the appellant's motives or that of its advisers.

[52] The same observation may be made in regard to the draft financial statements for the year ended June 2002 (prepared in November 2002) and the financial statements for that year as adopted by the appellant's board in March 2004. Since the changes in the financial statements were directed at eliminating notes and entries suggestive of the conducting of business, one might rightly have been sceptical about the changes and attached more weight to the draft prepared in November 2002 if the oral arrangements between the appellant and Steinhoff were in dispute. But if the undisputed facts point to the conclusion that the appellant was not conducting farming operations, it was appropriate and indeed necessary for its financial statements to be adjusted to reflect the true position.

The two-pronged enquiry

[53] Insofar as SARS' argument rests on the closeness of the connection between the disposal proceeds and the conducting farming operations, I consider that the argument (and thus the finding of the tax court) conflates two distinct issues. Section 26(1) does not apply merely because there has accrued to the taxpayer income which has 'derived from' farming operations; the section applies to a person carrying on farming operations to the extent that his income is derived from such operations. Two questions must therefore be answered: (i) Was the person whom SARS wishes to tax a person carrying on farming operations during the year of assessment in question? (ii) If so, did the particular item of income in dispute derive from those farming operations?

[54] The leading case on the direct-connection test in the context of s 26(1) is *Commissioner for Inland Revenue v D & H Promotions (Pty) Ltd* 1995 (2) SA 296 (A). That case was concerned with the second of the two questions I have identified. In *D & H Promotions* the taxpayer was undoubtedly carrying on farming operations (as a grower of sugar cane). The question was whether certain items of income derived from the farming operation. Interest payable on the purchase price of sugar cane in accordance with a statutory scheme was held to be part of the compensation for the sugar cane and was thus 'derived' from the farming operation.

[55] However, where the first of the two questions I have identified is in issue, it is impermissible to proceed directly to the second question as if it will also provide an answer to the first. The question is not whether the accrual to the taxpayer of a particular item of income is directly connected to the farming operations of any person but whether it is directly connected to (ie derived from) the farming operations of the taxpayer himself.

[56] Certain tax court decisions which were cited to us in argument appear to me, with respect, likewise to have erred in conflating the two questions. The first is *ITC 166* (1930) 5 SATC 85. There the owner of a farm had let out two portions to lessees at fixed rents and a third portion to another lessee at a rental of a half-share of the proceeds of the crops grown on that portion. Davis QC held the fixed rents from the first two portions were not derived from farming operations but from the letting of the farm. He regarded the rent for the third portion as standing on a different footing. He said that the arrangement (a partiarian lease in which the 'lessee' is known as a *colonus partiarius*) was *sui generis*, partaking in some respects of lease and in other respects of partnership. Because the landlord had a direct interest in the farming operations on the third portion, his share of the proceeds of the crops constituted income derived from farming operations.

[57] A similar view was reached by Galgut J in *ITC 1630* (1996) 60 SATC 59. There the owner let his farm to another against payment of rent equal to 15% of the gross proceeds of the lessee's crop. Regarding the nature of a partiarian lease, Galgut J said that in *Lubbe v Volkskas Bpk* 1992 (3) SA 868 (A) the Appellate Division had accepted that the true nature of such an arrangement was a lease rather than a partnership. (This accords with *Stevens v Van Rensburg* 1948 (4) SA 779 (T) at 783; see also *LAWSA* 2nd Ed Vol 14(2) §3; FH van den Heever *The Partiarian Agricultural Lease in South African Law* 1943 Ch 3). He continued to say that the question which needed to be answered was whether, by virtue of the partiarian lease, the income which the taxpayer earned was 'directly connected to the farming operations carried out by its lessee' (at 62). He considered that the relationship between the rent and the farming operations was a direct one, finding support for his conclusion in *ITC 166* and distinguishing his case from *ITC 732* 18 SATC 108 in which fixed rent was held not to be derived from farming operations.

[58] In both these cases (*ITC 166* and *ITC 1630*) the court went directly to the question whether there was a direct connection between the rent paid under the partiarian lease and the farming operations. I can perfectly understand the distinction between a fixed rent and rent linked to the proceeds of farming operations if the sole test were whether rent received by a taxpayer from a lease of agricultural land is income 'derived from farming operations'. That, however, is not the only question. There is an anterior question, namely whether the taxpayer to whom the income has accrued is a person carrying on farming operations.

[59] In that respect, I can understand that, if a partiarian lease constituted a partnership (a view on which Davis QC may have acted in *ITC 166*), the 'landlord', as a co-partner in the farming operations, might be regarded as carrying on farming operations. On the other hand, if a partiarian lease is viewed as a lease (which was Galgut J's approach in *ITC 1630*), I do not understand why the landlord should be said to be conducting farming operations merely because he takes his rent in the form of a share of crops or their proceeds rather than as a fixed rent. Such a landlord seems to me to be no more conducting farming operations than a shareholder of a farming company whose dividends are related to farming profits or an farm manager whose salary is supplemented by commission calculated with reference to the farming profits. The contracts in *ITC 166* and *ITC 1630* differed from the classic partiarian lease in that the landlord was to receive a share of the proceeds from the crop rather than a share of the crop itself but in neither case did the landlord share in the tenant's profit and loss. The landlord's share of sale proceeds, as in the case where he receives a share of the crops themselves, was unrelated to the tenant's operating costs.[5]

[60] If, on the facts of the present case, one were to conclude that the appellant was conducting farming operations, I think it would follow almost as a matter of

[5] See Van den Heever *op cit* 22-23: 'A moment's reflection will show that in agricultural partiarian leases profits do not enter into the contract at all. If the annual rental value of the land is £200 and the agreement is to the effect that the tenant renders to the landlord a third of the crops [*or, I would add, a third of the crops' gross proceeds*], the economic results may vary infinitely. Conceivably the tenant may employ machinery and labour and apply fertilizers on a scale which is ruinous; he may conceivably spend £800 to produce crops to the value of £600. In partnership this fact may affect the return which the landlord derives from his soil; in the partiarian agreement it does not. All that happens is that the landlord's return is *in natura* and that the amount is subject to a party casual and partly potestative condition, an amount certain but at present and ascertained.'

course that the proceeds of the disposal accrued to the appellant as a farmer. Ordinarily such a disposal would be of a capital nature but para 14 of the First Schedule deems it to be gross income. The real issue in the present case is not the second one (a sufficiently close connection between the income and farming operations) but the threshold enquiry whether the appellant was carrying on farming operations.

SARS' first basis

[61] I reject SARS' submission that para 14 of the First Schedule itself provides the answer to the question whether the appellant was carrying on farming operations. The purpose of para 14 is not to define what constitutes the carrying on of farming operations but to characterise a particular type of accrual as gross income rather than capital. The question as to what constitutes farming operations is a threshold enquiry. Para 14 does not stipulate in unqualified language that the proceeds of the disposal of a plantation constitute gross income. Para 14 states that the disposal of a plantation constitutes deemed gross income if it is an amount received by or accrued to 'farmer', ie a person carrying on farming operations as contemplated in s 26(1).

[62] I thus consider that there must be conduct by the taxpayer apart from disposing of a plantation previously acquired by the taxpayer in order to constitute the carrying on by him of farming operations.

[63] Farming operations involve the performance of a range of physical activities associated with the land with a view to profit (see *Commissioner, South African Revenue Service v Smith* 2002 (6) SA 621 (SCA) paras 22; see also, for the importance of the profit intention, *ITC 1319* (1980) 42 SATC 263 at 264 and *ITC 1324* (1980) 42 SATC 288 at 294-295). Farming operations as contemplated in s 26(1) are a particular form of 'trade' within the broad definition of that term in s 1 of the Act. 'Trade' in that sense embraces any activity or venture carried out with the object of making a profit (*Burgess v Commissioner for Inland Revenue* 1993 (4) SA 161 (A) at 181H-182I; see also *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* 1986 (1) SA 8 (A) at 33E-37D). Profit-making as a hallmark of trade

is concerned with the generating of income of a revenue nature. A person who buys an asset as an investment rather than as trading stock may expect or hope, if and when he comes to sell the asset, that he will realise a capital profit but this expectation or hope does not make him a trader in relation to the asset.

[64] The cultivation, maintenance and harvesting of timber with a view to profit plainly constitute farming operations. Farming operations in the form of plantation operations would typically involve the harvesting of trees from year to year. The proceeds from the annual sale of timber constitutes gross income of a revenue nature. The farmer would typically undertake the plantation operations with a view to his revenue from timber sales exceeding his operating expenditure, ie with a view to profit.

[65] I am prepared to go further and to accept, without so deciding, that a person who acquires a plantation and cultivates or maintains it or performs other operations on the land, not for the purpose of ongoing harvesting but in order to preserve or enhance its value with a view to profitable resale, is also performing farming operations. However, and accepting the proposition, it would operate only where the owner of the plantation is engaged in a profit-making venture, so that the proceeds of the sale in due course would on ordinary taxation principles be of a revenue rather than a capital nature. In such a case the land with the growing timber would as an indivisible whole be the taxpayer's trading stock. And in such a case, of course, SARS would not need to rely on s 26(1) read with para 14 of the First Schedule in order to treat the disposal proceeds as part of the owner's gross income (though other components of the First Schedule might come into play in the computation of the taxpayer's taxable income).

[66] SARS did not allege in the present case that the appellant was engaged in a profit-making scheme which would, on ordinary taxation principles, result in the plantation proceeds being of a revenue nature. Para 6 of the tax court's judgment records that the litigants were agreed that the appellant was not engaged in a scheme of profit-making. If SARS had contended otherwise, it would have been irrelevant (at least insofar as the taxation of the proceeds is concerned) whether or not the appellant was, in the course of its profit-making venture, carrying on farming

operations. Instead, it would have been necessary to enquire into the circumstances in which the appellant acquired the plantation and what its true intentions were.

[67] Since SARS did not contend that the appellant acquired the plantation and the land with a view to profitable resale rather than as a capital investment, I do not think, insofar as intention is concerned, one can say that the profit intention lay in the appellant's expectation that its investment would in due course turnout to be a good one. Most people make investments with that expectation.

[68] Despite the fact that the purchase and resale of the plantation was not alleged to be a profit-making venture, the disposal proceeds, despite their fiscal nature as capital, would be deemed to be part of the appellant's gross income in terms of para 14 of the First Schedule if, but only if, the appellant was carrying on farming operations. As I have said, SARS cannot, for that threshold premise, rely on para 14 itself. I would thus reject SARS' first basis for invoking para 14.

SARS' alternative basis

[69] It thus becomes necessary to consider SARS' alternative basis, which adds, to the appellant's acquisition and later disposal of the plantation, the farming operations carried out on its land by Steinhoff.

[70] It is clear, on the undisputed evidence concerning the oral arrangement, that Steinhoff's operations on the farm were not conducted as an agent for the appellant. Steinhoff was carrying on its own farming operations for its own profit and loss.

[71] It is so that Steinhoff was contractually obliged to the appellant to maintain the plantation to a particular standard and to return it upon termination of the arrangement with the same volume of timber as at June 2001. That is not enough, however, to attribute Steinhoff's farming operations to the appellant. If one reasons by analogy, it is at least settled law that s 26(1) does not apply to an owner of a farm who lets it out for a fixed rent rather than for a share of the farming profits. The case for treating the appellant as a farmer is weaker still than a fixed-rent lease, because Steinhoff had effectively the same rights as a lessee and the appellant was to

receive no rent at all. Even if the two tax court judgments which I queried earlier were correctly decided, there is no question here of the appellant having had any share of the profits from the farming operations conducted by Steinhoff.

[72] Most leases contain express terms regarding the duties of the parties in regard to the maintenance of the premises and the lessee's duty to restore the premises. It is an implied term of a lease that the duty of maintaining the premises in a condition reasonably fit for the purpose for which they are let rests on the landlord (*Poynton v Cran* 1910 AD 205) but, as with other implied terms, it may be excluded or varied by the parties, and this is typically done. The lessee might be obliged to maintain the premises in the same condition as they were received at the commencement of the lease (see, for example, *Sarkin v Koren* 1950 (1) SA 495 (C) at 497-499) or he may have to do so subject to fair wear and tear (see, for example, *Bresky v Vivier* 1928 CPD 202 at 203 and *ISEP Structural Engineering and Plating Pty Ltd v Inland Exploration Co Pty Ltd* 1981 (4) SA 1 (A) at 4 *in fine*). In *Henning v Le Roux* 1921 CPD 587 the lease of a farm required the lessee to maintain the buildings in good repair, to maintain and repair all fences, to keep clean and open all the water furrows and to cultivate the farm in a proper manner.

[73] The fact that the lessee has an obligation to maintain premises and to restore them in the same good order plainly does not mean that the landlord can be said to be conducting the business of the lessee. The landlord has an interest in the maintenance of the premises because the property constitutes an investment and, upon termination of the lease, he might wish to continue earning rents from it or to dispose of it at a favourable price. For example, if the owner of hotel premises lets them to an operator for the latter's own profit and loss on the basis that the latter must conduct the hotel operations to a certain standard and restore the hotel in good order at the end of the lease, it can hardly be said that the landlord is carrying on a hotel business.

[74] The oral arrangement between the appellant and Steinhoff was not a lease because Steinhoff was not obliged to pay rent. Although it is unnecessary to place a precise legal label on the arrangement, it could be described, I think, as a quasi-usufruct in favour of Steinhoff (*LAWSA* 2nd Ed Vol 24 §§ 581-584). The duty of the

usufructuary is to maintain the property and to restore it to the owner at the end of the usufruct *salva rei substantia* (*op cit* §§ 593 and 595).

[75] The decision in *Sekretaris van Inkomste v Aveling* 1978 (1) SA 862 (A), mentioned in passing in SARS' heads on a different point, appears to me to be of some assistance. The taxpayer had carried on livestock farming over the period 1952 to 1967. During November 1967 he made his livestock, implements and vehicles available to a company in terms of a 'lease' which would endure for five years. He became the manager of the company. In terms of the lease, the company was to pay a specified monthly rent and was obliged to manage the livestock properly, to use rams and bulls of only the best quality and upon termination of the lease to restore livestock of the same quality and quantity. During May 1972 the taxpayer agreed to take back a portion of the livestock from the company and to reduce the rent. The returned animals were immediately sold. The ultimate issue in the case was whether the sale proceeds constituted gross income in the taxpayer's hands.

[76] The tax court found that the taxpayer had discontinued his farming operations upon the conclusion of the lease in November 1967 and that as from that date he no longer farmed for his own account. The company was the entity carrying on farming operations. On appeal Rabie JA said that this was a factual finding by the special court and there was no basis on which the appellate court could interfere with it (877A).

[77] Rabie JA proceeded to consider a further contention by the Secretary that the tax court should, despite this finding, have held that s 26(1) and para 3 of the First Schedule applied to the taxpayer. Para 3 of the First Schedule deals with the manner in which livestock on hand at the end of a tax year must be dealt with in the farmer's returns. Para 3(3) states that any livestock which is the subject of a sheep lease or similar livestock agreement is deemed to be held and not disposed of by the grantor of the lease. The Secretary contended that para 3(3) had the effect that the taxpayer during the period of the lease had to reflect the livestock as his closing stock (which would thus increase his gross income).

[78] Rabie JA rejected this contention. He said that it was obvious that s 26 and the First Schedule could not apply to the taxpayer after he discontinued his farming operations and could at most apply up to the end of the 1968 tax year (because for a part of that year the taxpayer had still been conducting livestock operations) (877B-E). He was not prepared to accept an argument that para 3(3) itself had the effect of making the taxpayer a 'farmer', because that would be contrary to s 26(1), which states that the First Schedule applies only to somebody carrying on farming operations (at 877G-878B). What the learned judge of appeal meant, as I understand it, is that para 3(3) could only apply to a taxpayer who was as a fact carrying on farming operations (for example, a person who farmed with some of his animals but made others available to a third party in terms of a livestock lease).

[79] Having found that s 26 and the First Schedule did not apply to the taxpayer, Rabie JA went on to consider whether, on ordinary taxation principles, the returned livestock were held by the taxpayer on capital or revenue account. He said that the conclusion of the lease had not been sufficient to convert trading stock into capital assets. For this reason, the proceeds had correctly been taxed despite the inapplicability of s 26 and the First Schedule.

[80] As I have explained, in the present case SARS did not contend that the proceeds of the plantation were taxable on ordinary principles. The reasoning in *Aveling* on s 26 and the First Schedule is, however, relevant to the present case. The Appellate Division seems to me to have accepted that, on the basis of the tax court's factual findings regarding the arrangement reached with the company, the taxpayer could not be said, after the conclusion of the lease, to have been carrying on farming operations as contemplated in s 26(1) and that a different conclusion could not be reached by having regard to a paragraph in the First Schedule which required the value of livestock under an arrangement similar to a sheep lease to be included as closing stock. In the context of s 26(1), the paragraph in the First Schedule could apply only if the taxpayer was in fact carrying on farming operations.

[81] To the extent that *ITC 926* (1959) 24 SATC 254, which Mr Sholto-Douglas cited, held that para 3(3) could itself have the effect of making the lessor under a sheep lease a farmer, it is inconsistent with the later decision in *Aveling*. However,

ITC 926 does not seem to say so. There the taxpayer did in fact continue to conduct sheep farming, having concluded a sheep lease in respect of only some (albeit the bulk of) of his livestock. He was thus admittedly carrying on farming operations.

[82] If, in the present case, the appellant had initially conducted timber operations on its plantation and had later 'leased' the plantation in its entirety to Steinhoff on the basis that the latter could conduct the plantation operations on its own account but was obliged to restore the plantation in similar condition at the end of the arrangement, one would have been dealing with a situation closely analogous to that in *Aveling*. It is clear from what Rabie JA said at 877B-878B that his reasoning was not dependent on the fact that, in terms of a sheep or similar livestock lease, the ownership of the animals strictly speaking passes to the lessee, the latter's obligation being to restore not exactly the same animals but animals of a similar quantity and quality. Furthermore, although standing timber in terms of common law principles adheres to the land, so that strictly speaking the appellant remained the owner of any unfelled trees (see *Bourke's Estate v Commissioner for Inland Revenue* 1991 (1) SA 661 (A) at 673D), paras 14 to 16 of the First Schedule effectively create a separate fiscal asset in the form of a plantation. As in the case of a sheep or other livestock lease, Steinhoff's obligation was not to return the same trees but trees of a similar quantity and quality. Indeed, and as appears from the decision in *Bourke's Estate supra*, where a taxpayer is engaged in farming operations in which timber is from time to time felled and sold, the trees, even prior to severance from the land, will be regarded on ordinary taxation principles as trading stock. What is relevant is the fiscal character of the trees, not their legal status as adhering to the land (at 673F-I).

[83] The inapplicability of s 26(1) is, in the present matter, an *a fortiori* case. In *Aveling* the taxpayer was conducting farming operations up to the moment he concluded the livestock lease, so one could at least argue (though the Appellate Division rejected the argument) that para 3(3) required one to continue treating him as a farmer. Here, however, the appellant did not even start to conduct plantation operations. From the outset the appellant made the plantation available to Steinhoff so that the latter could conduct plantation operations for its own profit and loss.

[84] Mr Sholto-Douglas sought to persuade us, with reference to the documents mentioned by the tax court and passages from the oral evidence, that the appellant had appointed Steinhoff to manage the farming operations for the appellant, Steinhoff's 'fee' for management being its right to fell and appropriate mature timber. I have already explained why the labels used in the documents and in the oral evidence are not decisive, having regard to the common cause facts.

[85] One might just as well say that a lessee or usufructuary is 'managing' the property for the owner, because his use of the property is subject to compliance with certain standards. In the case of a lease, the extent of the lessee's maintenance obligations (ie 'management' of the property) will have an effect on the rent (the more onerous the lessee's maintenance obligations, the lower the market rent). But this linguistic deconstruction does not lead to a conclusion that the operations conducted by the lessee or usufructuary for his own profit and loss are management operations performed on behalf of the owner.

[86] I think Mr Kuschke was correct in submitting that, at most, Steinhoff was managing the appellant's investment while at the same time managing its own farming operations. I do not believe that the documents or witnesses intended to convey more than this. Steinhoff could not be regarded as having been managing the farming operations on behalf of the appellant for a fee (in the form of felled timber) when the appellant stood to make no profit or loss from the farming operations. The only risk which the appellant faced, if Steinhoff failed to conduct itself in accordance with the agreed standard, was that its investment's value might suffer, a risk which a landlord or bare *dominium* owner would also face if the tenant or usufructuary breached his obligations.

Conclusion

[87] For these reasons, I think that SARS's contentions must be rejected and that the tax court erred in dismissing the appellant's appeal. As a result, the appellant's pleaded contention (raised in the alternative) that it should have received a remission of the interest contemplated in s 89*quat* falls away. In case this matter goes further, I record that counsel were agreed that the s *89quat* issue was not

addressed at the tax court hearing and that the tax court should not be regarded as having dismissed the alternative appeal on interest. This means that, if it were ultimately found that SARS correctly succeeded in the tax court, the appeal on interest would need to be remitted to that court for decision.

[88] The parties agreed in the tax court that the correct capital gains tax treatment of the acquisition and disposal of the plantation and the land if the tax appeal on the main point were to succeed should stand over for later determination. Since the parties pleaded their respective cases on the CGT point, the appropriate order is to remit the CGT issue to the tax court for determination rather than to remit it to the Commissioner for assessment.

[89] I may perhaps mention, in conclusion, that although my interpretation of s 26(1) in this particular case happens to have an outcome favourable for the taxpayer, the more usual position is that it is the taxpayer who, because of certain favourable allowances granted in the First Schedule, seeks to bring himself within s 26(1). Had SARS's contentions in the present case been upheld, the result might have opened a Pandora's box for taxpayers.

[90] The tax court made no costs order in respect of the proceedings in that forum and there is no reason for us to do differently. The appellant is entitled to its costs in this court, including those attendant on the employment of two counsel.

TRAVERSO DJP:

[91] I concur. The following order is made:

(a) The appeal is upheld with costs, including those attendant on the employment of two counsel.

(b) The order made by the tax court on 19 August 2013 is set aside and replaced with an order in the following terms:

'(i) The appellant's appeal against the additional assessment in respect of its 2004 tax year, with a due date 1 September 2010, succeeds and the said additional assessment is set aside.

(ii) The capital gains tax treatment arising from the appellant's acquisition and disposal of the plantation and land which was the subject of the additional assessment is remitted to the tax court for determination on the pleadings already filed in the tax court on the capital gains tax issues.'

ALLIE J:

[92] I concur.

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TRAVERSO DJP

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ALLIE J

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ROGERS J

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