REPUBLIC OF SOUTH AFRICA

IN THE INCOME TAX COURT OF SOUTH AFRICA

HELD IN JOHANNESBURG

CASE NO: **14189**

(1) REPORTABLE: YES / NO
(2) OF INTEREST TO OTHER JUDGES: YES/NO
(3) REVISED

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SIGNATURE **DATE**

In the matter between:

XYZ (PTY) LTD **APPELLANT**

and

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

J U D G M E N T

MALI J

INTRODUCTION

[1] The court is asked to deal with whether the receipt of R125 million by the appellant in respect of a lease premium is of a revenue nature therefore taxable or it is of a capital nature, resulting in no tax liability. Key to the determination is whether the appellant earned the amount of the lease premium as a result of the lease agreement.

[2] The determination that an amount or expenditure will generally be of a capital nature is left to the court to define the meaning of the disputed receipt. There is no single test to determine the nature of an amount. Scrutiny of case law illustrates a few different tests applied by the courts. Intention or change of it by the taxpayer is key to the resolution of the impasse. There is myriad of case law; *inter alia* Commissioner for the ***SOUTH AFRICAN REVENUE SERVICES v FOUNDERS HILL (PTY) LTD***[1] at paragraph 26 it is stated:

> "The difficulties attendant on invoking the intention of the taxpayer as the litmus test which determines whether the proceeds of an asset sold are of a capital nature or income nature are made plain too in *Malan v Kommissaris van Binnelandse Inkomste*, where EM Grosskopf J said that intentions by their nature are changeable and often not fully formulated; and evidence after the event, however honest, is not always reliable, sometimes being reconstructed. And of course in *Natal Estates*, in the passage cited, Holmes JA said clearly that one must 'think one's way through all the facts and thus not rely upon what the taxpayer claimed had been its original and continuing intention….
>
> The problem lies in the fact that they had failed to appreciate that the realisation of property to best advantage applies to the realisation of a capital asset only and the fact that a taxpayer refers to an asset as a capital asset does not make it one."

[3] The appellant is a 100% state owned company. It is mandated to develop and operate 11 500 hectares of industrial land in the XYZ Special Economic Zone (*"SEZ"*). The appellant was established in 1999 with its key role as the developer and operator of the XYZ Industrial Development Zone (*"IDZ"*) as well as an investment attractor.

[4] The respondent is the Commissioner for the South African Revenue Service (*"SARS"*), appointed in terms of section 6 of the SARS Act No. 34 of 1997 (*"SARS Act"*) by the President of the Republic of South Africa, or the Acting Commissioner designated by the Minister in terms of section 7 of the SARS Act.

FACTS

[5] On 8 June 2009, the appellant concluded an agreement with DF (Pty) Ltd ("*DF"*). The appellant leased to DF its property in the IDZ ("*the property")*. The initial lease period for the property was for 12 (twelve) years and 2 (two) renewal periods thereafter of 12 (twelve) years and 5 (five) years respectively ("*the DF Lease Agreement")*. DF was the first major client with an international footprint. The DF agreement was profitable at R13 million per annum, the first of its kind for the appellant. DF required the appellant to build it a facility to rent. The facility was expected to be ready for occupation by 1 July 2010, being the effected date of the lease agreement.

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1 [2011] (5) SA 112 (SCA).

[6] The effective date of the DF Lease Agreement was 1 July 2010. It was then registered as a long-term lease in terms of section 77 of the Deed Registries Act No. 47 of1937 on 1 December 2010.

[7] The appellant expected its executive authority and shareholder to fund the construction of the DF rental facility. A construction company known as JK Construction ("*JK*") was granted a tender to build the facility. In the second month of the building the appellant ran into financial difficulties and could not afford to pay JK. Its executive authority and shareholder did not assist the appellant with funding the construction of the DF rental facility.

[8] The failure to pay JK had attendant reputational risk and other financial constraints, i.e. the payment of R15 000 per day as a penalty. JK offered to continue construction work on condition that it would be repaid by being appointed for future projects of the appellant. JK's offer was not accepted as it did not comply with the requirements of the Public Finance Management Act No. 1 of 1999 (*"PFMA"*).

[9] The appellant leased the property to MN for a period of 50 (fifty) years subjected to DF's tenancy in terms of the DF Lease Agreement. Taking into account 'Projected Income'[2] the period of 50 (fifty) years is broken up as follows:

> "an amount of R1 023 019 increased on each anniversary of the Rental Date by 6.5% per annum for the years 1 to 12 of the Lease, 6.9% per annum for years 13 to 24 of the Lease and 6.5% per annum for years 25 top 50 of the Lease…"

[10] On 8 December 2010, the appellant concluded an agreement ("*the MN Agreement")* with MN Properties (Pty) Ltd ("*MN*") being a subsidiary of OP (Pty) Ltd. The following clauses of the MN Agreement are pertinent:

10.1 MN would pay to the appellant a monthly rental in the nominal amount of R1 (one Rand) per month until the expiry of an initial lease period of 12 (twelve) years ("*the first period*");

10.2 MN would pay to the appellant a monthly turnover equal to 10% (ten per centum) of the gross rental received in respect of the Property for a lease period of 25 (twenty five) years commencing immediately after the first period (*"the second period"*).

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[2] Page 5 paragraph 1.3.23 of the leave agreement between the Appellant and MN found on page 118 of the dossier.

10.3 The appellant ceded and assigned the DF Lease Agreement to MN (*"MN Cession and Assignment Agreement"*). In consideration for the MN Cession and Assignment Agreement;

10.3.1 MN would pay the appellant an amount of R125 million upon the Rental Date;

10.3.2 The appellant would be substituted by MN as landlord, in terms of the DF Lease Agreement;

10.3.3 DF would pay all amounts due in terms of the DF Lease Agreement to MN.

[11] On or about 11 February 2011, appellant, MN and DF concluded a deed of assignment in terms whereof, DF consented to the assignment of the appellant's rights, title and obligations in terms of the DF Lease Agreement to MN. The appellant assigned its rights, title and obligations in terms of the DF Lease Agreement to MN with effect from 1 August 2010.

[12] On or about 7 April 2011, MN and ST Limited (*"ST"*) concluded an agreement of sale of rental enterprise to ST; and agreement to pay the lease premium arising therefrom. The purchase price was R135 000 000 (R135 million) in terms of which R125 million payable by ST to MN would be payable directly to the appellant on behalf of MN. An amount of R10 000 000 (R10 million) would be paid by ST to MN.

[13] As agreed the amount of R125 million was paid to the appellant by ST. It is not in dispute that when the appellant filed its income tax return for the 2012 year of assessment, the appellant did not include the whole lease premium amount of R125 million received as a gross income. Instead the appellant amortised the premium in its tax return.

[14] On 21 October 2013 the respondent enquired about the abovementioned omission. `The appellant alleged that the premium was a customer deposit, which is a liability to the appellant. The appellant could not substantiate the above explanation. As a result on 23 September 2014 the respondent issued a finalisation of audit letter to the appellant. The respondent raised additional assessment in respect of R125 million and imposed a 10% (ten per centum) understatement penalty (*"USP"*). The appellant objected to the additional assessment. The objection was disallowed by the respondent.

[15] The argument advanced on behalf of the appellant is that the payment is of a capital nature being proceeds in respect of the disposal by the appellant of an asset (comprising of its rights, title and interests in and to the DF Lease Agreement) and therefore it does not fall within the appellant's gross income as contemplated in the general definition, alternatively.

[16] In the event the court finds that the receipt is not of a capital nature, the appellant should be entitled to the deduction in terms of section 11(*h*) of the Income Tax Act No. 58 of 1962 (*"the Act"*).

LAW

[17] Section 1 of the Act defines gross income in so far as it relates to the inclusion of premiums is as follows:

> " **'gross income'**, in relation to any year or period of assessment, means—
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature but including, without in any way limiting the scope of this definition, such amounts whether of a capital nature or not so received or accrued as are described hereunder, namely—
>
> ….
>
> (*g*) any amount received or accrued from another person, as a premium or consideration in the nature of premium—
>
> (i) for the use or occupation or the right of use or occupation of land or buildings;"

[18] Section 11(*h*) applies in instances where a premium or the value of improvements to lease property was included as gross income in the determination of a taxpayer's taxable income. Silke describes the inter-relationship between the inclusion of a premium and the allowance provided by section 11(*h*) as follows:[3]

> "The whole amount of the premium is included in the gross income in the year in which it is received or accrued. The lessor is not entitled to the benefit of a spread of the amount over a period."

[19] The essentials of a contract of lease was set out in ***KESSLER v KROGMAN***:[4]

> "the essential of a contract of lease are that there must be an ascertained thing and a fixed rental at which the lessee is to have use and enjoyment of that thing"

[20] In ***NOVARTIS SA (PTY) LTD v MAPHIL TRADING (PTY) LTD***[5] it is stated that

> "it is the role of the court not witnesses to interpret a document."

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3 Stiglingh M et al Silke: South African Income Tax (2014) Lexis Nexis, on page 53.

4 at page 3 1908 TS 290 at 297; Cooper, Landlord and Tenant 2 edition.

5 at paragraph 27 [2015] ZASCA 111, 2016(1) SA 158 (SCA).

[21] In ***DEXGROUP (PTY) LTD v TRUSTCO GROUP INTERNATION (PTY) LTD AND OTHERS***[6] the court stated:

> "In regard to the interpretation of the contract it was submitted that the arbitrator was bound by the 'well established rule that a contract must be interpreted by construing its plain words' and that it is only in cases of ambiguity or uncertainty that an arbitrator can take account of surrounding circumstances 'or its so-called factual matrix'. It is surprising to find such a submission being made in the light of the developments in the interpretation of written documents reflected in *KPMG Chartered Accountants (SA) v Securefin Ltd and Another* and *Natal Joint Municipal Pension Fund v Endumeni Municipality*. These cases make it clear that in interpreting any document the starting point is inevitably the language of the document but it falls to be construed in the light of its context, the apparent purpose to which it is directed and the material known to those responsible for its production. Context, the purpose of the provision under consideration and the background to the preparation and production of the document in question are not secondary matters introduced to resolve linguistic uncertainty but are fundamental to the process of interpretation from the outset. The approach of the arbitrator cannot be faulted in this regard."

[22] The crux of Securefin quoted above is found at page 18 paragraph 39 which reads as follows:

> "First, the integration (or parol evidence) rule remains part of our law. However, it is frequently ignored by practitioners and seldom enforced by trial courts. If a document was intended to provide a complete memorial of a jural act, extrinsic evidence may not contradict,"

[23] In ***COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE v REUNERT (PTY) LTD***[7] Cachalia JA stated as follows:

> "A proper interpretation of the relevant provisions of the clause 4 requires a consideration of their language, the context within which they appear, their purpose and the background giving rise to them. **In addition, as the clause is apparently aimed at achieving a legitimate commercial purpose, an interpretation that sensibly advances this purpose rather than one inimical to it should be chosen.**"
>
> (Added emphasis.)

ANALYSIS OF EVIDENCE

[24] Section 102(1)(*a*) and (*f*) of the Tax Administration Act No. 28 of 2011 (*"TAA")*, provides that a taxpayer bears the burden of proving that an amount, transaction, event or item is exempt or otherwise not taxable; or that a *"decision"* that is subject to objection and appeal under a tax Act is incorrect.

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6 SCA 687/12 at page 13 paragraph 16.

7 See paragraph 9 (971/2016) [2017] ZASCA 153 (22 November 2017).

[25] In the present case the appellant bears the burden of establishing that the Cession and Assignment of Lease Agreement to MN relieved the appellant the status and the rights of landlord over DF; thus resulting in the lease premium from DF not being taxed in the hands of the appellant. Notwithstanding other layers and or role players like ST and DF, the eyes of the court should be on the ball, the ball being the agreement between the appellant and MN.

[26] I turn now to examine the transaction by summarising the evidence tendered by the two witnesses of the appellant. They are Messrs D and E.

EVIDENCE OF D

[27] Mr D testified that he had been in the employ of the appellant for over 18 (eighteen) years. His role was to attract business and oversee the development of projects. He was involved in all the permutations of the transaction. He was an Account Manager at the time.

[28] He further stated that he worked with a team of different professionals in exploring many possible options for funding. The team amongst others comprised of Mr H and Mr H from the appellant's commercial department. Mr H was the leader of the team. Someone from a bank advised the appellant to cede the lease agreement. He was then contacted by the holding company of MN Property Group. MN wanted to buy the land and building. Due to the timeframes and requirements of the PFMA it was not possible to sell the land and the building to MN. The major reason was that appellant was not in the business of selling land and or assets.

[29] An unprecedented financial crisis caused the appellant to enter into a cession agreement with MN, and later MN, entered into lease agreement with DF. MN on sold the lease agreement to ST. The appellant invoiced ST for the payment of R125 million.

[30] Mr D described the cession and lease transactions as a disposal of rights in the DF Lease Agreement. The lease amount was calculated to be close to the amount of R140 million owed to JK. The term or concept lease premium did not mean lease per se as almost all involved in the appellant's organisation used the term lease premium loosely. It was never meant to be a lease as in a rental lease but rather a sale of rights.

[31] The Commercial Manager who drafted the contract also used the term lease premium. The submissions to the Board of Directors of the appellant (*"Board")* for approval were made by the members of the Commercial Unit. The Commercial unit at the time was headed by Mr Zeiss a very experienced commercial lawyer who was responsible for the finalisation of the contracts, working with the law firm XXX Attorneys.

[32] Furthermore, the Board of the appellant approved the transaction along the lines of a lease premium. Despite this testimony Mr D was adamant that the payment thereof did not mean upfront rental. The co-author to the Board submissions is Mr I, a financial analyst who obtained tax law advice from an audit firm allegedly on transactions similar to the one in issue. The crux of the advice sought is based on the following statement by Mr I:

> "some investors have indicated that they may be prepared to enter into a lease agreement for property in the XYZ IDZ should they be able to make a once-off payment in lieu of rent over the period of the lease."

[33] Under cross-examination D agreed that from the day the appellant concluded the MN agreement he knew that MN was not going to occupy the building, instead DF would. On the face of this there is nothing untoward if the main lessee does not occupy a rented space, in the event that the contract provides for a sub-lease clause. This practice is in compliance with common law lease as the lessee is entitled to sub-lease the *merx*. The only problem is that the court is persuaded to believe that the transaction was the sale of rights.

[34] Further under cross-examination D conceded that the tax opinion from the audit firm was addressed to Mr I; thereafter Mr I prepared a submission for the Board. Nevertheless he persisted that the tax advice was not meant for the transaction under scrutiny; although he could not link it to any specific matter. When he was directly asked by the respondent's counsel:

> "What did CDC sell to MN? After failing to render a direct answer after some time he said: "We were 'cessioning' the lease."

On the payment to be made by ST he stated,

> "Yes we wanted to have some control of type of tenants we required."

[35] Under cross-examination when he was asked to comment on why the portion of payment was amortised in the tax return , he said:

> "I am not aware of the middle stages."

He further testified that variations were not in writing as was agreed in the MN contract and conceded that if there was anything to be changed it could have been in writing. The invoice issued to ST by the appellant reflected a lease premium. He sought to explain this away by the proverbial talk; that the left hand did not know what the right hand was doing. His exact testimony was

> "there was a curtain between the projects and finance departments."

[36] Mr D's evidence is not in accord with the implementation of the agreement. It became clear that he did not know everything about the transaction despite presenting himself as the champion of the deal. He did not even name the person from Standard Bank who suggested the cession and he neither gave the dates when the appellant was contacted by Gateway. At his level and being in charge of a lucrative and a unique deal it is reasonable to expect that he could have kept a record of events.

[37] For someone who expects to persuade the court that he was involved in every step of the way, the lack of crucial details is momentous. When he was re-examined by the appellant's counsel, he stated that he was not part of all MN and the appellant's meetings; but he is aware of MN and DF meetings.

[38] As alluded above he worked with others, including Mr I who was not called by the appellant. He stated that Mr Zeiss passed away; there was no reason advanced as to why Mr I was not called to testify. This is important because the appellant managed to call Mr Billings the second witness who was not working for the appellant at the time. His suggestion that two separate transactions were concluded further does not accord with his testimony that appellant wanted the ultimate agreement with MN to be as close as possible to what they were familiar with; that is to say, the leasing of property in return for rental income. A lot was said about the due diligence conducted by the appellant on MN. If the appellant intended to sell an asset in the form of rights, it would have applied the same due diligence and would have entered into a proper sale agreement with MN. In fact D stated:

> "we could outright sell, we would have done that".

[39] The evidence of Mr D is not admissible because it contradicts what was intended as the complete memorial of a jural act in the form of an agreement between the appellant and MN.

EVIDENCE OF E

[40] Mr E was not in the employ of the appellant at the time of the agreement under review. He tried his best to analyse and formulate his opinion on the transaction. He was not called as an expert witness. His opinion was not welcomed. His evidence is not admissible.

ARGUMENTS

[41] The argument of substance over form as submitted on behalf of the appellant does not appreciate that MN should have assented to the contract as a contract of sale of rights. The appellant did not lead evidence that it once changed its intention; from being a landlord to a seller of assets. Even if the said evidence was led, the courts have long battled with the interposition of entities in order to achieve undue tax benefits. See ***ERF 3183/1 LADYSMITH (PTY) LTD AND ANOTHER v CIR***[8] In this case the interposition of MN as a cessionary and the on selling to ST is a case in point.

[42] In an enquiry as to whether the receipt is of a capital or revenue nature, the starting point is the intention of formation of the taxpayer. In the present case the appellant was formed to attract investment by utilising the land of the appellant through rentals. It is not in dispute that the appellant never and was never mandated to sell assets.

[43] The warning sounded in **Malan** above as to the difficulties on invoking the intention of the taxpayer is also found in the present case. The intention can be honest as ever, however evidence after the fact requires a high standard of scrutiny because it is prone to reconstruction.

[44] The submissions to the Executive Management ("EXMA") and the Board of the appellant referred to the offer of MN being one that constitutes an upfront payment of rental income. Furthermore, the evidence that the amount of the lease premium is as close as possible to the amount of the DF Lease Agreement demonstrates the close ties with the DF Lease Agreement. The argument that that there is no correlation between the monthly rental for 12 (twelve) years and the R125 million lump sum payment cannot be accepted.

[45] The evidence suggests how the amount was arrived at. The full rental received for the 12 (twelve) years was discounted to its present value to benefit the appellant. The sum of R125 million in 12 (twelve) years' time would have lost the value it has currently and this is where the benefit arises for the appellant. There is no dispute that the appellant was also advised to buy back the lease from MN in year 13 (thirteen) when its financial position had improved. The argument is contradictory when it refers to the cession of the rights. It should have referred to the disposal of an asset and not what the appellant referred to as a discounted rental as shown throughout the appellant's documents to be a lease premium.

[46] Furthermore, there is also the issue of the tax advice with curious timing. Of prominence is the fact that the cession agreement followed shortly after the tax advice. The timing of the tax advice despite the appellant's delinking it from the impugned agreement find expression. Again on the issue of tax; in the event the appellant was

[8] 1996 (3) SA 942 at page 8.

confident and certain that it was not supposed to pay tax from the receipt of R125 million it could not have amortised the receipt in the tax returns. Appellant was expected to offer an appropriate explanation and not refer to a customer deposit. Be that as it may the omission in the tax return is attributed to one Ms O who is no longer working for the appellant. There was no reason advanced as to why she was not called to testify.

[47] The well-articulated control of ST by the appellant is suggestive. D's testimony under cross-examination about ST's involvement is that the appellant wanted to have some control over the type of tenants it required. It is probable to assume that ST was considered to be a sub-tenant; hence the control. This evidence strengthens that there was a correlation between the landlord being the appellant and subtenants through MN signifying a rental transaction. It does not auger that the party that has totally ceded the rights would still be interested in controlling the tenants of the cessionary.

[48] The evidence on behalf of the appellant is that the sale of a major part of the asset is regulated by the PFMA and the Companies Act No. 71 of 2008. The appellant did not adduce any evidence of compliance with these regulations. It was repeatedly submitted on behalf of the appellant that the above compliance referred to above had little or no bearing in the matter.

[49] If it is accepted that all the members of the appellant used the term lease agreement loosely, as per D's testimony, it is however baffling that an experienced commercial lawyer (I) and XXX Attorneys did not see anything wrong in drafting contracts in that fashion. This makes it clear that all other role players knew that they were really dealing with a rental and not the sale of any asset. I am inclined to believe that, this is the reason Mr I or attorney/s involved from XXX Attorneys were not called to give evidence. It looks like the witnesses are carefully hand-picked. The other parties except for D knew precisely they were dealing with a pure lease agreement and not a sale of asset.

[50] On behalf of the appellant the court was further referred to amongst others ***TURNBULL v CIR 18***[9]. The case of Turnbull is distinguishable in that it was applied within the spirit of Income Tax Act No. 31 of 1941 (*"the 1941 Act"*). The 1941 Act excluded receipts of a capital nature in its definition of gross income. The current law as shown above includes receipts of a capital nature in-so-far as the special inclusions are concerned. The nature of a premium for the use or occupation or the right of use or occupation of land or building is specifically included in the definition of gross income. The appellant's action was not aimed at achieving a legitimate commercial purpose.

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9 SATC 336.

[51] The consistency in the accounting treatment supports the respondent's argument. The Audited Annual Financial Statements (*"AFS"*) for the 2012 and 2013 financial reporting period do not show the accounting policy of how such a sale of the assets will be treated by the appellant. The Investment Property Asset note did not show any evidence of such asset being sold. The cash flow and income statements did not show such evidence of proceeds from sale of assets.

[52] The appellant did not produce evidence that the AFS was later corrected to indicate such intention in subsequent years. IAS 40 clearly defines Investment Property of which one key element is land or building held to earn rentals or for capital appreciation. Mr E's evidence stating that at the time the appellant did not have a policy for the sale of rights transactions is hearsay as alluded above. In fact even if his evidence was admissible; accepted accounting standards provide for the reporting of the sale of intangible assets.

[53] From the above it is ostensible that; the intention of the appellant was always to enter into a rental agreement, fully knowing that the receipt flowing therefrom is of a revenue nature. The lease agreement with DF was the only lucrative deal at the time. From D the court heard of the excitement and hype of closing a large deal with an international client. The appellant guarded the deal jealously. That sort of wariness extended to the protection of every cent flowing from the deal; as the appellant was expected to be self-sustaining. The appellant worked around the clock; and in the process crossed the line in an attempt to attain an undue tax benefit.

[54] From the above it is apparent that the agreement between the appellant and MN was intended to provide the true intention of the parties. Evidence adduced is to the contrary. The cession and/or sale of bundle of rights is not viewed as purported by the appellant to be a sale of assets. It was intended for the appellant to earn a lease premium. The court finds that the receipt of R125 million by the appellant is of a revenue nature and therefore taxable in the hands of the appellant.

[55] Regarding the alternative pleaded by the appellant, Section 11(*h*) applies in instances where a premium or the value of improvements to the lease property was included as gross income. It is common cause that the R125 million was not included in the gross income. The only amount included was far less than R125 million in the formation of amortisation as alluded in paragraph 14 above. From the evidence, it is apparent that the appellant was not truthful about the receipt.

UNDERSTATEMENT PENALTY

[56] The respondent initially imposed the USP at the rate of 25% (twenty five per centum) in terms of section 223 of the TAA. However, the Commissioner believed it to be fair and equitable to reduce the USP of 25% (twenty five per centum) to 10% (ten per centum) in view of the fact that the former would have caused the appellant significant hardship. I find the imposition of penalty by the respondent to be in order.

SECTION 89*QUAT* INTEREST

[57] From the above discussions it has been concluded that the appellant did not include the receipt of the lease premium as gross income. The appellant has not advanced any reasonable grounds for the remission of interest in terms of section 89*quat*(3) of the Act. It follows that the omission by the appellant to return and or pay the receipt on time has led to the Commissioner suffering financial loss; therefore liable for interest.

[58] In the result the following order is granted:

58.1 The appeal is dismissed.

58.2 The Commissioner's assessment of 2012 year of assessment dated 23 September 2014 is confirmed.

58.3 The imposition of 10% (ten per centum) USP and interest is confirmed.

58.4 There is no order as to costs.

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N.P. MALI

JUDGE OF THE HIGH COURT

Date of Hearing: 8 – 12 October 2018

Date of Judgment: 20 December 2018