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VENTURE AND TRADE CONDUCTED BY NATURAL PERSONS FOR INCOME TAX PURPOSES

Mini dissertation by

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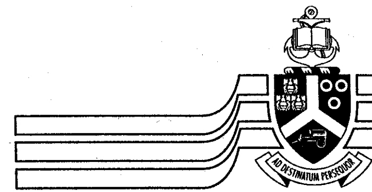

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ABSTRACT

VENTURE AND TRADE CONDUCTED BY NATURAL PERSONS FOR INCOME TAX PURPOSES

by

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STUDY LEADER	:	ADV. R.D. DE SWARDT
DEPARTMENT	:	TAXATION
DEGREE	:	MAGISTER COMMERCII (TAXATION)

In order to deduct the start-up costs associated with a new business from the entrepreneur's income for South African income tax purposes, the entrepreneur has to prove that he/she is in fact carrying on a trade, as defined.

Taken from the definition of the term 'trade' the term 'venture' is not specifically defined in the Income Tax Act. At present there is no concrete guidance from SARS or the legislature assisting an entrepreneur in deciding whether his venture cost incurred falls in the ambit of the definition of a trade, assuming that all other requirements are met for a deduction from the natural person's income.

The objective of this study is to design a set of tests based on current legislation and relevant case law, aimed at assisting a natural person in determining whether venture costs will qualify as a trade, as defined. The tests will firstly assist in determining whether the entrepreneur is carrying on a trade as defined, and secondly whether venture costs incurred is of a revenue nature.

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OPSOMMING

ONDERNEMINGS EN BEDRYWE WAT DEUR NATUURLIKE PERSONE VIR INKOMSTEBELASTINGDOELEINDES AANGEGAAN WORD

deur

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Voordat ‘n entrepeneur sy aanvangskostes wat met sy nuwe besigheid verband hou as aftrekking van sy inkomste, vir Suid-Afrikaanse inkomstebelastingdoeleindes kan eis, moet hy kan bewys dat hy ‘n bedryf beoefen het, soos gedefinieer.

Ingesluit in die definisie van ‘n bedryf is die term, onderneming (‘venture’), alhoewel die term nie spesifiek gedefinieer word in die Inkomstebelastingwet nie. Tans is daar geen formele riglyn vanaf SARS of die wetgewer om ‘n entrepeneur leiding te verskaf om te bepaal of sy ondernemingsonkostes binne die vereistes van die defenisie van ‘n bedryf val nie, as aanvaar word dat daar aan alle ander voorgeskrewe vereistes vir die aftrekbaarheid van sodanige onkostes van die natuurlike persoon se inkomste voldoen word.

Die doelwit van die studie is om ‘n stel toetse daar te stel, wat gebaseer is op huidige wetgewing en relevante hof uitsprake, wat gefokus is om natuurlike persone by te staan om te bepaal word of hulle ondernemingsonkostes binne die definisie val om as ‘n bedryf, soos gedefinieer te kwalifiseer. Die toetse sal eerstens help bepaal of die natuurlike persoon ‘n bedryf beoefen en tweedens, of die ondernemingsonkostes van ‘n inkomste aard is.

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Chapter 1
BACKGROUND AND PROBLEM STATEMENT

1.1 Background

The opening statement of the Deputy Minister of Trade and industry in the South African Government's Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises states that: "*[t]he crucial barometer for the success of the Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises is the continued creation of new start-up firms by all segments of society and in all corners of our country resulting in the improvement of economic and social well being of the poor communities.*" (http://www.thedti.gov.za/smme/strategy.pdf).

In order to deduct the start-up costs associated with a new business from the entrepreneur's income for South African income tax purposes, the entrepreneur has to prove that he/she is in fact carrying on a trade, as defined. If the entrepreneur is carrying on a trade, he/she has to determine whether the relevant expenses were incurred for the purpose of his/her trade as stated by section 23(g) of Income Tax Act No.58 of 1962 (reference to sections refers to sections of the Income Tax Act No.58 of 1962, unless specified otherwise). The entrepreneur then has to determine whether the relevant expenses are of a revenue or capital nature. If of a revenue nature, the expense may qualify for a deduction in terms of section 11(a). If of a capital nature, the expense may qualify for a capital allowance (sections 11 – 19).

The taxpayer, in this case the entrepreneur, bears the *onus* of prove to show that he/she complies with the above criteria (section 82).

The term 'trade' is defined in section 1 which states that a trade: *"…. includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, No. 57 of 1978, or any design as defined in the Designs Act, No.*

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195 of 1993, or any trade mark as defined in the Trade Marks Act, No. 194 of 1993, or any copyright as defined in the Copyright Act, No. 98 of 1978, or any other property which is of a similar nature".

Taken from the definition of the term 'trade' the term 'venture' is not specifically defined in the Income Tax Act, however a short definition of the term 'venture' can be found in **ITC 368**, (1936) 9 SATC 211:212, where the court stated that: "*… the term 'venture' must have a certain limitation. Prof. H.C. Wyld, in his Universal Dictionary, defines 'venture' as 'a financial or commercial speculation,' and, in the trade sense, that is the meaning which is ordinarily given to the word*". Therefore a transaction in which a person risks something with the object of making a profit qualifies as a type of financial or commercial speculation.

At present there is no document or other guidance available from South African Revenue Services ('SARS') to assist an entrepreneur in determining whether the venture costs incurred qualifies for a deduction from the entrepreneur's income. Examples of venture costs would include, but is not limited to, the purchase of materials, renovation of a proposed business site, consultation costs, and marketing costs. In essence the entrepreneur has to consider a range of court cases that has interpreted the provisions of section 11(a) read together with section 23(g) in deciding whether his/her venture costs are deductible.

If the entrepreneur conducts his/her venture activities through an entity, such as a company as oppose to in his/her own name, the entrepreneur is at an advantage when it comes to his/her *onus* of prove. When a company has to prove that it is in fact carrying on a trade, the company is assisted by an objective statement of its purpose in the form of its object statement in its memorandum of association (**ITC 1302,** (1979) 42 SATC 86(C), **Reliance Land & Investment Co (Pty) Ltd v CIR,** (1946) 14 SATC 47:48; De Koker (2005:859).

A natural person has to comply with the same criteria as a corporate entity in order to claim its venture costs as a deduction from his income (section 11(a) read together with section 23(g)). However, a natural person (compared to a corporate entity) cannot rely on an

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objective statement of his purpose in substantiating his compliance with the above criteria. Consequently, a natural person might be incurring venture costs without the certainty as to whether the costs will be allowed as a deduction from his/her income through not meeting the criteria of a trade. In addition certain limitations apply exclusively to natural persons through ring-fencing certain defined trades known as 'suspect trades' as stipulated in section 20A.

However section 11A allows the deduction of so-called start-up costs or pre-trade expenditure not otherwise allowable under sections 11(a), (bA) or (bB). This section permits the deduction of expenditure incurred before the commencement of trade if it would have been allowed had it been incurred after trading had commenced. This implies that these costs are therefore deductible in the year in which trading commences, if the costs have been incurred in years prior to the commencement of trade. For this study it is therefore important for the natural person to determine when he/she commenced their trade, by determining in which year their qualifying venture costs would be allowed as a deduction.

There is no definition of the term 'start-up costs' used in s11A in the Income Tax Act, however the 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003' refers to costs such as advertising and marketing promotion, insurance, accounting and legal fees, rent, telephone, licences and permits, market research and feasibility studies. These costs must be allowed as a deduction under section 11.

The Revenue Laws Amendment Bill, 2008, as part of the amendments to the Sixth Schedule, introduced a presumptive turnover tax for South African tax years beginning on or after 1 March 2009. This initiative is available for natural persons as well as for companies which have been registered as micro businesses. Although this taxation would be determined on turnover as defined in the Sixth Schedule of the Revenue Laws Amendment Bill, 2008, before any income tax deductions are deducted the taxpayer still needs to have received the receipts from carrying on business activities to qualify as turnover. The term business forms part of the definition of a trade. There appears to be no

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additional guidance provided in determining whether a natural person has conducted a trade as defined.

Specific studies have been conducted on the barriers that taxation presents to start-up businesses which might de-motivate informative natural persons when considering entering a venture. In the United Kingdom, informative articles have been written offering guidance on, and insight into new tax legislation in South Africa for start-up firms by Lee (2008) and Gauche (2006).

Lee (2008), states that the South African Government has proposed new tax incentives for investors in small companies and start-ups, in an attempt to encourage the country's private equity industry to back early stage projects. He further states that in general, the only targeted enterprises are high growth, high-tech companies and junior mining and exploration companies. This is therefore not aimed at natural persons pursuing a venture for the first time.

Gauche (2006), states that in South Africa the Department of Trade and Industry (DTI), and the Industrial Development Corporation (IDC), oversee the incentives schemes in the form of non-tax grants. The small and medium business assistance program is aimed only at employment creation, investment promotion for tourism, manufacturing, information technology, agricultural developments and sustainable business projects. Compensation for a maximum of 10% of the original investment cost is provided to these businesses. However these incentive schemes are limited to the above mentioned industries and do not address the need for general guidance on all types of start up firms.

In the United States of America intensive research has been done on the impact that changes to current tax legislation and additional tax regimes has on start-up firms (including therefore ventures). Broadway (2003:2-17), an American researcher conducted research on the various forms of market failure that could arise when innovating entrepreneurs consider entering a specific industry, and outlined some of the possible implications for public policy. According to this study, one of the various non-financial barriers that arise relates to government policies, especially business tax policies. He

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states that the structures of many business tax systems discriminate against start-up firms - the main reason being the absence of loss offsetting or refund ability provisions. He also supports the view that start-up ventures typically show losses in the initial period and that, if they cannot fully refund these losses, this leads to increased costs and eventually puts them at a disadvantage. In South Africa the incentives available under the DTI is limited to a limited number of industries such as tourism as mentioned above by Gauche.

In Broadway's (2003:14) study he refers to McGee (1998: 653 – 673) who developed a model to show that a reduction in capital gains taxation tends to increase investments proportionately in established firms rather than in new firms – and can even lower investments in new firms for some parameter values – because it deepens what is sometimes referred to as "the Equity Trap". That is, new equity issues incur liability for dividend taxation, whereas investments financed out of retained earnings is effectively sheltered from dividend taxation liabilities that are already incurred (Auerbach, 1983:905-940). This problem is mitigated to the extent that capital gains are effectively taxed at a similar rate to dividends. Consequently, a capital gains tax cut is not particularly effective at targeting investment incentives for natural persons of their start-up firms even though taxation on dividends in the form of secondary taxation on corporations have been discontinued in South Africa and does not apply to natural persons.

Broadway (2003:14) also noted that Gordon (1998:49-80) argues the combined personal-corporate tax system can actually favour start-up entrepreneurs. If the tax rate on personal income is higher than the tax rate on corporate income, there have to be incentives to reclassify earnings as corporate rather than personal. However in South Africa the creation of a legal entity leads to additional expenses such as incorporation costs, potential audit fees and annual subscription fees.

Furthermore, Broadway (2003:15) also noted that Fan and White (2002:1) found, that particular provisions in the bankruptcy system could also have an impact on natural persons' decisions to become entrepreneurs. Since the debts of non-corporate firms are liabilities of the owners, unsuccessful entrepreneurs have strong incentives to file for personal bankruptcy, in which case all assets relating to the start-up firm that are in excess

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of a certain exemption level are lost. Therefore the higher the exemption level the more likely it is for non-corporate start-ups to form.

Broadway (2003:15) then also referred to Vigneault (1996:479-494) and Wen (1997:129-148) who recognised that literature on the political economy of capital taxation had brought to light a further problem that might have a bearing on new firms, the so-called capital levy (or hold-up) problem. Due to an inability to commit to future tax rates, governments find it difficult to avoid setting taxes on capital excessively high in an effort to tax capital already invested. In South Africa tax rates are also determined year on year. Since it is difficult to discriminate in favour of new capital, new investment is affected as well. This however has more bearing on start-up firms which are more capital-incentive driven, even though this can be mitigated by up-front investment incentives. In South Africa the Department of Trade and Industry has correctly identified and addressed this issue as noted above in the article by Gauche (2006) through tax grants. However, Marceau and Smart (2002:forth coming) argue, political lobbying might also mitigate the capital levy problem. They propose a common agency model in which firms first announce their investment plans and then lobby politicians to receive preferential tax treatment. In South Africa the arrangement with a political party by an individual to receive preferential tax rates would not be feasible.

Broadway even went further and indicates that the effects of taxation on entrepreneurial activity are mixed. Cullen and Gordon (2002:mimeo), empirically found that reductions in personal income tax rates lowers entrepreneurial activity, given that firms have the option to incorporate, lower personal tax rates discourage risk taking and entrepreneurship by decreasing tax deductions in the case of losses. In contrast, Rosen (2002:mimeo), empirically reports higher personal tax rates induces entrepreneurs to expand their businesses more slowly, lower capital investment and reduce the probability that workers are hired. Gentry and Hubbard (2001:mimeo), show empirically that the level of marginal tax rates has no effect on self-employment but that progressive marginal tax rates lower entry into self-employment and business ownership.

From the above discussion it is noted that current new legislation incorporated in the South African taxation laws that are aimed at stimulating start-up business are limited to specific

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industries. Also that incentive schemes exist in the form of non-tax grants, but are also only focused on specific industries. Numerous structures of business taxation systems exists that have a discriminating effect on start-up firms and the main reason for this appears to be the absence of loss offsetting or refund ability provisions.

As stated by Broadway (2003:13), there are natural persons who use after tax money (e.g. where employment remuneration are their only source of income) to pursue a venture. When the expenses are incurred in the pursuit of this venture and these costs are not deductible for income tax purposes, a double burden is placed on the natural person because, after tax money where used in an effort to create more income and subsequently no credit is received for the effort.

1.2 Problem statement

At present there is no concrete guidance from SARS or the legislature assisting an entrepreneur in deciding whether his venture cost incurred falls in the ambit of the definition of a trade, assuming that all other requirements are met for a deduction from the natural person's income. The taxpayer has to refer to guidance in case law that has interpreted the provisions of section 11(a) and 23(g) of the Income Tax Act.

This, together with the fact that a natural person does not have the benefit of relying on an objective statement in support of his purpose, may result in uncertainties regarding whether venture costs incurred by a natural person will qualify for an income tax deduction. This uncertainty may create a disincentive for a natural person engaging in venture activities.

1.3 Objective of the study

The objective of this study is to design a set of tests aimed at assisting a natural person in determining whether venture costs incurred by a natural person will qualify as a trade, as defined. The tests will firstly assist in determining whether the entrepreneur is carrying on a trade as defined, and secondly whether venture costs incurred is of a revenue nature.

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The guiding objectives for purposes of this study are:

- to extract meaningful guidance regarding a venture, by implication this would include a trade, from sections of the Income Tax Act by SARS;
- to refer to current case law available in defining a venture;
- to lay down a set of tests to solve the problem statement, without giving room for loopholes that could cause the set of tests to be proven void through basing these tests on current legislation and relevant case law; and
- to perform a validation test through the use of a case study applying the tests proposed by this case study.

1.4 Research methodology

A qualitative design, guided by available theoretical frameworks available, has been used in this study. The theoretical frameworks used are based on the current case law principals of the general deduction formula as determined by section 11(a) read together with section 23(g) and the gross income definition in section 1 of the Income Tax Act.

Technological developments available such as available software packages on taxation and the world-wide-web were utilised through their separate such functions broadening the scope and the depth of this study.

A search of published cases and literature were done through available search functions of relevant software packages such as Butterworth's, search engines available on the world-wide-web as well as the SARS website using the term 'venture' and then refining the search for 'ventures for South African income tax purposes'. The results have then been sorted through reading them to determine whether one of the main considerations contained in each case was, to determine whether a venture has been pursued for South African income tax purposes and/or whether any authority has been quoted to define the term 'venture' for South African income tax purposes.

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As can be seen from the background discussion in chapter 1.1 above, there are limited numbers of studies which quotes authority and mostly relates to the developed countries such as the United Kingdom (UK) which had specific articles on initiatives by the DTI in South African and the United States of America (USA) had studies done on possible taxation systems available and their impact on ventures through the discussion of start-up firms. Although the legislation contained in the South African taxation systems have differences from that of the UK and USA, the taxation systems have structural similarities. Take for example, the UK, USA and South African have separate tax rates for natural persons and corporations have capital gains tax and though secondary taxation on dividends is to be discontinued, on a date yet to be announced in South Africa. it is currently still applicable in the South African income tax legislation.

Only the relevant results which have a direct relation and which would add value to this study have been discussed and made applicable to the objectives stated in chapter 1.3 above. Conclusions will then be reached and tested through an example to illustrate and validate the findings of this study.

1.5 Beneficiaries

The person that would benefit most from the set of tests that are designed as part of this study is a natural person who wants to engage in entrepreneurial activities. By applying the tests the natural person should be able to determine whether he/she is carrying on a trade for income tax purposes. This would assist the natural person in deciding whether venture costs incurred may qualify for a deduction from his/her income for South African income tax purposes.

1.6 Limitations to the study

The set of tests are not aimed at determining whether full compliance of all the requirements set in s11 and s23(g) have been met in order to qualify for a deduction for

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income tax purposes, have been met, but only whether the requirements have been met to qualify as a venture and trade.

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Chapter 2

LEGISLATION RELATING TO "TRADE" AND "VENTURE"

2.1 Introduction

In this chapter the terms 'trade' and 'venture' have been explored by referring to current legislation and literature. Numerous sections in the Income Tax Act contain the term 'trade'. The term 'trade' is specifically defined in the Income Tax Act but does not contain a definition for the term 'venture'. Various other relevant sections aid in explaining the context in which these terms should be understood.

It should be determined which sections of the Income Tax Act are applicable for purposes of this study to reach an appropriate conclusion.

The sections of the Income Tax Act, stated below have relevance in defining a 'trade' and 'venture':

2.2 General deduction formula

Section 11(a) provides for the deduction of: '*expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature*'. Section 23(g) provides that: '[*n]o deductions shall in any case be made in respect of the following matters, namely-- . . . '(g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade*'. The above sections refers to the term trade and in the opening words of section 11 it also stipulate that: '[f]*or the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived . . . .*'

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From the above paragraph it is apparent that for costs to be taken into consideration as a possible deduction for income tax purposes, the natural person must have conducted a trade as defined.

Section 23(g) changed for years of assessment starting on or after 1 January 1993. Previously, expenses had to be wholly or exclusively for the purposes of trade, which is much more limiting than the current version which stipulates the expenditure would be allowed as a deduction to the extent to which such moneys were not laid out or expended wholly or exclusively for the purposes of trade.

The term trade is given a very wide meaning in section 1. It includes: *'every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act [57 of 1978], or any design as defined in the Designs Act [195 of 1993], or any trade mark as defined in the Trade Marks Act [194 of 1993], or any copyright as defined in the Copyright Act [98 of 1978], or any other property which is of a similar nature'.*

Whether a taxpayer is or is not carrying on a trade have been determined to be a question of law to be decided on the facts of each case (**CIR v Stott**, (1928) AD 252, 3 SATC 253:258). Furthermore, unless the context indicates otherwise, any meaning ascribed to a word or expression in this study must bear the meaning so ascribed by current legislation and its interpretations relating to the Income Tax Act. Section 1 does not define the term 'venture'.

This study focuses on the word venture in the above definition of a trade. Further investigation is done to determine whether tests could be developed to use as guidance when determining whether costs incurred, which some times leads to losses, by a natural person in pursuit of a venture could be deducted in referring to the case law created by the interpretation of the above wording of the sections (case law is explored in chapter 3).

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2.3 Expenditure incurred prior to commencement of trade

In preventing the artificial disguise of costs as business expenses, section 11A limits expenses incurred as follow; expenditure incurred prior to the commencement of trade may only be set off against income from that trade and may only be claimed as a deduction in the year of assessment the trade commenced.

The 'expenditure and losses' contemplated in section 11A(1) which exceeds the income derived during the year of assessment from carrying on that trade (after the deduction of any amounts allowable in that year of assessment in terms of any other provision of the Income Tax Act), may not be set off against any income of the person concerned, which is derived otherwise than from carrying on that trade. Notwithstanding section 20(1)(b), which allows a taxpayer to set off an assessed loss incurred in one trade against income derived in another. Effectively, therefore, these 'expenditure and losses' can neither create nor increase a trade loss.

If the natural person had incurred expenditure prior to commencement of trade and wants to adhere to the requirements of the above section 11A, he or she must prove that a venture had commenced and that the income thereof is separately identifiable, therefore qualifying as a trade. The deduction will then be allowed for the expenditure prior to commencement of trade, but limited to the income derived from that specific trade in the year of assessment the trade commenced. This would imply that the venture should be separately identifiable.

2.4 Assessed losses

Natural persons pursuing a venture might not realise a taxable profit in their first year of trade. It is therefore necessary to consider the tax implications thereof and whether or not the loss incurred would qualify as an assessed loss for income tax purposes.

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Section 20 defines 'assessed losses' as *'…any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible*'. A taxpayer other than a company would *'…not be prevented from carrying forward a balance of assessed loss merely by reason of the fact that he has not derived any income during any year of assessment.'* There is also an interpretation note (Interpretation Note 33) written regarding assessed losses which is discussed on its own later in this chapter.

SARS has identified certain suspicious trades for which the expenditure incurred in relation thereof will be ring-fenced. For natural persons falling in the ambit of section 20A, assessed losses stemming from an activity that fails to qualify as a trade (which would include a venture) after application of the general 'facts and circumstances' test set out in section 20A would only be allowed the setting-off of losses from a 'suspect trade' against other income from that trade. Useful guidance has been provided in the provisions of section 20A in determining whether a trade is being conducted in attempting in determining the intention of the taxpayer in the following six objective factors:

- Firstly the proportion of the gross income derived from that trade in the year of assessment in relation to the amount of the allowable deductions incurred in carrying on that trade during that year of assessment. According to the 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003', this factor focuses on the proportion of gross income that the taxpayer derives from the activity in relation to the deductions arising.

- Secondly section 20A states that the level of activities carried on or the amount of expenses incurred on advertising, promoting or selling in carrying on the trade (section 20A(3)(b)). The 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003' points out that, typically, trading requires regular selling and marketing initiatives in terms of time and expense.

- Thirdly, it needs to be determined whether the trade is carried on in a commercial manner (section 20A(3)(c)). According to the 'Explanatory Memorandum on the

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Revenue Laws Amendment Bill, 2003', a hallmark of a trade, it states, is the business-like system or method pursuant to which the activities are carried out.

- As a fourth requirement, the number of years of assessment during which assessed losses have been incurred by the person concerned in carrying on the relevant trade in relation to the total period of carrying on that trade (section 20A(3)(d)). The 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003' explains that consideration must also be given to unexpected or unforeseen events that may give rise to losses, such as heavy rains or droughts that would provide grounds for mitigating sustained losses for farmers and the nature of the activity, for instance, whether the activity typically has a long start-up period, such as olive farming.

- As a fifth requirement, the taxpayer needs to indicate that his/her business plans together with changes thereto that the future income is derived from carrying on the trade (section 20A(3)(e)). According to the 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003', favourable consideration will be given to the business plans and steps put in place by the taxpayer concerned to prevent or limit further losses. Consideration will also be given as to whether the taxpayer intervened strategically to ensure that the activity will ultimately be profitable (section 20A(3)(e)).

- The sixth requirement limits the extent to which any asset attributable to the trade is used, or is available for use, by the person concerned or any relative for recreational purposes or personal consumption (section 20A(3)(f)). The extent of private use of assets should therefore be taken into consideration. The 'Explanatory Memorandum on the Revenue Laws Amendment Bill, 2003:60' points out that this factor goes to the heart of the matter, but is often the most difficult to prove or disprove. The *onus* rests upon the taxpayer to prove that the asset was generally unavailable or not actually used by the taxpayer or his relatives for recreational use or personal enjoyment.

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Further to the discussion on assessed losses in Interpretation Note 33, Assessed Losses: Companies: The trade and income requirement, 4 July 2005, referring to the Income Tax Act, it was noted that: "*[t]here is, however, . . . a vast difference between the mere laying of plans for the . . . future, on the one hand, and the commencement of preparatory activities for a future venture, on the other . . .*.", and therefore the natural person should have at least actively pursued the venture.

It should be noted that section 20B stipulates that any deduction allowable during any year of assessment in terms of section 11(o) in respect to the disposal by a person during that year of any asset (the full consideration of which will not accrue to that person during that year), must be limited in relation to the consideration attributable thereto in that year.

Therefore, if the venture includes or consists of the sale of an asset included in the ambit of section 20B, the allowable deduction would be limited to the consideration determinable for the relevant period. By implication a venture can therefore still exist if consideration is partially received.

2.5 Restricting sections

Section 23 sets out numerous restrictions including costs which are deemed personal expenses not directly attributable to conducting a trade for example, cost incurred in the maintenance of any taxpayer, his family or establishment as well as domestic or private expenses.

The natural person must therefore be able to distinguish between his private and venture costs and be able to prove that the costs incurred directly relates to his venture and would otherwise not have been incurred were it not for the venture pursued, otherwise he may not be deemed to have conducted a venture.

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2.6 Conclusion

The relevant legislation to take in to consideration in determining whether a natural person has conducted a venture which is included in the definition of a trade can be summarised by taking the following into consideration.

In applying the general deduction formula as stated in chapter 2.2 above it was noted in **CIR v Stott**, (1928) AD 252, 3 SATC 253:258, where the court stated that it is a question of law to be decided on fact whether or not a trade is conducted. Therefore by combining similarities in the facts of relevant case law, tests can be developed based on these similarities to aid in determining whether a trade (including a venture) has been conducted. The relevant case law is considered in chapter 3 below.

It has also been noted in chapter 2.3 above that once the natural person has succeeded in proving that he/she has conducted a trade the costs incurred prior to the commencement of the trade would also qualify as a deduction, although it is limited to the relating income.

Sections relating to assessed losses (as discussed in chapter 2.4) provides relevant guidance as to whether or not a trade is conducted as explained in the Explanatory Memorandum on the Revenue Laws Amendment Bill (2003:60). This guidance could therefore be used in determining whether a natural person has been pursuing a venture as it is provided by the legislator.

The restricting sections (as discussed in chapter 2.5) have numerous types of costs which would naturally not be deemed to have been incurred in the pursued of a venture and these costs should be considered as they would therefore not aid in determining whether a natural person pursued a venture.

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Chapter 3
CASE LAW RELATING TO "TRADE" AND "VENTURE"

3.1 Introduction

Even though all cases are unique and should be considered individually, they bear common similarities, though not all being present in all cases, which can be used as a guide in determining a set of tests in assessing whether expenses incurred could be categorised to have been part of a venture. Case law available in the United Kingdom has also been consulted to add additional insight regarding the terms trade and venture.

3.2 Risk of something for profit making purpose in a commercial manner

The case law below has been identified to address the questions as to whether or not a natural person has conducted a trade.

In **Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:188,189 the taxpayer, being the managing director of a structural engineering works company, was also a director of various property owning companies and derived his income mainly from salaries and director's fees paid by these companies. He also owned some shares which are quoted on the stock exchange and, prior to October 1987, had speculated by buying and selling shares.

During 1987 the taxpayer had been approached by an insurance broker who had told him that '*over a year period we could make you a considerable amount of money*' and that all the taxpayer had to do was to put up a guarantee. The scheme to which the broker was referring was one which had been initiated by a company called Fenton Investments (Pty) Ltd (**Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:186).

The essence of the scheme was that money would be borrowed from a bank and invested for a short period (one or two years) in assets, such as shares, which were expected to

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appreciate in value. At the end of the period the assets would be realised, the bank repaid, and the balance are kept as profit by the taxpayer. In the 'Fenton scheme' this risk of depreciation in value of the taxpayer's investment would be reduced as the investment would be made, not by purchasing the assets themselves, but by entering into a single-premium pure endowment policy kept by Fenton, therefore transferring the risk of loss of the assets to Fenton.

The court held that the structures of the Fenton scheme were designed to achieve the commercial results of a short-term gain on the investment of borrowed money with some limitation on the extent of possible losses; no part of the structures can be described as artificial; each one was designed for a commercial purpose (**Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:188).

The court further held that if a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage; if he carries on a trade his motive for doing so is irrelevant (**Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:189).

Furthermore, the taxpayer's evidence indicated that his main purpose in making the investment was to make a profit from it and that his main purpose has not been impaired in any way. It is well-established that the definition of 'trade' should be given a wide interpretation and includes a 'venture' being a transaction in which a person risks something with the object of making a profit.

The court went further and stated that the taxpayer clearly undertook a venture by laying out the money required to obtain a bank guarantee and risked the amount of the guarantee in the hope of making a profit; it was a speculative enterprise par excellence.

Lastly the court held that although an element of risk is included in the concept of a 'venture' in its ordinary meaning, this must not be taken to mean that a scheme like the

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present would only constitute a 'trade' if it is risky; whether it would or not, would depend on its own facts; if there is no risk involved it might still be covered by giving an extended meaning to 'venture' or by applying the rest of the definition of a trade which is, in any event, not necessarily exhaustive.

Accordingly, the taxpayer's claim for a deduction in respect of his liability for interest should have been allowed. Therefore a taxpayer who laid out money to obtain a bank guarantee, therefore risk loosing part of his investment, in the hope of making a profit, would qualify as being an activity in pursued of a venture.

In **SARS v Smith**, 2002 (6) SA 621 (SCA), 65 SATC 6:7, the taxpayer was a medical practitioner at Uitenhage who, in 1982, had purchased a farm in the Steytlerville district. The taxpayer had intended to farm particularly, angora goats, mainly devoting his weekends to the project.

In about 1987 he decided to convert to game farming and he had testified that he envisaged deriving a viable income from hunting after eight to ten years of development of the farm and the animals on it. The taxpayer, during the 1990-1 year of assessment, sold a portion of the farm, having found that it was unsatisfactory for running game and in 1993 he sold the remainder of the farm because of the pressures of ill-health and the opportunity offered by an unsolicited buyer.

Within a few weeks the taxpayer then acquired another farm in the Jansenville district as he was greatly taken with its potential for running game and his health had improved. The land was already well-stocked with trophy animals and he purchased springbok and improved the roads, dams, kraals and accommodation. He then became involved in a dispute with a neighbour which threatened the future profitability of the farm which he sold in March 1996.

Furthermore, the taxpayer ran both farms at a substantial loss and in his income tax returns he had set off the losses against the profits derived from his medical practice as permitted by section 20(1)(b) of the Income Tax Act. The Commissioner for SARS had allowed the

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set-off until 1996 when, on 22 July 1996, he notified the taxpayer that he would not allow the losses for the years 1992, 1993, 1994 and 1995 '*aangesien boerdery net soos enige ander onderneming 'n moontlikheid van winsgewendheid moet toon, en in die geval nie moontlik blyk nie*.' The Commissioner amplified his refusal by adding that taxpayer had not at the relevant times been carrying on bona fide farming operations within the terms of section 26(1) of the Income Tax Act.

The taxpayer then appealed successfully to the South Eastern Cape Special Court (per Erasmus J, ITC 1698 (2000) 63 SATC 161) where his contention was upheld that the requirement of section 26(1) was prove of '*activity in the nature of farming undertaken with the genuine intention of ultimately realising profit in the endeavour*.'

The court rejected the Commissioner's assertion that the section required prove that the activity should be carried on with a reasonable prospect of profit (albeit not generated in the tax year in which the loss arose) as an element independent of the taxpayer's intention. In response to this case the Commissioner implemented section 20A of the Income Tax Act.

When the Commissioner implemented section 20A he also provided relevant guidance in determining whether or not a trade is conducted which has been discussed in chapter 2.4.

The principal gained from the above court case in determining whether a trade is conducted is the taxpayer should have carried on his activities with a reasonable prospect of making a profit.

In **ITC 1404,** 1986 48 SATC 1:2, the taxpayer, then a director of companies and before the taxpayer becoming a director he had been a university lecturer. During 1981 the taxpayer purchased a block of six two-bedroom rent-controlled flats situated in the central business district. He financed the purchase with R20 000 cash he had available and the balance on bond. During the 1982 and 1983 tax years the taxpayer incurred rental losses, in respect of the said building.

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These losses were initially allowed in the assessments issued on the taxpayer for the 1982 and 1983 years of assessment but were subsequently added back to the taxpayer's income in additional assessments for those years. The taxpayer's objection having been overruled, appealed to the Special Court. Having regard to all the circumstances, the taxpayer had discharged the *onus* of proving that the expenses in question fulfilled the dual requirements of sections 11(a) and 23(g) of the Act. Appeal was accordingly allowed.

The case highlights the necessity to fulfil the dual requirements of sections 11(a) and 23(g) when determining whether or not a natural person is conducted a trade. The relevance of sections 11(a) and 23(g) has been discussed in chapter 2.2.

A number of decisions in the Income Tax Special Court, in considering the provisions of section 23(g) in relation to cases of the present kind, have suggested that where the evidence shows that in a particular year of assessment there is no possibility of the taxpayer earning a profit, then the expenses are not deductible as determined in **ITC 1292,** (1979) 41 SATC 163:165, where Myburgh J stated that: '*[i]f the possibility to earn a profit is excluded by the evidence, as is the position in the present case, then such expenses are not deductible. The test is the real hope to make a profit. Such hope must not be based on fanciful expectations but on reasonable possibility*.'

The above statement supports the findings in **Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:189, mentioned above, where it has been determined that the natural person pursuing the venture should have a reasonable prospect of making a profit and section 20A (as discussed in chapter 2.2) provides relevant guidance in determining whether the natural person had a reasonable prospect of making a profit.

In **New Mines Ltd v CIR**, 1938 AD 455, 10 SATC 9, in the opening summary it is noted that: *'… when the Legislature inserts an amendment into an existing Act and, in so doing, clearly indicates the meaning of the context in which the amendment must be read, that meaning is the meaning of the context. The position is the same as if the enactment had originally been passed in the form in which it now stands ....'*

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As there are no separate sections dealing with the term venture, it should be understood in its widest sense and only be restricted by the context in which it is included; being the definition of a trade as noted in **ITC 770**, (1953) 19 SATC 216:217, where Dowling J said, dealing with the similar definition of trade in the Income Tax Act 31 of 1941, that it was *'obviously intended to embrace every profitable activity and . . . I think should be given the widest possible interpretation.*'

3.3 Level of activities giving rise to a venture

In **Solaglass Finance Co (Pty) Ltd v CIR**, 1991 (2) SA 257(A), 53 SATC 1: 4, 5, the taxpayer was a private company and a wholly owned subsidiary of Plate Glass Shatterprufe Industries Limited (PGSI), a public company quoted on the Johannesburg Stock Exchange. PGSI is the holding company of a group of companies known as the Plate Glass Group (the Group).

The taxpayer's subsidiaries are of the order of two hundred, most of which are wholly owned by the parent company. The Group is involved in the manufacture, processing, wholesaling and retailing of timber wood and glass products. Until about 1973 the finances of each company in the Group were largely the responsibility of the particular company itself. In 1973 the taxpayer decided that the financial affairs of the Group would be best served by a finance company which would secure and arrange the funds required by all the companies in the Group.

It would also monitor the use of those funds in the hands of the subsidiaries. In order to give effect to this decision a dormant subsidiary, previously called Plate Glass and Shatterprufe Industries Finance Company (Pty) Ltd, but whose name was subsequently changed to Solaglass Finance Company (Pty) Ltd – the present taxpayer – was utilised.

One of taxpayer's objects, in terms of its memorandum of association, was to lend money to any person or company and to borrow such money as it deemed fit. This object was not

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changed when the decision was taken to utilise the taxpayer for the purposes contemplated. Henceforth, subsidiary companies requiring funds would apply to the taxpayer who would, having regard to the budget of the subsidiary concerned, provide the necessary funds by way of loans. Security was not required on such loans.

The subsidiaries were, however, required to pay interest on their loans. The rates varied, depending on the financial position of the subsidiary concerned, but generally the rates of interest charged were approximately 1 per cent higher than the taxpayer itself paid for moneys borrowed by it. Surplus funds in the hands of the subsidiaries were required to be placed with the taxpayer on a daily basis. The taxpayer did not, however, rely solely on the surplus funds received from its fellow subsidiaries. It borrowed moneys from the holding company as well as from commercial banks, in the case of the latter by means of overdrafts and acceptance credit facilities.

Loans obtained by the taxpayer from banks would generally be guaranteed by the holding company. Initially the taxpayer's borrowings and lending were confined to the holding company and the companies in the Group. Subsequently the taxpayer's field of activities extended to loans being made to staff members of companies in the Group and bills being discounted for customers of trading subsidiaries in the Group, in many instances with the object of enabling those customers to settle their accounts with the subsidiaries.

The taxpayer also deposited money with building societies to enable staff members to obtain mortgage bonds. The taxpayer in this case, did not, lend to the broad public. The taxpayer did not seek to obtain security for the loans which it advanced. Its business was not structured to maximise profits. On the other hand, the taxpayer's sole business consisted of borrowing money and utilising the money so acquired for making loans, albeit only to companies in the Group, to staff members and customers of trading companies in the Group. This business was moreover conducted on an extensive scale.

In this case the court held that the purpose of the business which the taxpayer so conducted in accordance with the decision taken by its controlling shareholder, was to

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make a profit out of the loans it made and the bills it discounted; the loans were all advanced and the bills discounted in the furtherance of that purpose.

The court further held that the fact that the making of the loans and the discounting of the bills lead to another result, namely that of providing a benefit to the Group – which was inherent in the expenditure in question – did not disqualify the taxpayer from claiming the deductions.

Furthermore the court found that it is by no means uncommon, in a large group of companies, for the business of the Group to be rationalised in such a way that the activities of each subsidiary are structured with the interests of the group in mind.

Furthermore the fact that the loans were made necessarily, resulted in an advantage to the Group – the result did not, however, constitute a 'purpose' different from that of promoting the business which the taxpayer was itself conducting.

The court (**Solaglass Finance Co (Pty) Ltd v CIR**, 1991 (2) SA 257(A), 53 SATC 1:7) stated that the losses in question were not disqualified as deductions by reason of section 23(g). and that the appeal should thus be allowed with costs, including the costs consequent upon the employment of two counsel and substitute an appropriate order for that made by the Transvaal Special Income Tax Court.

Although the above mentioned case happened before the 1993 amendment to section 23(g), it is still necessary for the expenditure incurred to have been for purposes of conducting a trade for the activities to qualify as that of in the nature of a trade.

In **De Beers Holdings (Pty) Ltd v CIR,** 1986 (1) SA 8(A), 47 SATC 229:230, 231, the taxpayer, who in this case was a share-dealing company had appealed after the disallowance of a deduction on its claim to deduct a loss sustained during its tax year ended 31 December 1979 on the sale of two shares in EHSA (Pty) Ltd.

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The Commissioner's disallowance of this claim had been reversed by the Special Court but sustained on appeal to the Provincial Division in 46 SATC 47. During 1969 the taxpayer, together with two other companies (AAC and RSC), acquired a substantial parcel of EHSA shares in the respective proportions 40:40:20.

The taxpayer held its 40 per cent directly. The intention at that stage was to place EHSA into voluntary liquidation, to dispose of all its assets and to distribute the proceeds among the shareholders. On 7 April 1970 EHSA was placed in voluntary liquidation and most of its assets were realized. For reasons not directly material hereto, all the shares in EHSA were then sold to Meton, a subsidiary of a company controlled by the taxpayer, AAC and RSC in the same proportions 40:40:20.

However, the voluntary winding up of EHSA was terminated and certain reconstruction took place resulting in Meton becoming the holder of the total issued shares of EHSA's and receiving substantial sums paid out from share premium distribution and reduction of capital.

The court held that profit-making is not of the essence of trading and that the provisions of section 23(g) of the Act did not operate to defeat the taxpayer's claim. The court stated that the taxpayer had failed to show that a distribution of EHSA's assets in cash to the shareholders was not the purpose of the taxpayer's acquiring the EHSA shares.

Furthermore, examining the evidence and analysing the definition of 'trading stock', the EHSA shares, once acquired by the taxpayer, did not constitute trading stock in its hands; and that this conclusion was unaffected by concessions to the contrary made by the Commissioner's representative at certain stages of the proceedings.

The court also held that 'trading stock' in section 22 of the Income Tax Act means 'trading stock' as defined and that the EHSA shares were not governed by the provisions of section 22 and that whether or not the cost to the taxpayer of the EHSA shares was deductible in

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the 1973, or any other, tax year must be determined in the light of section 23(g) read together with s 11(a) and 23(f) of the Income Tax Act.

The court determined that, although moneys laid out in a non-profitable transaction may nevertheless in certain circumstances fulfil the requirements of section 23(g), where a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy section 23(g), be shown to have been so connected with the pursuit of the taxpayer's trade (e.g. on ground of commercial expediency or indirect facilitation of the trade) as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for the purposes of trade. Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer.

Although this case happened before the 1993 amendment of section 23(g) it is noted that a profit motive is not a prerequisite or a determining factor when considering whether or not a trade is conducted but that each case's facts should be considered in its whole also noted in **CIR v Stott,** (1928) AD 252, 3 SATC 253:258.

In **CIR v Pick 'n Pay Wholesalers (Pty) Ltd,** 1987 (3) SA 453(A):453, 49 SATC 132, during April 1977 the taxpayer company undertook to donate to the Urban Foundation in equal annual instalments. In its returns of income for each of the 1978 and 1979 tax year's the taxpayer sought to deduct, as advertising expenses, the first instalment, pursuant to the aforesaid undertaking, paid to the Foundation.

The Commissioner disallowed both claimed deductions and overruled the succeeding objection. The taxpayer then successfully appealed to the Special Court. An appeal by the Commissioner to the Provincial Division resulted in a remittal to the Special Court which, after hearing further evidence, again decided in favour of the taxpayer.

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Thereafter leave was granted in terms of section 86A(5) of the Income Tax Act for the Commissioner to appeal direct to the Appellate Division. The taxpayer is the managing company of a group of companies conducting a retail business throughout the Republic. The chairman and managing director of the taxpayer was Mr Ackerman who, in addition to being the 'main-spring and driving force behind the group's activities', is a public figure who takes a leading part in several public bodies.

At all times material hereto the Mr Ackerman was a member of the main board of the Urban Foundation ('the Foundation'). Initiated in 1976, the Foundation is a body whose activities are directed towards improving the quality of life of the less privileged urban dwellers, more especially in upgrading housing and providing community facilities.

During the period relevant to this case the chairman and chief executive of the Foundation was Mr Justice Steyn. Evidence led before the Special Court established that for an enterprise such as the taxpayer's sustained advertising is considered essential and falls into three categories: First, the day-to-day advertising of goods; secondly, advertisements relating to so-called special events as, for instance, the anniversary of the opening of a supermarket; and, thirdly, what is known as 'indirect advertising.'

This last category embraces obtaining favourable notice in the news and editorial columns of the media. It is, according to the evidence, not readily achieved but is considered to be the most important and desirable form of advertising. Expert evidence was also given that advertising, whether direct or indirect, has effect only for a relatively short term; for that reason, it is necessary for a business like the taxpayer to advertise continuously.

The Special Court decided against the Commissioner on all the issues raised by him before it. The critical issue in the present case was whether taxpayer had shown that its sole object in making the donation to the Foundation was the acquisition of indirect advertising.

The court (**CIR v Pick 'n Pay Wholesalers (Pty) Ltd**, 1987 (3) SA 453(A):149, 49 SATC 132) held that the meaning of the words '*wholly and exclusively for the purposes of trade*' is

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that the taxpayer must have expended the money for the purpose of carrying on and making profits in the trade.

Although the 1993 amendment of section 23(g) does no longer require that the taxpayer should have incurred the expenditure '*wholly and exclusively for the purposes of trade*', the purpose of the expenditure is still a main consideration as well as the level of activities (in this case advertising) when determining whether a trade is conducted, although not a determining factor.

In **Kirsch v CIR**, 1946 WLD 261, 14 SATC 72:73, the taxpayer had been employed as a clerk and commercial traveller since 1929. In 1938 the taxpayer advanced a loan to the firm which employed him, upon which interest was to be paid at 8 per cent and which was repayable on six months' notice. Simultaneously with the making of this loan an agreement was entered into between the taxpayer and his employers under which the taxpayer was entitled to receive, while he remained in the service of the firm, a proportion of the profits of the business in the same proportion that the advance made by him bore to the capital of the firm, and was required to bear a proportion of the losses of the firm based on the same ratio.

As from the 1st July, 1942, the taxpayer ended his employment with the company and started trading in his own capacity. The court held that the relationship created between the parties to the agreement of the 1st April, 1938, was one of creditor and debtor and not of partnership or joint venturing and that the taxpayer did not from that date carry on a "trade" within the definition of the term as contained in section 24 of the Income Tax Act No 25 of 1940 (now repealed).

It had been mentioned that the repayment terms of an advance (in the above case, the advance could be repaid like profits occurred), does not make it part of the venture in which the profits had been made to enable the repayment of the advance. Therefore even though the repayment of the capital amount of the advance is linked to profits incurred the

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repayment thereof would still be of a capital nature and would therefore not qualify as a trade.

In **Channels v COT,** 1936 SR 100, 8 SATC 181:189, the court held that carrying on a trade, within the meaning of the Statute for the time being, although the transaction might be isolated would include the purchase, transformation of the things purchased either through manufacturing or industrial process and thereafter the re-sale thereof. The transaction being may be one of such magnitude that it might in the ordinary course be the whole business for the time being of a person regularly engaged in the trade.

Therefore even if the transaction is not one normally entered into it might well qualify when the whole of the transaction is taken into consideration. It therefore should not be seen as a prerequisite to have also been engaged, on a regular base, in the venture. A question should rather be ask, whether amounts received with regard to the venture, would be classified as taxable income in the hands of the natural person

In **ITC 1627, (**1998) 60 SATC 26:27, 28, the taxpayer was a professional person who at all material times hereto had been employed by a professional firm and had received an income from it by way of salary. The taxpayer, while so employed, had developed a township but had underestimated the cost of developing it and in order to facilitate its development had borrowed certain moneys.

The loans in question had not been fully paid off by the time the last stand in the township had been sold and the taxpayer continued to pay off the loans and interest thereon after such time. The Commissioner for Inland Revenue allowed expenditure on interest after the township development and sale of township phases had been completed up to 1989.

However, in the 1990, 1991 and 1992 years of assessment he changed his position and disallowed the deduction of expenditure, claiming that the interest payments could only be allowed as a deduction against township income and not against the taxpayer’s salary. It was common cause between the Commissioner and the taxpayer that the loans were

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actually incurred; not of a capital nature; incurred wholly or exclusively in the production of income; raised for the purpose of earning income; and closely linked to the township development costs so as to form part of the production of income.

The taxpayer contended that as long as he was servicing the loans, the interest paid on them had to be set off against the income earned by him as and by way of salary. The issue to be determined by the court was whether the expenses incurred in the production of income and therefore deductible in terms of sections 11(a) and 23(g) of the Income Tax Act continue to be deductible if not fully paid by the time when active trading has ceased.

The court held that as the taxpayer had at all material times been employed and earned an income from that employment, then for the purposes of the Income Tax Act, the taxpayer would be deemed trading.

Furthermore the court held that, in view of the provisions of sections 20(1)(a), 20(2) and 20(2A) of the Income Tax Act, the taxpayer was entitled to deduct from the income earned by him from his salary, the amount of the interest paid by him in respect of the loans raised by him while trading.

The court also held that it was therefore not necessary to decide whether trading for the purposes of the Income Tax Act ceases when active trading is no longer carried on and stated that there is much to be said for the view that trading only ceases when all the debts of the businesses have been paid and all sums due to it have been collected.

From the above case law it is apparent that costs incurred as a result of a debt for a previous venture, would help identify whether or not a new venture is pursued when income is derived by other means as in the first qualifying venture.

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3.4 Cases in the United Kingdom defining 'trade' and 'venture'

In **Pickford v Quike**, CA 1927, 13 TC 251, the taxpayer was a member of four different syndicates involved in buying and selling cotton-spinning mills. The syndicate acquired shares in a mill-owning company, liquidated it and sold its assets as profit to a new company. The Revenue assessed the taxpayer on his share of the profits of each syndicate. The court upheld the assessments as these transactions were deemed of a speculative nature. Therefore activities of a speculative nature are deemed that of trading.

Another case identified being of a speculative nature is **Edwards v Bairstow & Harrison**, HL 1955, 36 TC 207; [1956] AC 14; [1955] 3 All ER 48. The taxpayer who had been one of two individuals purchased a cotton-spinning plant and resold it in five lots, at a profit. The court held that the only reasonable conclusion on the evidence before the Commissioners was that there had been an adventure in the nature of trade.

The above two cases where the taxpayers both had been pursuing an adventure in the nature of trade, strengthens the fact that a taxpayer needs to risk something in order to make a profit in pursuit of a venture which would then be deemed being of a speculative nature.

Furthermore, in **McManus v Griffiths** (and related appeal), Ch D 1997, 70 TC 218; [1997] STC 1089, a golf club employed a stewardess, who was required to provide catering services. The Revenue issued an assessment charging tax on her profits from this. She appealed, contending that she had been an employee of the club. The General Commissioners rejected this contention and dismissed her appeal, and the Commissioner upheld their decision. Based on the evidence, the taxpayer had been carrying on the catering business on her own account. The club had no entitlement to, or participation in, the receipts or profits of the catering business.

The above case supports the fact that the extent of activities can help to identify whether or not a venture has been pursued. If the taxpayer had only one golf club which she was

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catering for, she might have been deemed an employee. However, the taxpayer had been providing these catering services for several different customers and the only person benefiting financially from this being the taxpayer and would therefore be seen as a venture.

Regarding illegal trading, in **Canadian Minister of Finance v Smith**, PC 1926, 5 ATC 621; [1927] AC 193, during the 1920s the Province of Ontario, unlike the rest of Canada, prohibited the sale of alcohol. A taxpayer who sold alcohol ('bootlegging') in Ontario was assessed to Canadian excess profit tax. The taxpayer appealed, contending that his profits were not assessable because his activities were illegal under Ontario legislation. The Privy Council rejected this contention and upheld the assessments. Lord Haldane held that '*once the character of a business has been ascertained as being in the nature of a trade, the person who carried it out cannot found upon the elements of illegality to evade the tax*'.

Therefore, when determining whether a taxpayer is conducting a venture the fact that the activities might have been against the law should not be taken into consideration.

3.5 Conclusion

In determining whether a natural person had pursued a venture, case law (as discussed in chapter 3.2 above) has stated that the taxpayer should have had a purpose of making a profit and the venture activities should have been conducted in a commercial manner. The above implies that the taxpayer should have risked something with the aim and future prospect in realise a future profit. The activities should also be able to be linked to this profit motive. Furthermore, the fact that the activities might have been against the law does not impact the decision whether or not a trade has been conducted.

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Chapter 4
TESTS IN DEFINING A "TRADE" AND "VENTURE"

4.1 Introduction

As mentioned in chapter 2.2, each case is unique and should be considered individually based on the facts presented (**CIR v Stott** (1928) AD 252, 3 SATC 253:258), however there are common similarities, though not all being present in all cases, which can be used as a guide in determining a set of tests in assessing whether expenses incurred could be categorised as part of a venture and therefore qualifying as a trade as defined.

4.2 Set of tests

A set of tests to help define the term 'venture' and 'trade' for income tax purposes, are determined by the following questions through answering in the affirmative:

- What is the level of activities that have been carried on or the amount of expenses incurred on advertising, promoting or selling in carrying on the venture (chapters 2.4, 3.3 and 3.4)?

The above question would help determine the natural person's intention, whether or not he/she believes in his/her own efforts, by pursuing the venture through making potential customers aware of the venture, therefore distinguishing the relevant activities from that of a hobby. As stated in chapter 2.4 (section 20A(3)(b)), trading requires regular selling and marketing initiatives in terms of time and expense.

The case of **CIR v Pick 'n Pay Wholesalers (Pty) Ltd**, 1987 (3) SA 453(A):149, 49 SATC 132 was examined in chapter 3.3 where it was noted that the taxpayer should be able to indicate that his business benefited, either directly or indirectly, from the advertising/promoting activities.

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The level of activities also help distinguish a venture from being purely employee activities as stated in chapter 3.4 in **McManus v Griffiths**, Ch D 1997, 70 TC 218; [1997] STC 1089. Although employment qualifies as a trade, the deductions allowable which are associated with employment are limited by section 23(m). Section 23(m) expenses falls out site of the scope of this study.

- Is the venture carried on in a commercial manner (chapters 2.4 and 3.2)?

As mentioned in chapter 2.4 (section 20A(3)(c)) 'commercial manner' is the business-like system or method pursuant to which the activities are carried out. In chapter 3.2 (**Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:188), the court described 'commercial manner' as a certain structure being put in place by the taxpayer. This would involve that there are accounting records, a business plan/budget or strategy being followed.

- Does the natural person risk something with the object and purpose of making a profit out of the transaction (chapters 1.1, 3.2, 3.3 and 3.4)?

Risk implies uncertainty, which relates to the uncertainty associated with the future results of the transactions involved, either resulting in earning income or, losing money (chapter 3.4). The transactions involved should be with a profit purpose and with a realistic prospect of making a future profit as opposed to a superficial hope thereof (chapter 3.2 as stated in **ITC 1292,** (1979) 41 SATC 163:165). The *onus* of prove rests on the natural person as stated in chapter 1.1 (section 82).

If for some reason there is a lack of profit motive, the natural person should be able to indicate and justify that the transactions have been closely connected with the pursuit of his/her venture (e.g. on ground of commercial expediency or indirect facilitation of the venture) (chapter 3.3 as stated in **Beers Holdings (Pty) Ltd v CIR,** 1986 (1) SA 8(A), 47 SATC 229:231).

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As discussed in chapter 3.4 speculative activities (**Pickford v Quike**, CA 1927, 13 TC 251) and adventurous activities, due to future uncertainties implying risk (**Edwards v Bairstow & Harrison**, HL 1955, 36 TC 207; [1956] AC 14; [1955] 3 All ER 48), would aid in determining whether an natural person undertook risk associated activities for purposes of realising a future profit. The reason for this relates to the future uncertainties implying risk.

4.3 Conclusion

Based on chapter 4.2, similarities in ventures conducted by natural persons will normally have three distinguishing characteristics in common being:

- promotional activities;
- commercial structure/running of activities; and
- undertaking risk for the purpose of making a profit.

The tests in chapter 4.2 should be applied taking into consideration the wide meaning given to the word ‘trade’ by the legislature in the Income Tax Act (chapter 3.2 stated in **ITC 770**, (1953) 19 SATC 216:217).

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Chapter 5
CASE STUDY

5.1 Introduction

The tests identified in chapter 4.2 are applied in this chapter in the form of a case study in order to verify the validity and practicality thereof. The case study below is used to help explain the tests laid down in determining whether a natural person is conducting a venture. Furthermore, the case study includes different scenarios to aid in the interpretation of the relevant tests.

5.2 Case study information

A natural person (called A herein after), had an idea for making money by registering a website on the internet which A would use to rent out advertising space to potential customers. The website has been developed to keep record of all customers who made use of this website and A opened a separate bank account for the website business. A incurred telephone, fuel, consulting, advertising and other expenses after the website has been set up but before any customers had been obtained. During this time the tax year came to an end. In the succeeding tax year customers were obtained and rental fees received by A for advertising space rented out to these customers.

The question arises, as to whether A was conducting a venture in year one for income tax purposes. By applying the three tests set out in chapter 4.2, the answer is determined in chapters 5.3, 5.4 and 5.5. By applying the tests it is going to be assumed that the other two tests requirements have been met to illustrate the interpretation of each of the three tests individually.

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5.3 Applying the tests – Promotional activities

What is the level of activities that have been carried on or the amount of expenses incurred on advertising, promoting or selling in carrying on the venture (chapter 4.2)?

From the case study information it is apparent that A incurred fuel, consulting, advertising and other expenses and is therefore able to indicate through the level of his activities that he had advertised and promoted his website in terms of time and expense (s20A(3)(b) as examined in chapter 2.4) to potential customers.

Taking the case study information in and say A only incurred fuel and entertainment expenditure for his personal purposes, he would have difficulty indicating the manner in which his activities would qualify as a venture, because he did not incur, to an acceptable level and for the purposes of his venture, promotional activities by investing the necessary time and expense (chapter 3.3 in **CIR v Pick ‘n Pay Wholesalers (Pty) Ltd**, 1987 (3) SA 453(A):149, 49 SATC 132).

5.4 Applying the tests – Commercial structure/running of activities

Is the venture carried on in a commercial manner (chapter 4.2)?

From the case study information it is apparent that A’s website venture has been conducted in a commercial manner by taking the following into consideration: A designed the website to keep record of transactions with customers and opened a separate bank account for the website which would enable A to keep record of income and expenses (chapter 2.4 and section 20A(3)(c)).

If the same set of information is taken as set out in chapter 5.2, but say A did not design his website to keep record of any transactions, but only count the number of hits (being the number of people visiting the site) and A did not open a separate bank account for the website venture. A, would then be in a disadvantage to illustrate that a structure (chapter

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3.2 **Burgess v CIR**, 1993 (4) SA 161(A), 55 SATC 185:188) had been put in place to help identify/distinguish a website venture, through its relating and corresponding transactions and activities.

5.5 Applying the tests – Undertaking risk for the purpose of making a profit

Does the natural person risk something with the object and purpose of making a profit out of the transaction (chapters 1.1, 3.2, 3.3 and 3.4)?

From the facts in the case study information (chapter 5.2) it is apparent that A undergone the risk of financial loss as follows: A has incurred costs with the purpose of making a profit (**ITC 1292,** (1979) 41 SATC 163:165 as discussed in chapter 3.2), by renting the website out to customers for advertising space, together with the uncertainty of whether the website will be profitable in the near future. The expenses were closely connected to the profit motive for the purposes of the website venture (chapter 3.3 as stated in **Beers Holdings (Pty) Ltd v CIR,** 1986 (1) SA 8(A), 47 SATC 229:231) and the website venture appears to be commercially feasible.

If the same set of information is taken as set out in chapter 5.2 but say A has not incurred any costs to date but has only put together his website venture as a future plan on paper. A, would not have risked any financial loss, because there has been no financial expense on A's part and would therefore not qualify as a venture/trade (chapter 3.2 as stated in **ITC 1292,** (1979) 41 SATC 163:165).

5.6 Conclusion

From chapters 5.3, 5.4 and 5.5, it is apparent that A conducted a venture (and therefore a trade as defined) through the application of the three tests set out in chapter 4.2. The fact that the website had not generated income in year one, is irrelevant in determining whether a venture is conducted for income tax purposes.

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Chapter 6
CONCLUSION

6.1 Introduction

There is currently no concrete guidance from SARS or the legislature in determining whether venture cost incurred by a natural person, falls in the ambit of the definition of a trade, assuming that all other requirements have been met for a deduction from the natural person's income. The taxpayer has to refer to guidance in case law that has interpreted the provisions of section 11(a) and 23(g).

6.2 Objective

The objective of this study is to design a set of tests aimed at assisting a natural person in determining whether venture costs incurred will qualify as a trade, as defined. Firstly to assist in determining whether the natural person is carrying on a trade and secondly, whether venture costs incurred is of a revenue nature by firstly qualifying as a trade.

The three tests have been discussed in chapter 4.2 and the key words associated with these tests are listed below:

- promotional activities;
- commercial structure/running of activities; and
- undertaking risk for the purpose of making a profit.

The tests are applied through asking three questions and to qualify, these questions need to be answered in the affirmative and are listed below:

- What is the level of activities that have been carried on or the amount of expenses incurred on advertising, promoting or selling in carrying on the venture (chapters 2.4, 3.3 and 3.4)?

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- Is the venture carried on in a commercial manner (chapters 2.4 and 3.2)?
- Does the natural person risk something with the object and purpose of making a profit out of the transaction (chapters 1.1, 3.2, 3.3 and 3.4)?

The three tests have been based on relevant legislation in chapter 2 which have been explained under the following headings:

- General deduction formula (chapter 2.2)
- Expenditure incurred prior to commencement of trade (chapter 2.3)
- Assessed losses (chapter 2.4)
- Restricting sections (chapter 2.5)

The three tests have also been based on relevant case law in chapter 3 which have been explained under the following headings:

- Risk of something for a profit making purpose and in a commercial manner (chapter 3.2)
- Level of activities giving rise to a venture (chapter 3.3)
- Case law in United Kingdom defining 'trade' and 'venture' (chapter 3.4)

Furthermore, the three tests have been explained through a case study in chapter 5, where the case study information and different changes to the case study information have been considered.

6.3 Conclusion

When a natural person is able to indicate that he/she complies with the three tests (chapter 4.2), he/she can be confident that a venture has been conducted for income tax purposes and therefore would qualify as a trade, as defined. The *onus* of proof however, still resides with the natural person (chapter 1.1 and section 82).

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