

# THE “TRADE” REQUIREMENT FOR INCOME TAX PURPOSES: A REAPPRAISAL

## CSARS v SMITH 65 SATC 6

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## 1. INTRODUCTION

For income tax purposes it is often vital that a taxpayer conducts a trade. Although it is not the case that only amounts arising from trading activities that are taxable (Definition of “taxable income in s 1 of the Income Tax Act 58 of 1962 (“the act”)), generally expenditure is only deductible if the taxpayer conducted a trade (s 11(a)). Where expenditure is partly incurred for the purposes of trade and partly for non-trading purposes, a deduction is only allowed to the extent that the expenditure was incurred for the purposes of trade (s 23(g)). In addition, a company may only carry forward an assessed loss if it conducted a trade in the subsequent year of assessment (s 20(2A)). Special rules are also applicable to certain specific trades: see, for example, s 26, which provides for the determination of taxable income of any person carrying on pastoral, agricultural or any other farming operations.

Although it is clear that trade has to be conducted, uncertainty often exists about whether an objective or subjective approach needs to be followed to establish whether a trade was conducted. If an objective test is followed, it is important that, *inter alia*, a reasonable prospect of profit exists. On the other hand, if a subjective test is applied, the mere intention of the taxpayer to conduct a trade will be sufficient.

The word “trade” is defined in s 1 of the act to include every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use or the granting of permission to use any intellectual property.

The purpose of this discussion is to analyse case law to determine which approach should be followed to determine whether a trade was conducted.

## 2. OBJECTIVE TEST

Earlier case law seems to indicate that an objective test needs to be applied. On numerous occasions the tax court has been called upon to adjudicate on whether an objective or subjective approach has to be followed to determine whether the taxpayer conducted trading activities. One of the best-known cases is *ITC 129241 SATC 163*. The facts of the case were briefly that the taxpayer built himself a holiday home in the close vicinity of his relatives. Initially the taxpayer occupied the house during vacations, but subsequently he occasionally let it when he himself did not occupy it. Subsequently he entered into a two-year, fixed-lease period for a lease of R1 100 per annum. However, his expenses in the form of interest on the mortgage bond and assessment rates far exceeded the rental income. The question before the tax court was whether he could deduct the loss incurred or whether a deduction of the expenditure was prohibited under s 23(b), which provided at the time that expenses on any premises or dwelling house were not deductible unless it was occupied for the purposes of trade.

Without discussing the question, the court assumed that a trade could only be conducted if:

“the real hope to make a profit [existed]. Such hope must not be based on fanciful expectations but on a reasonable possibility” (165).

Despite the fact that the taxpayer testified that the renting activities might generate a profit at some future date, the court decided that no reasonable prospect to make a profit existed in the years in which the loss was generated. As a result the loss could not be deducted, as the expenditure was not incurred for the purposes of trade. The mere intention of a taxpayer to

conduct a trade is not sufficient.

The court clearly applied an objective test. It is submitted that the court erred in refusing to take the fact that a profit may be made in subsequent years into account. In doing so, the court confused the "trade" requirement in s 11(a) with the "in production of income" requirement. In addition, in applying the "in production of income" requirement, the court erred in holding that actual income has to be produced. The then appellate division made it clear in *Sub-Nigel v CIR* 15 SATC 381 at 384 that the "in production of income" requirement does not mean that actual income must be received, but merely that the intention to receive income must exist.

The view that trading activities will only be conducted if the intention was to make a profit was also applied in *ITC 208* 6 SATC 55 at 56, *ITC 561* 13 SATC 313 at 314, *ITC 1319* 42 SATC 263 at 264, *ITC 1367* 45 SATC 39 at 43 and *ITC 1644* 61 SATC 23 at 26 (see also 1984 *The Taxpayer* 198-9). It should be noted that none of these cases constitutes binding authority as they are merely decisions by the tax authorities and as such are only binding on the specific taxpayer regarding the specific issue in dispute. As the act does not stipulate the requirement that there must be a reasonable prospect of making a profit, it is doubtful whether the judgments in these cases are correct (see Vorster "Profits prospects and deductibility" 1986 *SATJ* 117). The view expressed in the 1984 *The Taxpayer* 199 that insisting on the reasonable prospect of generating a profit may be too stringent a test is supported:

"If the taxpayer intends to farm in the hope of an ultimate profit why should he be held not to be farming because his hope is ill-founded or unreasonable? That it is ill-founded or unreasonable can be a test of his genuineness but that there should be a reasonable prospect that an ultimate profit will be derived is to propound a criterion which, with respect, we consider the Act does not require."

At most, the possibility of generating a profit can be one of the facts to take into account to determine whether a trade was conducted.

### 3. SUBJECTIVE TEST

In 2002 the supreme court of appeal was confronted with the question of whether an objective or a subjective test needs to be applied to determine whether a trade was conducted. The facts in *CIR v Smith* 65 SATC 6 were briefly that the taxpayer, a medical practitioner, purchased a farm in 1982 with the intention to farm stock on weekends, in particular angora goats. In 1987 he converted to game farming as he envisaged a viable income from hunting. However, in 1990 he sold a portion of the farm after establishing that the farm was not suitable for game farming and, due to ill-health and an opportunity offered by an unsolicited buyer, he sold the remainder of the farm in 1993. His health improved, however, and he bought another farm shortly after he sold the first farm. Although this second farm was already well stocked with trophy animals, he bought additional springbuck. In addition he also improved the roads, dams, kraal and accommodation. However, a dispute with his neighbour forced him to sell the farm in 1996.

The taxpayer incurred a substantial loss on both farms, which he attempted to deduct for income tax purposes. As the South African Revenue Service ("SARS") was of the opinion that, objectively speaking, the land was not suitable to use for farming purposes and that no reasonable possibility of a profit existed, the taxpayer did not conduct farming operations and as a result the losses were not deductible. In particular, SARS argued that the taxpayer did not carry on *bona fide* farming activities as required under s 26(1).

Although the court was not confronted with the question whether a trade was conducted, but with the question whether farming operations were carried on, it is submitted that the judgment will be at least of persuasive authority when a court is in future confronted with the question whether a trade was conducted. This view was held despite the view of the tax court in *ITC 1414 46 SATC 174* in which it was held that carrying on farming operations connotes something less than a trade.

The Tax Court held that the reasonable prospect of a profit in future cannot be the sole test to determine whether farming operations were conducted (decision reported as *ITC 1698 63 SATC 161*). With reference to a case decided in the Zimbabwean special court, the court refused to hold that apart from the subjective intention of the taxpayer, farming operations would be deemed to have been carried on if, objectively speaking, farming operations were indeed carried on. However, it does not follow that objective factors are completely irrelevant, as these factors

“indicate whether the activities of the taxpayer are in the nature of farming operations. The nature and extent of the enterprise are relevant here, for example the size and location of the property on which the operation is being conducted, the portion of the property being used for that purpose, capital expenditure, turnover, labour, the regularity and purposefulness of the activity, the time and effort spent thereon by the taxpayer in relation to his other gainful activities, if any, and the existence of a real prospect of profit (or lack thereof). The list is not exhaustive and the permutations of such activities are indefinite. None of these considerations is necessarily in itself decisive” (170)

The objective facts of the case supported the taxpayer’s *ipse dixit* that his intention was to conduct farming activities. Interestingly enough, it counted in the taxpayer’s favour that he persevered with the farming activities, despite incurring losses.

It is submitted that the judgment of the Tax Court cannot be faulted: A taxpayer’s intention to conduct farming operations is not sufficient: such intention has to be supported by objective factors of which the real prospect to make a profit is but one factor.

However, SARS did not agree and appealed to the supreme court of appeal on the basis that, despite the intention of the taxpayer, it is not possible to conduct farming operations in the absence of a prospect of ultimate profitability.

In a surprising judgment with reference to Australian and New Zealand authority on the question whether a business was conducted, this court held that the test to determine whether farming operations was conducted is purely subjective.

“... I conclude that a taxpayer who relies ... [on the fact that he is conducting farming operations is] only required to show that that he possesses at the relevant time a genuine intention to carry on farming operations profitably. All considerations which bear on that question including the prospect of making a profit will contribute to the answer, none of itself being decisive.” (13)

From this quote it is clear that although none of the objective factors, including the real prospect to make a profit, is decisive, they still have to be taken into account to determine the true intention of the taxpayer. However, the supreme court of appeal did not analyse any of the objective factors to determine whether they supported the taxpayer’s *ipse dixit* that he conducted farming activities. As a result, the conclusion which can be drawn from the case is that a purely subjective approach is followed to determine whether a trade was conducted.

As the court made it clear that objective facts cannot be elevated above the subjective element

(i.e. the intention of the taxpayer), it is submitted that even if the objective factors indicate that a taxpayer did not conduct a trade, for example, where the land was not suitable for trading activities, the mere intention of the taxpayer to trade would be sufficient. This places SARS in an untenable position, as it cannot read the mind of a taxpayer. No doubt, precisely for this reason the legislature decided to introduce s 20A, which ring-fences losses from certain suspected trades, including farming unless the operations are carried out on a full-time basis, against income received from that trade.

#### 4. CONCLUSION

The *Smith* case is subject to interpretation that a purely subjective approach has to be followed to determine whether a taxpayer carried on farming operations. This raises the question whether a subjective test also has to be followed to determine whether a taxpayer generally conducted a trade. It is submitted that the question has to be answered in the affirmative. Firstly, the court in the *Smith* case based its decision on authority dealing with the question whether a business (i.e. trade) was conducted. Secondly, despite the fact that it was held in *ITC 1414 46 SATC 174* that the carrying on of farming operations connotes something less than a trade, it is submitted that, in the absence of any contrary indications in the wording used by the legislature to determine whether farming operations or a trade was conducted, the same approach should be used for both. It does not follow that, simply because farming operations connote something less than a trade, the same approach (i.e. subjective or objective) cannot be followed in determining whether a trade or farming operations were conducted.

