

**FORMULATION OF GUIDANCE ON THE SOUTH AFRICAN INCOME TAX
CONSEQUENCES OF EXPENDITURE INCURRED IN A TENDER PROCESS**

by

Elza Johnson

Thesis presented in partial fulfilment of the requirements for the degree

Master of Accounting (Taxation) in the

Faculty of Economic and Management Sciences

at Stellenbosch University

Supervisor: Mr Rudie Nel

March 2016

DECLARATION

By submitting this thesis electronically, I declare that the entirety of the work contained therein is my own, original work, that I am the sole author thereof (save to the extent explicitly otherwise stated), that reproduction and publication thereof by Stellenbosch University will not infringe any third party rights and that I have not previously in its entirety or in part submitted it for obtaining any qualification.

March 2016

ACKNOWLEDGEMENTS

I do not have words to thank my amazing parents, my siblings and my friends, who have always been there cheering me on. A special thank you to my three best cheerleaders, who supported through words and actions and made sure I didn't go crazy: Shivani, Jeanne-Marie and Ginelle.

My PwC colleagues who had to listen to unending updates on the status of the thesis and made sure I kept to all deadlines. A very special thank you to Charles de Wet who gave me the space and opportunity to get it done, always believing in me and being such a remarkable mentor.

I was lucky to have the best supervisor anyone could wish for. Although his attention to detail may have been frustrating at first, through his support and commitment I was able to deliver a document that I can be proud of. Thank you Rudie for all your advice and the hours and hours of work you put in.

Above all things, the grace of God prevails and it is in Him I place my trust and all thanksgiving. The next adventure awaits.

'Not all those who wander are lost' - *JRR Tolkien*

SUMMARY

The government and private practice utilise tenders in order to acquire goods and services at the most competitive price. The goods and services which are acquired through government spending represent not only a substantial amount of public resources spent, but also a source of income for the service providers.

There is a standard tender process which is followed which includes a number of phases during which both the bidder and the party offering the tender have certain duties to fulfil. During this tender process the bid is awarded to one of the bidders, this point in the tender process is referred to as the deciding event. Prior to the deciding event the bidders incur expenditure, some of these are necessary and others in order to enhance their chances of successfully being awarded the tender. As the expenditure can be significant it is necessary to determine the tax consequences thereof for the bidder. It should be determined whether the expenditure incurred is deductible in terms of the general deduction formula in section 11(a) of the Income Tax Act 58 of 1962. Should it be held that the expenditure is capital in nature, therefore not deductible in terms of section 11(a), the possible Capital Gains Tax ('CGT') in terms of the Eighth Schedule should be investigated.

In determining the tax consequences of expenditure incurred during the tender process, it is necessary to consider the tender process as well as the form of the bidder. The form of the bidder affects when a 'person' will exist which could be a taxpayer in determining the applicability of section 11(a). The tender process and specifically the deciding event affects whether the bidder could be found to be carrying on a 'trade' for purposes of section 11(a). Furthermore, if any right is conveyed as result of the deciding event such right could also result in CGT being applicable on a subsequent disposal of such right.

Based on the extended literature review performed, it is found that the deciding event would also be decisive in determining the nature of expenditure. If the tender is awarded successfully to the bidder expenditure incurred in the tender process is submitted as capital in nature as a right to earn future income is established for the bidder (therefore not deductible in terms of section 11(a) but subjected to CGT if the right is disposed of). If the tender is not awarded to the bidder expenditure incurred in the tender process is submitted as not capital in nature therefore deductible in terms of section 11(a).

OPSOMMING

Die regering en die privaat sektor maak gebruik van tenders om goedere en dienste teen die mees mededingende prys te bekom. Die goedere en dienste wat verkry word verteenwoordig nie net 'n aansienlike bedrag van openbare hulpbronne bestee nie, maar ook 'n bron van inkomste vir die diensverskaffers.

Daar is 'n standaard tenderproses wat gevolg word, wat 'n aantal fases insluit waartydens beide die bieër en die party wat die tender geplaas het sekere pligte vervul. Gedurende hierdie proses word die tender toegeken aan een van die bieërs, waarna verwys word as die beslissende gebeurtenis. Voor die beslissende gebeurtenis sal die bieërs uitgawes aangaan, sommige van hierdie is noodsaaklik terwyl ander uitgawes bloot aangegaan word om hul kans te verbeter om die tender te wen. Aangesien die uitgawes beduidende kan wees, is dit nodig om die belasting-gevolge daarvan vir die bieër vas te stel. Daar sal bepaal moet word of die uitgawes aangegaan ingevolge die algemene aftrekkingsformule in artikel 11(a) van die Inkomstebelastingwet 58 van 1962 aftrekbaar is. Indien die uitgawes as kapitaal van aard gevind word, dus nie aftrekbaar ingevolge artikel 11(a) nie, moet die moontlike Kapitaalwinstbelasting ('KWB') ingevolge die Agtste Bylae ondersoek word.

Om te bepaal wat die belasting-gevolge van uitgawes aangegaan gedurende die tenderproses is, is dit nodig om die tenderproses sowel as die regsform van die bieër te oorweeg. Die regsform van die bieër affekteer wanneer 'n 'persoon' sal bestaan alvorens 'n belastingbetaler ter sprake kan wees in die bepaling van die toepaslikheid van artikel 11(a). Die tenderproses en spesifiek die beslissende gebeurtenis affekteer wanneer die bieër 'n 'bedryf' beoefen vir doeleindes van artikel 11(a). Daarenbove, indien enige regte geskep word as gevolg van die beslissende gebeurtenis kan KWB moontlik van toepassing wees indien die reg oor beskik word.

Gebaseer op die uitgebreide literatuurstudie uitgevoer, is daar gevind dat die beslissende gebeurtenis ook beslissend in die vasstelling van die aard van uitgawes is. Indien die tender suksesvol aan bieër toegeken is, word aangevoer dat die uitgawes deur die bieër aangegaan in die tenderproses kapitaal van aard is omrede 'n reg geskep word vir die bieër om inkomste te kan genereer (dus nie aftrekbaar ingevolge artikel 11(a) is nie maar aan KWB onderhewig indien die reg oor beskik word). Indien die tender nie die bieër toegeken is nie, word aangevoer dat die uitgawes aangegaan nie kapitaal van aard is nie en wel aftrekbaar ingevolge artikel 11(a) is.

TABLE OF CONTENTS

CHAPTER 1	1
INTRODUCTION	1
1.1 Background to the tender process in South Africa	1
1.2 Income tax uncertainty regarding tender expenditure	3
1.2.1 General income tax considerations	4
1.2.2 Specific considerations relevant to the application of section 11(a)	5
1.2.3 Specific considerations relevant to Eighth Schedule	6
1.3 Problem statement and research questions	8
1.4 Rationale for the study	9
1.5 Research design and methodology	10
1.6 Scope and limitations	10
1.7 Framework of the Study (Outline of chapters)	11
CHAPTER 2	13
BACKGROUND TO THE TENDER PROCESS IN THE SOUTH AFRICAN CONTEXT ...	13
2.1 Introduction	13
2.2 The definition of terms relevant to a tender process	14
2.3 Relevant aspects relating to the process of tenders in the South African context	15
2.3.1 Phases/stages in the tender process	16
2.3.2 The different forms of bidders in a tender process	18
2.4 Income tax treatment of tender expenditure in terms of current South African tax legislation	19
2.4.1 The levying of tax on income received in a tender	20
2.5 Conclusion	21
CHAPTER 3	22
DEDUCTIBILITY OF EXPENDITURE INCURRED IN A TENDER PROCESS	22
3.1 Introduction	22
3.2 Requirement that a 'person' exists	23
3.3 Requirement of a 'trade' being carried on	28
3.3.1 Continuity factor	33
3.3.2 Profitability factor	34
3.3.3 Carrying on a business	36
3.3.4 Passive income-earning activities	37
3.3.5 Numerous trades	38

3.3.6	Activities prior to commencing a trade ('pre-trade expenditure')	40
3.3.7	Conclusion on requirement of a 'trade'	43
3.4	Expenditure or losses	47
3.5	Actually incurred	48
3.6	During the year of assessment	49
3.7	In the production of income.....	50
3.7.1	Purpose of the act which necessitated the expenditure	52
3.7.2	Closeness of connection between expenditure and income-earning activity	53
3.8	Overall conclusion.....	57
CHAPTER 4		62
CAPITAL OR REVENUE NATURE OF THE RIGHT TO EARN FUTURE INCOME.....		62
4.1	Introduction	62
4.2	Tests applied to determine capital versus income nature of expenditure.....	63
4.2.1	Enduring benefit test	64
4.2.2	Once and for all test.....	65
4.2.3	Income earning operations or structure	67
4.2.4	Distinction between fixed versus floating capital	69
4.2.5	Profit making scheme	71
4.2.6	Conclusion on the capital versus revenue nature of expenditure incurred in a tender process	72
4.3	CGT in terms of the Eighth Schedule.....	75
4.3.1	Asset for the purpose of CGT	75
4.3.2	The concept of disposal for the purpose of CGT.....	78
4.3.3	Base cost and Proceeds for purpose of CGT.....	82
4.4	Conclusion	83
CHAPTER 5		86
CONCLUSION.....		86
5.1	Introduction	86
5.2	Concluding on research question.....	87
5.3	Concluding remarks and recommendations.....	93
LIST OF REFERENCES.....		94

LIST OF DIAGRAMS

Diagram 2.1: Tender process flow diagram	18
Diagram 3.1: Deduction in terms of section 11A in the context of the tender process	41

LIST OF TABLES

Table 3.1: Determining the concept of person in the context of a tender process	27
Table 3.2: Summary on the requirement of 'trade' applied in the tender process: Objective versus subjective tests	45
Table 3.3: Application of objective factors of 'carrying on of a trade' in the context of the tender process (including section 11A)	59
Table 4.1: Application of Capital tests to the tender process	74
Table 4.2: Application of capital concepts to tender expenditure	85
Table 5.1: Application of objective factors of a trade to the tender process	88
Table 5.2: Capital versus revenue tests to expenditure in tender process	91
Table 5.3: Application of CGT requirements to expenditure in tender process	92

CHAPTER 1 INTRODUCTION

1.1 Background to the tender process in South Africa

A tender process is of importance for the operation of national government, due to the fact that national government utilised this process extensively for the supply of goods and services (Ngobeni, 2011:12). This legislative obligation on government is specifically governed through the Preference Procurement Policy Framework Act (no. 5 of 2000), the Public Finance Management Regulations (Framework for Supply Chain Management published on 05 December 2003) as well as the Public Finance Management Act (no. 1 of 1999) (Ngobeni, 2011:3). The request for a tender for the supply of goods and services is thus a standard procedure in national government (Gildenhuys, 2002:603). Effective tender processes are essential to the operations of a government since improperly managed tenders can lead to operations being interrupted, poor quality products, late deliveries, customer service declines, as well as a number of other problems (Waters, 2002:562). It is for this reason that government should take responsibility to ensure that there is a proper procurement policy in place to ensure the government's overall economic objectives are met (Ngobeni, 2011:13).

The goods and services that are acquired by national government represent not only a substantial amount of public resources spent but also a significant source of income to private companies providing those services (Moeti, Khalo, Mufinisa, Nsingo & Makondo, 2007:122). Some private companies' main business may be the provision of goods or services specifically in response to tender requests. This indicates the importance of the tender process for all entities wishing to provide goods or services to either the national government or to a para-statal organisation. It follows that tax certainty around tender procedures are thus equally important.

Tax risk within an organisation is outlined by the OECD (Organisation for Economic Co-operation and Development, 2009:6) as being attributable in general to uncertainty about the interpretation of tax law, specifically in relation to particular transactions, and whether the tax administration (South African Revenue Services or 'SARS' in the context of South Africa) could have a different interpretation to that of the taxpayer. In some countries, it has been suggested that the way to address this tax uncertainty is to enhance the relationships

between the tax administration and large businesses. For example, a large business in Australia noted that engaging in early and transparent consultations with the tax administration resulted in fewer audit interventions and reduced tax uncertainty (Organisation for Economic Co-operation and Development, 2009:6). In the same manner, providing guidance on the treatment of expenditure incurred in a tender process could also provide greater tax certainty. This is especially true for entities who regularly tenders to provide goods and services to the national government or para-statal organisations.

In the process of a tender, the bidder (who will ultimately become the supplier of goods or services) is incurring expenditure. This expenditure may be in the form of licence and legal fees (Monteiro, 2008:4) or expenditure incurred to participate in a restricted bid (which will be elaborated on in **Chapter 2**), where the bidder may be required to 'purchase' the bid documents as a pre-requisite to participation in the tender. The question that arises for the taxpayer is whether the expenditure incurred can be described as 'revenue' in nature and therefore deductible in terms of the general deduction formula for the purpose of determining taxable income, or whether it is 'capital' in nature and therefore falls within the ambit of Capital Gains Tax ('CGT'). Irrespective of the nature of the expenditure, the tax liability is outlined in the Income Tax Act No.58 of 1962 ('the Act').

This was the question that arose in *ITC 1772 (2004) 66 SATC 211* where the Gauteng Tax Court had to make a determination as to whether the licence and licence fees incurred were capital or revenue in nature. In response to an invitation to tender by the Minister of Transport and the Minister of Post and Telecommunications, the appellant (who was the bidder) in this case had been successful in applying for these licences and was awarded the right to provide certain services. The court held that the licence fee (except for the annual licence fee) and some of the legal fees incurred, had not been routinely incurred but rather expended in order to expand on the appellant's 'income earning operation' since it granted the appellant the right to perform the operations rather than being part of the actual performance thereof. The court held that this expenditure is thus of a capital nature.

Subsequent to this case, the Revenue Law Amendment Bill 2008 proposed the insertion of a new section in the Income Tax Act, which served to address tax uncertainty such as that described. The explanatory memorandum acknowledges that businesses are often required to obtain government licences to conduct certain business activities and that such licences are characterised by monetary outlays, whether cash or otherwise, at the directive of

government. The memorandum further addresses the fact that since such expenditure is capital in nature, there is uncertainty as to the treatment thereof as there is no specific income tax relief for this type of expenditure. This uncertainty may lead to differing tax and accounting treatment of this expenditure in different circumstances. It is for this reason that section 11(gD) was introduced into the Act. This section provides for a deduction of expenditure incurred in order to obtain licence fees necessary for the purpose of trade, where this licence was required by national government, provincial administration, municipality or by a regulatory entity governed by the Public Finance Management Act 1 of 1999 (so-called 'PFMA entities'). As the memorandum clearly states, the licence must be a pre-requisite or a necessary condition for the taxpayer to conduct a trade. The deduction is only applicable in regards to licences obtained for the provision of telecommunication services; the exploration, production or distribution of petroleum or the provision of gambling services.

The introduction of section 11(gD) has provided some clarity on the treatment of licence fees incurred in specific instances. However, section 11(gD) has also resulted in tax uncertainty in other instances, as it does not address the issue of deductibility of licence fees where the recipient is not a part of the national or provincial government (Monteiro, 2008:4) or expenditure incurred in an industry not specifically included in the scope of the section. In respect of the type of expenditure – this section only refers to licence fees, whereas other expenditure could also reasonably be incurred as a pre-requisite to trade in the tender process. Such expenditure incurred in a tender process does not necessarily lead to the obtaining of a licence with a specific lifespan (such as was applicable in *ITC 1772*), therefore the question arises whether it is precluded from being treated in a similar manner as set out by section 11(gD). It is therefore submitted that there remains uncertainty as to the treatment of expenditure incurred in a tender process and whether such expenditure should be treated as capital or revenue in nature.

1.2 Income tax uncertainty regarding tender expenditure

In a rules-based tax system, such as in place in South Africa, tax uncertainty arises due to the ambiguity in the language itself, thereby requiring of judges to exercise discretion in adjudicating the tax rules in the Act (James, 2010:574). Rules do however give the taxpayer a degree of protection against judges exercising their powers in an unpredictable manner which could ultimately lead to unwanted tax results and unexpected costs (*ibid*).

The tax uncertainty arising from expenditure incurred in a tender process will be discussed in further detail with reference to the general application of the Act, the application of the general deduction formula in section 11(a) (read together with section 23(f) and section 11A), as well as the Eighth Schedule.

1.2.1 General income tax considerations

The liability of a taxpayer for income tax is imposed in terms of section 5(1) on 'persons' irrespective of whether they are natural persons, companies, close corporations or other taxable entities, which could include trusts and estates. Normal tax is payable on the taxpayer's 'taxable income' (Stiglingh, Koekemoer, Van Zyl, Wilcocks and de Swardt, 2014:2-3). The term 'taxpayer' is defined as any person chargeable with any tax leviable under the Act. Thus, although not explicitly stated, there is a prerequisite that a 'person,' as defined by the Act, must exist in order for the liability for income tax to be considered. Within a tender process, it is possible that an entity will only come into existence once the tender process has already begun, or even on condition that the tender is successfully awarded to the entity. For example, in the case where a consortium of companies are bidding or where a company is, in terms of the Memorandum of Association ('MOA'), created only on condition of a successful allocation of the tender. The relevant consideration is to determine at which point a person will come into existence for the purpose of income tax.

In determining the 'taxable income' of a taxpayer, it is necessary to subtract all the allowable deductions from the amount of 'income' as defined in section 1 of the Income Tax Act (Stiglingh *et al*, 2014:136). The deductibility of expenditure is determined in terms of the 'general deduction formula.' This formula comprises section 11(a) of the Act which determines what may be deducted and section 23(g) of the Act which stipulates what may not be deducted (*ibid*). In terms of section 11(a) a taxpayer may only deduct certain expenditure where the expenditure is actually incurred in the carrying on of a trade, in the production of income and where the expenditure is not capital in nature. While 'trade' is defined in the Act, the concepts of 'in the production of income' and 'not of a capital nature' are determined by *stare decisis*, through case law. The concept of a 'person' is also relevant in the context of section 11(a), as this section presupposes the existence of a person who is carrying on a trade.

The two main considerations that may influence the tax treatment of the expenditure incurred during the tender process, are the tender process, for which purpose a generic tender process will be referred to, as well as the form that a bidder takes when participating in a tender. It will also be important to consider the type of expenditure incurred, specifically in determining the nature thereof as income or capital.

According to Ngobeni (2011:18-25) the following make up the stages in a standard tender process: request for invitation of tenders; calling for tenders; submission and receipt of tenders; opening of tenders; assessing of tenders; and awarding of tenders. The steps in this tender process, including the pre- and post-tender stages, are relevant for the application of the general deduction formula. For this reason the general deduction formula is evaluated within the context of these stages or phases, rather than in isolation. Specifically, in the tender process there is a so-called 'deciding event' which is illustrated in **Diagram 2.1**. The deciding event is the event which determines the outcome of the tender process, namely the point at which the bid is awarded. It is submitted that the deciding event impacts on the tax consequences of the expenditure incurred.

1.2.2 Specific considerations relevant to the application of section 11(a)

Within the context of a tender process, it is necessary to determine whether the requirement of 'trade' had been met. Due to the wide nature of the definition of 'trade' in the Act and the interpretation thereof in *Burgess v CIR 1993 (4) SA 161 (A)*, the requirement is not submitted as contentious. Section 11(a) however requires the 'carrying on' of trade, which may necessitate a level of continuity and potentially the objective of making a profit (Stiglingh *et al*, 2014:137). Where entities are created with the sole purpose of bidding to provide goods/services, these continuity and profit objectives may not be met. Alternatively, this requirement may only be met once there is a reasonable chance of successfully being granted the tender. In addition to carrying on of a trade such trade should also result in the production of income.

The requirement of 'in the production of income' is not defined in legislation. However, in the case of *The Commissioner of South African Revenue v BP South Africa (Pty) Ltd 2006 5 SA 559 (SCA)* the courts gained some clarity and legal certainty in regards to the determination thereof. It was decided in this case that the court would look at the purpose of the expenditure and what the expenditure affects, in order to determine whether or not the

expenditure is deductible (Etsebeth, 2007:221). Part of determining the purpose of expenditure is to examine how closely connected this expenditure is related to the income-earning activities of the person (Stiglingh *et al*, 2014:143). When evaluating the expenditure incurred in the tender process, the purpose of the expenditure should be examined. This will assist in determining whether the expenditure had been incurred in the production of income. As with the determination of trade, this requirement requires consideration, not in isolation, but rather within the context of the tender process as well as with reference to the form of the bidder.

Section 11(a) furthermore excludes from deductible expenditure any expenditure that is 'capital in nature'. Only expenditure that is not capital in nature will fall within the ambit of allowable deductions in section 11(a). Where expenditure is found to be of a capital nature, the principles of the Eighth Schedule, which relates to CGT, need to be considered to determine the tax treatment thereof. The term 'capital nature' is not defined in either the Act or the Eighth Schedule but is rather determined with reference to tests as set out in case law (Olivier, 2012:172). In case *ITC 1722*, it was found that licence fees incurred in terms of a successful tender was capital in nature, as the expenditure was necessary for the continued operation of the appellant's income earning structure. For this reason, it is submitted that it may be found that other expenditure incurred in a tender process may also be found to be capital in nature. The nature of expenditure incurred is to be evaluated in the context of the tender process, taking into account the different stages. The classification of the expenditure as capital in nature may only be reached at one of the later stages of the tender process when there is a reasonable prospect of successful allocation of the tender or after the deciding event has occurred. The nature of the expenditure as 'capital' is thus potentially only a question of timing. The outcome as to whether expenditure incurred is capital or revenue in nature could also be affected by the nature or form of the bidder.

Should it be found that the expenditure is capital in nature, in order to determine the tax consequences of that expenditure, the principles of the Eighth Schedule must be considered as a further point of inquiry.

1.2.3 Specific considerations relevant to Eighth Schedule

The principles in the Eighth Schedule require that the CGT 'building blocks' must be present before levying of CGT occurs (Olivier, 2007:35–36). These building blocks are: the existence

of an *asset*, which is *disposed of* for *proceeds* which exceed the *base cost*. In the context of expenditure incurred in a tender process, initially the ‘form’ of the asset needs to be determined in order to evaluate whether there is an ‘asset,’ as defined, for the purpose of the Eighth Schedule. It can be said that the asset acquired in a tender process is the ‘right to earn future income’ which is obtained during the tender process and leads to the bidder earning income in return for delivering the goods or services. This right, to earn future income, is a personal right as it is only enforceable against another person, unlike a real right which is a right to property enforceable against all other persons. There is uncertainty in the law as to whether a personal right can be considered as an asset and whether a person can transfer this asset in order to ‘dispose’ thereof (Van der Merwe, 1998:354–355).

In terms of the SARS Comprehensive Guide to Capital Gains Tax (‘CGT guide’), personal rights are explicitly included as ‘assets,’ such rights being defined as imposing a personal duty upon the grantor thereof in favour of the grantee for a specific performance (McAllister, 2011:38). However the CGT guide further states that although the right to claim payment is a personal right, it is not always recognised as an asset for the purpose of CGT (*ibid*). There are no specific sections in the Eighth Schedule dealing with the CGT treatment of rights and specifically the treatment of a ‘right to earn future income’. In determining whether an ‘asset’ is created by the expenditure incurred, it is relevant to consider not only the form of the bidder, but also the tender process and specifically the deciding event as set out in **Diagram 2.1**.

Furthermore, even if expenditure incurred in a tender process is held to be an ‘asset’ it must be possible to determine the value of the proceeds and the base costs in monetary terms (McAllister, 2011:268). It is submitted that determining the base cost is not a contentious matter as the expenditure incurred in the tender process will form part of this cost and is measurable. The ability to measure proceeds might, however, be more difficult due to the requirement that rights created (if any) in terms of the tender process should be transferrable. The transferability of the right is dependent on the nature of the right as well as on the contract terms. If the right to earn future income in a tender is an asset, it needs to be determined whether and how it can be disposed of and how to determine the proceeds and base cost obtained from such a disposal.

1.3 Problem statement and research questions

The overall objective of this study is to formulate guidance regarding the income tax treatment of expenditure incurred in a tender process in terms of the South African Income Tax Act. The formulated guidance could address the uncertainty as set out in the introduction and background. This objective will be met through application of existing guidelines as found in the South African tax legislation as well as by means of the application of the methodology (judicial tests) developed by the courts as described in case law. These tests have been developed over the years in jurisprudence through the application of legislative principles. These tests provide greater clarity on the manner in which the legal principles should be applied.

The primary question addressed in this research paper is whether the expenditure incurred during a tender process will be deductible for income tax purposes in terms of the general deduction formula contained in section 11(a) (read together with section 11A). Alternatively, whether the expenditure incurred, if not deductible, can be seen as capital in nature, in which case the principles of CGT in the Eighth Schedule should be applied to determine the income tax consequences.

The primary research question of this study is thus concerned with the tax treatment of expenditure incurred in a tender process. This primary question will be addressed and concluded on with reference to the following secondary research questions:

- (i) At which point during a tender process can it be said that a 'taxpayer' exists for the purpose of determining the income tax liability?

This entails investigating whether tax will be levied on income eventually earned from the tender and whether a person is applicable for the purpose of section 11(a) to determine deductibility. This is specifically relevant in the situation where an entity is to be established only once a tender is successfully obtained;

- (ii) Can a bidder in a tender process be seen to be conducting a 'trade'?

This question will be answered with reference to the form of the bidder as well as determining the impact of the tender process on the evaluation thereof. Additional factors that affect the question of trade is the question of a bidder who has numerous trades (where the bidding for a tender is merely one of the activities). Where it is found that a trade is carried on, the application of section 11A should be considered as to the timing of deductibility of expenditure incurred;

- (iii) During the tender process, can it be said that the bidder has incurred the expenditure in the production of income?

This is of specific interest as the bidder does not have a reasonable expectation of success in the tendering process before the deciding event of the tender process; and

- (iv) Can the expenditure incurred during the tender process be classified as capital in nature?

If found that the tendering expenditure is capital in nature, therefore not deductible in terms of section 11(a), some pertinent further research questions arise in determining the implications of this 'capital asset' for purposes of the Eighth Schedule:

- Can the right to earn future income as created in the tender process be defined as an 'asset' since, in the case of a tender process, this right is only a personal right. It also requires determination of the point in time at which this right may be seen to be an asset (if at all), which should be done with reference to the tender process.
- Whether, and at which point, is it possible to dispose of the personal right to earn future income in the context of the tender process.

In the process of answering these questions posed above, this study will satisfactorily and appropriately answer the primary question regarding the tax treatment of the tender expenditure for income tax purposes.

1.4 Rationale for the study

As noted in the background discussion, taxpayers in a tender process are bidding to obtain the exclusive right to provide goods or services to the government or a parastatal organisation, or in the private sector they are bidding to provide goods or services to another organisation. Due to the extensive nature of these tender processes, taxpayers are unavoidably incurring expenditure which could include licence fees, royalty fees, socio-economic investment expenditure as well as expenditure in relation to advisors.

The tax consequences of the expenditure incurred is affected by the types of expenditure incurred, the purpose of the expenditure, the tender process as well as the various forms a bidder may take. For each bidder who is also a taxpayer the question arises, when completing their tax returns for South African tax, to what degree can the expenditure so incurred in a tender process be deducted in determination of their taxable income. Alternatively, whether this expenditure incurred should be regarded as having a CGT

consequence. For this reason, the clarification of the interpretational issues noted above will be valuable in providing guidance for the South African Revenue Services ('SARS'), bidders in a tender process who are taxpayers (whether resident or not) and tax advisors.

1.5 Research design and methodology

This study is an extended literature review, which is characterised by the study of secondary data. This methodology is justified as the purpose is not to produce new empirical studies or to validate any existing empirical studies but rather to review literature to answer a theoretical or conceptual research question, through inductive reasoning (Mouton, 2001:179-180). The research focused on a literature review of academic articles, legislation and case law, to determine a feasible solution for the theoretical question, which could be indicative of the resolution of the practical issues to which they relate.

For the purposes of interpreting legislation, the judgment and opinion of tax experts as well as the principles of interpretation of law as found in textbooks and journals will be consulted. Case law will also be referred to as it provides additional guidance on the application of legislation. While the majority of sources to be considered will be South African, international sources may provide additional insight which should be considered. This is specifically the case where there is uncertainty in the South African legislation as to the tax treatment and the international sources provide additional guidance. Also, in order to set a proper background to the study and the concept of a tender process and bidding, it was necessary to consult international sources, dictionaries and informal web-based sources.

1.6 Scope and limitations

It is important to understand what, if any, is the difference between a 'tender' and a 'bid' as these terms are often used interchangeably. The dictionary defines the verb tender as 'to make a bid or tender' whereas the term 'bid' is further defined as 'to offer to do work for a particular price' (Merriam-Webster, 2015). Even in this sense the terms do appear to be used interchangeably. The Oxford dictionary's definition is consistent and defines tender as 'make a formal written offer to carry out work, supply goods, or buy land, shares, or another asset for a stated fixed price' (Oxford University Press, 2015).

Another source defines a tender as:

‘To invite bids for a project, or to accept a formal offer such as a takeover bid. Tender usually refers to the process whereby governments and financial institutions invite bids for large projects that must be submitted within a finite deadline’ (Investopedia, 2015).

Investopedia (*ibid*) further clarifies the term to say that for projects or procurement, most institutions have a well-defined tender process, as well as processes to govern the opening, evaluation and final selection of the vendors which ensures that the selection process is fair and transparent. Investopedia (*ibid*) refers to the term ‘bid’ only in the sense of investments and securities and is thus not relevant for this study. However even in the definition of ‘tender’ the word bid is used.

A tender is also defined as the process whereby an organisation invites bids for the supply of goods and services and awards the contract to the best offer, according to predetermined criteria without negotiation and a tender is thus a proposal to provide a good or service in competition with other potential suppliers (Ngobeni, 2011:15). Ngobeni does not distinguish between a tender in comparison to a bidding process.

For the purpose of this study there will henceforth be referred to the term ‘tender’ and ‘bid’ interchangeably and refer to the participant in a tender as a ‘bidder’ unless there is reason to make a specific distinction between these terms.

1.7 Framework of the Study (Outline of chapters)

Chapter 2 will serve as an introductory chapter which will examine in more detail the background and workings of the tender process in the South African context. This chapter also sets out the stages or phases of a tender process which will serve as a framework within the other chapters to ensure that all aspects of tender expenditure have been considered in the study.

In **Chapter 3** it is investigated whether expenditure incurred in the tender process complies with the requirements as set out in section 11(a), excluding the ‘capital in nature’ requirement, as a first step to evaluate deductibility. This is done with reference to the tender process and the form of the bidder.

Chapter 4 entails an investigation as to the question of the capital or revenue nature of the expenditure. This is done through an investigation as to how the terms have been set out in legislative tests. This chapter also considers the application of the principles of the Eighth Schedule to determine the CGT consequences, if any, of expenditure incurred in a tender process. Chapter 4 also considers the form of the bidder and the tender process and the impact thereof on the nature of the expenditure incurred.

The final chapter, **Chapter 5**, concludes by submitting findings on the specific research question of this study and potential recommendations to address the issues noted.

CHAPTER 2

BACKGROUND TO THE TENDER PROCESS IN THE SOUTH AFRICAN CONTEXT

2.1 Introduction

The main reason a government receives goods and services through a tender process, is to obtain the best market response, including the best quality, timely delivery and lowest cost (Leads2Business, 2015). Whereas other objectives are also applicable, for example, reduction of business and technical risks, achieving socio-economic objectives and so forth, governments, large organisations and parastatals often rely on the process of a tender to obtain the best services and goods at the most competitive price (Bolton, 2009:388). Parastatals are also referred to as state-owned enterprises or public entities, these are enterprises or institutions that are directly or indirectly controlled by the state (Sonnekus, 2011:297). There are numerous parastatals in South Africa, some of the larger ones are: Transnet, Telkom, Eskom, Safcol, Denel and Metrorail (*ibid*).

In the context of South Africa, as was noted in the background to the study, legislation compels government to subscribe to a tender process and tender guidelines when acquiring goods and services.

It is possible that an entity will only come into existence once the tender process is in progress, or even on condition that the tender is successfully awarded to that entity. An example of such an instance is where a consortium of companies are bidding or where a company is created only upon successful allocation of the tender in terms of the MOA of the company. The question is thus at which point a 'person' comes into existence for the purpose of income tax.

It is important to understand some concepts relevant to a tender, as these set the framework for the study. Definitions and terms used throughout will be defined. Then some general aspects of a tender will be addressed, for example, the form of bidders and the legal nature of these bidders; the income tax treatment of tender expenditure in the Act; and the generic process of a tender.

2.2 The definition of terms relevant to a tender process

There are a number of key concepts which will be used throughout this study. The manner in which these key terms are defined will be determined through legislation and if necessary further defined. The following terms are defined in the Preferential Procurement Regulations, 2011 in section 1:

'Consortium or joint venture' – means an association of persons for the purpose of combining their expertise, property, capital, efforts, skill and knowledge in an activity for the execution of a contract.

'Contract' – means the agreement that result from the acceptance of a tender by an organ of state.

'Functionality' – means the measurement according to predetermined norms, as set out in the tender documents, of a service or commodity that is designed to be practical and useful, working or operating, taking into account, among other factors, the quality, reliability, viability and durability of a service and the technical capacity and ability of a bidder.

'Sub-contract' – means the primary contractor's assigning, leasing, making out work to, or employing, another person to support such primary contractor in the execution of part of a project in terms of the contract.

'Tender' – means a written offer in a prescribed or stipulated form in response to an invitation by an organ of state for the provision of services, works or goods, through price quotations, advertised competitive tender processes or proposals.

'Trust' – means the arrangement through which the property of one person is made over or bequeathed to a trustee to administer such property for the benefit of another person.

2.3 Relevant aspects relating to the process of tenders in the South African context

It is important to ensure that the process of a tender is well defined and understood prior to commencing a discussion on the subsequent income tax consequences of expenditure incurred in such a process. This process may affect the outcome of the investigation as to the tax consequences and therefore sets the framework for the study.

A tender can be defined as a proposal, which is usually made formally and in writing to supply goods and or services, in response to a competitive offer which is put out either by the public or private sector (Janse, 2008:4). Another source defines the process of bidding as the process whereby an organisation invites offers for the supply of goods and services and awards the contract to the most appropriate offer according to predetermined criteria without negotiation (Ngobeni, 2011:15). A tender can thus be seen as a proposition to provide goods or services in competition with other potential suppliers in a formalised manner (*ibid*).

Thus far in this study, tenders have been understood in the context of private companies providing services to government or parastatal bodies. Tenders are also important in the private sector, specifically in the case where an entity requires goods or services of a more specialized nature to satisfy a very specific need, for example, in the case of a company requiring a large IT system with complex system requirements (as illustrated by Lauesen and Vium (2004:1)).

There are various tender procedures that an entity can employ in order to manage a tender process. These are open, restricted or negotiated tender procedures (Janse, 2008:6). Whereas the general 'process' or lifecycle of these various tender methods may be similar or even consistent, the distinction is rather in the parties who are allowed to participate in the tender. In an open procedure, there is no restriction on the participants who are allowed to offer bids, however as the name indicates, in a restricted process the participants must be granted the 'right' to participate in the tender process before being able to tender (Janse, 2008:7).

Within the context of a tender, irrespective of the type thereof, there is a standard process which groups the typical activities of a tender into stages or phases. Additionally, bidders

can take on numerous forms in the legal sense. Both of these aspects, the stages of the tender and the nature of the bidders, are discussed in further detail below.

2.3.1 Phases/stages in the tender process

The process of a tender is one which involves numerous parties and activities. In general, the participants are grouped into two main categories as the party or parties requesting the tender and the parties who are bidding in terms of this request. The actions or activities of both groups follow a very distinct process, which is set out below as per Ngobeni (2011:19-25). Where necessary, additional information has been provided:

Calling for tenders

Tender documents set out the specifications of the goods or services required by the issuing party. The tender documents form an integral part of the invitation to tender. These documents should also set out the due dates applicable and the process to be followed during the tender. Participants submit offers based on the tender documents. The calling for tender could also include the sale of such tender documents and as well as briefing sessions for bidders.

Submission and receiving of tenders

Generally, in the case of a government tender, the bids are physically submitted in a formal process. Typically these processes are private, in that bidders may not see one another's bids.

Opening of tenders

The tenders are received and should be opened in such a manner as to avoid any irregularities or the prejudicing of any one bidding agent, for example, in public or in the presence of competing bidders if appropriate.

Assessing of tenders

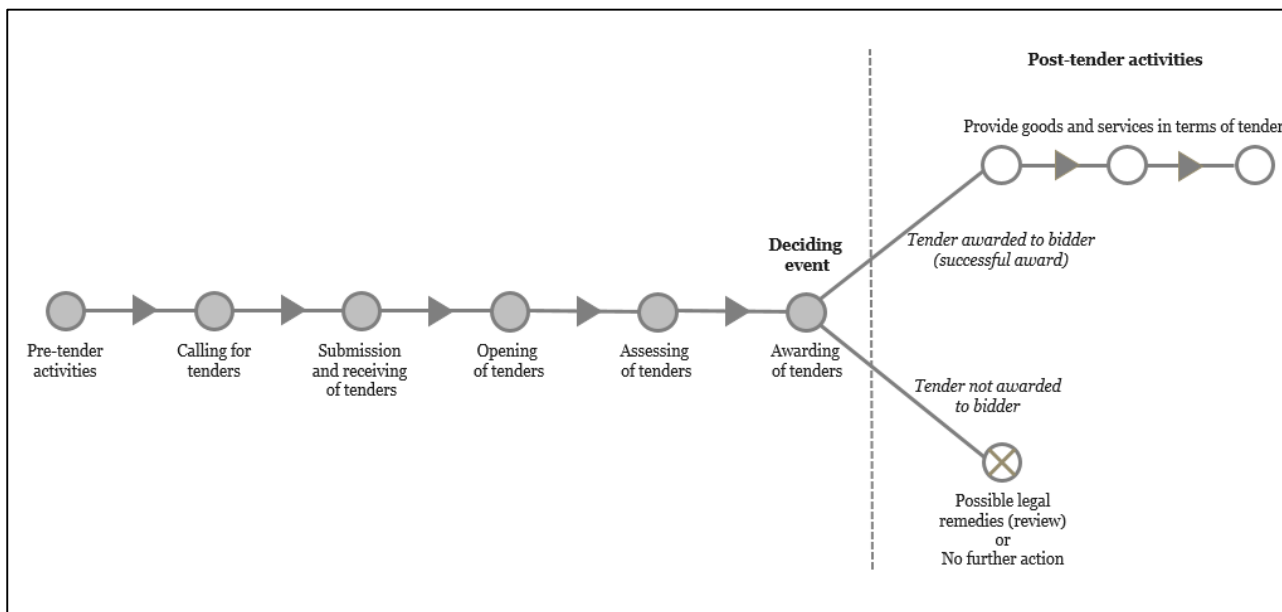
The tenders should be assessed by competent officials and the tender committee should make a selection to whom the bid is awarded. The necessary contracts are then prepared for the successful bidder. In the case of government, the evaluation and assessment of tenders should be done in accordance with department evaluation procedures. This is done by taking into account the specifications as documented in the bid documentation.

Awarding of tenders

It is suggested that prior to formally awarding the tender, an audit be conducted to confirm that the tender process has been performed without flaws. Thereafter successful bidders are notified and the formal contracts are signed, this allows for the goods/services to be delivered.

It is submitted that there are two additional stages which has not been referenced by Ngobeni (2011:19-25), namely the stage prior to the tender commencing which will be referred to as the Pre-tender stage as well as the stage which follows after the tender which will be referred to as the Post-tender stage. These stages are relevant since in the stage prior to a tender, there are numerous business decisions being made by a bidder (including whether to bid and in what 'form' to bid). This could be a very involved process which in turn can affect, either directly or indirectly, the tax treatment of expenditure incurred. In the same way, given the results of a tender, the bidder will be in a position which affects its business and may alter the business decisions it makes. The effect of the successful or unsuccessful allocation of the tender could thus similarly affect the tax treatment of the expenditure incurred.

Throughout the study, where it is relevant, reference will be made to these stages where these stages may affect the income tax treatment of expenditure incurred. For simplification, it may be that some of the stages are grouped together in order to facilitate the discussion. Within these phases, the bidder is actively working to obtain the bid. This may include having to comply with specific requirements of the tender documents and proving their ability to provide the requested goods and services. Although each phase of the bid has its own set of activities, in general when considering the tax consequences, it is possible to condense the relevant activities to two main groups. There are activities prior to the tender being awarded, and thereafter. The awarding of the tender is the event that changes the outcome of activities occurring prior thereto and is thus the deciding event. Within the context of this study, this will be the framework of the discussion except where the individual ungrouped phases are relevant. **Diagram 2.1** sets out the phases of a tender, as well as the deciding event, as discussed.

Diagram 2.1: Tender process flow diagram

Author compiled

2.3.2 The different forms of bidders in a tender process

Another consideration relevant in determination of the tax treatment of expenditure incurred during the tender process relates to the ‘form’ in which the bidder bids. Form in this context is used to describe the legal nature of the bidder. There are various forms that a bidder may take when submitting a tender (if not explicitly disallowed by the tender documents), which include but may not be limited to: an individual, a company, a close corporation, a partnership or a consortium (which may also be referred to as a joint venture).

The legal form will affect the income tax treatment of expenditure incurred in one of three ways:

- The bidder must be a ‘taxpayer’ as set out in the Act in order to be both subject to tax and eligible for tax deductions.
- The form of the bidder may have an impact on the tax treatment of expenditure incurred with reference to the requirements of deductibility. A ‘person’ must be applicable in terms of the general deduction formula in section 11(a) (as discussed in **Chapter 3**).
- The existence of a person may have an effect on the timing or applicability of whether the expenditure incurred is of a capital nature and the subsequent CGT consequences thereof (as discussed in **Chapter 4**).

A bidder's existence as a person may be subject to a successful allocation of a tender. As mentioned, it is possible that the bidder only be incorporated upon successful allocation of a bid. Prior to the bid allocation, the form of the bid is thus uncertain and the bidder has, what may be referred to, as a 'conditional existence'. A consortium serves as an example of a conditional existence as in some cases the parties to the joint venture or consortium have come together for the sole purpose of applying for that tender and should the bid fail, the consortium may come to an end. This scenario is well illustrated in the case of *Steenkamp NO v Provincial Tender Board, Eastern Cape* (2007) 3 SA 121 (CC). In this case the tender board invited tenders for the supply of a new IT system which would assist in the payment of welfare grants in the province (Quinot, 2008:102). The tender was awarded to a wholly owned black company which was *especially incorporated* for the purpose of bidding for this particular government contract (own emphasis). The bidder in this case thus had not been created for the purpose of general trade but for the purpose of bidding in this contract. The High Court held that the bidder failed to submit a valid tender because it was not incorporated in terms of the Companies Act at the time when it submitted its tender, thus the bidder did not exist at the time of submitting the tender and that for this reason it was not a valid tender (Quinot, 2008:103). The decision of the High court was upheld both in the Supreme Court of Appeal as well as in the Constitutional Court, based on different reasons. It should be noted however that the decision of the courts did not focus exclusively on the legal existence of the bidder but rather concerned the legal claims (if any) applicable to an unsuccessful bidder in a tender process.

The question of whether a bidder who submits a tender in the form above, namely with a 'conditional existence,' is a person in terms of the Act, will be discussed in detail in **Chapter 3**.

2.4 Income tax treatment of tender expenditure in terms of current South African tax legislation

The liability to pay annual income tax or normal tax as it is referred to in the Act, is imposed in terms of section 5(1) on any person or any company. The Act further stipulates that normal tax is to be paid during the year of assessment. Section 5 of the Act is thus the levying provision for normal tax. Although section 5(1) does not refer specifically to a 'taxpayer' but refers rather to a 'person', in section 5(7) of the Act reference is specifically made to a

taxpayer. The term 'taxpayer' is defined in section 1 of the Act and means any person chargeable with any tax leviable under the Act.

Although not explicitly stated, when considering the terms defined above as well as the levying provision, it is held that there is a prerequisite that a 'person' must exist in order for the liability of income tax to be considered. Furthermore, there must be a section of the Act which levies tax on this person. The concept of 'person' is thus wider than the concept of a 'taxpayer' and whereas every taxpayer is in fact a person, the same cannot be said for the converse. Therefore, normal tax is payable on a taxpayer's 'taxable income' which is received or accrued (Stiglingh *et al*, 2014:2–3) and every taxpayer falls within the definition of a 'person'.

Before a determination can be made on the income tax implications of expenditure incurred in a tender process, it is thus important to establish firstly whether a 'person' exists and whether tax is levied on this 'person' in order to determine if that person is a 'taxpayer'. It will be investigated in §2.4.1 below whether there is a provision which levies tax on the bidder in a tender process. The concept of person will be discussed in **Chapter 3** in the context of trade and the tender process.

2.4.1 The levying of tax on income received in a tender

The imposition of normal tax, as determined in section 5(1) of the Act, refers to tax payable on 'taxable income.' This term can broadly be referred to as the amount remaining after allowable deductions have been deducted from a person's 'income' as defined. Income is the amount remaining after exempt income has been excluded from 'gross income' (Williams, 2001:272). In order to have 'taxable income' a person would first need to determine whether there was 'gross income.' The Juta commentary on the Act describes gross income as the 'central concept of the entire Act' (Davis *et al*, 2015:1 gross income-1). The term 'gross income' is defined in the Act as to mean, in the case of a resident, 'the total amount, in cash or otherwise, received by or accrued to or in favour of such resident' and then goes on to include specific amounts which may not have been ordinary included as such. For the purpose of the current study, no further analysis will be done on the legislative meaning of 'gross income'.

The most important consideration is whether income that is earned by means of a tender, would be included in 'gross income' and subsequently also in 'taxable income.' Based on the wide meaning of the term and the fact that there is no specific exclusion principle that would preclude tender income from being understood as 'gross income', it is held that income earned from a tender will be included. Whereas it is possible that certain tenders may lead to the earning of exempt income, thus reducing the amount of 'gross income,' we will assume for the purpose of this study that 'taxable income' will be applicable.

Therefore, for the purpose of section 5(1), the requirement that tax must be levied, will be deemed to be met.

2.5 Conclusion

Due to the working of the Act and the manner in which tax is imposed, as was noted, it is important to first establish whether, in the case of a bidder, a 'taxpayer' is present, in order to establish whether there will be any income tax implications to expenditure incurred in the tender process. In order to determine whether a taxpayer is applicable, the definition of the term was taken into account and the result is that in order to be a taxpayer, two requirements must be met:

- A 'person' must exist; and
- Tax must be levied in terms of the Act on this person.

This study has already concluded on the second requirement, the first requirement is discussed further in **Chapter 3**. If one assumes the existence of a person, then both requirements of the concept of 'taxpayer' have been met, the conditions outlined in section 5(1) have been met, and therefore it is necessary to determine the income tax implications of the expenditure incurred during a tender process.

Should it be found, after further investigation, that a person as defined does not exist in the context of the tender process, the effect that this would have on the income tax consequences of the entity submitted the tender, will be discussed in **Chapter 3**.

CHAPTER 3

DEDUCTIBILITY OF EXPENDITURE INCURRED IN A TENDER PROCESS

3.1 Introduction

The income tax to be paid to the South African Revenue Services is the amount of tax that is levied on the statutorily defined 'taxable income' of a taxpayer. In order to determine the 'taxable income' of a taxpayer, exempt income is excluded after which all allowable amounts are deducted (Williams, 2001:272). In *Sub-Nigel v CIR 1948(4) SA 580 (A)* at 588 the judge set out the rule in regards to allowable deductions as follows:

'...the court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of the prudent trader, but merely with the deductions which are permissible according to the act.'

Allowable deductions are thus determined with reference to the relevant legislation, namely the Income Tax Act, specifically in terms of the 'general deduction formula' as defined by section 11(a) as read with section 23(g) (Thackwell, 2010:41). These sections are also referred to as the positive test i.e. what may be deducted in terms of section 11(a) and the negative test i.e. what may not be deducted in terms of section 23(g) (Stiglingh *et al*, 2014:139).

The general deduction formula is not applied in the case where an item of expenditure is dealt with under a specific section of the Act. The determination of deductibility can thus be done through the process of elimination (Willemse, 2010:75). First one applies the specific relevant section and only after that would one employ the general deduction formula, if required. In the case of expenditure incurred in a tender process, there is no relevant section which deals specifically with such expenditure. A number of the expenses incurred during a tender process, may be ordinary business expenditure for which a section is applicable. For example, section 11(gD) provides for a deduction of expenditure incurred in order to obtain licence fees necessary for the purpose of trade, where this licence was required by PFMA entities. The general deduction formula will be discussed and should be taken into account with regards to general tender expenditure. Where a specific section is applicable, this will trump the applicability of the discussion below.

Expenditure incurred by one party, is income to another party. There is generally no relationship between the tax consequences of the money owned by the two transacting parties. Therefore the fact that the income may be taxable in the hands of the recipient, has no direct impact on the deductibility thereof in the hands of the payer (Williams, 2001:275). There is an exception to this general rule, namely where legislation speaks specifically to this, for example section 11(g) proviso (vi) of the Act. It is also important that the accounting view on whether expenditure is deductible is irrelevant (Davis *et al*, 2015:11(a)–1), which was illustrated in the quote above from *Sub-Nigel v CIR*.

When applying section 11(a), read in conjunction with section 23(g), to expenditure in order to determine deductibility, it is possible to distinguish a number of criteria that have to be met, namely:

- requirement that a ‘person’ exists;
- requirement of a ‘trade’ being carried on;
- expenditure or losses;
- must be actually incurred;
- during the year of assessment;
- in the production of income; and
- not be of a capital nature (investigated in **Chapter 4**).

Each of the requirements listed above, excluding ‘not be of a capital nature,’ will be discussed in further detail below. The application thereof in the context of expenditure incurred in a tender process will form part of this discussion. The requirement that expenditure not be of a capital nature and the application thereof in the context of the tender process will be investigated separately in **Chapter 4**.

3.2 Requirement that a ‘person’ exists

Section 11(a) allows expenditure and losses incurred to be deducted for tax purposes by ‘any person’ from income earned in ‘carrying on any trade.’ It is thus a prerequisite for the application of section 11(a) that a ‘person’ as defined must exist. In **Chapter 2** it was discussed whether tax will be imposed on a bidder in a tender process, however it was noted that it is further required to establish that a ‘person’ is applicable in a tender process and this requirement will be investigated below.

In terms of section 1 of the Act, a 'person' is defined as follows:

“Person’ includes -

- (a) an insolvent estate;
 - (b) the estate of a deceased person;
 - (c) any trust; and
 - (d) any portfolio of a collective investment scheme,
- but does not include a foreign partnership.’

With reference to the Juta Commentary on the Income Tax Act (Davis, Olivier, Urquhart, Engels-van Zyl, Roeleveld, Mollagee, Coetzee & Benetello, 2015:1 person–0) a ‘person’ includes natural persons as well as legal persons despite the definition not specifically including a reference to either terms. This can be substantiated with the application of the principles of interpretation of statutes.

The use of the word ‘includes’ in the definition is meant to contain certain items but not to be exhaustive (de Koker, 2012:25.7) and therefore the meaning of the term ‘person’ can be wider than the list in the definition above. In *Estate Brownstein v CIR* (1957) 21 SATC 262 the court held that the word ‘includes’ in definition sections are meant to add unusual items to the ordinary meaning of the word being defined (de Koker, 2012:25.7). This supports the commentary of Davis *et al* that both natural persons and legal persons are included in the term as this would be consistent with the ordinary meaning thereof. This was confirmed in the case of *Jones & Co Ltd v CIR* (1926) CPD1 2 SATC 7 at 10 where the judge said that the term ‘includes’ is not a term of exhaustive definition but rather indicative of the legislature wishing to extend or enlarge the term being defined (Clegg & Stretch, 2012:2.13). In *Dilworth v Commissioner of Stamps 1899 AC 99* the judge confirmed that the word ‘includes’ is generally used to enlarge the meaning of words and phrases (Clegg & Stretch, 2012:2.13).

The Interpretation Act 33 of 1957 section 2 further defines a ‘person’ to include any bodies of persons, corporate and incorporate as well as any company incorporated or registered as such under any law. It was also confirmed in *CIR v JW Jagger and Co Ltd 1945 CPD 331* that a ‘person’ includes a company (Davis *et al*, 2015:1 person–0).

The term ‘body of persons’ is not further defined in the Interpretation Act, nor in the Income Tax Act and the commentary on such legislation is silent as to its meaning. This term is also used in the Value-Added Tax Act 89 of 1991 (‘Value-Added Tax Act’) which defines ‘person’

to include any public authority; any municipality; any company; any body of persons (corporate or unincorporate); the estate of any deceased or insolvent person; any trust fund; and any foreign donor funded project. Botes (2015:51.2) in his commentary on the Value Added Tax Act, looks at the term 'body of persons' and notes that since this term is not defined, that it should take on its normal meaning. Botes (*ibid*) provides examples of unincorporate 'body of persons' namely a joint venture, a partnership or a club and states that there is no requirement for it to be a legal entity. However when referring to a corporate body of persons, such company or close corporation should be a legal entity which is registered and thus incorporated in terms of law. There is thus no doubt left that a company or close corporation would thus be included in the definition of 'person.'

Despite the term 'body of persons' not being specifically included in the definition of person for the purpose of the Income Tax Act, due to the wide ambit of the definition and its inclusion in the definition of 'person' in both the Value Added Tax Act and the Interpretation Act, it is submitted that this term should be included in the ambit of person. Furthermore, reference to a 'body of persons' would give effect to the levying of tax on companies and close corporations, which is within the scope of the Income Tax Act, taking into account the tax levying provision of section 5(1). In conclusion, this interpretation lends a very wide meaning to the concept of 'person' which is not inconsistent with other provisions of the Act.

There is no exhaustive list of the form that a bidder may take in a tender process (although it should be noted that the tender documents may require of the bidder to be in a certain form). Based on the analysis above, it is clear that where the bidder is a natural person or incorporated legal person (for example, company or close corporation) there is no doubt that that bidder is a 'person.' In the case of other formal business arrangements (for example, partnership or joint venture) these would arguably form part of the concept of a 'body of persons' and also fall within the ambit of 'person' due to the wide interpretation thereof as set out.

In **Chapter 2**, reference was made to bidders who have a 'conditional existence' or are specially incorporated for the purpose of a tender. The question is thus whether a person would come into existence in the case of bidders with a conditional existence, where such existence is reliant on a bid allocation, and therefore their existence is outside of their control. Should the bid be awarded to the bidder and it comes into existence as a company or close corporation (for example), there is no question as to whether a 'person' exists or not, due to

the wide interpretation thereof. However, there is an uncertainty around the timing of the deciding event, as the person may or may not have existed at the time of the expenditure being incurred. This issue, around the timing of the formation of the person, is linked closely to the question of trade and the tax consequences of expenditure which has been incurred prior to a trade being carried on. It will therefore be addressed later in this chapter with reference to section 11A of the Act. Section 11A of the Act relates to pre-trade expenditure. In the case of an unsuccessful tender allocation, there is more uncertainty as to whether a 'person' ever came into existence and thus whether any tax implications can be attached to the expenditure incurred during the tender process.

It is held, with reference to 'unincorporated body of persons', that this concept is wide enough to include a bidder that may only come into existence upon a successful bid allocation. In discussion of this term, Botes (2015:51.2) includes an example of co-owners of a property as being a body of persons, even where such parties are not in a formal partnership. In a tender process, significant actions may in some cases be required during the process of tender and the duration of this tender could stretch over an extended period of time, during which the parties to the tender will be conducting these activities with some sense of collaboration and financial involvement. Two or more parties who are endeavouring to tender together, may thus be compared to co-owners of a property (as listed in the examples of Botes) and therefore be included in the concept of a 'body of persons'. Based on the argument of Botes, there is no reason not to conclude that a 'person' will exist during the tender process, irrespective of the fact that such parties may not yet have created a body of persons which is incorporated. Further investigation is required as to the exact tax treatment of expenditure incurred and potential income earned in the hands of all individual parties involved, separately from the 'person' to be formed. Such a discussion is outside of the scope of this study and is an area for future research.

Based on the arguments above, there will in the case of the tender process, always be a 'person.' This application of the requirement of 'person' will be relevant to section 5(1) in determining the levying of tax, but also to section 11(a) as to the possible deductibility of expenditure incurred. In conclusion **Table 3.1**, which follows, was compiled as clarification on whether a 'person' is applicable in the context of the tender process, based on the literature review.

Table 3.1: Determining the concept of person in the context of a tender process

Form of bidder	Literature review	Person in terms of Act?
Individual	The term 'person' includes natural persons as well as legal persons despite the definition not specifically including a reference to either terms Davis <i>et al.</i> (2015:1 person–0). This can be substantiated with application of the principles of interpretation of statutes.	Yes
Company/Close corporations (legal persons)	According to Davis <i>et al.</i> (2015:1 person–0) a 'person' includes natural persons as well as legal persons despite the definition not specifically including a reference to either terms. This can be substantiated with application of the principles of interpretation of statutes. The Interpretation Act 33 of 1957 section 2 further defines a 'person' to include any bodies of persons, corporate and incorporate as well as any company incorporated or registered as such under any law (confirmed in CIR v JW Jagger and Co Ltd 1945 CPD 331).	Yes
Consortium of bidders (joint venture or partnership)	Botes (2015:51.2) includes an example of co-owners of a property as being a body of persons, even where such parties are not in a formal partnership. In a tender process, significant actions may in some cases be required during the process of tender and the duration of this tender could stretch over an extended period of time, during which the parties to the tender will be conducting these activities with some sense of collaboration and financial involvement. Two or more parties who are endeavouring to tender together, may thus be compared to co-owners of a property (as listed in the examples of Botes) and therefore be included in the concept of a 'body of persons'. A 'person' is thus applicable in irrespective of the fact that such parties may not yet have created an incorporated body of persons.	Yes
Company only being created once the bid is successfully awarded	<p>Prior to bid allocation</p> <p>It is held, with reference to 'unincorporated body of person', that this concept is wide enough to include a bidder which may only come into existence at successful bid allocation. See also the discussion under 'consortium of bidders' in the preceding row of this table.</p> <p>Bid successfully awarded to bidder</p> <p>Should the bid be awarded to the bidder and it come into existence as a company or close corporation (for example), there is no question of whether a 'person' is applicable due to the wide interpretation thereof, and there is purely a question of timing, for example, whether the person had existed at the time of the expenditure being incurred.</p> <p>Bid unsuccessful awarded to bidder</p> <p>Difficulty arises in the case of a tender being awarded unsuccessfully. It is submitted that in this case the person that had been created may cease to exist and subsequent tax effects need to be investigated.</p>	<p>Prior to bid allocation</p> <p>Yes</p> <p>Bid successfully awarded to bidder</p> <p>Yes</p> <p>Bid not awarded to bidder</p> <p>Person ceases to exist</p>

At the outset of this discussion, it was noted that section 11(a) allows as deduction from income, expenditure which is incurred by a person who is 'carrying on a trade.' As it has been established that a person exists in the context of the tender process, it is required to investigate further whether the person is carrying on a trade.

3.3 Requirement of a 'trade' being carried on

In terms of section 11(a), a prevailing principle exists, namely that the taxpayer must be 'carrying on a trade.' For this reason it is important to understand what this term refers to in the context specifically of section 11(a) and then to apply it to the activities occurring in a tender process. While the phrase carrying on of a trade as per section 11(a) is not specifically defined in the Act, the term 'trade' is (Davis *et al.*, 2015:11(a)–2).

In order to investigate the applicability of this requirement in the context of the tender process, the definition of 'trade' will be set out initially. Thereafter, the manner in which this term has been defined through case law and interpreted by authors will be described in order to identify the tests as well as factors that should be taken into account to determine whether a taxpayer is carrying on a trade. These tests and factors will then be applied to the specific aspects relevant to a taxpayer who is a bidder in a tender process, namely by applying it to the phases in a tender process, the form of the bidder as well as the nature of expenditure, as is applicable.

The definition of 'trade' in the Act is defined as to include more general activities rather than an exhaustive list of all possible trading activities. In *Burgess v CIR* the court described it as a well-established principle, stating further that the definition should be given a wide interpretation (Stiglingh *et al*, 2014:137). Most activities may thus constitute the carrying on of a trade for the purposes of the Act as the definition is phrased broadly, including the following;

- every profession, trade, business, employment, calling, occupation or venture;
- the letting of property; and
- the use of or the grant of permission to use any patent, design, trade mark, copyright or any other property which is of a similar nature.

The question as to whether a particular taxpayer is carrying on a trade is determined by the particular circumstances of that taxpayer's activities. There have been cases in which a lack of continuity, or the lack of a profit motive, have been held to exclude the taxpayer concerned from carrying on a trade, however neither of these factors are prerequisites for the carrying on of a trade (Stiglingh *et al*, 2014:137).

The courts have not consistently determined the meaning of 'carrying on a trade' over time. In *Burgess v CIR* it was held that if the activities of the taxpayer on its own **objectively** constitute a trade, then the trade requirement is met, irrespective of the intention of the taxpayer, and therefore his motive is irrelevant (*Burgess v CIR* at 179H – 180A). In the case *ITC 1292 41 SATC 163* the court also determined that a purely objective approach is to be followed to determine whether the trade requirement has been met. In this case the overriding factor the court took into account was whether the taxpayer had the probability of making a profit, irrespective of the intention of the taxpayer. It is held that this approach has confused the requirement of 'trade' with the requirement 'in the production of income' (Olivier, 2009:191), this opinion appears to be substantiated by the case of *Sub-Nigel v CIR* where the court determined that the 'in production of income' requirement does not entail that actual income needed to be received but focusses instead on the intention of the taxpayer. According to Davis *et al.* (2015:11(a)–2), taking into account these cases, the question of 'trade' is purely objective and therefore there is no discretion required by the Commissioner in this regard. If the objective factors indicate that the taxpayer is trading, then the trade requirement has been satisfied. If this is the case, the motive of the taxpayer for trading is irrelevant and even where the sole motive of the taxpayer is to obtain a tax benefit, should objective facts indicate that the taxpayer is conducting trade activities, then the trade requirement will have been met (*Burgess v CIR* at 179H - 180A).

In the *C:SARS v Smith 2002 (6) SA 621 (SCA)* case, the court came to a conclusion contradictory to the cases stated above, as it was determined that a **subjective approach** has to be followed to determine whether a taxpayer carried on farming operations in the context of section 26 of the Act. Section 26 sets out the manner in which to determine taxable income derived from farming of a taxpayer. Since the case was decided in the context specifically of farming activities, it is uncertain whether a subjective test should also to be followed to determine whether a taxpayer generally conducted a 'trade' for the purposes of section 11(a) of the Act. It is submitted that the judgment will be at least persuasive authority, due to the fact that the court based its decision on authority dealing with the question

whether a business (i.e. trade) was conducted (Olivier, 2009:192). Davis *et al* (2015:11(2)–2A) have held that this case is sufficient authority to find that a purely subjective approach should be followed, since there is no wording in the act to distinguish farming operations specifically from trading activities more generally.

In *CSAR v Smith* the Supreme Court of Appeal concluded that for the purpose of determining farming activities, objective factors are relevant to determine the *ipse dixit* or subjective intention of the taxpayer, but it cannot be elevated above the subjective test as the mere intention of the taxpayer remains the conclusive factor (Olivier, 2009:192). It is submitted that a stricter interpretation of statutes should be followed in this context. Section 26 refers to a person carrying on pastoral, agricultural or farming operations whereas section 11(a) refers to a person ‘carrying on a trade.’ These terms are not interchangeable and had the purpose of the legislature been to infer a similar meaning to the terms, then the wording would have made such a purpose clear. It can be said that for the most part, the term ‘trade’ is defined widely enough so that farming operations can be included in its ambit. However, it is submitted that upon determining whether a person is conducting a ‘trade’ versus conducting ‘farming operations’ that some differentiation is important.

A subjective approach requires a determination as to the state of mind of the taxpayer, however it is only the taxpayer himself who knows what his intention is or was (specifically in the case of an individual) (Oguttu, 2003:231). In the case of juristic persons, Tshikororo (2014:8) states that a legal entity normally has been incorporated indicating the purpose of trade through means of its MOA. The courts have not always placed much weight on the objectives of the company as set out in the MOA as illustrative of its intention, but rather relied more heavily on what the company did in practice (Oguttu, 2003:232). In the case of *Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd 1956 (1) SA 602 (A)* the court considered the intention of the directors of the company (*ibid*), essentially piercing the corporate veil for the purpose of determining intention. The importance of this is that the court has tended to not exclusively look at the wording of the company’s incorporation documents which sets out the intentions of the person, but may well consider the substance over form of activities being undertaken, thus negating the importance placed on the subjective approach.

In the context of activities forming part of the tender process, it will need to be determined for the purpose of applying section 11(a) whether a trade is being carried out. This is done by applying the definition and tests identified above, to the tender process as well as the form of the bidder. With consideration to the **form of the bidder** (see **Table 3.1**), the main contentious matter related to bidders who only come into existence with the allocation of a tender in their favour. The question as to whether a 'person' exists for the purpose of the income tax was answered in the affirmative. The next question to be answered is whether it can be said that this bidder is conducting a trade or whether the manner in which this bidder is set up, would in some way alter the applicability of the term 'trade' to the actions that the bidder is carrying out, or intends to carry out, in the context of a tender. Although a bidder may only come into existence at the allocation of a successful tender, there are no substantive differences between that bidder and a bidder who has been incorporated prior to the tender process. Therefore there is no additional investigation required as the conclusion would be similar to that of every other bidder. The two factors that could, upon review of all aspects to consider, negate the fact that a trade is being conducted in this specific context, is the question of profitability and continuity. Both of these factors will be investigated in detail below.

In view of the inclusive wording of the definition, it would appear that virtually all activities of a taxpayer would constitute a trade for tax purposes (Davis *et al.*, 2015:11(a)–2). Applying the definition of 'trade' to the activities occurring during the **process of a tender**, is thus redundant as the resultant answer is clearly in the affirmative. However, the courts have gone further than merely looking at the definition of trade in determining whether a taxpayer can be said to be carrying on a trade, as was noted during the discussions of case law above. Uncertainty exists as to whether an objective or subjective approach should be followed. If an objective test is followed, it is important that the objective factors indicate that trading is applicable (Davis *et al.*, 2015:11(a)–2). On the other hand, if a subjective test is applied, the mere intention of the taxpayer to conduct a trade will be sufficient. The subjective and objective approaches therefore require consideration.

Should the bidding activities of the taxpayer be measured against 'trade' by applying the so-called subjective test, some further questions arise. There is an argument to be made that all bidders would have the intention of conducting a trade, merely by virtue of bidding for the right to provide goods or services, as this act of the bidder indicates the subjective intention to make a profit or obtain some business benefit in the future. However, when ascribing the

intention of a bidder to the acts it performs, then a purely subjective approach is not followed. If a proper subjective determination is to be done which involves the intention or motive of the taxpayer, then a legal question may arise as to determining the actual intention of certain types of persons, such as a consortium of bidders (for example, where companies are bidding together for purposes of the tender) or in the case where the company bidding will only be brought into existence on the condition that the bid is successful. Determining the intention of a legal entity is normally done with reference to its MOI when applicable (Tshikororo, 2014:8). The manner in which to determine intention is uncertain in the case of a consortium of bidders where no such MOI exists. It is uncertain whether it would be appropriate to look at the future MOA to be created for the combined entity or whether to pierce the corporate veil in order to determine the underlying intention of the persons governing the legal person. Determining the actual intention of a bidder can thus only be done in practice and the approach as to how to determine such an intention is outside of the scope of this study.

The Tax Court in *ITC 1698 63 SATC 161* held that despite following a subjective approach, the objective factors are not entirely irrelevant but rather should support the *ipse dixit* of the taxpayer (Olivier, 2009:192). According to Olivier (*ibid*) the approach of the tax court was correct, namely that the intention of the taxpayer must be supported by objective factors, of which the prospect of making a profit is one. The court held in *C:SARS v Smith* that the objective factor in a case cannot be elevated above the intention of the taxpayer. It is clear in case law that the courts continue to consider these factors.

The objective test used by courts to determine whether a taxpayer is conducting a trade requires of the court to consider a number of factors which could provide more evidence as to whether a trade is applicable or not. Since the court has determined that the list of factors to be considered is not exhaustive, and not one factor is conclusive (*Stephan v CIR (1919) 31 SATC 54 61*), the approach to follow is to examine the activities concerned as a whole and to question whether it should be regarded as the carrying on of a trade. In determining if a trade is being carried out, one must take into account the nature, scope, magnitude and objective of activities as well as the continuity and profitability thereof (Tshikororo, 2014:7). This is also the opinion of the court in *Estate G v CoT 1964 (2) SA 701 SR* stating that activities should be considered as a whole to establish whether the taxpayer is carrying on a trade (Stiglingh *et al*, 2014:137).

Some of these factors will be considered below. The application of these factors in case law will also be discussed. The factors will then be applied in the context of the tender process to establish whether a trade has been conducted. The factors that will be investigated includes the following:

- continuity
- profitability
- carrying on a business
- passive income-earning activities
- numerous trades
- activities prior to trade

3.3.1 Continuity factor

One of the considerations to determine whether a trade has been conducted is the continuity of the operation (*Modderfontein Deep Levels Ltd v Feirnstein (1920) TPD 288*), which requires that continuous active steps should be taken. It is however not possible to lay down an exhaustive definition of what degree of activity is required to constitute the carrying on of a trade (*Estate G v CoT*). It should rather be stated that continuity is a positive indicator of the fact that a trade is applicable (Tshikororo, 2014:8), as it was stated already that there is no authority that requires continuity as an absolute indicator. The continuity factor is specifically a good indication to determine whether an individual is conducting a trade, whereas a legal entity normally would have been incorporated and in doing so would indicate the purpose of trade through its MOA. In such instances continuity may be less relevant (Tshikororo, 2014:8).

There is an argument to be made that the continuity of operations can be seen as a distinct additional requirement for section 11(a). The section allows deductions for persons who are 'carrying on a trade.' It was already discussed that there is only a definition in the Act for 'trade.' The ordinary meaning should thus be construed for the words 'carrying on' namely to continuously perform an activity or task (Katzke, 2009:6). According to Stiglingh *et al.* (2014:137) to fulfil the requirement of the carrying on of a trade, the features of the specific activities should be considered as they relate to 'trade' and that the concept of continuity lends itself to indicate that a trade is being 'carried on.' The words 'carrying on' in the section could thus be understood to mean that the taxpayer must continuously perform such trading activity. Stiglingh *et al.* (2014:137) describes the distinction with reference to the taxpayer

who lets property: the letting of property is specifically included in the definition of 'trade' however in order to be 'carrying on' a trade the taxpayer must continuously be renting out the property in order to comply with section 11(a) and not rent it out as a once-off activity. The courts have not interpreted section 11(a) in such a way as imply that continuity is an absolute necessity in determining whether a taxpayer is carrying on a trade.

When considering continuity in the context of a tender, one could be lead to a negative conclusion on whether a trade is being conducted, specifically since the allocation of the tender is not under the control of the bidder, thus the continuity of its activities could be questioned. This rings even more true for bidders where their existence is dependent on such a successful allocation of a bid. It is also worth considering that there may be some time delay between the availability of another tender for which the taxpayer may bid, if any other tenders exist at all. This is contradicted by the situation where the bidder is an incorporated person which, as part of its normal business activities, regularly tenders for the delivery of goods or services. In this situation there may be scope to find that the continuity factor is counting in the favour of concluding that a trade exists since the trading activities of the person extends not only to delivering the goods and services, but also to bidding in a tender process. Based on the number of possibilities pointed out, it is not possible to conclude on the applicability of the continuity factor in general in relation to tender activities, the continuity factor will have to be considered with reference to the specific facts of each case.

Similar to continuity, the profitability factor had been discussed considerably in case law, although the factor is also not one that is an absolute requirement in the Act. It is relevant as it may serve as a positive indication of whether the taxpayer had been carrying on a trade. This is discussed in detail below.

3.3.2 Profitability factor

In terms of *ITC 770 (1954) 19 SATC 216* the definition of trade should be widely construed to embrace all profitable activity (Tshikororo, 2014:4). In the case of *Green and Sea Point Municipality v Egnal and Co (1902) 19 SC at 376* the court determined that the word 'trade' has been held to mean 'any occupation from which a man derives profit or subsistence.' This determination implies that a person should make a profit out of their occupation or trading activities.

Profitability has been indicated as a persuasive indication that a trade is being conducted, however the absence of a profit would not disqualify the activities of a taxpayer from being classified as trade. This is illustrated in *De Beers Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (A)* at page 323(2) where the judge noted:

‘It is true, as I have already indicated, that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer’s trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of section 23(g). Such moneys may well be disbursed on grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayer’s trade.’

It should thus be considered that a transaction may be carried out with the foresight that no profit will be made, which does not contradict the conclusion that, based on the specific circumstances, there is clearly a trade (Meyerowitz, 2008:11.28). It is also not correct to ascertain the existence of a profit simply by comparing the cost price and selling prices of an article, as numerous other factors may be relevant in determining whether that taxpayer obtained some fiscal advantage or ‘profit’ (*ibid*).

Tshikororo (2014:18) contradicts the conclusion of the *De Beers Holdings (Pty) Ltd v CIR* case by stating that where the motive of the taxpayer is not to make a profit, the carrying on of a trade will not be ascribed to the activities of the taxpayer. It can be argued that based on case law, the motive of profitability cannot be construed as being the overriding factor in determining whether the taxpayer is conducting a trade, specifically considering the outcome of *Burgess v CIR*. In this case, the court found that even where the sole motive of a transaction or trade is the tax benefit thereof, this would not preclude it from being a trading activity as long as the objective factors suggests a trade is conducted (Davis *et al.*, 2015:11(a)–2). The *Burgess v CIR* case indicates that the profit motive of the taxpayer is not the absolute standard for determining the existence of a ‘trade’.

It is submitted that in case law and the interpretation thereof, writers have not been consistent in their application of the profitability factor. It is possible to draw a distinction between a taxpayer who obtains a profit and a situation in which the taxpayer has the intention of obtaining a profit. Whereas the former has a definite objective standard, and measures profitability as a factual outcome, the latter lends itself to conclude that if the subjective intention of the taxpayer was to obtain a profit, then the actual outcome is

irrelevant. Both these factors are indeed relevant as an indication of whether trade is being carried on, however determination thereof will rely again on the differentiation between an objective versus subjective determination as discussed earlier in this study.

The question as to profitability in the context of the tender process is a challenging one. At any given point during the tender process, until such time as the bid is awarded, it is doubtful whether it is possible to say that the bidder has any reasonable expectation of profit, even though it can be assumed that the bidder's intention is to make a profit. The concept of profit should not be narrowly understood in the accounting sense where a person's income exceeds their losses, rather, profit should be understood to refer to an economic or fiscal advantage (Meyerowitz, 2008:11.28). In the context of an unsuccessful bid, there are not many fiscal advantages, except the potential tax benefit that the deduction of tender expenditure may result in. It is possible to conclude that during the stages prior to 'bid allocation' there remains uncertainty as to the question of whether a bidder is profitable and thus this factor may not be conclusive evidence of the fact that a trade is conducted. However, after such time as a bid is awarded (the 'deciding event'), the successful bidder is in a position where there is a reasonable expectation of making profits and thus it may be said conclusively that the person is carrying on a trade at such time. If the bid is not awarded successfully, it is doubtful that the profitability factor would aid in concluding that a bidder carried on a trade.

3.3.3 Carrying on a business

The requirement of profitability is closely related to the concept of carrying on a business. Since the definition of 'trade' includes the concept of 'business' it is possible that an activity be 'trade' but not 'business', however the converse is not possible. 'Trade' is a wider concept than that of 'business' (Williams, 2001:276-277). Since the term business is specifically included in the definition of trade it is worthwhile considering its meaning in order to gain better clarity as to the meaning of what possibly constitutes a trade. Tshikororo (2014:6) states that the ordinary meaning of business refers to a commercial enterprise which may be a particular occupation, employment or other activity which is executed for profit. The criteria is thus that a direct and primary objective of any business is to make a profit and merely hoping for a profitable outcome is insufficient (*Ibid.*). This is substantiated in the case of *Cape Town Municipality v Clarensville (Pty) Ltd 1974 (2) SA 138 (C)* where business is defined as almost anything which is an occupation and requires attention, rather than being

done only for pleasure. It is also defined as activities that occupy someone's time and attention, and are done so with the goal of making a profit. The first definition connotes more of an objective test, for example, it would be possible to look reasonably at the time a person spends on their activities, and the nature of those activities, whereas the latter definition uses the word 'purpose', and this word necessitates a subjective interpretation of the reason that person has participated in those activities.

It is doubtful that the guidance regarding 'business' contributes more to the question of whether or not a bidder in a tender process is conducting a trade. Since the concept of business is related to the concept of making a profit, the discussion in §3.3.2 above will suffice. The one additional aspect that could add value to this discussion is the definition of business in of *Cape Town Municipality v Clarensville* which states that a business is an occupation, and a business is not activities undertaken merely for pleasure. In this context, the activities of a tender would easily be seen as a 'business' as opposed to pleasurable activities such as hobbies. This definition contributes to the case for finding that a trade is in fact being conducted.

3.3.4 Passive income-earning activities

In the context of passive income-earning activities, the courts have provided more clarity as to whether a 'trade' is being conducted. Although the courts have determined that any activity that leads to profit making or generates income is to be understood as 'trade' for the purpose of section 11(a) (Stiglingh *et al*, 2014:137), in the case of *ITC 1476 52 SATC 141* the court found that the carrying on of a trade involves some active step. In *ITC 1275 (1978) 40 SATC 197 (C)* a person who invested money in interest-bearing securities or shares was found not to derive the income of the carrying on of a trade (Stiglingh *et al*, 2014:137). This is also the position that the Commissioner follows in practice.

Practice Note 31 makes provision for two different situations which supports this practice:

- Interest paid on funds borrowed for the purpose of lending them out at a higher rate will constitute a permissible deduction as the activities of the taxpayer constitute a trade; and
- A taxpayer who is not a moneylender, but earns interest on capital or surplus funds invested, is not regarded as carrying on a trade. Expenditure incurred in production of such interest is thus not deductible. Nevertheless, the Commissioner may allow expenditure incurred to the extent that it does not exceed such income.

The practice notes, although referring more specifically to the act of money lending, distinguish active versus passive income earned and thus determine that income earned through investment activities will not be considered as 'trade' for the purpose of section 11(a). In the case of *Burgess v CIR* at 171, the court states that in spite of the wide meaning of trade as defined in the Act, it does not embrace all activities that might produce income; for example, income in the form of interest, dividends, annuities or pensions does not necessarily result from trade. A person who accumulates his savings and invests them in interest-bearing securities or shares held as assets of a capital nature, does not derive the income from carrying on any trade (*ITC 512 (1944) 12 SATC 246*). A taxpayer who was not carrying on the business of buying and selling equities and interest-bearing securities, but was rather maintaining his investments, was held not to be carrying on a trade (*ITC 1275*).

Participation in a tender requires definite active steps by the bidder and the question as to passive income earning activities is not relevant. This factor thus does not contribute to the question of trade in this context. A bidder may however participate in passive income earning activities such described above and also bid in tenders. The question as to the treatment of expenditure in the case of a bidder with numerous trades may be relevant and require further investigation.

3.3.5 Numerous trades

The scenario in which a taxpayer has more than one trade, one of which is bidding in tenders, leads the study to the question of deductibility of expenditure incurred in such a situation. Section 11(a) makes use of the words 'any trade', which proposes that the assorted deductions incurred by a taxpayer may not be aggregated, but rather specifically deducted from the income obtained from the trade to which it relates (Williams, 2001:275). Williams (2001:275), contradicts this statement by saying that the taxable income of a taxpayer is defined as gross income (excluding income which is exempt) less allowable deductions, and that this does not require determining the income and deductions separately based on the applicable trade. This statement is substantiated by referring to section 20(1)(b) which allows expenditure of one trade to be offset using income from another trade in determination of an 'assessed loss' (*ibid*). Meyerowitz (2008:11.2) claims that allowable deductions are not only deductible from the income derived from trade, but rather from any income of the taxpayer which is subject to tax. This concept is relevant in considering the deductibility of taxpayers in situations where a taxpayer has numerous trades.

There remains uncertainty with regards to a taxpayer who conducts numerous 'trades' and whether it is correct to deduct expenditure incurred in one trade from the income earned in another trade. In the context of a tender process, the situation may arise where the bidder already has been awarded a number of successful tenders in terms of which it is delivering goods and services. For the purposes of this study it is important to clarify that should the bidder be participating in a new tender, and incurring expenditure, whether it is correct for that bidder taxpayer to deduct this expenditure from income earned from another bid. It is submitted that as the nature of the activities are similar, the regular trade of that person is bidding in and fulfilling tenders and bidding is thus seen as one trade. This should be contrasted to a situation where the taxpayer is conducting trades unrelated to bidding, and then decides to participate in a bid to expand their income base. The question is whether expenditure incurred during the new activity which relates to the bid can be deducted from income incurred in conducting their normal trading activities, or whether it is necessary to treat the bidding activities separately from their regular trade.

Additionally, the question arises whether it is possible to deduct expenditure incurred in conducting a trade from income obtained from sources not related to conducting that trade, for example, investment income. Specifically, in the case of a bidder who has not successfully won any tenders this may be relevant as the only potential income it could have earned may be from passive investment sources. Whereas the activities of the tender may be found to be in the carrying on a trade, it is assumed that the income earned from passive income sources is not earned in the carrying on of a trade.

There are no legislative guidelines which address this question, however there has been one court case which provides some clarity on the matter. In *Sekretaris van Binnelandse Inkomste v Olifantsriviere Ko-operatiewe Wynkelders Bpk (1976) 3 All SA 574 (A)* the court looked at the distinction between 'income' used in the context of taxability versus 'income derived in the carrying on of a trade' in the context of deductibility. The court found that using the latter term in section 11 of the Act was 'inclusive' in purpose, namely to allow amounts to be deducted from income obtained by conducting a specific trade. The purpose was not to limit every mention of 'income' to income derived from a specific trade. This court case is cited by Meyerowitz (2008:11.2) to support the assertion that allowable deductions are not only deductible from the income derived through a specific trade, but rather from any income of the taxpayer which is subject to tax. However, it is submitted that the decision in this case was in fact limiting, as it supports a legalistic interpretation that deductions are only allowed

from income derived through conducting a trade and not from income in general. Therefore, where a taxpayer earns income from sources that are not part of its trade (for example interest earned), expenditure cannot be deducted from such income in terms of section 11(a). This is not to say that expenditure incurred in conducting one trade can or cannot be deducted from income earned through another trade.

The Margo Commission of inquiry into the Tax Structure of the Republic of South Africa RP 34/1987 recommended that the preamble to section 11(a) be amended to allow for deductions from all income, as defined, rather than being limited to income from carrying on a trade. However, this recommendation has, to date, not been implemented (Davis *et al.*, 2015:11(a)–4). The question as to numerous trades and the deductibility of expenditure incurred in the expansion of one trade, from income earned from another trade, is one which still remains uncertain and is an area for future studies. In the context of expanding businesses and numerous trade activities, it is also important to consider the timing element relating to trade and the legislative approach to expenditure incurred prior to trade commencing.

3.3.6 Activities prior to commencing a trade ('pre-trade expenditure')

Taxpayers are allowed to deduct pre-start-up expenditure incurred despite a trade having yet occurred, in terms of section 11A of the Act. These deductions are ring-fenced and may only be used against any present and future income obtained from the same trade to which it relates (Davis *et al.*, 2015:11A–1). The pre-trade expenditure to which this section relates is not deductible in terms of the general deduction formula in section 11(a), as it assumes that a trade is not yet being carried on. Interpretation note 51 (SARS Legal and Policy Division, 2014:6) sets out the requirements of section 11A as follows:

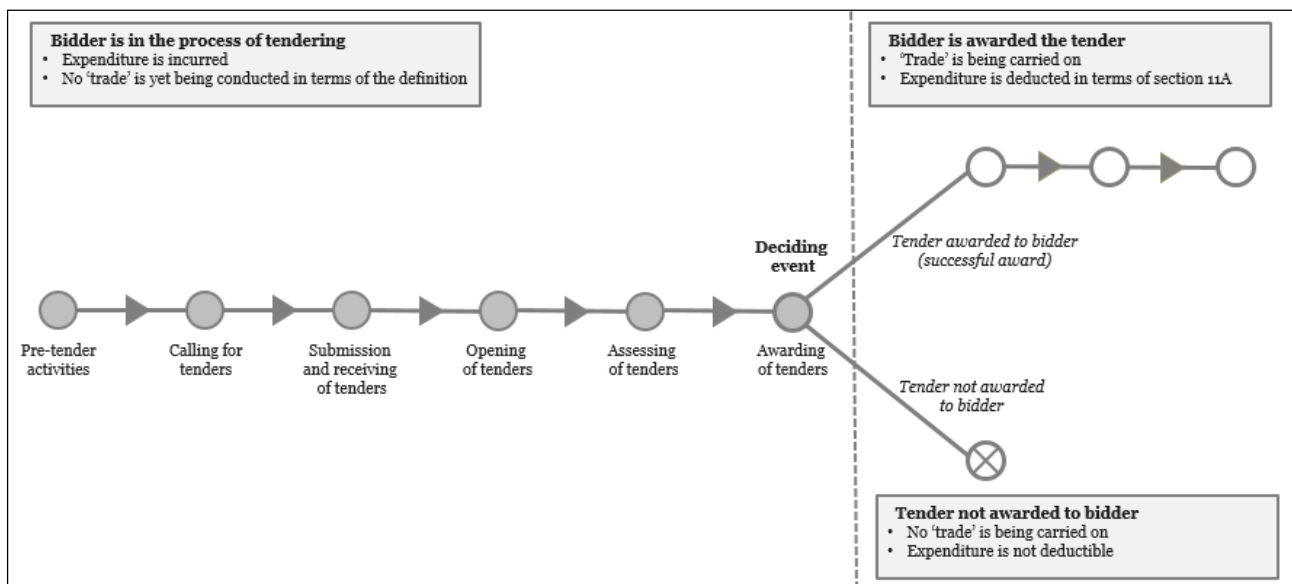
- The trade (to which the expenditure relates) must have been commenced by the taxpayer.
- The expenditure must have been actually incurred and in preparation of that trade.
- The expenditure would have been allowed in terms of section 11 (other than sections 11(x), 11B, 11D or 24J); and
- The expenditure may not have been deducted in that year or any previous year of assessment.

Based on the requirements set out, it is essential in terms of this section that there be a trade, prior to the deduction being allowed (Stiglingh *et al.*, 2014:138). Additionally, the other requirements of section 11(a) as discussed in this chapter are relevant as they will also need

to be complied with in order to test that the expenditure is deductible in terms of section 11. Trade is thus the ‘trigger event’ which regulates the timing of deductions. It is important to establish to which expenditure section 11A and the ring-fencing should be applied (SARS Legal and Policy Division, 2014:6). South African legislation does not stipulate when trade commences and reliance may be placed upon case law as it provides some guidance in this respect (*ibid*). This uncertainty has already been discussed as part of the trade requirement. For the purpose of investigating the application of section 11A, it will be assumed that trade commences once a bidder is successfully awarded a bid and accepts that bid.

It is relevant to address the question as to the timing of deductions in the situations where there is certainty that the taxpayer will be carrying on a trade. In the case of a bidder who has complied with all the listed requirements of section 11(a) and commences with trading activities (for example, in the case of a tender being successfully applied), the expenditure incurred prior to trade and thus in the process of a tender, will be deductible in terms of section 11A. Contrary to this, where a bidder is not awarded a bid and assuming that the bidder does not carry on a trade, the expenditure incurred in the tender process will not be deductible in terms of section 11A or section 11(a). These two situations can be understood in the context of the tender process, which is illustrated in **Diagram 3.2**.

Diagram 3.1: Deduction in terms of section 11A in the context of the tender process



Author compiled

It is clear from section 11A(2) that where expenditure incurred prior to trade exceeds the amount of income from this trade, such excess expenditure may not be deducted from income earned from another trade, however it may be carried forward to a following year to

be set off against potential income in that year (Stiglingh *et al.*, 2014:138). This is important in the context of a bidder where such a bidder has multiple trades. When expenditure incurred in a tender process is classified as pre-trade expenditure and deductible in terms of section 11A, this expenditure may only be deducted from income which is earned from the specific bid and not from income earned from other trades that the bidder may be carrying on.

An additional question may arise in the case of a bidder whose main trade is that of bidding for tenders (the bidder regularly and consistently participates in bids). If the study assumes for the sake of this investigation that the bidder is carrying on a trade in regards to their tender activities, it is necessary to consider whether this bidder, who is involved in a new tender, may deduct expenditure incurred in this new tender in terms of section 11(a) or section 11A from income earned in relation to a different tender. The fact that a trade is being carried on would lead one to conclude that the expenditure may be deducted in terms of section 11(a) of the Act. SARS (SARS Legal and Policy Division, 2014:7) set out in Interpretation note 51 the situation applicable where a taxpayer is expanding their business. In terms of this interpretation note, the courts have understood the Act to require that the person's income should be considered on a trade-by-trade basis, with the overall results of the trade being aggregated. The interpretation note further analyses the situation where the taxpayer owns income earning assets and incurs expenditure in obtaining a new income earning asset in order to expand the business. The interpretation note concludes that where a taxpayer is in the process of creating an asset for use in the business, expenditure incurred relating to the asset prior to bringing it into use will be of a capital nature and not incurred in carrying on of the existing trade (*ibid*). This is illustrated with the example of a taxpayer who owns a number of income producing properties and then obtains a new stand which is being developed. In this case the new stand was recognised as a separate business and not part of the existing trade of renting buildings. In terms of Interpretation note 51, the policy objective of SARS (2014:11) is that in the case of a taxpayer with numerous buildings, it should be considered on the facts whether a new property constitutes an independent new trade or forms part of the existing trade. The interpretation note states that it is likely that the letting of the new property will be considered to be an independent trade and that in terms of section 11A pre-trade expenditure is deducted only from the trade to which it relates (SARS Legal and Policy Division, 2014:6).

The situation set out above may be equated to the situation of a bidder who expands their business through means of a new tender. It has not yet been established in this study whether tender expenditure is of a capital nature or not, however based on this illustration, where a bidder is in progress of bidding in a new tender, this expenditure cannot be deducted from income earned from another tender but may only be deducted from future income earned from the specific tender which is applicable, assuming all requirements of section 11A has been met and the expenditure is not capital in nature. Clegg (2014:6) concludes that expenditure incurred on a new asset which is incurred prior to the use thereof in an existing trade will be wholly non-deductible.

In considering the manner in which the Interpretation Note 51 sets out the application of section 11A, this section is only applicable in the case of expenditure not being of a capital nature. Interpretation note 51 (SARS Legal and Policy Division, 2014:13) refers to a 'post-trade test' to be applied to expenditure. This test requires one to consider whether, if the expenditure had been incurred subsequent to the trade commencing, whether it would have been deductible and not capital in nature. The Interpretation Note explains it by submitting that generally expenditure incurred prior to and in creation of an income-producing structure being established will be found to be capital in nature, for example advertising, audit fees, rent, salaries and wages. However, testing the nature of these expenses against the post-trade test, one finds that it is not capital in nature and therefore section 11A is applicable. The effect is that section 11A changes the nature of the expenditure from capital to revenue (*ibid*). For this reason, section 11A will only be applied to expenditure which is revenue in nature (in applying the post trade test) and therefore prior to determining the application of section 11A, it is required to first consider the nature of the expenditure. In regards to the investigation of the nature of expenditure incurred in the tender process, this is done in **Chapter 4**.

3.3.7 Conclusion on requirement of a 'trade'

At the outset of this investigation as to whether a 'trade' can be said to exist, it was stated that the most prudent approach would be to take into account all aspects of trade to determine whether a trade is being conducted or not. All of the evidence reviewed, barring the subjective test (as it is not possible to state the motive of a taxpayer with certainty), indicate that a bidder in a tender process is conducting a trade. It is noted that the question may rather be one of timing, namely that prior to the successful allocation of trade, there is

some uncertainty as to whether a trade is being conducted. However, once the tender has been awarded and the bidder takes up the tender, it is clear that trade is being conducted.

Once it is established that a trade is being conducted by a taxpayer, it is furthermore required to establish that there had been 'expenditure or losses' which had been incurred as per section 11(a) and whether this requirement has been met in the context of a tender process.

In conclusion, the *onus* is on the taxpayer to show whether it has been trading and to provide evidence in this regard (Davis *et al.*, 2015:11(a)–4) and therefore in the case of a bidder who is participating in a tender, it would be for the bidder to provide evidence that the activities it partakes in can reasonably be seen as conducting a trade. The conclusion on the requirement of 'trade' and factors for consideration have been set out in **Table 3.2**, below, as it applies to the tender process. Once it is found that a trade is being carried on, the additional requirements of section 11(a) need to be met in order to consider the tax consequences of the expenditure incurred in a tender process.

Table 3.2: Summary on the requirement of ‘trade’ applied in the tender process: Objective versus subjective tests

Bidding cycle	Definition of trade	Subjective test of intention	Objective factors
<p>Pre-bidding stage (including request for invitation and calling for tenders)</p>	<p>In view of the very wide wording of the definition, it would appear that virtually all activities of the taxpayer would constitute a trade for this purpose (Davis et al., 2015:11(a)–2). Applying the definition of ‘trade’ to the activities occurring during the process of a tender, is thus redundant as the resultant answer is clearly in the affirmative</p>	<p>In <i>C:SARS v Smith 2002</i>, the court came to the conclusion that a subjective approach has to be followed to determine whether a taxpayer generally carried on a ‘trade.’</p>	<p>When considering continuity in the context of a tender, one could be lead to a negative conclusion on whether a trade is being conducted, specifically since the allocation of the tender is not under the control of the bidder, thus the continuity of its activities could be questioned (especially if the bidder’s future existence is dependent on allocation of a bid and thus prior to such bid allocation there is no continuity in its activities). Where a bidder is an incorporated person which, as part of its normal business activities, regularly tenders for the delivery of goods or services it is submitted that the continuity factor would exist since the trading activities of the person extends not only to delivering the goods and services, but also to bidding for tenders.</p>
<p>Submission and opening of tender</p>		<p>A subjective approach requires a determination as to the state of mind of the taxpayer, however it is only the taxpayer himself who knows what his intention is (specifically in the case of an individual) (Oguttu, 2003:231). In the case of juristic persons, Tshikororo (2014:8) states that a legal entity normally has been incorporated indicating the purpose of trade through means of its MOA.</p>	
<p>Assessing of tender</p>		<p>It is not possible to identify the subjective intention of each potential bidder, as it is based on intention or motive which is dependent on each person. The nature of a bid is such that the taxpayer will be conducting activities that would appear to be business-like and it is submitted that the majority of bidders would have the intention of carrying on a trade.</p>	

<p>Awarding of tender and Post tender process</p>	<p>Tender awarded to bidder and taken up</p> <p>Once the tender is taken up the bidder commences with providing services/goods in terms of the tender documents. At this time there seems to be no doubt that the bidder is carrying on a trade.</p> <p>Tender not taken up or not awarded to bidder</p> <p>Where the tender is not taken up, one needs to determine whether there had been a trade subsequent to such point in time. If it is argued that the tender activities prior to this point is equated to the 'carrying on of a trade' then at this point the trade of the bidder ceases. Alternatively, if no trade had yet been applicable then no trade is ever carried on by the bidder and section 11(a) and section 11A is not applicable and expenditure is not deductible in terms of either sections.</p>		<p>Tender awarded to bidder and taken up</p> <p>During the stages prior to 'bid allocation' there remains some uncertainty as to the question of whether a bidder is profitable and thus this factor may not provide conclusive evidence to the fact that a trade is carried on. However, after such time as a bid is awarded, the successful bidder is in a position where there is a reasonable expectation of profits and thus it is submitted that the tender is conducting a trade at such time.</p> <p>After successful bid allocation, there may also be more continuity in the activities of the bidder which also indicates trade.</p> <p>Tender not taken up or not awarded to bidder</p> <p>If the bid is not awarded successfully, it is doubtful that the profitability or continuity factor would aid in concluding that a bidder carried on a trade, except in the case of a bidder who regularly and continuously bids for tenders. Based, however, on the broad definition of 'trade' and the fact that expenditure is incurred for purposes of generating income it could still be regarded as a 'trade'.</p>
--	---	--	--

Author compiled based on literature review

3.4 Expenditure or losses

In determining whether expenditure or loss have been incurred, it is first necessary to determine what is meant by the terms. It is noted that the court has in the past created confusion between the terms expenditure and the discharging of an obligation or actual payment (Van Zyl, 2012:188). It is held that one should take into account the 'normal meaning' of expenditure; namely to focus on the action taken by the taxpayer whereby money, funds or other resources are being paid (De Kock, 2012:33). In the case of *C:SARS v Labat Africa Ltd 2013 (2) SA 33 (SCA)* at 37 the court determined that as there is no definition in the Act for 'expenditure', but it is an ordinary English word and this meaning must be attached to it unless the specific context indicates otherwise. The court then proceeded to define the term as:

'Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended.'

In *ITC 1783 66 SATC 373* the court defined 'expenditure' as 'the spending of money or its equivalent, for example, time or labour and a resultant diminution of the assets of the person incurring such expenditure.' Jansen van Rensburg (2013:63) provides that expenditure will have been incurred if an unconditional legal obligation is acquired, in terms of which some form of performance is due, provided that the performance has a monetary value. Expenditure, according to Meyerowitz (2008:11.31), may take on any form which has a value in money or money's worth, which could include: cash, lodge and board, transport or transferring an item of value (such as land).

Since section 11(a) specifically references expenditure or loss, it is also important to consider the term 'loss', the difference between the two terms and the relevance of that distinction. The Judge in the case of *Joffe & Co (Pty) Ltd v CIR 13 SATC 354* describes the term 'loss' and distinguishes it from the term 'expenditure' on page 360:

'...in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money. When trading operations cause damage to third parties and this damage has to be made good, then the payment which is made in satisfaction of such damage (and possibly even the pre-existing liability to make such payment) may properly be called a loss, but when the payment has been made then it can also properly be called an expenditure. Consequently, it is not clear to me that the word 'losses'...means anything different from 'expenditure'. The word 'loss' is also sometimes used as the antonym of 'profit', but then it denotes the final result of a trading operation after the expenditure has been deducted and it seems inappropriate to speak of a loss, in that sense, in conjunction with expenditure, as something which is incurred in the production of income. If any income at all (i.e., any return) is produced by a trading operation, then clearly the expenditure and the loss, in that sense cannot both be deducted from the income in order to arrive at taxable income, because it would entail a double deduction of so much of the expenditure as is a loss'.

It is clear from this paragraph that considering a distinction between the terms makes no material difference to the application of section 11(a). It may be said that while expenditure is voluntary and is done as a matter of choice, a loss may denote a certain sense of involuntary expenditure on the side of the taxpayer (Meyerowitz, 2008:11.31).

The expenditure incurred in a tender process (as set out by examples) clearly falls within the ambit of the term 'expenditure' and there is no uncertainty in this regard, therefore this requirement has been met. It is necessary to determine whether it had been 'actually incurred' as a further requirement to section 11(a).

3.5 Actually incurred

As with 'expenditure,' the term 'actually incurred' is not defined in the Income Tax Act and therefore to determine the meaning thereof, regard should be had for case law and the manner in which the court has interpreted this term. The Income Tax Special Court determined in the case of *CSARS v Labat Africa Ltd* that 'actually incurred' does not merely refer to 'paid' but rather refers to the existence of an obligation to pay or incurring of an unconditional legal obligation (Van Zyl, 2012:188). This principle is in line with the meaning of 'actually incurred' as it was laid down in *Edgars Stores Ltd v CIR (1988 3 SA 876 (A))*. It

has been found that where there is no absolute or unequivocal obligation to pay then the expenditure is not 'actually incurred' for the purposes of the general deduction formula. In *Nasionale Pers BPK v KBI 1986 (3) SA 549 (A)*, the judge states that expenditure is actually incurred in the tax year in which the obligation therefore legally arises. Therefore, the principle remains that expenditure is not actually incurred if there is no legal obligation to pay. However, expenditure is also not linked to the actual act of payment.

An additional aspect for consideration is whether the expenditure must be 'necessarily' incurred. In *Port Elizabeth Electric Tramway Co Ltd v CIR (1936) CPD 241*, the court determined that even if expenditure is not 'necessary,' as long as it has been actually incurred it will be deductible in terms of the general deduction formula. There is no obligation on the court to determine to what degree the expenditure was necessary to be incurred for the purpose of being deductible in terms of the general deduction formula. Meyerowitz (2008:11.34) states the there is no ground for a court to be able to refuse a deduction because the taxpayer had been conducting his business inefficiently or extravagantly. He does, however, note that it is still important that the court is concerned with actual expenditure and not 'notional expenditure' (Meyerowitz, 2008:11.40), which refers to the fact that accounting entries are irrelevant in determination of the deductible expenditure in a year of assessment.

Where an obligation has been incurred but is contingent on the fulfilment of a condition, the expenditure in this case will not be seen to be 'actually incurred' in the year under review unless this condition has been met. This is in line with the interpretation above which holds that the taxpayer must be subject to an absolute, unconditional liability (Williams, 2001:280).

In the context of expenditure incurred in the tender process, there is no reason that this requirement be in doubt, but merely requires of the bidder in the specific case to identify the correct period in which such expenditure had been actually incurred. As per section 11(a) the expenditure must have been incurred 'during the year of assessment'.

3.6 During the year of assessment

Deductions are allowable in terms of section 11(1) in the tax year in which the expenditure was incurred and not in the year that it is paid or in a year where it is still conditional. The general rule is that expenditure incurred in a specific year of assessment may not be

deducted in later years of assessment (Stiglingh *et al*, 2014:142) despite the fact that section 11(a) does not explicitly prohibit this. This rule is supported by the decision in *Concentra (Pty) Ltd v Commissioner for Inland Revenue 1942 CPD 509* where the court decided that deductible expenditure is limited to expenditure that was incurred in the specific year of assessment. This expenditure cannot be rolled over into another year of assessment, even though it may reasonably relate to income earned in that subsequent year. This principle is also applicable to years prior to the expenditure, subject to the principles set out in section 23H, which do allow for a deduction for expenditure incurred in a previous year of assessment under certain circumstances. There is no requirement in the legislation that expenditure be matched to the relating income and expenditure is deducted when the section 11(a) requirements are met, rather than when the deduction would make business or accounting sense.

There are exceptions to this general rule, the most noteworthy is the situation where the taxpayer is of the view that the expenditure incurred is capital in nature. In this situation the taxpayer does not deduct the capital expenditure (or purchase price of the asset) in the year in which it is incurred (Williams, 2001:283) but rather this expenditure will be dealt with in terms of the rules in the Eighth Schedule. The Eighth Schedule determines the calculation of taxable capital gains.

This principle, although important in determining when the deduction of the expenditure should occur, is secondary in importance in this study. Of primary importance to this study is the determination as to whether or not the expenditure is in fact deductible, which requires investigation as to whether such expenditure is incurred 'in the production of income' which is addressed below.

3.7 In the production of income

In order for expenditure or losses incurred to be deductible, they must have been incurred 'in the production of income' as required by section 11(a). According to Davis *et al.* (2015:11(a)–14) this requires that the expenditure must be incurred with the purpose to produce income. The section specifically refers to 'income,' as defined, rather than 'gross income'. It follows then, that expenditure that has been incurred in the production of income which is exempt will not fall within the ambit of section 11(a). This is because 'income' is defined as gross income less exempt income in terms of the Act (Williams, 2001:284). Thus,

expenditure must be incurred in the production of income which is subject to tax (Meyerowitz, 2008:11.16).

The judge in the *Port Elizabeth Electric Tramway Co Ltd v CIR* case followed a purpose-orientated approach in their interpretation of 'in the production of income', and in doing so considered the commercial purpose behind the provision (Thackwell, 2010:46). Had the judge followed a more literal approach, the deductions allowable in terms of the act may be significantly reduced as it would limit deductions to only those situations where actual income is earned. In earlier cases this literal approach had been followed, however it is submitted that this approach is no longer tenable (Davis *et al.*, 2015:11(a)–14). In *Sub-Nigel v CIR* the court determined that the requirement that expenditure must be incurred in the production of income does not mean that no deduction is possible unless income has been produced (Meyerowitz, 2008:11.19). A similar judgement was made in the *CIR v Allied Building Society 1963 (4) SA 1 (A)* case. In this case the court confirmed that the determining factor is the intention with which the expenditure was incurred. If the expenditure is deductible based on the other requirements set out, it is irrelevant whether that expenditure produced actual income or not, as the intention of the taxpayer is sufficient. It follows then, that there is no need to match that expenditure directly to any taxable income (Williams, 2001:282). The test that needs to be applied to determine whether expenditure was incurred in the production of income will be discussed in further detail below, including the manner in which this test may be applied to expenditure incurred in the tender process.

The *Port Elizabeth Electric Tramway Co Ltd v CIR* case is considered the *locus classicus* on the test to be applied in determining whether expenditure is incurred in the production of income. In this case the judges developed a 'two-fold' test in order to determine whether expenditure has been incurred 'in the production of income' (Davis *et al.* 2015:11(a)–15):

- The first determination is whether the purpose of the act or activity which necessitated the expenditure was to produce income.
- Secondly, it should be determined whether the expenditure is closely enough linked to this activity or act (*ibid*).

According to Williams (2001:285) the first requirement above requires a subjective determination of the *bona fide* purpose of the taxpayer whereas the second requirement is an objective determination of the link between the act and the expenditure in question (determining the closeness of the connection). In order to determine whether expenditure

incurred in the tender process is deductible or not in terms of section 11(a), it is necessary to evaluate said expenditure against the two-fold test, thus determining the purpose with which the expenditure had been incurred and the closeness in connection between the expenditure and the act producing the income. Each of the components of the test is discussed below.

3.7.1 Purpose of the act which necessitated the expenditure

In the *Port Elizabeth Electric Tramway Co Ltd v CIR* case, Judge Watermeyer states that it is the 'act entailing expenditure' that must be examined to determine whether this act is done with the *bona fide* purpose of earning income, in which case the expenditure associated or connected to this act will be deductible. It is for this reason that it is necessary to first determine the 'act entailing expenditure' and once this act has been identified, to then determine the intention of the taxpayer and whether the intention is *bona fide* (Williams, 2001:295). The first determination of the test is then specifically focused on the purpose behind such actions, rather than the purpose behind the expenditure itself. The taxpayer may have numerous reasons for the outlay of the funds, however the purpose that should be taken into account is the dominant purpose (Etsebeth, 2007:219).

In cases subsequent to *Port Elizabeth Electric Tramway Co Ltd v CIR*, the courts applied the two-fold test with different degrees of certainty. However, the court succeeded in obtaining some clarity and legal certainty in the case of *The Commissioner of South African Revenue v BP South Africa (Pty) Ltd*. It was confirmed in this case that the court should look at the purpose of the expenditure and what the expenditure actually affects, in order to determine whether or not that expenditure is deductible (Etsebeth, 2007:221). The judge determines that it is the true nature of the transaction which will be the deciding factor and that the purpose of the expenditure is key in determining the true nature of that transaction.

In the context of expenditure incurred in a tender process, the determination requires the identification of the 'act entailing expenditure' as set out in the *Port Elizabeth Electric Tramway Co Ltd v CIR* case. Thackwell (2010:49) interpreted the phrase 'act entailing expenditure' to refer to income that is produced by the performance of an act or a series of acts, and attendant upon them are expenditure. The income which is eventually produced is obtained from the delivery of goods and services in terms of the tender, should it be successfully awarded. The actions producing such income are not specifically the activities

incurring expenditure during the tender process. However, without the tender activities, there would be no income produced and therefore one could argue that these tender activities are part of the series of activities producing the income and therefore these form part of the act entailing expenditure.

One furthermore needs to determine the purpose of the act entailing expenditure and if such expenditure is performed with the purpose of earning income (Thackwell, 2010:48). This requirement is a subjective determination and one which is tested with reference to the purpose of the bidder in the tender process. In the case of a company, the subjective intention may be determined with reference to the object with which the company has been formed (Davis *et al.*, 2015:11(a)–15). It is submitted that, except in exceptional circumstances, bidders who are companies are formed in order to produce income through delivery of goods and services as part of business activities. As the tender process may be necessary in reaching this objective, the subjective purpose of incurring expenditure during the tender process is to produce income. This would apply also to the case of a consortium of bidders who bid together in a tender, as the purpose of the legal person formed would also be to produce income. As Williams (2001:286) sets out, once it has been determined that the expenditure was attached to the performance of a business operation and *bona fide* performed for the purpose of earning income, the only further requirement is determining the closeness in connection between the expense and the business operation.

3.7.2 Closeness of connection between expenditure and income-earning activity

The second part of the test determines the closeness of the connection between the expenditure and the act producing the income (Etsebeth, 2007:214). This part of the test necessitates that the action which produces the expenditure must be so closely connected to the income-earning activity that the expenditure can be considered part of the cost of performing that income-earning activity (Stiglingh *et al.*, 2014:143). In this regard the income-producing act is then seen to be causally linked to the expenditure. There is no fixed rule with which to assess the closeness in connection between activity and expenditure (Davis *et al.*, 2015:11(a)–15) which causes uncertainty in the application thereof. The requirement of the causal relationship between activity and expenditure was considered in the *Port Elizabeth Electric Tramway Co Ltd v CIR* case, firstly to identify the closeness of the relationship, stating the expenditure must be regarded as being part of the cost of performing a business operation and secondly in regards to the question of necessity. The court clearly

set out that necessity is not a determination to be made by the court. Williams (2001:286) interprets the judgement in a similar manner, stating that ‘the question is not whether the expenditure in question was inefficient or extravagant, nor whether it was ‘necessary’’. There was however some adaptation of the latter principle in the case *CIR v Genn and Co (Pty) Ltd 1955 (3) SA 293 (A)*. In this case the court set down the criterion that the expenditure should be ‘proper, natural or reasonable’ in order to be regarded as part of the cost of performing the operation and therefore operational expenditure. This slight deviation from the aforementioned principle introduces the concept that there is a question of degree to determine whether expenditure is considered to be operational expenditure and therefore deductible (Williams, 2001:286).

This closeness in connection requirement necessitates that there be a sufficient causal link between the act entailing expenditure and the income earned. In determining causality, the courts require that factual causation be present (*condition sine qua non* test) and secondly that legal causation exists (adequate cause test or *nova causa interveniens*) (Grant, 2005:896). The factual causation test sees the courts determining whether an actual *nexus* exists between the activities and the eventual outcome, which is determined by the *condition sine qua non* or ‘but for’ test (these tests are used interchangeably) (Visser & Kennedy-Good, 2015:150). The ‘but for’ test asks simply: but for the specific activities under consideration, would the outcome have been the same. Legal causation, in terms of the adequate cause test, determines whether the act has the tendency to bring around the type of situation (or income in this case) in the normal course of events (Grant, 2005:897). The *nova causa interveniens* test, which is supplementary to the adequate cause test, enquires whether anything abnormal had intervened which would break the chain of causation, namely determining whether an intervening act or *novus actus interveniens* had occurred (Grant, 2005:899). Case law indicates that a *novus actus interveniens* is only applicable if it is an ‘unsuspected, abnormal or unusual event’ and thus deviated from the ordinary course of events (*ibid*).

In considering tender expenditure, the determination should be made as to the closeness of connection between the expenditure and the actions producing the income and whether such expenditure is part of the cost of performing the operation (Williams, 2001:286). The nature of the expenditure incurred in a tender process is in general such that would ordinarily be seen as operational expenditure in a business. This expenditure in a tender process could include for example: legal expenditure, environmental studies, consultants, bidding

expenditure, socio-economical outlays etc. This expenditure is ordinarily incurred in business, however the question is whether it can be said that when it is incurred in a tender process, that it is operational as part of performing the business. The expenditure incurred as part of the tender process relates specifically to the process of bidding whereas the actions producing the income would be the delivery of goods and services after the successful allocation of a bid. There is an argument to be made that the expenditure is thus not sufficiently closely linked to the income producing actions, as the allocation of the bid is not within the control of the taxpayer. The test of causation is applied in order to determine whether this requirement in the two-fold test has been complied with.

The question of causation in the case of tender expenditure thus requires three determinations. First, it is necessary that a factual causal link between the expenditure incurred in a tender process and the income subsequently earned is established. It is submitted that there is a factual causal link when phrasing the *condition sine qua non* test as, 'but for the tender activities, no resultant income would be earned from the provision of goods or services'. This is based on the premise that in the case of a tender, the bidder must participate in the tender process if it wants to provide the goods or services. Second, legal causation is determined through the application of the adequate cause test. The adequate cause test investigates whether the act of bidding in the normal course of events would have brought about the income. This must also be answered in the affirmative, as this speaks to the general purpose of bidding in a tender. This also supports the finding that there is factual causation between the expenditure and the income produced. The third and final remaining question is whether there had been an intervening act (or *novus actus interveniens*) which could be said to break the causal link.

In a tender process, as set out in **Diagram 2.1**, there is a deciding event or intervening act, namely that an external party decides on the allocation of the bid. There is a decision made which is external to the bidder, and such external decision directly determines whether the bidder will have the right (and opportunity) to earn future income. It is necessary to investigate whether this act should be seen as a *novus actus interveniens* in the sense that the causal link between the act entailing the expenditure and the eventual income may be broken by a decision that is beyond the control of the bidder. According to Grant (2005:896) an intervening act is one which is an unsuspected, abnormal or unusual event. In a tender process, this awarding of a tender (deciding event) is a normal activity and is expected by all parties involved in order to determine the eventual outcome of the tender. Since this

exercise of discretion is not unsuspected or abnormal, the argument can be made that the deciding event is not to a *novus actus interveniens* or intervening act.

This finding is contradicted by the decision made by the court in *Commissioner for Inland Revenue v Shell Southern Africa Pension Fund 1984 1 SA 972 (A)*. In this instance a committee had exercised their discretion and made available a lump sum benefit to a member of the fund upon their death. The court had to decide, in terms of section 8C of the Act whether the benefit had accrued 'by virtue of' the deceased person's employment. This was thus a question of factual and legal causation. It was held that the death of the member had been the *condition sine qua non* for the receiving of the benefit (factual causation is thus established), however that the discretion exercised by the committee was considered a *novus actus interveniens* (du Plessis, 2005:118). The court in *South African Revenue Service v Kotze 2002 9 JTLR 343 (C)* came to a contradictory conclusion as it was found that the Police Commissioner's discretion exercised was not a *novus actus interveniens*. In both cases, an external party was exercising their discretion and this decision affected the outcome of the situation for the taxpayer. Du Plessis (2005:118) finds that in cases where the taxpayer affects the decision or causes the intervening event, for example, through their own exercising of an option, that a *novus actus interveniens* will not be applicable.

Given the meaning of an intervening act, it has to be submitted that due to the fact that the tender decision is normal and expected in the ordinary course of a tender this discretion should not be found to be an intervening act. Additionally, it may be added that a bidder has a role in the final tender decision, based on the adequacy of its bid being submitted. If the bidder is providing a competitive bid which meets all the requirements (these being within the control of the bidder) then it has a role in the tender decision in the sense that it has made a proper case for successfully being awarded the tender. In such an argument, the tender decision does not break the causal link, but is a response to the adequacy of the tender being submitted. This conclusion assumes that the tender process was carried out correctly without prejudicing any particular bidder. If a tender were to be irregularly awarded, and a bidder who had submitted a sufficient bid (or a bid that is objectively observed to be more appropriate than the winning bidder) is not awarded the tender, it is submitted that this could be described as an intervening act. However, this instance is beyond the purview of this paper. Based on these considerations, it is concluded that the deciding event in the tender process has not broken the causal link and the requirement of 'in the production of income' has been met.

3.8 Overall conclusion

It was determined at the start of this chapter that in order to establish deductibility of expenditure incurred in terms of section 11(a), a person must exist and that this person must be found to carry on a trade and actually incur expenditure (or losses) in the year of assessment, which is in the production of income and which is not of a capital nature. In determining whether a 'person' exists, it was considered what is included in the term person as the term is phrased widely. Specifically, the question was considered whether 'bodies of persons' is considered to be a person. Based on the evidence reviewed it was found that a 'body of person' can be understood as a 'person'. The main uncertainty as to the application of 'person' within the tender process relates to the situation where a bidder only comes into existence on the condition that a bid has been successfully awarded. This bidder, though their existence is conditional, is still considered to be a person. It is submitted that irrespective of the form of the bidder, a person does exist.

There is uncertainty in case law whether the question as to whether 'the carrying on of a trade' should be determined using a subjective evaluation of the intention of the person or an objective evaluation of the specific circumstances surrounding their activities. The subjective intention of a taxpayer who is not a natural person is assessed by looking at the objectives with which that taxpayer was created, as set out in its MOA or similar establishment document. If this includes bidding in tenders, then it is submitted that the bidder is conducting a trade during the tender process. In the case of a natural person and determining their intention in the tender process, this can only be done in practice. Where trade is determined with reference to the objective test, a number of factors are taken into account as identified by the courts, namely: continuity; profitability; carrying on of a business and passive income-earning activities. Additionally, the impact of a bidder who carries on numerous trades and the deductibility of activities which occur prior to trade commencing, specifically in terms of section 11A, was also considered. Each of these factors contribute to whether a trade is being carried on, and so were considered in the context of the tender process. It is submitted that none of these factors provide a conclusive answer as to whether a trade is conducted or not and this requires determination in the context of the individual bidder. It is submitted that in application of the objective factors one needs to distinguish between bidders who regularly and consistently bid in tenders versus those that are bidding for the first time without an existing trade in place.

Additionally, the objective factors should be considered in light of a bidder who is only created upon being awarded a tender as well as the impact of the 'deciding event' in the tender process as set out in **Diagram 2.1**.

It is submitted that the deciding event is key in determining whether a trade is being carried on or not, specifically in relation to bidders who have a conditional existence or has not previously been awarded a bid. Where the bidder's existence is dependent on a bid being awarded successfully, there can be no 'trade' prior to the deciding event occurring. There may only be trade after the deciding event occurs, if the bid is successfully won by that bidder. However, in the case of a bidder who regularly and continuously tenders in bids, it is submitted that trade is applicable irrespective of whether a specific bid is successfully awarded or not.

Section 11A requires that all other requirements relating to section 11(a) except for the trade requirement has been met. Consideration has to be given to the deductibility of expenditure in the situation in which a bidder carries on numerous trades (which in the context of a tender refers to a bidder who continuously and regularly bids in tenders). There is uncertainty as to whether expenditure incurred in one bid may be deducted from income earned in another bid. In terms of Interpretation note 51 (SARS Legal and Policy Division, 2014:7) a taxpayer's income should be considered on a trade-by-trade basis, with the overall results of all trades being aggregated to determine the taxpayer's final taxable income. In Interpretation note 51 it is further found that where a taxpayer has different income producing assets, that each of these income-producing assets should be considered individually; in terms of its income and the deductibility of its expenditure. Relating this finding to the tender process, it is submitted that each bid should be considered separately. Therefore, expenditure incurred in the tender process may only be deducted in terms of section 11A from income earned from the bid to which it relates (on the basis that the expenditure is not capital in nature).

The main findings in regards to the applicability of trade to the tender process, which has been set out above, has been summarised in **Table 3.3**, which follows.

Table 3.3: Application of objective factors of ‘carrying on of a trade’ in the context of the tender process (including section 11A)

Stages	Prior to the ‘deciding event’		Subsequent to ‘deciding event’		
			Bidder awarded tender	Bidder not awarded tender	
Form of the bidder	Bidder with ‘conditional existence’	Incorporated entity regularly bidding	All bidders	Bidder with ‘conditional existence’	Incorporated entity regularly bidding
Continuity	No continuity.	Continuity exists which indicates trade is applicable.	Continuity exists.	No continuity.	Continuity exists which indicates trade is applicable.
Profitability	No profitability.	Profitability factor indicates trade is applicable.	Profitability factor indicates trade is applicable.	No profitability.	Profitability factor indicates trade is applicable.
Carrying on a business	Not applicable.	Bidding is part of business.	Not applicable.	Not applicable.	Bidding is part of business.
Passive income-earning activities	Active steps undertaken in tender process indicate of trade being carried on.				
Application of s 11A (pre-trade expenditure)	Section 11A does not yet apply as there is no indication of whether a trade will be applicable.		A trade is applicable after allocation of a successful tender, therefore section 11A is applicable to expenditure incurred in the tender process unless it is capital in nature.	The bidder is not found to be carrying on a trade, therefore deductibility in terms of section 11A will not be applicable.	Consider the impact of numerous trades. In terms of Interpretation Note 51 the pre-trade expenditure of a new income-producing asset cannot be deducted if the trade relating to this asset is not taken up.

Author compiled

Where it is found that a person is conducting a trade, the additional requirements of section 11(a) must be considered. In determining whether expenditure is incurred in production of income, the courts are not required to investigate or evaluate the business efficacy of taxpayers (Davis *et al.*, 2015:7.19). There is no need for the bidder to prove the necessity or reasonableness of the expenditure incurred, as long as such expenditure is incurred with the *bona fide* intention to produce income. The test for expenditure incurred in production of income was determined with reference to the question as to which actions caused the expenditure and whether it can be said that such actions are sufficiently closely related to the resultant income (two-part test set out in *Port Elizabeth Electric Tramways Co Ltd v CIR*). The question was whether the activities in the tender process can be seen to be sufficiently closely related to the income earned through the eventual delivery of goods and services where a tender has been awarded successfully. This is done through investigating the causation between the activities (which result in the expenditure) and the future income. Three distinct causation aspects were considered in this study, namely factual causation, legal causation and the possible existence of an intervening act. It is submitted through application of the 'but for' test that factual causation exists between the activities and the income earned. With reference to the adequate cause test, legal causation is submitted to exist as the activities in a tender process have the capacity to bring about future income and thus meet this test. The last consideration was whether the allocation decision made by a tender board can be seen as a *novus actus interveniens*. The primary consideration was whether the deciding event which is external to the bidder, and out of the bidder's control, can be seen to break the causal link between the expenditure-incurring activities and the income eventually earned. When considering the meaning of an intervening act, namely one which is unsuspected, abnormal or unusual (Grant, 2005:896), it is submitted that the tender allocation is not an intervening act, because it occurs in the ordinary course of a tender process, as set out in **Diagram 2.1**.

The remaining requirements in applying section 11(a) relate to expenditure or losses, which is actually incurred and during the year of assessment. These requirements were briefly discussed, but for the purpose of the study it was not required to investigate in detail. This is primarily because expenditure incurred in the tender process complies with these requirements, whereas the year of assessment points towards the timing of the deduction.

In conclusion, it is submitted that although some uncertainty exists with regard to the tax treatment of expenditure incurred during the tender phases prior to bid allocation, there is clarity once the deciding event has occurred. Once the bid has been awarded to the bidder (unless the bidder does not take up the bid) there is little doubt that a trade is being conducted. This is true even in the instance where this is the first bid to be awarded to the bidder although there may be a potential lack of continuity. It is submitted that if the bid has been awarded to the bidder but is not taken up (namely the bidder decides not to proceed with providing goods and services), then the tax effect of the expenditure incurred is similar to that of a bidder who was not successfully awarded a bid namely that as no trade is carried on and the expenditure incurred is not in the production of income, that the expenditure may not be deductible in terms of section 11(a) or section 11A. The earning of actual income is not a distinct prerequisite of the requirement that expenditure be incurred in the production of income, however if the bid is not taken up then it is submitted that the purpose of the expenditure incurred was not to earn future income.

The remaining requirement of section 11(a) and section 11A which has not yet been considered, is the one regarding the nature of the expenditure, which will be investigated in **Chapter 4**. Should it be found that the expenditure is capital in nature, this will affect the applicability of both section 11A and section 11(a) and the only tax consequences attached to this capital expenditure are that which is discussed in **Chapter 4**.

CHAPTER 4

CAPITAL OR REVENUE NATURE OF THE RIGHT TO EARN FUTURE INCOME

4.1 Introduction

Throughout the previous chapters it was pointed out that in investigating the tax consequences of expenditure incurred in a tender process, it is necessary to take into account; the phases of a tender, the form of the bidder as well as the nature of the expenditure. The nature of the expenditure is considered in this chapter.

The general deduction formula refers to the deduction of expenditure, provided that such expenditure and losses are 'not of a capital nature.' The term 'capital [in] nature' is not defined in the Income Tax Act, therefore the distinction between capital and revenue must be determined through judicial precedent (Williams, 2001:294). The courts have determined that it is not possible to define this term in such a way that could be applied to all cases and therefore every case is to be determined on its own merits (Meyerowitz, 2008:11–19). The courts have identified a number of characteristics particular to expenditure of a capital nature which can be formulated as different tests. Davis *et al.* (2015:11(a)–19) has formulated the characteristics as four different tests, namely:

- Enduring benefit test;
- Once and for all test;
- Closeness of connection between expenditure and income producing activities or income-earning operations; and
- Distinction between fixed or floating capital.

Olivier (2012, 173–174) concurs with the conclusion that the courts do not have one singular test that is used and through an analysis of case law sets out the tests as to the capital or revenue nature of expenditure incurred in this way:

- Profit making scheme
- Fruit versus tree analogy; and
- Fixed versus floating capital

It is clear from the lists of tests above that there are numerous tests one can apply in determination of whether expenditure is revenue or capital in nature. The fruit versus tree analogy is similar to the income producing operations/structure test and these two tests will

be evaluated together. While some rely on objective factors, others consider the *ipse dixit* of the taxpayer in conducting the transactions. The tests listed above will be investigated further in the context of this study as it relates to expenditure incurred in the tender process.

Should it be found that the expenditure incurred in a tender process is not of a capital nature, the relevant tax consequences of the transaction will be determined with reference to the discussions in **Chapter 3**. This expenditure would then be deductible in terms of section 11(a) read together with section 23(g) and section 11A, if the requirements as discussed are complied with. If the expenditure incurred is of a capital nature, the tax consequences will be determined with reference to this chapter and the relevant sections in the Eighth Schedule of the Act which are discussed subsequent to the application of the capital versus revenue tests.

CGT has been in place since 1 Oct 2010, when it was introduced to the Income Tax Act in the form of the Eighth Schedule. CGT was introduced with the aim of broadening the tax base (Kotze, 2009:5). This tax is however aimed not at taxing the capital as such, but rather the capital gain made with through disposal of a capital asset (*ibid*). This is not tax which is different to normal income tax, instead capital gains are brought into the normal income tax calculation of the taxpayer through means of section 26A to the Act (Cassidy, 2004:164).

The investigation as to the tax consequences of the expenditure incurred will commence with a discussion as to the relevant judicial tests for determining the distinction between income and capital to determine the nature thereof and through application of such tests to the expenditure incurred in a tender process. On the basis that it could be found that the expenditure in a tender process may be of a capital nature based on these tests, an analysis of the Eighth Schedule and the applicability thereof will be investigated further.

4.2 Tests applied to determine capital versus income nature of expenditure

There is not one main or universal test for determining whether income or expenditure is income or capital in nature. Although, there are a number of judicial decisions that outline which factors to consider and how to apply these tests (Stiglingh *et al.*, 2014:144). In order to determine the nature of the expenditure, it is necessary to look at the facts of each case and the purpose of the expenditure incurred (*ibid*).

In the *CIR v Pick 'n Pay Employee Share Purchase Trust [1992] 2 All SA 245 (A)* case the judge states that (at 262):

‘There are a variety of tests for determining whether or not a particular receipt is one of a revenue or capital nature. They are laid down as guidelines only, there being no single infallible test of invariable application.’

The court in this case continues to state that the actual guideline selected is not of primary importance. Rather, the court should be concerned with ensuring that the classification of income versus capital is not contrary to sound commercial practice and common sense. In order to assist in evaluating the nature of expenditure incurred in the tender process, a number of these tests will be applied to this expenditure and used to provide guidance in making these determinations. The tests to be investigated further in this include the tests set out by Davis *et al.* (2015:11(a)–19) as well as the profit-making scheme test added by Olivier (2012, 173–174). These tests are:

- Enduring benefit test;
- Once and for all test;
- Closeness of connection between expenditure and income producing activities or income earning operations/structure;
- Distinction between fixed or floating capital; and
- Profit making scheme.

4.2.1 Enduring benefit test

The enduring benefit test is a simple determination of the kind of value that an asset brings to the taxpayer. If the expenditure incurred leads to an enduring benefit in the hands of the taxpayer, then that expenditure is of a capital nature (Davis *et al.*, 2015:11(a)–19). This should be determined based on the facts relating to the specific taxpayer, because expenditure which results in an enduring benefit for one taxpayer, does not necessarily result in similar benefits for another (*ibid*).

It is also important to note that the term ‘enduring benefit’ does not denote that the benefit must be indeterminable or that it should last for the duration of a taxpayer’s business (Davis *et al.*, 2015:11(a)–20). The term ‘enduring’ has been described as referring to ‘enduring in the way that fixed capital endures’ (Thackwell, 2010:95). This addition to the enduring benefit test links the test to that of the floating versus fixed capital distinction (*ibid*). It is clear

that the test cannot be applied as the only determination of the nature of expenditure, but should rather be considered in conjunction with other tests. Du Plessis (2006:191) describes the enduring benefit test as a subsidiary test which is applied in those cases where there are no clear results obtained from the test relating to the income producing structure or operations test. Criticism against this test is that it gives no guidance as to what length of time would be sufficient to be considered an enduring benefit (*ibid*) and this makes the test difficult to apply.

The tender process as set out in **Diagram 2.1** has been described as having a deciding event, which leads to one of two eventualities, either that the tender is awarded to the bidder or it is not. Where the tender is successfully awarded, the bidder then has the option of delivering goods or services by taking up this tender. The bidder thus obtains the right to provide the goods or services and thus the ability to earn income. This income or benefit will be obtained for the indefinite future, or until such time as that particular contract ends. It can thus be said that the bidder obtains an enduring benefit through the expenditure incurred and this may be capital in nature. In the alternative situation where the bidder is not awarded the tender, there is no right established to obtain future income and the expenditure incurred does not result in an enduring future benefit. Whether the expenditure incurred in a tender process is capital in nature is thus dependent on the outcome of the deciding event. The specific terms of the tender will also affect whether an enduring benefit has been obtained or not. In the case of a tender for the supply of once-off goods or services, it cannot be said that an enduring benefit is obtained by the successful bidder. Where the bidder is awarded a tender which stipulates that goods or services will be provided over a longer or indefinite period, an enduring benefit is obtained by the bidder.

4.2.2 Once and for all test

The next test to be reviewed is the 'once and for all test'. In terms of this test, expenditure that occurs regularly or is recurring, is expenditure that is revenue in nature (Davis et al., 2015:11(a)–20). It is not necessary for expenditure to be incurred annually, or in specific increments. If the expenditure is incurred to fulfil a recurring need, versus expenditure which occurs only once, then that expenditure is capital in nature (Willemse, 2010:45). This test was linked to the enduring benefit test in the *Nchanga Consolidated Copper Mines Ltd v Commissioner of Taxes 1962 (1) SA 381 (FC)* case. In this case, the court stated that when expenditure occurs, not only once and for all but with the aim of obtaining an enduring

benefit, that expenditure will most likely be capital in nature. As with other tests, this test is not conclusive and should be used in conjunction with other relevant tests. The recurrence or non-recurrence of expenditure cannot in itself be the only decisive factor in determining the nature thereof (Davis et al., 2015:11(a)–20A). Regular occurrence, or an expenditure paid in instalments, will not automatically alter the nature of expenditure from capital to revenue. Similarly, expenditure will not be capital in nature merely due to it being paid in lump sum (Davis et al., 2015:11(a)–21). This test is of limited application since it is open to manipulation by the taxpayer (Du Plessis, 2006:192) and for this reason it is important that the legal nature of the transaction be taken into account.

Rental expenditure is an example of how this test is applied in practice. Ordinarily, rental income is income in nature, and this is consistent with the recurring nature thereof. In *The Commissioner of South African Revenue v BP South Africa (Pty) Ltd* the tax court had to determine the nature of rental expenditure incurred. The court stated that ordinarily rental payments are deductible, but qualified this statement by stating further that ordinarily such rental payments are recurring in nature and bear some relation to the income earned through the occupation of the leased property. The court held that where such features are absent, it is necessary to look at the substance of the transaction (Etsebeth, 2007:220). It was found that the leasing expenditure (which consisted of upfront rental payments) was more closely related to an income-producing structure than being part of expenditure in the carrying on of a business or trade. The rental expenditure was thus found to be of a capital nature and not viewed as income in nature. The rental expenditure in this court case is comparable to the tender expenditure that is under consideration in this study. It is important to note that the court considered not only the fact that the payment was made once off, but examined the true nature of that payment and linked the test to the income producing structure test, which is discussed in further detail below.

Expenditure incurred in a tender process is incurred only once, but it may consist of a number of different payments all occurring in a specific timeframe prior to the deciding event. This expenditure occurs in the process of securing the potential tender and is not recurring expenditure. The expenditure is also incurred irrespective of whether the tender is eventually awarded to the bidder or not. Based merely on this test, it would be found that the expenditure incurred in securing a tender in a tender process is capital in nature, irrespective of the allocation of the tender.

4.2.3 Income earning operations or structure

One of the tests formulated by the courts refers to the 'income generating structure' test as articulated in *New State Areas Ltd v CIR*. This test implies that it must be determined whether the expenditure incurred is part of the cost of operating the revenue-generating structure (operational expenditure) or whether the expenditure is incurred with the intention of expanding (establish, improving or adding to) the revenue-generating structure (de Koker & Williams, 2015:7–22). The test has also been referred to as the 'tree and fruit' analogy, which is one of the tests used to determine the nature of income received (Davis *et al.*, 2015:11(a)–21). The expenditure incurred to acquire the 'tree' (or income producing structure) is capital in nature whereas the expenditure relating to the activities conducted to produce the 'fruit' is considered revenue in nature (*ibid*). Expenditure will be of a capital nature if it is related to the revenue-generating structure which enables the taxpayer to generate income, while expenditure related to the day-to-day operations is considered to be income in nature (Willemse, 2010:83).

In some instance this test is also formulated in such a way as to ascertain if the expenditure is 'closely related' to the income-producing operations, in which case it will be capital in nature (Davis *et al.*, 2015:11(a)–21). De Koker and Williams (2015:7–22) state that there must be a sufficient link between the expenditure and the income-earning operations. They state that this link must be so close as to lead one to the conclusion that the expenditure forms part of the income-earning operations rather than forming part of the cost of expanding the income-producing structure. This closeness of connection aspect to the test is related to the test for determining 'in the production of income' in the context of section 11(a) which is discussed in §3.7. This is illustrated clearly in the case of *New State Areas Ltd v CIR* where the court states the following (at 620):

'Expenditure may also occur in the acquisition by the taxpayer of the means of production, i.e. the property plant, tools, etc. which he uses in the performance of his income earning operations and not only for their acquisition but for their expansion and improvement. Both these forms of expenditure can be described as expenditure in the production of the income but the former is, as a rule, current or revenue expenditure and the latter is, as a rule, expenditure of a capital nature.'

The outcome of the 'in the production of income' test is either that expenditure is revenue in nature and falls within the ambit of section 11(a) or alternatively that expenditure is capital in nature and therefore the tax consequences is as discussed in this chapter.

Once again, as with the other tests for capital versus revenue, there is a great degree of overlap between the tests. In *Commissioner for Inland Revenue v George Forest Timber Co Ltd. 1924 AD 516* the judge sets out an explanation of the manner in which the income-producing structure test is applied. In his application of this test he also refers to the 'once and for all' test, which is based on the non-recurrence of capital expenditure. The judge in this case also explains the distinction in creating the income-producing concern versus using this capital structure to earn income, see the following quote at 526:

'Now, money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not.'

As noted previously, the tender process is such that if a tender is successfully awarded to the bidder, this will lead to the bidder obtaining the right to earn future income. In the *ITC 1772* case the court considered a similar situation where the taxpayer had successfully obtained licences to provide certain services through a tender process. In this case the court determined that such licence fees formed part of the taxpayer's income earning operations and thus these fees are not deductible in terms of section 11(a), as they are capital in nature. The expenditure was thus not incurred through operation of the income-producing structure, but in expanding or adding to it. This is similar to the outcome of the *Warner Lambert SA (Pty) Ltd v CSARS 65 SATC 346 2003 (5) JTLR 109* case in which the taxpayer incurred expenditure for social upliftment. The expenditure was not incurred out of choice but rather it was an obligatory outlay of funds (due to legislation in place in the United States of America at the time) which allowed the taxpayer to do business in South Africa. It was incurred to protect the income-earning structure rather than forming part of the cost of operating it (Davis *et al.*, 2015:11(a)–23). It is submitted that where expenditure is thus necessarily incurred in order to allow the taxpayer to be able to conduct trading activities and there is no option but to incur the expenditure, this expenditure is for the protection or maintenance of the income-producing structure of the taxpayer and therefore capital in nature. Since expenditure incurred in bidding in a tender process is obligatory in order to successfully be

awarded a tender, this expenditure can be considered in a similar manner, and therefore be found to be capital in nature.

This conclusion leads one to consider the situation in which expenditure incurred in the tender process is not incurred through necessity, or could even be seen as being excessive. The question is whether such expenditure can still be considered to be capital in nature. The 'necessity' guideline is not one which has been established directly by the courts but rather a guideline deduced in this study from the manner in which courts treated both the licence fees as well as the social upliftment expenditure. For this reason it should rather be seen as a helpful guideline. Based on the courts treatment of the license fees and the social upliftment expenditure, it can be deduced that expenditure that is seen as necessary is considered to be capital in nature.

Another situation requiring further consideration is one where the tender is not awarded successfully to the bidder. The expenditure has been incurred with the same purpose as the bidder to whom the tender is awarded, however, for the one taxpayer an income-producing structure is created whereas for the unsuccessful bidder, no future income is gained from such expenditure. Can it therefore still be said that the bidder had incurred the expenditure as part of creating or adding to his income-producing structure, where no future income will be gained. The courts have not explicitly noted this as part of the income earning structure test actual income must be earned from the capital expenditure incurred but rather has relied on the intention of the bidder with the outlay of the funds. There is thus some uncertainty as to what the courts may find in the case of an unsuccessful bidder. This uncertainty is addressed indirectly in a discussion in §4.2.5, which considers whether the taxpayer incurred the expenditure in a profit-making scheme. The next test to be considered is the distinction between fixed versus floating capital test.

4.2.4 Distinction between fixed versus floating capital

Courts have characterised the fixed versus floating capital distinction as one which provides further guidance as to the nature of expenditure incurred. An asset which is required for the purpose of sale is classified as trading stock. The income earned from such a sale is gross income in nature (Joubert, 2009:381). Trading stock can also be referred to as floating capital. Fixed capital is the operating structure which is employed in order to earn income, the disposal of such an asset results in income of a capital nature (Joubert, 2009:382).

The manner in which this test is to be applied is formulated clearly in *New State Areas Ltd v CIR*. The court states that when capital employed in a business is frequently changing its form from goods to money and vice versa, and that this is done for the purpose of making a profit, then the capital which is so employed is floating capital. The court continued, stating that expenditure which constitutes the use of floating capital must be deducted from the proceeds from the sale of such stock in trade in order to determine the taxable income of the taxpayer (Davis *et al.*, 2015:11(a)–24C). The example given for floating capital is the purchase and sale of trading stock by a merchant or the case of a manufacturer who purchases raw material for the purpose of conversion to a manufactured article. In *Commissioner for Inland Revenue v George Forest Timber Co. Ltd* the court explains the difference between fixed and floating capital by the manner in which it is consumed. Fixed capital is explained as being capital which produces new wealth but remains intact whereas floating capital is consumed and disappears in the process of producing the income.

In considering whether assets are of a fixed or floating nature, categories of assets are not classified as fixed (for example, land and buildings) whereas others are classified as floating (for example, movable assets), instead it is considered in which way the taxpayer will use the specific asset. What may be floating capital for one taxpayer, may be fixed capital in the hands of another taxpayer. An example of this is the difference between a loan in the hands of a bank (categorised as floating capital) versus the same loan in the hands of another taxpayer (categorised as fixed capital) (Davis *et al.*, 2015:11(a)–24C). It is also relevant to take into account the magnitude of the taxpayer's activities. In *Natal Estates Ltd v SIR 1975 4 SA 177 (A)* the court sets out the so-called Rubicon test which looks at the magnitude (regularity and consistency) of activities in determining the nature of the expenditure. In this case, the court questioned whether the taxpayer had crossed the Rubicon and by doing so embarked on a profit making scheme in the manner in which it was selling land and thereby using the land as trading stock (Joubert, 2009:384). Determining whether an asset is fixed or floating is thus done by looking at the intention of the taxpayer as well as through investigating the activities of the taxpayer.

The tender process is one which enables the bidder to earn income by providing goods or services in the future, upon successfully being awarded a bid. As part of delivering these goods or services, inventory may be considered to be floating capital if goods are being purchased for resale or for manufacturing. It is clear that during the tender process expenditure is not incurred in acquiring goods that are consumed, for example, floating

capital but rather in obtaining fixed capital which is used to produce new wealth but remains intact. This finding would lead one to conclude that the expenditure incurred is capital in nature. This finding is the same irrespective of whether the tender is awarded to the bidder or not, as the purpose with which the expenditure is incurred is the same.

4.2.5 Profit making scheme

A scheme of profit making implies that the taxpayer pursues and works towards the making of a profit as his main purpose and the profit is therefore not merely fortuitous (Oguttu, 2006:115). Where this is the case, the expenditure incurred and income earned will be classified as revenue in nature (*ibid*). According to Joubert (2009:381–382) the two tests that the courts have extensively used to determine the distinction between capital and revenue, are the ‘profit making scheme’ test as well as the fixed versus floating capital test. The majority decision in the *CIR v Pick n Pay Employee Share Purchase Trust* case has suggested that the profit making scheme test is the one to be used to determine the nature of expenditure incurred. The judge in the *CIR v Pick n Pay Employee Share Purchase Trust* case considered the profit making scheme test and phrased the application thereof as follows at 258:

‘...if the Trust can show that what it did in acquiring the shares and then selling them to its employees, was not in pursuance of a scheme of profit-making, it will have discharged the *onus* of showing that such profits as it made or losses it sustained were of a capital nature.’

If the activities were not in pursuance of profit-making, the expenditure incurred and revenue earned is of a capital nature. The court also determined that since this case was not one with a single or isolated transaction but one that involved a series of transactions, it was necessary to determine whether the activities of the trust amounted to the carrying on of a trade or business which contributes to determining whether a profit making scheme is intended. Despite the objective facts in the case indicating that a business may be carried on, the judge emphasised the importance of the intention of the taxpayer in carrying on the activities. The intention of the trust was not to conduct a business in shares but only to act as conduit for acquiring shares for employees. The fact that the Trust may obtain a profit from the transactions was irrelevant.

Joubert (2009:390) analysed the *CIR v Pick 'n Pay Employee Share Purchase Trust* as well as a number of other cases, based on this analysis he finds that case law has not established that the profit-making scheme should be the only test applied in the determination of the nature of expenditure. However, it remains important to establish the intention of the taxpayer both at acquisition of the asset as well as in the subsequent treatment thereof to determine whether the asset was obtained with the motive of generating an income (*ibid*).

In the process of bidding for a tender there is, in the majority of cases, the expectation of the bidder to obtain future profits. This is true irrespective of how realistic this expectation is, for example, in the case of the bidder who will eventually not be awarded a tender or a bidder whose bid does not fulfil the requirements of the tender. Based on this assertion, in terms of this test, the expenditure incurred is not capital in nature as it is incurred in a scheme of profit-making. The question of profitability had been discussed in detail as part of the question of 'trade' and 'in the production of income' in **Chapter 3** and will not be addressed in further detail as it applies to the tender process.

4.2.6 Conclusion on the capital versus revenue nature of expenditure incurred in a tender process

During the investigation as to the nature of expenditure incurred through application of the tests above the one consistent finding is that there is a lack of consistency in the manner in which these tests are applied. The courts have used one test, or a number of the tests above, and in some instances the lines between the tests are blurred during their application. As an example, in *Natal Estates Ltd v SIR* the court referred to capital or stock in trade which is used in a scheme of profit-making (Joubert, 2009:383), thereby in effect combining two different tests in one determination.

At the outset of the investigation as to the nature of expenditure incurred in a tender process, it was stated that the outcome of the findings must be in line with commercial and good sense and that this should be the deciding factor.

The quote from *CSARS v Knuth and Industrial Mouldings (Pty) Ltd [1999] JOL 5805 (EC)* at 8 summarises the approach of the courts as follows:

‘Of course, these various ‘tests’ are no more than guidelines and, ultimately, one is called upon to make a decision which is not contrary to sound commercial and good sense.’

In the majority of tests above, the conclusion was made that there is a strong indication that expenditure incurred in the tender process is capital in nature, except in such tests where there is a profitability or revenue aspect to consider. When applying the tests which requires a profit-motive, there remains uncertainty as to the nature of expenditure incurred in the situation where the bid is not awarded successfully to the bidder.

The conclusions reached for each of the capital versus revenue tests has been summarised in **Table 4.1**, below. Although the application of any one these tests is not conclusive in determining the nature of expenditure incurred in a tender process, it is submitted that the application of these tests as a whole provide a strong indication that this expenditure is capital in nature. This outcome will also be one that makes good commercial sense. For this reason, the expenditure will not be deductible in terms of section 11(a) but rather the tax consequences will be determined with reference to the Eighth Schedule to determine the applicability of CGT, this is considered in §4.3 which follows.

Table 4.1: Application of Capital tests to the tender process

Capital tests	Tender is awarded to bidder	Tender is not awarded to the bidder
Enduring benefit test	<p><u>Awarded for recurring provision of goods or services:</u> The bidder obtains the exclusive right to earn future income in exchange for delivering goods and services. This income or benefit will be obtained for the indefinite future, or until such time as the contract stipulates. The bidder therefore obtains an enduring benefit through the expenditure incurred and the expenditure thus regarded as capital in nature.</p> <p><u>Awarded for once-off provision of goods or services:</u> Bidder obtains no enduring benefit indicative that not capital in nature.</p>	No right to earn future income vests in the bidder on the basis of the tender process and consequently the expenditure incurred does not result in an enduring future benefit for the bidder. It is submitted that the expenditure is not capital in nature. The nature of the expenditure is dependent on the deciding event described in Diagram 2.1 .
Once and for all test	Expenditure incurred in a tender process is incurred only once, initially in the process of securing the potential tender, during the period prior to the deciding event and is not a recurring expenditure. The expenditure is incurred irrespective of whether the tender is eventually awarded to the bidder or not. Consequently the expenditure incurred in securing a tender is capital in nature based on this test.	
Income earning operations or structure	It is submitted that where expenditure is thus necessarily incurred in order to allow the taxpayer to be able to conduct trading activities and there is no option but to incur the expenditure, that this expenditure is for the protection or expansion of the income-producing structure of the taxpayer and therefore capital in nature (based on principles of Warner Lambert SA (Pty) Ltd v CSARS 65 SATC 346 2003). Since expenditure incurred in bidding in a tender process is necessary in order to successfully be awarded a tender, this expenditure would thus be capital in nature. The question as to necessity is not a rule established by the courts but a helpful guideline identified from judicial decisions.	Despite the bid not being successfully awarded to the bidder, the expenditure has been incurred with the same purpose as the bidder to whom the tender is awarded. For the one taxpayer an income-producing structure is created whereas for the unsuccessful bidder, no future income is gained from such expenditure and no income-producing structure is gained. There is thus some uncertainty as to the nature of the expenditure in the case of an unsuccessful bidder. Based on findings it is submitted that the expenditure is capital in nature since it is not a prerequisite that actual income be earned and the bidder had still incurred the expenditure with the view of expansion of their operations.
Fixed versus floating capital	During the tender process the expenditure is not incurred for the acquisition of goods that are consumed (akin to floating capital) but rather in establishing capital which produces new wealth. This test would lead one to conclude that the expenditure incurred is capital in nature. This finding is the same irrespective of whether the tender is awarded to the bidder or not, as the purpose with which the expenditure is incurred is the same.	
Profit making scheme	In the process of bidding for a tender, there is the expectation of the bidder to obtain future profits, irrespective of how realistic this expectation is and it is submitted that based on this reasoning, the expenditure is incurred in pursuance of a profit-making scheme and not capital in nature.	

Author compiled

4.3 CGT in terms of the Eighth Schedule

The Income Tax Act imposes normal tax on the taxable capital gain of a taxpayer, and refers to such tax as CGT. Section 26A of the Act includes the taxable capital gain in the taxable income of a person for a year, as determined in terms of the Eighth Schedule to the Act (Stein, 2015:1–1). All references in this chapter to paragraphs are paragraphs in the Eighth Schedule.

In terms of paragraph 3 of the Eighth Schedule, the capital gains that are taxed are those derived from assets disposed of on or after 1 October 2001. In order to obtain a capital gain or loss, four requirements must be met, namely that an **asset** should exist, and that it must be **disposed** of during the year of assessment, for which the **base cost** and the **proceeds** must be determined (McAllister, 2011:26). These four components are often referred to as the ‘building blocks’ which are required as the foundations for determining CGT. While the proceeds and the base cost are important for the actual calculation of the capital gain/loss, the two key components for determining whether CGT is applicable is whether an asset exists and whether this asset has been disposed of (Cassidy, 2004:164). These building blocks will be discussed in further detail, as well as the applicability thereof to the tender process, in order to determine the CGT consequences, if any, attached to expenditure incurred.

4.3.1 Asset for the purpose of CGT

The definition of ‘asset’ in the Eighth Schedule includes property of any nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and a right or an interest of any nature in such property.

A distinction should be made between real rights versus personal rights. Real rights are those which links a person to an object and consists of two categories, namely ownership (which is the most direct right to an object) and limited real rights which infers upon the person a right over another’s property (Green, 2008:1). Real rights include a usufruct, fiduciary interests, right of use and a right of habitation (*ibid*). Personal rights, as the wording suggests, imposes a right upon a person and therefore entitles its holder to claim something from another person, for example the right of a person to income from a trust (*ibid*).

Real rights infer the right of a person to an object while personal rights are those between two persons (Badenhorst, Pienaar & Mostert, 2003:51). The rights that come into existence during a tender process are not related to any specific property or object. These are rights created between the two parties, namely the bidder and the organisation who put out the tender. The organisation acquires the right to claim delivery of goods or services from the bidder, in return the bidder receives the right to obtain income. The rights in question are thus personal rights. This corresponds to the distinction made by Badenhorst *et al.* (2003:52) who notes that the difference between real and personal rights relate to the enforceability thereof – whereas real rights (claims to a property) are enforceable against the all other persons, personal rights are conferred only to the holder thereof the right only to claim from a particular person.

The expenditure incurred in the tender process is being incurred in the process of obtaining the future benefit in the form of an exclusive right to earn income through providing goods or services to the government, parastatal organisation or private organisation. This right is enforceable not against any property but only against the party who has awarded the tender to the bidder. The question thus arises whether this right to earn future income can be defined as an asset for the purpose of the Eighth Schedule.

An asset is defined in part (b) to ‘include’ the rights to or interest in property. In *Estate Brownstein v CIR* the court held that the use of the word ‘includes’ in a definition section is meant to add unusual items to the ordinary meaning of the word being defined (de Koker, 2012:25.7). The term is thus not defined to be exhaustive and could be read widely enough to include the right to earn future income. This finding corresponds with the CGT Guide which states that personal rights are included as assets (McAllister, 2011:38). These rights are defined as imposing a personal duty, to perform an action as per the granted right, upon a person in favour of another person (McAllister, 2011:38). The CGT guide further states that although the right to claim payment is a personal right, it is not always recognised as an asset for the purpose of CGT (*ibid*). There are no specific sections in the Eighth Schedule dealing with the CGT treatment of rights and specifically the treatment of a right to earn future income.

Albeit the definition of ‘asset’ is phrased in very wide terms (Swart, 2005:1), uncertainty exists as to whether this definition is wide enough to include both real and personal rights. It is noted that some of the authors define the right to future income as ‘property’ rather than

as an 'asset' (see Swart (2005:3)). In doing so, these authors infer such a right to earn future income as an asset in terms of subsection (a) in the definition and that reference to subsection (b) is unnecessary. This summary is consistent with the interpretation of Davis *et al.* (2015:Sch 8 para 1–5), who found that the term 'asset' is synonymous with 'property' and that all rights can be applied to either term in the same manner.

Davis *et al.* (2015:Sch 8 para 1–5) argues that it would be difficult to find that whatever has been disposed of falls outside of the definition of asset. The focus is thus placed on the fact that the asset must be subject to CGT, rather than on whether or not that object can be legally classed as an asset. Green (2008:17) refers to the example of a personal right, namely the right to income from a trust, and notes that according to the CGT guide, personal rights are included in the definition of 'asset'. It was noted by Moosa (2013:187) that the Constitution of South Africa protects every individual's right to property and that the term property has been assigned a comprehensive meaning which includes intangible assets such as rights. In light of this, personal rights should be considered to be 'constitutional property'. In terms of Roman-Dutch law (common law), corporeal and incorporeal things are included as assets and incorporeal movable property includes all personal rights (Green, 2008:17). It has already been noted that personal rights are explicitly included in the definition of 'asset' in terms of the CGT guide (*ibid*). Swart (2005:3) comes to the same conclusion in his analysis of the term 'property' and states that it would include personal rights, specifically if it has a monetary value and that the definition of 'asset' is construed widely enough to include such rights. Davis *et al.* (2015:Sch 8 para 1.6) states clearly that both personal as well as real rights are regarded as assets for the purpose of CGT and identifies transferability or not of such a right as the factor which affects the applicability of CGT. This will be investigated further in discussion of the concept of disposal. Olivier (2007:38) explains the concept of a personal right through the use of an example, namely the situation where a person receives compensation for a breach of contract and notes the fact that this compensation is subject to CGT consequences. The result of including reference to rights and interest in the definition of asset is that both personal and real rights should be regarded as assets (*ibid*). It is submitted that a person may reasonably come to the conclusion that personal rights be included within the definition of asset.

In the tender process as set out in **Diagram 2.1** it is noted that there is a deciding event, namely whereby the tender is awarded to a bidder. The right to earn future income will only vest in a bidder if such a tender is awarded successfully and the bidder takes up his right to

provide goods and services by complying with the tender requirements. In the case of an unsuccessful tender, no personal right vests and there would be no further investigation as to the CGT consequences in that instance. This is because here is no personal right being created and therefore no 'asset.'

It is submitted that to include personal rights in the term asset is a conservative approach due to the fact that a disposal event is still necessary for CGT to be applied, which may yet prove to exclude personal rights from resulting in CGT consequences in terms of the Eighth Schedule. Should a personal right not be transferable (requirement of disposal) or have a monetary value attached to it (requirement of base cost and proceeds) then no CGT consequences can be attached to such an asset. The concept of disposal (§ 4.3.2) and the base cost and proceeds (§ 4.3.3) are discussed below.

4.3.2 The concept of disposal for the purpose of CGT

The term 'disposal' is defined in paragraph 1 as an event, act, forbearance or operation of law which is treated as the disposal of an asset in terms of the Eighth Schedule. It refers to the relinquishing of ownership of an asset either by means of the transfer of ownership or merely by abandoning the asset (Wilcocks & Strydom, 2002:312). Additionally, the act or event in the definition should result in the creation, variation, transfer or extinction of the asset. It also appears that the act requires a causal relationship between the act or event and the last mentioned results (*ibid*). The definition of 'disposal' must be read in conjunction with paragraph 11, which provides examples of events that would or would not be classified as disposals, and paragraph 12, which sets out acts that can be deemed as disposals (Davis *et al.*, 2015:Sch 8 para 11–3). The disposal of an asset is the 'trigger event' without which no CGT consequences are applicable (Williams, 2005:176). The term disposal has been defined widely (*ibid*). Where an asset is disposed of to another person, the receiving party is treated as having acquired an asset at that time, however the term disposal has been defined widely enough that a disposal can also occur where there is no acquisition by another party (Williams, 2005:177). When considering the definition of disposal together with that of asset, it is clear that a disposal must involve an asset. In this regard, these two concepts are almost inseparable (*ibid*). The definition of disposal is drafted so widely that it does not provide guidance on this question. Guidance will be sought from authors' interpretation of the concept as well as with reference to the Australian concept of 'disposal.'

Davis *et al.* (2015:Sch 8 para 11-3) state clearly that since personal and real rights represent assets, the extinction or creation of such a right will constitute a disposal, and a CGT event. The transferability of rights should be considered in order to establish whether such a right may be disposed of. There is, however, support for the argument that the transferability of a right is not a requirement expressly set out by the legislature (Davis *et al.*, 2015:Sch 8 para 1–6). This assertion is supported by the opinion of de Koker and Williams (2015:24.2) who also state that there is no requirement that the right must be transferable. Swart (2005:6) contends that the manner in which disposal is defined confirms that personal rights should be recognised as assets. This finding is based on the premise that certain events included as disposals clearly provide for the application thereof to personal rights, and that CGT events such as this would not have been included in the act had personal rights not been intended to be included as assets (*ibid*). To establish whether transferability should be a consideration in determining the disposal of rights, guidance is sought from the manner in which Australian legislation has dealt with the matter.

Chapter 2 of the Constitution of South Africa, namely the Bill of rights, section 39 states that courts are required to consider international law and may consider foreign law. International law refers to the collection of treaties, customs, and multilateral agreements governing the interaction of nations and multinational businesses or non-governmental organisations whereas foreign law comprises the body of law which governs the domestic law of a foreign country (Steenkamp, 2011:28-29). Consideration of foreign case law, although not binding on South African courts, can be persuasive and informative (Clegg & Stretch, 2010:2.4.2). However, in applying such judgements, it should be considered that they may be based on statutes which are worded differently (de Koker & Williams, 2015:25–12). The court established in *Joffe & Co v CIR* that the principles established in foreign cases are relevant when they are related to sections with wording which is similar to that in the South African Act (Steenkamp, 2011:29). The concepts of ‘asset’ and ‘disposal’ as included in the South African Income Tax Act also provided the basis for attracting CGT in the Australian tax regime in the original version of their CGT rules which was introduced through the Income Tax Assessment Amendment (Capital Gains) Act 1986 (Cassidy, 2004:164). In the writing of the CGT principles of the Eighth Schedule, the legislature considered specifically the Australian as well as the United Kingdom CGT guidelines (McAllister, 2011:24). It is therefore appropriate to consider Australian law as it relates to the application of CGT.

The courts in Australia have come to the conclusion that for the CGT legislation to make sense, it is essential that the asset be capable of transmission and that the essence of property under Australian property law is the fact that it is transmissible to a third party (Cassidy, 2004:168). In terms of the Australian CGT principles as included in the Income Tax Assessment Act 1997 certain CGT events are specifically aimed at the disposal of contractual and other rights. The so-called CGT event D1 is applicable where a contractual or other right is created and the time of the event refers to the time at which the taxpayer enters into the contract or creates the applicable right (Deutsch *et al.*, 2010:354–355). An example of such a right is where the taxpayer enters into a restrictive covenant which prevents it from competing with another person or entity (*ibid*). It is clear that the Australian legislation relating to CGT principles not only includes personal rights as assets, but also provides for the disposal thereof by creating specific CGT events relating to such rights. Transferability of a personal right is thus entrenched in the Australian law.

Moosa (2013:187–188) discusses the right that a taxpayer acquires through the working of section 18(1)(d) of the Act as a personal right of the taxpayer against the fiscus which, although it can be valued in terms of section 18(2), cannot be transferred or disposed of in any way and therefore it cannot be classified as property in the ordinary sense, nor does it constitute constitutional property. It is submitted that the question of transferability should not affect the conclusion on whether an asset exists, as argued by Moosa (2013:187–188), although it does affect whether the personal right, which is an asset, can be disposed of. Swart (2005:16) evaluates whether the transferability of a personal right in the context of a fiduciary or similar right where the right is inseparably attached to a person and can therefore not be transferred, however it will still be considered to be an asset in terms of the Eighth schedule. In this situation, the transferability of the right, or the lack thereof, will rather affect its valuation (*ibid*). There is the argument to be made that due to the manner in which the CGT principles are structured, it lends itself to find that transferability of a right is required. This conclusion is reached in considering that in order to be subject to CGT, there must be an asset which is disposed of and that the ‘time of supply’ rules presuppose that a change of ownership should occur (Olivier, 2007:38). It is submitted that this view is one which is conducive to the manner in which the Eighth Schedule has been set out and that transferability should be considered as synonymous with disposal in the case of personal rights and therefore a distinct requirement for CGT to apply. This would also be an approach which is consistent with the Australian approach.

Prior to the allocation of the tender, a bidder only has a *spes* or hope to future income which is similar to that of a beneficiary in a trust with only a discretionary right. However, once the tender has been awarded successfully to the bidder, that bidder obtains a right to earn future income similar to that of a beneficiary with a vested right in a trust. O'Halloran (2007:23) states that a beneficiary in a trust with only a discretionary right has no 'interest' in terms paragraph (b) of the definition of an asset, due to the contingent nature of the right, based on the decision in *CIR v Sive's Estate 1955 (1) SA 249 (A)*. Since this interest has no value, cannot be divided and cannot be sold in part, it is submitted that the asset also cannot be disposed of (*ibid*). Although there is an argument to be made that the discretionary right can be sold as a whole, it is not possible to place a value on this right (*ibid*). This is consistent with the findings relating to a bidder who has not yet been awarded a tender. Since this bidder has no enforceable right to earn future income, it has been submitted that no asset is applicable. Additionally, even if such asset existed, it could not be disposed of due to the lack of contractual terms allowing such a transfer. Therefore no CGT consequences can be attached to the expenditure incurred in this situation.

O'Halloran (2007:23) finds that CGT can only be applicable where the beneficiary receives a consideration for his right in trust income, which would attach a value to the interest. This finding does not provide further guidance on the disposal of a personal right, but considers the value of the right to earn future income and whether that valuation will indirectly contribute to the question as to whether these rights can be disposed of. Based on the findings of the authors considered thus far, there is no clear answer as to whether it is possible to dispose of a personal right or not. In addressing this question it would seem the majority of authors choose rather to address it as a question of whether an asset does in fact exist or alternatively whether it is possible to attach value to the personal right.

It is submitted that prior to a bidder being awarded a tender, such a bidder only has a *spes* or hope of future income, which if found to be an asset, cannot be disposed of. A bidder who is awarded a successful bid, obtains a personal right to earn future income through contracts being entered into. It is submitted that such rights may be disposed of in part (for example, through subcontracting some goods or services) or in full, unless the contract provides otherwise. This will only be true where, on the basis of the argument made by O'Halloran (2007:23), a value can be attached to that personal right. The concepts of base cost and proceeds (which underlies the valuation of an asset) for the purpose of CGT are considered before concluding.

4.3.3 Base cost and Proceeds for purpose of CGT

CGT is calculated based on the net capital gain made by a taxpayer in the applicable year of assessment (Wilcocks & Strydom, 2002:312). This capital gain is calculated by deducting the base cost from the proceeds obtained through disposal of the asset, subject to certain exclusions which are not relevant for the current discussion. Proceeds are determined in terms of paragraph 35(2) which provides that this amount is determined as the amount received by or accrued to the taxpayer in respect of the disposal (Olivier, 2007:40). The base cost of an asset is calculated as the cost of acquisition, including some other categories of expenditure in terms of paragraph 20, except in the case of assets obtained prior to 1 October 2001 at which point CGT came into effect (Olivier, 2007:42). It is not required for the scope of this study to investigate in depth the manner in which these terms are interpreted. It is submitted that the base cost of a right to future income in the case of a tender process will include the expenditure incurred during the tender process. In relation to the proceeds, the question remains to be answered whether it is possible to value the right to future income in order to calculate whether the disposal has resulted in a capital gain. The ability to value an asset, both its base cost and proceeds with disposal, is important in order to determine CGT consequences, as both of these elements form part of the basic CGT building blocks.

The question of whether a personal right can be valued is one which is not addressed directly by any of the authors. This is specifically the case as the ability to value a personal right is dependent on numerous factors, for example the type of personal right in question, whether there is a market for such personal rights and whether that right is legally transferable (this would depend on the specific contract terms). According to Cassidy (2004:168), the ability to value property is connected to the ability to sell that asset to a third party, and to this end it is necessary that the market value of the asset must be ascertainable. For this reason, Cassidy (*ibid*) finds that personal rights are not assets as they cannot be sold and they cannot be valued. The argument is also made that even if it were to be found that such personal rights are assets, the CGT principles have not been drafted in such a manner as to accommodate this finding, despite the expansive meaning ascribed to the terms asset and disposal (Cassidy, 2004:169). The concepts of disposal and proceeds are thus regarded as inherently linked, in the sense that if an asset can be disposed of, it is presupposed that there is a value that can be attached to it and similarly if a value can be attached to a right, that it is able to be disposed of.

It is submitted that if it is not possible to ascribe a value to the personal right that is obtained in a tender process (whether determined by the parties or in terms of a market value), then no CGT consequences can be attached to the disposal of that asset as it would not be possible to calculate the applicable taxable capital gain/loss.

4.4 Conclusion

At the outset of the investigation in this chapter, it was stated that the nature of expenditure incurred in a tender process needs to be determined in the context of section 11(a) in order to establish the tax consequences thereof. Based on the application of the numerous capital versus revenue tests, it is submitted that there is sufficient argument to be made that in the case of a bidder who has successfully been awarded a bid, the expenditure incurred prior to the deciding event is capital in nature.

If the tender is not awarded to the bidder the expenditure incurred in respect of the unsuccessful tender can be compared to that of marketing expenditure and deductible in terms of section 11(a). Marketing expenditure is incurred with the hope of promoting the possible sale of goods or services with no enforceable right being created between the marketer and prospective clients. It has also been confirmed in Interpretation Note 45 that marketing expenditure is deductible in terms of section 11(a) (SARS Legal and Policy Division, 2012). If the bidder incurred expenditure with the hope of being awarded the tender, but in being unsuccessful did result in an enforceable right being created to supply such goods or services (similar to the outcome of marketing expenditure incurred) - resulting in no enduring benefit or income producing structure being created.

If the tender is awarded to the bidder and enforceable right is created to provide goods or services and this right is submitted as being of a capital nature and therefore not deductible in terms of section 11(a). The expenditure incurred in the tender process is being incurred in the process of obtaining an exclusive right to earn income through providing goods or services to the government, parastatal organisation or private organisation who put these required goods or services out on tender. A personal right is thus created in the hands of the bidder and this personal right should be measured against the CGT requirements. It was thus investigated whether this right to earn future income can be defined as an asset, which can be disposed of, with proceeds and a base cost, both of which are determinable.

The nature of the expenditure was only the first determination in this chapter, thereafter the CGT impact thereof was considered in order to determine the relevant tax consequences. In the context of a tender process it was investigated whether the asset under discussion is a right to earn future income, which is based on a contract and is a personal right. Based on a review of authors on the CGT consequences of personal rights, it remains uncertain whether a personal right, such as the right that is created in a tender process, can be defined as an asset or in all cases can be disposed of with determinable proceeds. If it is determined that a right to earn future income can be classified as an asset and can be disposed of (ceded/sold etc.), then the effect is that CGT will be applicable to the capital gain or loss determined and included in the taxable income of the taxpayer for the year of assessment. Where it is not possible to determine proceeds or a base cost for personal rights, there will be no CGT consequences applicable. This is because the concept of valuation of an asset is a necessary part of an asset's disposal. The aspects for consideration in determining the CGT effects of expenditure incurred in a tender process are set out in **Table 4.2** which follows. **Table 4.2** includes a conclusion on the capital or revenue nature of the expenditure incurred as well as the CGT requirements.

Table 4.2: Application of capital concepts to tender expenditure

CGT Building blocks	Tender is awarded successfully to bidder	Tender is not awarded to the bidder
Asset	The right to earn future income only vests in a bidder if such a tender is awarded successfully and the bidder takes up his right to provide goods and services by complying with tender requirements. It is submitted that this personal right created is an asset.	In the case of an unsuccessful tender, the person has a mere hope or <i>spes</i> of earning income. Since there is no enforceable right, no personal right vests and no asset is applicable.
Disposal	The successful bidder who obtains a personal right to earn future income through contracts being entered into. It is submitted that such rights may be disposed of in part (for example, through subcontracting some goods or services) or in full, unless the contract provides otherwise. This will only be true where, on the basis of the argument made by O'Halloran (2007:23), a value can be attached to the personal right.	Prior to the allocation of the tender, a bidder only has a <i>spes</i> or hope to earn future income. Such interest also has no value, cannot be divided or sold in part and therefore the asset cannot be disposed of (<i>ibid</i>). Additionally, as no asset has come into existence no disposal is possible.
Proceeds	According to Cassidy (2004:168), the ability to value property is connected to the ability to sell the asset to a third party. It is submitted that the concepts of disposal and proceeds are inseparably linked in the sense that if an asset can be disposed of, it is presupposed that there is a value that can be attached to it. The ability to determine the value of the personal right is determined on factors unique to the specific right, for example as set out in the contract.	Since there is no asset and no disposal, no additional investigation as to the base cost or proceeds is required as no CGT consequences are applicable.
Base cost	The base cost of an asset is calculated as the cost of acquisition, including some other categories of expenditure, except in the case of assets obtained prior to 1 October 2001. The base cost of a right to earn future income in the case of a tender process will be the expenditure incurred during the tender process.	

Author compiled

CHAPTER 5 CONCLUSION

5.1 Introduction

At the outset of this study, it was determined that the tender process is an important instrument through which goods and services are acquired. Government engages in tenders to obtain services and goods with the best market response, including the best quality, time-effectiveness and cost (Leads2Business, 2015). Governments, large organisations and parastatals often rely on the tender process as it may assist in reducing risks, achieve socio-economic objectives and obtaining the best services and goods at the most competitive price.

In a tender process, bidders incur both necessary expenditure and expenditure in order to provide a competitive tender, in an attempt to be successfully awarded the tender. Such expenditure could include legal expenditure, financial advisors, environmental specialists, licence fees and the like. There is no guideline in the Act that explicitly regulates the income tax consequences of such expenditure incurred. It was noted that there are three distinct factors that influence the eventual tax consequences, namely the tender process, the form of the bidder and the nature of the expenditure. The investigation as to the tax consequences of expenses incurred during the bidding process was discussed with this in mind.

Within the context of a tender, irrespective of the type thereof, there is a generic process which groups the typical activities of a tender in stages or phases. This process has been set out in **Diagram 2.1**. Within these phases, the bidder is actively working to receive the bid which would include having to comply with the specific requirements of the tender documents and proving their ability to be able to provide the requested goods and services required. The allocation of the tender is the event that changes the outcome of activities occurring prior thereto and is thus a deciding event which will be seen to affect the tax consequences of expenditure incurred.

In concluding, answers to each of the specific research questions are submitted below. These are followed by concluding remarks and recommendations.

5.2 Concluding on research questions

Based on the literature review performed in this study, the following answers are submitted to address the research questions formulated in § 1.3:

(i) **At which point during a tender process can it be said that a ‘taxpayer’ exists for the purpose of determining the income tax liability?**

The legal form of the bidder is seen to affect the income tax treatment of expenditure incurred in two distinct ways. Firstly, the bidder must be a ‘taxpayer’ as set out in the Act in order to be both subject to tax and eligible for tax deductions. Secondly, the form of the bidder may have an impact on the tax treatment of expenditure incurred with reference to the requirements of deductibility, namely that the taxpayer also be a ‘person’.

The determination of whether a person exists for the purpose of section 11(a) was done with reference to the legal form of the bidder in the tender process. In terms of an interpretation of the definition of ‘person’ it was found that where the bidder is an individual, a company or close corporation (incorporated entity) or in a partnership or joint venture, that there was no doubt that this bidder was also a person. The situation which posed difficulty was the one where a bidder was bidding as a consortium of persons and that in terms of their agreement an incorporated entity would only come into existence if they were the successful winners of that bid. This is referred to as ‘conditional existence’ for the purpose of this study. This uncertainty brought into question the concept of ‘bodies of person’ which is included in the definition of person and it was found that on a wide interpretation of the term, even in this case where there is a conditional existence, for legal and tax purposes it can be stated that a person does exist. It is submitted that a bidder in a tender process, regardless of its legal form, will be found to be a ‘person’ for the purpose of section 11(a). It is however submitted that in the case of a bidder who has a conditional existence, if the bid is not awarded to that bidder, that the existing ‘body of persons’ will cease to be a ‘person’ as defined as the condition for becoming established has not been met. This is based on the premise that the parties are working together for the sole purpose of bidding in the specific tender. These findings are presented in summary form in **Table 3.1**. As it is found that a person exists, it is necessary to investigate whether it can be determined if the bidder carried on a trade.

(ii) Can a bidder in a tender process be seen to be conducting a ‘trade’?

In applying the subjective approach of the court to the question as to whether a bidder is carrying on a trade, no conclusive finding can be submitted. Determining the actual intention of a bidder, as required by the subjective approach, can only be done in practice. However, it is submitted that all bidders have the intention of carrying on a trade, based on their participating in the bid to obtain the right to provide goods or services. The action of submitting a bid can be seen as indicative of an intention to trade; the intent to make a profit or obtain some business benefit in the future. In addition to the subjective intention the objective test provided additional findings in respect of the ‘trade’ requirement.

The objective test entailed applying a number specific factors, identified by the courts, to the tender process, these are: continuity; profitability; carrying on a business and passive income-earning activities. The impact of a bidder who conducts numerous trades and where activities are conducted prior to a trade being established was also investigated. The different potential forms of the bidder and the stages in a tender process were discussed, with regards to the question of whether a trade is carried on. The application of these factors, in the context of the tender process and specifically with reference to the deciding event in **Diagram 2.1** has been summarised in **Table 5.1**, which follows.

Table 5.1: Application of objective factors to determine ‘trade’ the tender process

	Stages prior to the ‘deciding event’		Stages subsequent to ‘deciding event’	
	Bidder with ‘conditional existence’	Incorporated entity regularly bidding	Bidder awarded the tender	Bidder not awarded the tender
Continuity	No continuity.	Continuity exists which indicates trade is applicable.	Continuity exists.	No continuity.
Profitability	No profitability.	Profitability factor indicates trade is applicable.	Profitability factor indicates trade is applicable.	No profitability.
Carrying on a business	Not applicable.	Bidding is part of business indicating trade is applicable.	Not applicable.	Not applicable.
Passive income-earning activities	Active steps undertaken in tender process indicate of trade being carried on.			

The main conclusions relating to the carrying on of a trade, are submitted as follows:

- Where a bidder's existence is subject to being awarded a bid (bidders with 'conditional existence'), no trade is being carried on during the phases prior to the bid being awarded. Expenditure may, however, still be deductible in terms of section 11A, which relates to pre-trade activities should a trade eventually commence. This will be the case where the bidder is awarded the tender.
- A bidder who regularly bids to win tenders as part of its normal trading activities will be found to be conducting a trade, even during the phases prior to the bid being awarded. A trade is carried on regardless of whether the bid is eventually awarded to that bidder or not. There is however some uncertainty as to whether the expenditure incurred in an unsuccessful bid may be deducted from income earned from another source or if the tax consequences of numerous trades must be considered separately.
- Where a bidder is awarded a tender successfully, it will be found that a trade is being carried on.
- Where a tender is not awarded to the bidder (and that bidder does not bid regularly), it is submitted that there could still be an argument for a 'trade' as incurred in attempt to generate possible income (the intention to carry on a trade).

Pre-trade activities in terms of section 11A was investigated, specifically with regards to the situation of a bidder who is found not to conduct a trade during the tender process, but indeed does carry on a trade subsequent thereto. In the case of a bidder who has complied with all the listed requirements of section 11(a) and commences with trading activities (for example, in the case of a tender being successfully awarded), the expenditure incurred prior to trade and thus in the process of a tender, will be deductible in terms of section 11A if it is not capital in nature. Contrary to this, where a bidder is not awarded a bid and assuming that the bidder never carries on a trade, the expenditure incurred in the tender process will not be deductible in terms of section 11A or section 11(a). In the circumstances where it was found that a bidder is not carrying on a trade, no further investigation is required since one of the section 11(a) requirements has not been met. In relation to those circumstances where a trade is being carried on, it was further investigated whether the expenditure had been incurred in the production of income in the context of section 11(a).

(iii) During the tender process, can it be said that the bidder has incurred the expenditure in the production of income?

The question of whether the expenditure had been incurred 'in the production of income' required the application of the two-fold test as set out in the *Port Elizabeth Electric Tramway Co Ltd v CIR* case. The two-fold test requires determination of the purpose of the activities which necessitated the expenditure and whether the expenditure incurred is linked to these activities. In the case of a tender, the income to be produced is obtained from the delivery of goods and services once the tender has been successfully awarded. The actions or activities producing this income are thus not specifically the activities in the tender process, but rather the activities once the bid has been awarded. The delivery of goods or services would only commence once a bidder has been awarded a tender and without the tender activities there would be no income produced. It is submitted that the act of bidding for the tender can therefore be seen as the act which necessitated the expenditure. It is further submitted that the purpose of such expenditure would be to produce income which speaks to the first requirement in the two-fold test. In terms of the second requirement of the two-fold test, it was determined whether the tender activities were sufficiently linked to the expenditure (referring to the closeness of connection). This determination necessitates an investigation as to whether there is sufficient causation between the act entailing expenditure and the income earned. It is submitted that there is sufficient factual and legal causation between the act entailing the expenditure and the income earned. However, consideration was given as to whether it could be found that because the bid allocation is not within the control of the bidder, it may be found to be a *novus actus interveniens* (intervening act) which breaks this link of causation. Grant (2005:896) defines an intervening act as an action which is unsuspected, abnormal or unusual. With regards to the tender process, a tender decision is normal and expected in the ordinary course of a tender. It is acknowledged that this discretion is being applied by an outside party, although this is still insufficient grounds for finding that the tender decision is an intervening act. This finding is consistent with the conclusion of Du Plessis (2005:118) who determines that where the taxpayer could affect the discretion being applied, that this discretion cannot be found to be an intervening act. The activities in the tender process can thus be found to be sufficiently linked to the income produced. Based on the outcome of applying the two-fold test, it is submitted that in the case of expenditure incurred in a tender process, the requirement of 'in the production of income' is met.

Lastly, in order to determine whether section 11(a) is applicable and therefore the expenditure in a tender process deductible for the purposes of determining taxable income, it was investigated whether the nature of the expenditure could be found to be capital in nature.

(iv) Can the expenditure incurred during the tender process be classified as capital in nature?

Each of the capital versus revenue tests were applied to expenditure incurred in the tender process. During this investigation it was necessary to distinguish between the situation where the bidder has been successfully awarded the tender versus the situation where the bidder was not awarded the tender (referring to the deciding event as described in **Diagram 2.1**). The conclusion reached is summarised in **Table 5.2**, which follows.

Table 5.2: Capital versus revenue tests to expenditure in tender process

Capital tests	Tender awarded successfully to bidder	Tender is not awarded to the bidder
Enduring benefit test	<u>Awarded for recurring provision of goods or services:</u> Bidder obtains an enduring benefit indicative that capital in nature. <u>Awarded for once-off provision of goods or services:</u> Bidder obtains no enduring benefit indicative that not capital in nature.	Expenditure incurred does not result in an enduring future benefit for the bidder and is not capital in nature.
Income earning operations or structure	Expenditure incurred in bidding in a tender process is necessary in order to successfully be awarded a tender, it relates to income earning structure and is capital in nature.	No future income is gained from such expenditure therefore no income earning structure is created. Expenditure is not capital in nature.
Once and for all test	The expenditure is incurred irrespective of whether the tender is eventually awarded successfully or not. Expenditure incurred in a tender process is incurred only once and therefore is capital in nature.	
Fixed versus floating capital	Expenditure incurred in tender process is fixed capital and therefore is capital in nature rather than floating capital which is regarded as income in nature.	
Profit making scheme	Expenditure incurred in obtaining future profits, and is therefore capital in nature.	

If the tender is not awarded to the bidder the expenditure incurred is submitted as not resulting in an enduring benefit or income producing structure being created (regarded as being comparable to marketing expenditure as submitted in §4.4). Therefore not being regarded as capital in nature and considered deductible in terms of section 11(a).

If the tender is, however, awarded to the bidder and enforceable right is created to provide goods or services and this right is submitted as being of a capital nature and therefore not deductible in terms of section 11(a). The expenditure incurred in the tender process is being incurred in the process of obtaining an exclusive right to earn income through providing goods or services to the government, parastatal organisation or private organisation who put these required goods or services out on tender. A personal right is thus created in the hands of the bidder and this personal right should be measured against the CGT requirements. It was thus investigated whether this right to earn future income can be defined as an asset, which can be disposed of, with proceeds and a base cost, both of which are determinable. The focus of the study was not on determining the valuation of the right to earn future income. Each of the four CGT requirements had been applied to the right to earn future income as obtained from the tender process and the conclusion is summarised in **Table 5.3**, which follows.

Table 5.3: Application of CGT requirements to expenditure in tender process

Building blocks of CGT	Tender is awarded successfully to bidder	Tender is not awarded to the bidder
Asset	The right to earn future income obtained in a tender process is a personal right which is an asset.	No right to earn future income vests in the bidder therefore there is no asset.
Disposal	A bidder who is awarded a bid, obtains the personal right to earn future income which can be disposed of if it can be valued.	Since a bidder only has a <i>spes</i> or hope of future income, no asset has come into existence and therefore no disposal is possible.
Proceeds	If the right to earn future income can be disposed of and it has a value, then the proceeds can be determined.	Since there is no asset and no disposal, consequently no CGT consequences are applicable.
Base cost	The base cost of a right to future income in the case of a tender process will be the expenditure incurred.	

5.3 Concluding remarks and recommendations

The overall conclusions reached based on this study are:

- If the tender is awarded successfully to bidder expenditure incurred in the tender process is submitted as capital in nature as a right to earn future income is established for the bidder and not deductible in terms of section 11(a). The only tax consequence that may be applicable is CGT, as determined in relation to the Eighth Schedule.
- If the tender is not awarded to bidder expenditure incurred in the tender process is submitted as not capital in nature therefore deductible in terms of section 11(a). Where a bidder is not awarded a tender, there can be no CGT consequences as no asset comes into existence.
- A bidder who is awarded a tender will be subject to CGT on disposal of their right to earn future income, on the basis that this right is one for which a value can be determined. The base cost of this right will include the expenditure incurred in the tender process.

During the investigation as to whether a bidder is carrying on a trade and specifically in the case of a bidder who conducts numerous trades, it was noted that some uncertainty exists as to whether pre-trade expenditure is ring-fenced to be deductible only from the specific trade. It was investigated whether in the case of a bidder with numerous trades the expenditure incurred in the tender process of one bid may be deducted from income earned from other trades. The decision in *Sekretaris van Binnelandse Inkomste v Olifantsriviere Ko-operatiewe Wynkelders Bpk* leads to a conclusion that that expenditure incurred in conducting one trade cannot be deducted from income earned through another trade. This is substantiated by Interpretation Note 51 which finds that expenditure in expansion of a business will not be deductible from income earned from existing trades (SARS Legal and Policy Division, 2014:11). It is submitted that this is a very narrow interpretation of the concept of trade and not applied in practice. This inconsistency is thus recommended as an area for future research.

LIST OF REFERENCES

List of books, dissertations, journals and other sources considered

- Badenhorst, P.J., Pienaar, J.M. & Mostert, H. 2003. *Silberberg and Schoeman's The Law of Property*. Fourth Edition. Durban: LexisNexis Butterworths.
- Bolton, P., 2009. *The status of contracts exceeding a municipal tender call*. Tydskrif vir die Suid-Afrikaanse Reg, 2:382–392.
- Botes, M. 2015. *Juta's Commentary on the Value Added Tax Act*. Cape Town: Juta and Company (Pty) Ltd.
- Cassidy, J. 2004. *CGT in South Africa: Lessons from Australia*. SA Mercantile Law Journal, 16(2):164–195.
- Clegg, D. & Stretch, R. 2012. *Income Tax in South Africa Volume 1*. Durban: LexisNexis.
- Clegg, D. 2014. *Pre-production problems: is section 11A of the Income Tax Act a solution?* Business Tax and Company Law Quarterly, 5(1):1–6
- Davis, D., Olivier, L., Urquhart, G., Engels-van Zyl, R., Roeleveld, J, Mollagee, O., Coetzee, S and Benetello, M. 2015. *Juta's Income Tax*. Cape Town: Juta and Company (Pty) Ltd.
- De Kock, A., 2012. *Die uitreik van aandele ten einde verpligtinge na te kom – onkoste werklik aangegaan vir inkomstebelastingdoeleindes of nie*. Unpublished Master's thesis, University of Stellenbosch.
- De Koker, A. & Williams, R. 2015. *Silke on South African Income Tax*. Johannesburg: LexisNexis.
- De Koker, A. 2012. *Silke on South African Income Tax - Memorial Edition Volume III*. Cape Town: LexisNexis.
- Deutsch, R.L., Friezer, M.L., Fullerton, I.G., Hanley, P.J. & Snape, T.J. 2010. *Australian Tax Handbook*. Sydney: Thomson Reuters (Professional) Australia Limited.
- Du Plessis, I., 2005. *Section 8C of the Income Tax Act: a discussion*. Stellenbosch Law Review, 16(1):104–124.

- Du Plessis, I., 2006. *Deductibility of royalties : a recent case that ruffled feathers [discussion of the judgment of Waglay J. in case number 11454 in the tax court]*. Stellenbosch Law Review, 17(1):190–201.
- Etsebeth, V., 2007. *The evolution of the test for 'in the production of income.'* Tydskrif vir die Suid-Afrikaanse Reg, (1):214–221.
- Gildenhuys, J.S.H. 2002. *Public financial management*. Pretoria: Van Schaik.
- Grant, J., 2005. *Causation by adequate cause and novus causa interveniens*. South African Law Journal, 122(4):896–906.
- Green, C., 2008. *An analysis of the use of limited real rights in tax planning*. Unpublished Master's thesis, Nelson Mandela Metropolitan University.
- Investopedia, 2015. *Definition of 'Tender'*. Available at: <http://www.investopedia.com/terms/t/tender.asp> [Accessed April 29, 2015].
- James, M., 2010. *Critical Perspectives on Accounting - Humpty Dumpty's guide to tax law: Rules, principles and certainty in taxation*. Critical Perspectives on Accounting, 21(7):573–583.
- Janse, N.A.W., 2008. *An analysis of the distribution process of accounting and auditing tasks from the EU to public and private firms*. Unpublished Master's thesis, University Maastricht.
- Joubert, D., 2009. *Income tax: gross income - capital versus revenue, profit-making scheme or fixed / floating-capital test?* Obiter, 30(2):381–391.
- Katzke, A.C.R., 2009. *Farm and factory: An analysis of the distinctions between and fiscal treatment of taxpayers simultaneously carrying on farming operations and manufacturing processes under the Income Tax Act No. 58 of 1962*. Unpublished Master's thesis, University of Cape Town.
- Kotze, J.H., 2009. *Die invloed van Kapitaalwinsbelasting op boedelbeplanning en boedelbelasting en die toepaslikheid van trusts in boedelbeplanning na die inwerkingtreding van Kapitaalwinsbelasting*. Unpublished Master's thesis, University of Stellenbosch.

Lauesen, S. & Vium, J.-P., 2004. *Experiences from a Tender Process: The customer's dreams and the supplier's frustrations*. In V. Regnell, B., Kamsties, E. Gervasi, ed. Proceedings of REFSQ'04, Riga, Essener Informatik Beitrage. 29–46.

Leads2Business, 2015. *Understanding the tender process*. Available at: http://www.l2b.co.za/ProductInformation/Tender_Process [Accessed September 26, 2015].

McAllister, D.S., 2011. *SARS Comprehensive Guide to CGT*.

Merriam-Webster, I., 2015. *Merriam-Webster Dictionary*. Available at: <http://www.merriam-webster.com/dictionary/tender> [Accessed April 29, 2015].

Meyerowitz, D. 2008. *Meyerowitz on Income Tax*. Cape Town: Cape Town: The Taxpayer
Moeti, K., Khalo, T., Mufinisa, J., Nsingo, S. & Makondo, T. 2007. Public finance fundamentals. Cape Town: Juta.

Monteiro, C., 2008. *License fees — the state of play*. Moneyweb's Tax Breaks, (November):4–5.

Monteiro, C., 2009. *Licence fees: The current state of play*. Moneyweb's Tax Breaks, April (279):4–5.

Moosa, F., 2013. *The scope of the expression 'necessarily incurred' in section 18(1) of the Income Tax Act*. SA Mercantile Law Journal, 25(2):84–196.

Mouton, J. 2001. *How to succeed in your Master's and Doctoral Studies - A South African Guide and Resource Book*. Pretoria: Van Schaik.

Ngobeni, S.A., 2011. *An analysis of the tender process in national government in South Africa*. Unpublished Master's thesis, North-West University.

O'Halloran, P., 2007. *What to Do if You Want to Go to Harlem*. Tax, Aug / Sep(7):22–24.

Oguttu, A.W., 2003. *The courts will not be beguiled*. Juta's Business Law, 11(4):230–233.

Olivier, L., 2007. *Determining a taxable capital gain or an assessed capital loss: some problems*. Meditari Accountancy Research, 15(1):35–50.

- Olivier, L., 2009. *The 'trade' requirement for Income Tax purposes: A reappraisal - CSARS V Smith 65 SATC 6*. Journal of Economic and Financial Sciences, 3(2):189–194.
- Olivier, L., 2012. *Capital versus Revenue: Some Guidance*. De Jure, 45(1):172–177.
- Organisation for Economic Co-operation and Development, 2009. *Tax guidance series - Corporate governance and tax risk management*.
- Oxford University Press, 2015. *Oxford Dictionaries*. Available at: <http://www.oxforddictionaries.com/definition/english/tender#tender-2> [Accessed September 26, 2015].
- Quinot, G., 2008. *Worse than losing a government tender: Winning it*. Stellenbosch Law Review, 1:101–121.
- SARS Legal and Policy Division, 2012. *Interpretation Note no 45 (Issue 2): Deduction of Security Expenditure*.
- SARS Legal and Policy Division, 2014. *Interpretation Note no 51: Pre-trade expenditure and losses*.
- Sonnekus, J.C., 2011. *Shielding parastatals against claims for performance: an unwarranted digression*. South African Law Journal, 128(2):297–326.
- Steenkamp, L.-A., 2011. *A Critical analysis of the Reportable Arrangements Provisions of the Income Tax Act, focusing on section 80M (1)(d)*. Unpublished Master's thesis, University of Cape Town.
- Stein, M. 2015. *Stein on CGT*. Johannesburg: LexisNexis.
- Stiglingh, M., Koekemoer, AD., Van Zyl, L., Wilcocks, JS. & de Swardt, RD. 2014. *Silke: South African Income Tax*. Pietermaritzburg: LexisNexis.
- Swart, G., 2005. *Interpreting some core concepts governing the taxation of capital gains*. SA Mercantile Law Journal, 17(1):1–18.
- Thackwell, R., 2010. *The contribution made by Mr Justice EF Watermeyer to South African tax jurisprudence*. Unpublished Master's thesis, Rhodes University.

Tshikororo, N., 2014. *A critical analysis of the concept of carrying on trade in the South African Income Tax Act*. Unpublished Master's thesis, University of Johannesburg.

Van der Merwe, B.A., 1998. *Cession of a Right to Future Income – Income Tax Implications*. SA Mercantile Law Journal, 10:354–367.

Van Zyl, S., 2012. *The meaning of 'expenditure' for purposes of section 11(a) and (GA) of the Income Tax Act 58 of 1962 - CSARS v Labat Africa Ltd [2011] ZA SCA 157*. Obiter, 33(1):186–192.

Visser, C.J. & Kennedy-Good, C., 2015. *The emergence of a 'flexible' conditio sine qua non test to factual causation? Lee v Minister of Correctional Services 2013 (2) SA 144 (CC): cases*. Obiter, 36(1):150–163.

Waters, D. 2002. *Operations Management-producing Goods and Services*. Essex: Pearson Education Limited.

Wilcocks, J.S. & Strydom, J.J., 2002. *The concept of 'disposal' for the purposes of CGT in South Africa*. Meditari Accountancy Research, 10(1):311–325.

Willemse, C.L., 2010. *Die inkomstebelasting hantering van Franchisefooie betaalbaar deur Franchisehouers in die Suid-Afrikaanse petroleum-bedryf*. Unpublished Master's thesis, University of Stellenbosch.

Williams, R., 2002. *The impact of CGT on trusts and trust beneficiaries*. Acta Juridica:136–160.

Williams, R.C. 2001. *Income Tax and CGT in South Africa: Law & Practice* Third Edition. Durban: Butterworth Publishers (Pty) Ltd.

Williams, R.C. 2005. *CGT: A Practitioner's Manual Second edition*. Landsdowne: Juta.

List of cases considered

Burgess v CIR 1993 (4) SA 161 (A), 55 SATC 185.

C:SARS v Labat Africa Ltd 2013 (2) SA 33 (SCA).

C:SARS v Smith 2002 (6) SA 621 (SCA).

Cape Town Municipality v Clarensville (Pty) Ltd 1974 (2) SA 138 (C).

CIR v Allied Building Society 1963 (4) SA 1 (A).

CIR v Genn and Co (Pty) Ltd 1955 (3) SA 293 (A).

CIR v JW Jagger and Co Ltd 1945 CPD 331.

CIR v Pick 'n Pay Employee Share Purchase Trust [1992] 2 All SA 245 (A).

CIR v Sive's Estate 1955 (1) SA 249 (A).

Commissioner for Inland Revenue v George Forest Timber Co Ltd. 1924 AD 516.

Commissioner for Inland Revenue v Richmond Estates (Pty) Ltd 1956 (1) SA 602 (A).

Commissioner for Inland Revenue v Shell Southern Africa Pension Fund 1984 1 SA 972 (A).

Concentra (Pty) Ltd v Commissioner for Inland Revenue 1942 CPD 509.

CSARS v Knuth and Industrial Mouldings (Pty) Ltd [1999] JOL 5805 (EC).

De Beers Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (A).

Dilworth v Commissioner of Stamps 1899 AC 99.

Edgars Stores Ltd v CIR (1988) 3 SA 876 (A).

Estate Brownstein v CIR (1957) 21 SATC 262.

Estate G v CoT 1964 (2) SA 701 SR.

Green and Sea Point Municipality v Egnal and Co (1902) 19 SC.

ITC 1275 (1978) 40 SATC 197 (C).

ITC 1292 41 SATC 163.

ITC 1476 52 SATC 141.

ITC 1698 63 SATC 161.

ITC 1772 (2004) 66 SATC 211.

ITC 1783 66 SATC 373.

ITC 512 (1944) 12 SATC 246.

ITC 770 (1954) 19 SATC 216.

Joffe & Co (Pty) Ltd v CIR 13 SATC 354.

Jones & Co Ltd v CIR (1926) CPD1 2 SATC 7.

KBI v Van der Walt 1986 (4) SA 303 (A).

Modderfontein Deep Levels Ltd v Feirnstein (1920) TPD 288.

Nasionale Pers BPK v KBI 1986 (3) SA 549 (A).

Natal Estates Ltd v SIR 1975 4 SA 177 (A).

Nchanga Consolidated Copper Mines Ltd v Commissioner of Taxes 1962 (1) SA 381 (FC).

New State Areas LTD v CIR 1946 AD 610.

Port Elizabeth Electric Tramway Co Ltd v CIR (1936) CPD 241.

SBI v Olifantsriviere Ko-operatiewe Wynkelders Bpk (1976) 3 All SA 574 (A).

South African Revenue Service v Kotze 2002 9 JTLR 343 (C).

Steenkamp NO v Provincial Tender Board, Eastern Cape (2007) 3 SA 121 (CC).

Stephan v CIR (1919) 31 SATC 54 61.

Sub-Nigel v CIR 1948(4) SA 580 (A).

The Commissioner of South African Revenue v BP South Africa (Pty) Ltd 2006 5 SA 559.

Warner Lambert SA (Pty) Ltd v CSARS 65 SATC 346 2003 (5) JTLR 109.