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TAXATION | BASIC/INTERMEDIATE

# Video Transcription: Capital and Revenue

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People often believe that Income Tax is a set of rules without any logical consistency, something to be memorised rather than understood. But Income Tax has principles on which it is based, even if those principles are not written down in the Income Tax Act. Hi, I am Shaun Parsons, let me guide you through what is probably the most important principle in Income Tax.

A friend tells you he has sold his car, and before he spends the money he wants to know whether he will have to pay any income tax on the sale of the car. He wants your advice. Probably the most fundamental and distinctive principles of Income Tax is whether income or expenditure is considered to be Capital or Revenue. Whether income or expenditure, Capital or Revenue amounts will lead to very different income tax consequences.

Have a look at the definition of gross income, and note that it excludes receipts or accruals of a capital nature. Similarly, the s11(a) General Deduction formula says that we may only deduct expenditure that is not of a capital nature. Since, at the most basic level, we pay income tax on our gross income less our s11(a) deductible expenditure, we can see that in both cases, capital amounts are excluded.

Why is this? In 1901 Lord Macnaghten famously stated in the case of London County Council vs Attorney General that “Income Tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else.” What he meant by this statement is that Income Tax focuses on income, and income represents an increase in the wealth of the taxpayer. Capital receipts are excluded, on the basis that they do not represent increases in wealth, but only a change in the form of the taxpayer’s wealth.

What do we mean by this? A taxpayer who owns a house worth R1 million is no richer or poorer than if he sells his house for R1 million and puts the R1 million in the bank. Before the transaction, he has a house worth R1 million; after the transaction he has cash worth R1 million. In the same way, capital expenditure is not allowed as a deduction under s11(a) because this expenditure does not represent a decrease in wealth. For example, the taxpayer with R10 000 in the bank is no richer or poorer than the taxpayer who spends the R10 000 to buy new manufacturing machinery, and now has machinery worth R10 000. Their overall wealth is the same, it just takes a different form.

Let’s look at why your friend won’t include the proceeds on the sale of his car in his gross income, but a car dealer will include the proceeds from the sale of cars in his gross income. It is important to note that there is no definition of “capital” in the South African Income Tax Act, so we need to look at the precedents laid down in previous income tax case judgements (in other words, the decisions made in those cases) to understand what the courts have interpreted “capital” to mean, and how they have decided which amounts are capital and which are not.

The courts look to previous income-related cases in deciding whether or not a receipt or accrual is capital, and to previous expenditure-related cases to determine whether or not an amount of expenditure is capital. While the thinking in these two groups of cases may be similar, it is important that we think of them separately.

Let's consider income first. In considering whether a receipt or accrual is capital in nature, the courts have distinguished between capital and revenue amounts using the "tree and the fruit" idea. In this idea, the tree is the capital and the fruit is the revenue. Why is this? The point of having a fruit tree is not to sell the tree but to benefit from the fruit that it produces. So revenue income arises from the sale of the fruit, while capital income arises if and when the tree is sold.

So how do we use this thinking if what is sold is not a fruit or a tree? How do we decide whether the proceeds are capital or revenue? There are many possible ways that the courts could have answered these questions – What type of asset is it? How long did he own it? Did he make a profit when he sold it? – but none of those approaches perfectly fit the distinction, and all are open to manipulation.

The test that the court settled on is, "What was the intention of the taxpayer when he bought the asset?" In other words, why did he buy it? Was it to benefit from the use of the asset, or to benefit from the sale? If his intention was to benefit through its use, then the income made through using the asset will be revenue, but from selling the asset will be capital. However if he bought the asset with the intention of selling it for a profit then the asset is his trading stock, and the proceeds on sale will be revenue.

So, what happens if the taxpayer and the South African Revenue Service, disagree? The taxpayer will need to prove that the amount is capital (since this is the best outcome for the taxpayer, since it will be excluded from his gross income). The taxpayer will need to provide evidence to show that the asset was purchased to benefit from its use.

There is no single piece of evidence that is automatically accepted as proof, but past considerations have included: how long the taxpayer owned the asset, whether the taxpayer could point to any benefits or income that he obtained from its use, or why he sold it. If the taxpayer sells an asset soon after he buys it then the logical assumption is that it is trading stock; however if he could show that he only sold it to due to an emergency then the asset may not be trading stock. If a taxpayer benefitted significantly from using the asset while he owned it then it seems likely that it was bought to be used; if he didn't benefit from using it then it seems more likely that he bought the item to sell it.

It is important to remember that there is no prescribed formula; each situation needs to be judged individually on its own information.

Now let's look at expenditure. The courts' approach in distinguishing between capital and revenue expenditure is similar to income. When trying to identify whether expenditure is capital in nature the central issue is whether it provides the taxpayer with a lasting benefit or whether the benefit is quickly consumed.

The courts have also indicated that capital expenditure is incurred when a source of future profits or a capital asset is purchased; whereas revenue expenditure is incurred when using the source or asset. Recurring expenditure is more likely to be considered revenue in nature, although not all once-off expenditure is automatically considered capital.

With expenditure, of course, the taxpayer would prefer an amount to be revenue rather than capital, since this reduces his taxable income. For this reason, if the taxpayer and SARS have different views, the taxpayer needs to show that the amount is not capital.

So back to our original question: Why won't your friend include the proceeds on the sale of his car in his gross income, but a car dealer would? The answer is because your friend bought his car to use it, and not to sell it at a profit. The proceeds on sale are therefore capital in nature. The car dealer buys cars to sell them at a profit; the proceeds on his sales are revenue in nature.

The distinction between capital and revenue is one of the fundamental principles of Income Tax. Capital receipts or expenditure may still have tax consequences. These may include special inclusions or deductions, capital allowances and capital gains tax. You can explore these further in other videos, in this series.