

CIR v Niko: A question of economic reality¹

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ABSTRACT

This article analyses the facts and judgment in *CIR v Niko*, involving the transfer of business assets from a sole trader to a company, the shares of which were substantially owned by the same sole trader. This case changed the inherently flawed, but prevailing practice at that stage of regarding a lump-sum payment from a lock-stock-and-barrel sale of a business as a receipt of a capital nature, to a receipt that needed to be allocated to the various assets included in the sale, and therefore potentially the receipt would be partly of a capital and partly of a revenue nature. Although the conclusion relating to lock-stock-and-barrel sales in general was sound, the submission made in this article is that, in the particular circumstances of the case, the economic reality of the transaction was not considered – virtually no economic gain was realised by J. Niko, the seller and sole owner of the business to a company of which he was also the substantial shareholder. Two subsequent court decisions, which similarly ignored the economic reality of the transactions in the context of a group of companies, followed this judgment. In this article, the problematic nature of the decisions that ignored the economic reality of the transactions is demonstrated with reference to accepted canons of a good taxation system. The article also explains the partial legislative relief that has subsequently been granted for transfers of assets from a person to a company and for transfers within a group of companies, but concludes that there is a need for full recognition of a group of companies as an economic entity for tax purposes.

Key words: integrated group tax system, economic reality, economic unit, group of companies, lock-stock-and-barrel sale, principles of equity and neutrality, sale of a business

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¹ *CIR v Niko*, 1940 AD 416, 11 SATC 124.

*CIR v Niko*² is a landmark case in South African tax history. It changed the previously accepted tax consequences of disposing of a business, lock-stock-and-barrel for a lump-sum amount. Lawyers, accountants and businesspeople had thereafter to take note of the decision and adjust all agreements and conditions of lock-stock-and-barrel sales accordingly. Prior to the decision in the *Niko* case, taxpayers were able, when selling their businesses lock-stock-and-barrel (the so-called “slump sale” as it was referred to at the time), to have the whole lump-sum proceeds treated as a receipt of a capital nature.³ The outcome of the *Niko* decision was that even if the selling price is expressed as a lump sum in the agreement of sale, the taxpayer has to allocate the selling price to the individual assets of the business. In so far as the purchase consideration consists of items of a revenue nature, such as trading stock, the amount allocated to such item would be included in the taxpayer’s gross income and thus ultimately be taxable.⁴

On the day of the Special Court hearing which preceded the Provincial Division hearing and the Appellate Division (now the Supreme Court of Appeal) hearing, Mr Ditz, who appeared on behalf of Mr J. Niko (referred to hereafter as “Niko”), was the first to address the court. One can easily imagine Mr Ditz as a carbon copy of Raymond Chandler’s description of an accountant from the 1940s: “*A long stooped yellow-faced man with high shoulders, bristly eyebrows and almost no chin. The upper part of his face meant business. The lower part was just saying goodbye[e]. He wore bifocals ... He was a C.P.A. [accountant] and looked it every inch. He even had ink on his fingers and there were four pencils in the pocket of his open vest.*”⁵ Mr Ditz confidently argued that the lump-sum amount in question was of a capital nature according to the general practice at that stage,⁶ as confirmed in numerous Special Court decisions⁷ prior to the *Niko* case. The prevailing practice to simply regard the whole selling price as capital in nature was thus generally accepted as correct, and no lawyer or accountant questioned that practice as it was generally to the benefit of their clients. Nevertheless, this practice was often questioned by the Commissioner⁸

2 1940 AD 416, 11 SATC 124.

3 Kruger, D., Stein, M., Dachs, P., and Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition, Durban: LexisNexis at 48.

4 Olivier, L. “Tax Implications of the Sale of a Business”. 2007. *The South African Law Journal*. Vol. 124(3) at 600–617.

5 Chandler, R. *The Lady in the Lake*, 1944. [Online] Available at: http://www.ae-lib.org.ua/texts-c/chandler_the_lady_in_the_lake_en.htm [Accessed: 16 June 2014 at 23].

6 Kruger, D., Stein, M., Dachs, P., and Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition, Durban: LexisNexis at 48.

7 *ITC 15* (1924) 1 SATC 122, *ITC 27* (1924) 1 SATC 218, *ITC 151* (1929) 4 SATC 296, *ITC 223* (1931) 6 SATC 150, *ITC 305* (1934) 8 SATC 87, *ITC 317* (1934) 8 SATC 171, *ITC 332* (1935) 8 SATC 269, *ITC 399* (1937) 10 SATC 99.

8 *AB v COT* (1921 Southern Rhodesia, 1 SATC 77), *ITC 15* (1924) 1 SATC 122, *ITC 27* (1924) 1 SATC 218, *ITC 151* (1929) 4 SATC 296, *ITC 223* (1931) 6 SATC 150, *ITC 305* (1934) 8 SATC 87, *ITC 317* (1934) 8 SATC 171, *ITC 332* (1935) 8 SATC 269, *ITC 399* (1937) 10 SATC 99.

and it became inevitable that the matter would finally be settled in a higher court. Even the Commissioner's counsel in the *Niko* case did not, during the Special Court hearing, challenge the capital nature of the sales proceeds. Instead, he challenged the *value* of the trading stock reflected in the final accounts of Niko's sole trader business. Neither the Special Court nor the Provincial Division questioned the capital nature of the proceeds, but continued to question the value of the trading stock. It was only when the case went to the Appellate Division that the court questioned the capital nature of the amount.

In the years after the *Niko* decision, several leading South African tax publications (rightly) accepted this decision as authority for the taxation of lump sums arising from the sale of a business.⁹ In the same way that Mr Ditz, during the court hearing, presumed that the widely accepted practice of regarding lock-stock-and-barrel sales as the correct practice, lawyers and accountants thereafter simply accepted that the decision reached in the *Niko* case was accurate in all respects. But was this really a lock-stock-and-barrel sale, or was Niko simply transferring his assets from a sole proprietorship to a company in order to benefit from the advantages of corporate existence and to extend his business activities? Was the issue really whether this was a capital receipt, or was the taxpayer merely incorporating his business without a receipt or accrual having been realised?

The main purpose of this article is to demonstrate that, based on the *Niko*¹⁰ decision, the economic reality of transactions that take place in economic units should be recognised. The article thus addresses the following:

- to discuss the facts of the case and analyse the judicial arguments presented in the case;
- to enhance the understanding of the case by placing it in the context of the historical era in which the transactions giving rise to the appeal took place and briefly sketching the history of economic units and group taxation; and
- to explain developments in the taxation of economic units in South Africa, subsequent to *Niko*.

This article makes a contribution by demonstrating the inequity arising from the judgment in the *Niko* case. The economic reality of the *Niko* case is revealed through the discussion of the facts of the case and by interpreting the court decision in terms of basic tax principles. The most important contribution, however, is that

9 De Koker, A.P. and Williams, R.C. 2013. *Silke on South African Income Tax*, Volume 1, Service 49, Durban: LexisNexis, at 3-2-1.

10 *CIR v Niko*, 1940 AD 416, 11 SATC 124.

this article demonstrates that the economic reality of transactions that take place within economic units needs to be recognised in legislation.

The article commences with a detailed discussion and analysis of the facts of the case and the judgment, including the judgments of the lower courts, and describes the context in which the case took place. The economic reality of the *Niko* case is then investigated, with particular reference to the principles of tax neutrality and equity. Thereafter a brief history of economic units and group taxation, and tax developments relating to economic units in South African tax law subsequent to the *Niko* case is presented, including a discussion on two recently decided South African tax cases that dealt with the question of economic unity within a group of companies. The article concludes by recommending a system of group taxation in order to recognise the economic unity of a group of companies.

The background of the *Niko* case

In 1933, Niko commenced business in Durban as a contractor, scrap-iron merchant and second-hand dealer. These were the years of the Great Depression, a worldwide economic downturn that began in 1929 and lasted until about 1939,¹¹ and they were difficult years in which to do business. Niko was ambitious and hardworking and his business grew through these difficult economic years to a point in 1936 when he needed to expand his business. His business, based near the harbour, consisted of contracting for the repair of equipment and harbour craft, and dealing in second-hand spare parts. He bought old harbour craft like tug boats and dredgers and other equipment, which he dismantled and sold as second-hand spare parts to the shipping industry or as scrap metal, or used it in the contracting arm of his business. His business strategy was to purchase the trading stock as cheaply as possible and sell it at the highest price possible.

By 1936, merchants in the shipping industry had noticed Niko's success as a contractor and supplier of shipping spares. Among these were the De Gersigny family, who were major clients of his business and well known for their involvement in the shipping industry in Durban during those years.¹² It was logical that the best way for

11 Encyclopædia Britannica. 2013. *Great Depression*. [Online] Available at: <http://www.britannica.com/EBchecked/topic/243118/Great-Depression> [Accessed: 6 June 2013].

12 The De Gersigny family's involvement in the shipping industry started out in Mauritius from where it extended to Durban. In 1934, Xavier de Gersigny and W.B. Grindrod formed Grindrod, Gersigny and Company (Pty) Ltd, today known as the Grindrod Group, a highly respected business in the shipping industry, both in South Africa and worldwide. Grindrod Ltd. 2010. *The Grindrod Whistler*. [Online] Available at: http://www.grindrod.co.za/Uploads/Grindrod_Whistler.pdf [Accessed: 18 April 2013 at 1-4].

Niko to expand his business was to introduce partners from the shipping industry and in this way secure future sales for his business. The extension of his business by engaging with a business in the same supply chain is similar to a vertical merger which takes place where suppliers in the same supply chain integrate their businesses to satisfy a common need, for example, where a manufacturer and a supplier merge their companies. Vertical mergers became extremely popular in the 1920s and 1930s¹³ and a classic example of vertical mergers was that of the Ford Motor Company, where Henry Ford decided to acquire coal and iron mines, glasswork companies, sawmills, blast furnaces and other companies in order to take total control of the Ford vehicle supply chain.¹⁴

Like any sensible businessman, Niko probably obtained advice from his lawyer and accountant and the transactions were carefully planned and executed. He disposed of his sole proprietorship lock stock and barrel to a company, J. Niko (Proprietary) Limited, formed specifically for the purpose of acquiring this business. He then acquired 75 per cent of the nominal capital of the newly formed company, with the De Gersigny family taking up the remaining 25 per cent. The selling price was to be paid in cash (for the nominal value of the shares awarded to the De Gersigny family) and shares (the nominal value of the shares awarded to Niko).¹⁵

Had it not been for the uncertainty surrounding the value of the closing stock reflected in Niko's final assessment as a sole proprietor, the transaction would probably not have been challenged by Inland Revenue as being anything other than of a capital nature.

The courts recognised that it was impossible for Niko to keep a perpetual stock system of this "heterogeneous collection of oddments".¹⁶ The actual cost price of the trading stock on hand was therefore not available. The cost of sales ratio, expressed as a percentage of sales, nonetheless remained constant throughout Niko's whole accounting period¹⁷ as sole proprietor. Thus when Niko had to value the stock at hand in respect of his last return as sole proprietor, he used the cost of sales ratio, applied it to the turnover for the final assessment period and calculated backwards to a closing stock value of £1 954, as an estimate of the cost price. The major reason for Inland Revenue's query was probably because the closing stock figure of £1 954

13 Roberts, Wallace and Moles. 2010. *Mergers and Acquisitions*. [Online] Available at: <http://www.ebsglobal.net/documents/course-tasters/english/pdf/h17mq-bk-taster.pdf> [Accessed: 6 June 2013 at 17].

14 *The Economist*. 2009. "Moving on up". [Online] Available at: <http://www.economist.com/node/13173671> [Accessed: 6 June 2013].

15 The selling price was £12 500 and consisted of sundry debtors, machinery, buildings, motor lorries, a lease contract, goodwill and stock-in-trade of £5 279.

16 *CIR v Niko*, 1940 AD 416, 11 SATC 124 at 420.

17 *Niko v CIR*, 1940 NPD 64 at 77.

used in Niko's last assessment as sole proprietor, differed substantially from the stock figure of £5 279 as indicated in the sales agreement.

It was clear therefore that Niko used a completely different method of accounting to determine the value of the trading stock for the purposes of the sales agreement, as opposed to what he used for his tax return. Two stock-takings were held, one on behalf of the seller, Niko, and the other on behalf of the De Gersigny family. An average market value £8 800, was determined from which 40 per cent was deducted, apparently to allow the company to make a profit upon disposal of the stock-in-trade, resulting in a value of £5 279. This valuation was done purely to place a value on the trading stock for the purposes of determining the share price for the new company.

The facts of the case

On assessment, the Commissioner added the difference between the value of the stock-on-hand, as disclosed by Niko in his accounts for the sole proprietorship business (£1 954) and the value of the stock-in-trade as disclosed in the selling agreement (£5 279) to Niko's taxable income. According to the assessment, the difference was assessed as representing "profit on sale of stock, value taken over by the company". At this stage the Commissioner did not question the value of the closing stock, but decided to tax the "profit" made on selling the trading stock at a higher value to the company.

Niko objected to this assessment on two grounds: Firstly, that any profit made by him on selling all his assets was purely a capital accretion, which was in retrospect the correct argument, based on the prevailing practice and case law and, secondly, that the transaction was not in the ordinary course of business and was merely the realisation of capital at an enhanced value, being a lock-stock-and-barrel sale. One can therefore understand why Niko's representative, Mr Ditz, argued in the Special Court hearing that the "profit on sale of stock" assessed by the Commissioner was part of a lump sum received from a lock-stock-and-barrel sale, and was purely capital in nature.

After Mr Ditz had addressed the court, it was the turn of the representative of the Commissioner. He was possibly persuaded by Mr Ditz's strong argument regarding this widely accepted practice as he agreed with Mr Ditz's line of reasoning. He had no choice but to concede that the sale was a lock-stock-and-barrel sale and the profit was accordingly of a capital nature. But then, unexpectedly and probably in an attempt to counter Mr Ditz's argument, the Commissioner's representative raised a totally different point. He argued that the value of the closing stock in Niko's final return for his sole trader business was incorrect. He presented a strong argument to convince

the court that closing stock should be brought in at the selling price stipulated in the sales agreement. Mr Ditz must have been astonished, but did not raise the point that he had apparently been taken by surprise by this new line of reasoning; nor did he ask for an adjournment to consider the new argument. Mr Ditz, clearly confident of his case, responded immediately to the new contentions raised by the Commissioner. The exact nature of his reply is not clear from the court records, but the comment was made by the Judge that: “the wisest and best course of action cannot be taken on the spur of the moment by a person faced with a sudden element of surprise”.¹⁸ Then, in an interesting turn of events, the Special Court ignored the actual question whether or not the profit was of a capital nature, and confirmed the assessment on the grounds that differed from the original grounds, based on the argument advanced by the Commissioner’s representative.

Being dissatisfied with the decision, Niko appealed to the Natal Provincial Division of the Supreme Court. Mr ES Henochsberg¹⁹ now represented the taxpayer. After hearing the arguments put forward by both parties’ representatives, Judge Selke, of the Natal Provincial Division, first addressed the functions and duties of the Special Court.²⁰ He confirmed that the Special Court was not precluded from upholding the Commissioner’s assessment on different grounds, but then the other party’s counter-argument must be properly considered.²¹ He concluded that, in the *Niko* case, the Special Court had erred in not allowing Mr Ditz a fair opportunity to reply to the Commissioner’s new contentions.²² Selke J therefore held that the Special Court was not entitled to confirm the Commissioner’s assessment on a ground other than that upon which the assessment had originally been made.

The Natal Provincial Division referred the matter back to the Special Court with a specific instruction to reframe the questions in order to afford both parties the proper opportunity to put forward their arguments on all the questions, as well as the new grounds that had emerged in the Special Court hearing.²³ When the Special Court acted on this instruction, it again ignored the original question, whether or not the profit arising on the lump-sum lock-stock-and-barrel sale was of a *capital nature*. Instead, the Special Court reframed all the questions based on the argument put

18 *Niko v CIR*, 1940 NPD 64 at 72.

19 Well known for his publications on the Companies Act.

20 *Niko v CIR*, *Supra* at 72.

21 *Maxim audi alteram partem* is the legal principle which determines that each party must be afforded the opportunity to respond to the evidence against him or her.

22 *Niko v CIR*, *Supra* at 73.

23 The Supreme Court has the jurisdiction to review a Special Court decision where the Special Court has not properly applied its mind to the matter. According to Cenvivres, this is not a question of law, but a matter of procedure. The *Niko* case is quoted in several tax publications stating this fact.

forward by the Commissioner's representative, namely that the *value* of the closing stock disclosed in the final tax return submitted for Niko's sole trader business was incorrect.

Unfortunately, the judgment in the Natal Provincial Division was limited to the questions as reframed by the Special Court, relating to the *valuation* of the stock and not whether or not the stock was of a capital nature. Selke J nonetheless considered the economic reality of the transaction by exploring the possible reasons for the fact that the closing stock figure of £1 954 used in the tax return differed substantially from the value of £5 279 used in the deed of sale. He suggested that the value of £5 279 used in the deed of sale was used for a specific purpose, namely to determine the amount which Niko was to receive, largely in shares in the company, and could not be considered to be an accurate valuation of the stock. He rejected the notion that any appreciation in the value of stock should be taxed as income while it remained unsold as no profit had yet been realised.²⁴ It appears that Selke J was of the view that the transfer of a business to a newly incorporated company cannot be considered to be an actual sale or the realisation of any profit.

In considering the closing stock figure of £1 954, representing the estimated cost price based on the cost of sales percentage, Selke J accepted that the nature of Niko's trading stock made it difficult to determine the actual cost. He reasoned that because the cost of sales ratio had remained constant throughout the whole accounting period, there could be no question about the correctness of the figure of £1 954. The Natal Provincial Division therefore set aside the order made by the Special Court and allowed the appeal. Thereafter the Commissioner appealed to the Appellate Division of the Supreme Court. The result of the decision in the Natal Provincial Division would have been that the value of the stock amounting to £1 954 would have been reflected in the final return of Niko's sole trader business, but the amount of £5 279 used in the deed of sale would have been deductible²⁵ by the newly formed company in determining its taxable income. Furthermore, the entire proceeds of the sale of Niko's business to the company would have been of a capital nature and no tax would therefore have been payable on these proceeds. This would clearly have been a favourable result for the taxpayer, achieved at the cost of the fiscus.

The Appellate Division acknowledged from the outset that the original grounds for appeal, whether the proceeds as stipulated in the agreement were of a capital nature, actually related to the question to be answered and not the questions relating to the stock values considered by the lower courts. Centlivres JA delivered the

24 *Niko v CIR*, 1940 NPD 64 at 78.

25 S11(2)(a) of Income Tax Act, 40 of 1925.

judgment. He found that the amount realised by the sale of the stock-in-trade was clearly a receipt or accrual in terms of the definition of “gross income” and the only question to consider was whether it was an amount “other than receipts or accruals of a capital nature”.²⁶ This phrase was taken from the “gross income” definition in section 7 of the 1925 Income Tax Act,²⁷ being the relevant provision in effect at that time. A similar phrase is found in the “gross income” definition in section 1 of the present Income Tax Act,²⁸ but the words “other than” have been replaced by the word “excluding”, and the provision now reads “excluding receipts or accruals of a capital nature”. Neither the meaning nor the definition of “other than receipts or accruals of a capital nature” was given in the Act itself, and the court had to rely on earlier decisions by the Appellate Division of the Supreme Court in regard to its meaning.

Centlivres JA relied on the *George Forest Timber* case²⁹ to determine whether the proceeds on the trading stock sold as part of the lock-stock-and-barrel sale, were capital or revenue in nature. He held that the trading stock represented Niko’s floating capital, or, as referred to in the *Lace Proprietary Mines Ltd* case,³⁰ capital productively employed to earn profits. According to Centlivres JA, Niko’s objective was clearly to resell the trading stock at a profit. He concluded that the selling price of £5 279 constituted “gross income”, but that in terms of section 11(2) of the 1925 Income Tax Act, Niko was entitled to deduct the cost of the trading stock of £1 954 (see *Baikie v CIR*³¹).

Mr Henochsberg contended on behalf of Niko that the cases referred to did not apply to the present case because the sale was similar to the sale in the *Doughty* case.³² The sale to the company was not in the ordinary course of Niko’s business but was a “slump” or “lock-stock-and-barrel” sale. The *Doughty* case, in New Zealand, was referred to in most reported South African judgments³³ dealing with slump sales prior to the *Niko* case. The *Doughty* case concerned two partners, general merchants from Wellington, who incorporated their partnership by “selling” all their partnership assets, including trading stock, to a private limited company in which they became the only shareholders. The company issued shares to the partners in consideration for the partnership assets. The Commissioner of Taxes taxed the difference between the

26 *CIR v Niko*, 1940 AD 416, 11 SATC 124 at 417.

27 No. 40 of 1925.

28 No. 58 of 1962.

29 *CIR v George Forest Timber Co Ltd*, 1924 AD 516, 1 SATC 20.

30 *Lace Proprietary Mines Ltd v CIR*, 1938 AD 267, 9 SATC 349.

31 *Baikie v CIR*, 1931 AD 496, 5 SATC 193.

32 *Doughty v COT*, 1927 NZPCC 327.

33 *ITC 223* (1931) 6 SATC 150, *ITC 317* (1934) 8 SATC 171, *ITC 332* (1935) 8 SATC 269, *ITC 399* (1937) 10 SATC 99, *ITC 441* (1939) 10 SATC 473, *ITC 451* (1939) 11 SATC 103.

value of the trading stock (as shown in the partners' last balance sheet) and the value of the trading stock taken over by the company as "profits or gains derived from any business"³⁴ being the relevant requirement effective at that time.

The decision in the *Doughty* case was that the "profit" on the trading stock "sold" was held to be non-taxable. The New Zealand Court of Appeal provided *two* reasons for its decision. Firstly, the transaction could not be treated as a sale, as there was *no separate sale* of the trading stock. It formed part of the transfer of all the assets of the partnership and was therefore considered a "slump transaction".³⁵ Secondly, the transaction was a "mere readjustment of the business position of the partners, resulting in no profit. The two partners had made no money by the mere process of having their stock in trade valued at a high rate when they had transferred to a company consisting of **their two selves**" [own emphasis].

The similarities between the *Doughty* case and the *Niko* case are clear. In both cases, the taxpayers incorporated their businesses, in both cases all the assets were "sold" to the companies as part of the incorporation process and in both cases the trading stock was taken over by the company at a higher value, not to reflect the purchase price of the trading stock but to "square the capital account"³⁶ – in other words, to calculate the number of shares that should be allocated to the partners. It appears that Selke J,³⁷ in the Natal Provincial Division, acknowledged these similarities when he considered the reason for the increased value of trading stock used in the deed of sale. Yet Centlivres JA was of the opinion that the *Niko* case differed from the *Doughty* case: "it is clear that there [in the *Doughty* case] the figure at which the stock-in-trade was taken over from the partnership was fixed, not as representing the purchase price of the stock, but because it was necessary to bring about an **adjustment of figures in order to square the capital account**" (own emphasis).³⁸ The reason advanced by Centlivres JA for the difference is confusing as it appears that *Niko* determined the trading stock value at £5 279 for that very same reason – for the purpose of the deed of sale.

It is respectfully submitted that Centlivres JA was correct in arguing that the trading stock sold by the taxpayer represented floating capital and must form part of the respondent's "gross income", but it is also respectfully submitted that Centlivres JA overlooked the similarities in these two cases³⁹ in dismissing the taxpayer's

34 New Zealand. 1916. Land and Income Tax Act No. 5 of 1916.

35 *Doughty v COT, Sura* at 327.

36 *CIR v Niko*, 1940 AD 416 at 420.

37 *Niko v CIR*, 1940 NPD 64 at 78.

38 *CIR v Niko, Supra* at 429.

39 The only difference between these cases was that *Niko's* interest decreased from 100 per cent to 75 per cent after incorporation, whereas in *Doughty's* case the taxpayer's interests remained the same.

contention that this sale was similar to the sale in the *Doughty* case. In disregarding the first reason advanced in the *Doughty* case, Centlivres JA argued that any profit on the sale of trading stock cannot be of a capital nature even if sold as part of a realisation transaction. Therefore, regardless of whether trading stock is sold to third parties as part of a realisation sale (“large blocks of stock”) or in the normal course of business activities (“a series of gradual and smaller sales”),⁴⁰ the proceeds from selling trading stock remain non-capital in nature. Even where the total price of a realisation sale is expressed as a lump sum (a slump transaction), it still includes receipts and accruals, some of which are of a capital nature and others of a non-capital nature.⁴¹ Therefore, the selling price of a business expressed as a lump sum must be allocated to receipts and accruals of a capital nature and those of a non-capital nature and the non-capital amounts must be included in the seller’s “gross income”. These principles provided in Centlivres JA’s judgment are the legacy of the *Niko* case and cannot be disputed. It therefore appears that the first reason given in the *Doughty* decision for not taxing the profit does not apply to *Niko*’s case; profits realised in respect of the sale of trading stock cannot be regarded as capital in nature, even if sold as part of a slump sale. Following the *Doughty* case, the tax legislation in New Zealand was amended. Before the amendment “assessable income” included only “all profits or gains derived from any business”. After the amendment “any increase in the value of stock in hand at the time of transfer or sale of the business” was added.⁴²

The economic reality of the *Niko* transaction

In the *Niko* case, Centlivres JA disregarded the decision given in the *Doughty* case. Mr Henochsberg’s contention that the *Doughty* decision should be applied to the *Niko* case nonetheless seems correct, not for the first reason given in the *Doughty* judgment (a slump transaction), but for the second reason that the transaction was a mere incorporation, and the two partners did not realise any profit when they transferred the trading stock at a higher value to the company “consisting of their two selves”. By increasing the value of the trading stock, the partners merely

40 *CIR v Niko*, *Supra* at 429 where Judge Centlivres quoted Lord Phillimore from *Doughty v COT*, 1927 NZPCC 327 at 331–332. However, Lord Phillimore argued that *no separate sale* (neither realisation nor ordinary) had been affected in the *Doughty* transaction.

41 Centlivres referred to *Rhodesia Metals Ltd (In Liquidation) v COT*, 1938 AD 282, 9 SATC 363, which he regarded as being similar to the *Niko* case, in which the purchase price had to be apportioned and the profit on the mining claims, being of a non-capital nature, taxed.

42 New Zealand Inland Revenue. 2004. *Public Ruling: Trading stock: Tax Treatment of Sales and Agreements to sell*. [Online] Available at: <http://www.ird.govt.nz/technical-tax/public-rulings/2004/public-ruling-2004-0406.html> [Accessed: 15 January 2015 at 4].

adjusted the value of the shares issued to them. No profit was realised as there had been no sale to outsiders.⁴³

One of the inherent characteristics of trading stock is its potential to earn profit. Profit is “locked” into the value of trading stock because its selling price is normally higher than its cost price. This “profit” (the difference between potential selling price and cost price) is unrealised and can only be realised once it is sold to outside parties. The appreciation in the value of trading stock can therefore not be considered to be “gross income” within the meaning of the Income Tax Act,⁴⁴ until the trading stock has been realised. This is the reason why the value of closing stock for both accounting and tax purposes is reflected at the lower of cost or market value, to prevent the unrealised profit component from being taxed.

Considering the transactions in both the *Doughty* case and the *Niko* case from a purely economic point of view, it is clear that a person cannot make a profit from a transaction where he or she is both the seller and the buyer. In both cases, these businessmen transferred their trading stock from one business they owned to another business that they also owned. These businesses make up one economic unit. The businessmen involved were none the richer as a result of the transactions. Their economic wealth did not increase. To extract tax on such transfer of assets would be inequitable. The economic reality was that Niko and his company were in fact one economic unit.

The only difference between the *Doughty* case and the *Niko* case was that Niko’s interest in his business decreased by 25 per cent and it would therefore be fair to argue that 25 per cent of the “profit” on the trading stock was realised. If Niko had sold his business to a partnership with the De Gersigny family as partners, only 25 per cent of the profit on the trading stock would have been realised. From a purely economic point of view, 75 per cent of Niko’s company constituted the same economic unit as his sole trader business.

The *Niko* case also differed from preceding court cases dealing with lock-stock-and-barrel sales (“slump sales”), where the sellers had sold their businesses and then disappeared from the business scene for reasons such as retirement or ceasing to carry on business. There are various factors mentioned in the judgment that indicated Niko’s intention to remain involved in the business after the sale:

- Niko acquired the majority interest of 75 per cent of the ordinary share capital;
- the newly formed company was registered as J. Niko (Proprietary) Limited;

43 *Doughty v COT*, 1927 NZPCC 327 at 336.

44 No. 40 of 1925 and No. 58 of 1962.

- according to the deed of sale, Niko agreed to lend a cash amount of £1 000 to the newly formed company;
- Niko and the De Gersigny family agreed to draw only half of their dividends every year. The other half of the dividends would remain in the company;
- Niko undertook to purchase the De Gersigny family's shares should either of them desire to dispose of their shareholding; he would then pay for the shares within one year of receiving written notice; and
- Niko undertook to act as Managing Director of the company.⁴⁵

Interpreting legislation in accordance with basic tax principles

Over the years, the judiciary has gradually shifted away from the so-called “strict and literal approach” to the interpretation of statutes to the purposive approach. The strict and literal approach does not take into account justice, equity and fairness because it follows the letter of the law strictly,⁴⁶ looking “at what is clearly said. There is no room for intendment. There is no equity about a tax.”⁴⁷ There has been a definite shift to the purposive approach where the purpose underlying the statute is sought.⁴⁸ This means not merely seeking the “intention of Parliament”, but also considering the history of the provision, its broad objectives, the constitutional values underlying it and its interrelationship with other provisions. According to section 39(2) of the Constitution of the Republic of South Africa, 1996, all legislation, including fiscal legislation, must promote values that underlie an open and democratic society and must therefore be based on equality, fairness and human dignity. There is thus an obligation on the judiciary to promote these values.⁴⁹

To understand the meaning of these principles in a fiscal environment, one needs to go back to Adam Smith's book, originally published under the title, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, in 1776, where he advocated that the “Canons of Taxation” were equity, certainty, convenience and efficiency.⁵⁰ These “Canons of Taxation” were restated in 1998 by the Organisation for Economic Cooperation and Development (the OECD) as applicable in the modern electronic

45 *Niko v CIR*, 1940 NPD 64 at 68.

46 Goldswain, G.K. “The Purposive Approach to the Interpretation of Fiscal Legislation—the Winds of Change”. 2008. *Meditari*. Vol. 16(2) at 119.

47 *Cape Brandy Syndicate v IRC*, 1921(1) KB 64 at 71.

48 Goldswain, G.K. “Hanged by a Comma, Groping in the Dark and Holy Cows—Fingerprinting the Judicial Aids used in the Interpretation of Fiscal Statutes”. 2012. *Meditari*. Vol. 16(3) at 31.

49 Goldswain, G.K. “Hanged by a Comma, Groping in the Dark and Holy Cows—Fingerprinting the Judicial Aids used in the Interpretation of Fiscal Statutes”. 2012. *Meditari*. Vol. 16(3) at 52.

50 Smith, A. *The Wealth of Nations*. 2003. 5th edition, New York: Bantam Books.

age. The OECD omitted the convenience principle and added the principles of simplicity, effectiveness, flexibility and neutrality. In the *Niko* decision, it appears that two of these canons, namely neutrality and equity, were compromised.⁵¹

A good tax system based on the principles of neutrality implies that taxpayers should not be influenced by the tax system in their choice of one course of action over another simply because of the tax benefits or disadvantages of a particular option. In terms of the South African tax system, no profit is realised where trading stock is moved from one division to another division in the same entity. But a problem arises if the trading stock is moved from one legal entity to another, even if both are owned by the same taxpayer, as the resulting profit then becomes taxable. This means that trading stock of a business conducted in the form of a partnership or sole proprietorship cannot be transferred tax free to a company owned by exactly the same persons, because the profit will then become taxable (except where section 42 of the Income Tax Act⁵² applies – this section was introduced in 2001 and is discussed below). Tax should be neutral when the taxpayer transfers his sole trader business to a company. Had *Niko* chosen a partnership as the new entity, it would have resulted in only 25 per cent of the profit being realised. Clearly tax neutrality did not apply in the *Niko* case.

One could also argue that the equity canon was compromised in the *Niko* case. A tax should be seen to be fair in its impact on all individuals. The equity of tax relates to a taxpayer's ability to pay and includes horizontal equity, which requires that taxpayers who are in a similar economic position should bear an equal tax burden, and vertical equity, which requires that taxpayers with a higher level of economic well-being bear a greater tax burden. For example, if a transfer of trading stock within a group of companies at a price higher than the cost price attracts tax, while the transfer between divisions within a company does not, the horizontal equity principle is compromised. The principle of equity also requires that tax should be levied according to the ability of a person to pay.⁵³ The assessment of tax should be

51 It appears that the other canons were not compromised: "Certainty" and "simplicity" imply that tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction. "Flexibility" entails that tax systems should be flexible and dynamic to ensure that they keep pace with technological and commercial developments. "Efficiency" means that compliance costs for taxpayers and administrative costs for tax authorities should be minimised as far as possible, and "effectiveness" means that taxation should produce the right amount of tax at the right time. See OECD: Committee on Fiscal Affairs. 1998. "Electronic Commerce: Taxation Framework Conditions". [Online] Available at: <http://www.oecd.org/tax/consumption/1923256.pdf> [Accessed: 15 August 2013 at 4].

52 No. 58 of 1962.

53 The equity principle can also be approached from two viewpoints: the "ability to pay" and the "benefit principle". The benefit principle recognises that a person benefits directly from a broad range of goods and services provided by the government. This viewpoint sounds fair in principle but has several limitations and is difficult to apply in practice. Therefore the "ability to pay" appears to be a more appropriate approach in the *Niko* context. See Leape, J. 2008. "User Charges – a Reassessment". In Wales, C. (ed). *Fair Tax: Towards a Modern Tax System*. London, UK: The Smith Institute at 75–83.

based primarily on increases in income and wealth. In Niko's case there was only a small increase in income and wealth as only a small percentage of the profit was realised. Yet Niko had to pay tax on 100 per cent of the profit. He had to dig into his capital store to pay the tax – an inequitable situation. Clearly, the decision in *CIR v Niko* represented an inequitable outcome for Niko.

Economic units and group taxation

The *Niko* case illustrates the problems associated with the tax treatment of different economic units. Businesses frequently start out as sole proprietorships or partnerships and incorporate as companies at some later date. Mergers with and acquisitions of other companies may take place as the company grows, in order to acquire a greater market share or for other economic reasons. Ownership of the original business often remains the same in the newly incorporated companies, or the group of companies or other entity.

Tax should be neutral in relation to the choice of the form of business enterprise. The need for tax neutrality is used as an argument in favour of group taxation and moving trading stock between members of a group of companies should be treated in the same way as moving trading stock from one division to another division in the same entity. A group of companies forms an economic unit and should therefore be treated as a single taxable unit.⁵⁴

New tax legislation is often introduced as a consequence of new business trends or economic activities. The concept of group taxation emerged worldwide immediately after the first mergers and acquisitions took place in the late 19th century, almost in response to this “new” business trend to operate in groups. Mergers and acquisitions often occur in waves and are driven by external economic forces such as changes in the global economy. The first major wave of mergers occurred between 1890 and 1910, when railway systems linked major cities for the first time.⁵⁵ The first group tax model was “developed” in 1902 as a result of a Prussian High Administrative Court Decision,⁵⁶ where the judges decided to treat the subsidiaries of the group as parts of the parent company (the *Organschaft* model).⁵⁷ Today it is almost impossible

54 Masui, Y. 2004. *IFA 58th Congress: General Report on Group Taxation*. Vienna, Austria. 9 September 2004. Amersfoort: IFA, at 34.

55 Roberts, Wallace and Moles. 2010. *Mergers and Acquisitions*. [Online] Available at: <http://www.ebsglobal.net/documents/course-tasters/english/pdf/h17mq-bk-taster.pdf> [Accessed: 6 June 2013 at 17].

56 *Preußische Oberverwaltungsgericht (PrOVG)*, Urteil v. 31.5.1902 – VI G 38/01, OVG in *Staatssteuersachen* Bd. 10, 391.

57 Masui, Y. 2004. *IFA 58th Congress: General Report on Group Taxation*. Vienna, Austria. 9 September 2004. Amersfoort: IFA.

to imagine judges making the daring decision to treat a group of entities as a single taxpayer purely by interpreting a statute, without the support of legislation.

As early as the 20th century, group tax systems were introduced in Europe, while the first formal group tax legislation was introduced in South Africa only in 2001 and these measures offer only partial relief. Unfortunately, the tax relief measures introduced in 2001 in South Africa in terms of sections 42 to 47 of the Income Tax Act⁵⁸ are complex,⁵⁹ as illustrated by the numerous amendments made each year since the introduction of the corporate rules.

To address the problem of economic reality, a full group tax system is necessary. In countries with an integrated group tax system, there is no need for special tax relief measures such as the corporate rules, as the group is taxed as a single entity.⁶⁰ Group taxation gives fiscal recognition to the fact that a group of companies acts as a single economic unit. A group tax system gives the group flexibility to organise its business affairs using internal restructuring without having to bear any adverse tax consequences.⁶¹ It is therefore possible for a business to grow through mergers and acquisitions without any adverse tax implications.

The current wave of mergers and acquisitions, identified as the fifth wave, is the result of new technology such as the internet opening up worldwide markets. The fifth wave is ongoing and is remarkably similar in many ways to the first wave which was initiated as a result of railroad networks.⁶² Yet South Africa still does not have a group tax system. Numerous studies have indicated that South Africa needs a group tax system to address the problems in its current tax system.⁶³

58 No. 58 of 1962.

59 *Business Day*. 2008. "Anxious Wait for Clarity on Tax Law". [Online] Available at: <http://www.businessday.co.za/articles/economy.aspx?ID=BD4A709186> [Accessed: 16 April 2013].

60 *Business Day*. 2009. "Group Tax System will Attract Foreign Investment, Says Analyst". [Online] Available at: <http://www.accessmylibrary.com/article-1G1-210707840/group-tax-system-attract.html> [Accessed: 15 August 2013].

61 Jones Day. 2003. *Group Taxation*. [Online] Available at http://www.jonesday.com/files/Publication/6f660ab8-97d0-4230-9c5b-1822ff023d9/Presentation/PublicationAttachment/dcd768bf-489c-4b58-8dbd-b510aaba5b69/Group%20Taxation_1.pdf [Accessed: 16 April 2013].

62 Roberts, Wallace and Moles. 2010. *Mergers and Acquisitions*. [Online] Available at: <http://www.ebsglobal.net/documents/course-tasters/english/pdf/h17mq-bk-taster.pdf> [Accessed: 6 June 2013 at 18].

63 South Africa. 1995. *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa—Chairman: MM Katz*. Pretoria: Government Printer. Wilcocks, J.S. and Middelmann, S.N. 2004. "Evaluation of the Need to Introduce a System of Group Taxation in South Africa". *Southern African Business Review*. Vol. 8(3). Lerner, D. and De Reus, S. 2009. "Group Tax: What can SA Expect?" *Tax Conference of the Southern African Institute for Chartered Accountants*. Johannesburg, 26–27 September 2009.

Developments relating to taxing economic units in South Africa

In 2001, the so-called “corporate rules” were introduced into the Income Tax Act⁶⁴ to provide some relief to groups of companies in the case of mergers, acquisitions and rationalisations. Section 42 allows a taxpayer (including a natural person) to transfer its assets to a company in exchange for shares in the recipient company, without incurring any immediate tax liabilities. There are no requirements with regard to the percentage shareholding in a listed company, but in the case of an unlisted company the transferor must hold at least 10 per cent of the shares and voting rights after the transaction or, in the case of a natural person, be employed on a full-time basis by the company (in *Niko*’s case, Niko held 75 per cent). In terms of section 42, income tax and capital gains tax relief is granted to both the transferor and the transferee company in respect of the transfer of capital assets, trading stock, allowance assets and contracts. Niko would have been able to enjoy the tax relief provided by section 42, had this transaction taken place today.

Sections 43 to 47 of the Income Tax Act⁶⁵ provide only partial relief to group companies in the case of amalgamations, intra-group transactions, unbundling transactions and liquidations, and South African tax legislation still lacks an integrated group tax system. Over the years, several court cases have illustrated the problems created by the lack of a group tax system in South Africa. Two fairly recently decided cases are discussed below that illustrate that the judiciary still fails to recognise the economic reality of groups.

The *Wooltru Property Holdings* case⁶⁶ is the first example. The subsidiaries of the holding company had previously paid lease premiums in respect of and effected leasehold improvements to leased property. The expenditure was claimed as deductions in terms of sections 11(f) and 11(g) of the Income Tax Act.⁶⁷ As part of a rationalisation process whereby the group of property-owning companies was restructured, Wooltru Property Holdings had received these leasehold rights tax free (in terms of a rationalisation exemption in terms of the provisions of s 48 of the Taxation Laws Amendment Act⁶⁸) in an *in specie* liquidation distribution. Wooltru Property Holdings subsequently disposed of these assets to a third party. The South African Revenue Service (SARS) assessed Wooltru Property Holdings on the basis that the deductions previously claimed by the subsidiaries in terms of sections 11(f) and 11(g) had been recouped in the hands of the holding company in terms of section

64 No. 58 of 1962.

65 No. 58 of 1962.

66 *CSARS v Wooltru Property Holdings (Pty) Ltd*, 2008, 70 SATC 223.

67 No. 58 of 1962.

68 No. 87 of 1988.

8(4)(a). The Special Court, as well as a full bench of the Cape Provincial Division, agreed that this amount was not a recoupment in the hands of the holding company, as the allowable deductions were not claimed by the holding company itself. The fact that the holding company had submitted consolidated tax returns on behalf of the group was merely an administrative practice allowed by SARS at that stage, and this did not mean that the allowances were granted to the holding company itself. The realisation as a result of the transfer from the subsidiaries to the holding company was in actual fact not a true realisation, but only an intra-group transaction. It was only once the holding company sold the property rights to a third party that realisation took place. SARS lost this case because the economic reality of this transaction (that a group of companies is one economic unit) was not recognised in the South African tax system.

The *Ackermans Ltd* case⁶⁹ is a further example. Ackermans Ltd sold its retail business, including certain contingent liabilities, as a going concern to Pepkor Ltd, a member of the same group of companies. The outcome of this case has been discussed by several commentators,⁷⁰ but one crucial point was not considered by any commentators or by the judiciary: the economic reality of the transaction was that these companies were part of the same economic unit. The issue of whether a liability that is only conditional can be claimed as expenditure actually incurred (in the production of the income from carrying on a trade) as required by s 11(a) of the Income Tax Act, was considered by the court only because in South Africa transactions within groups are treated as if they are transactions with outside parties. If a consolidated group tax system had applied, where the group is treated as one economic unit, this would not have been an issue as obligations and liabilities (whether or not contingent) transferred between group members would have been ignored.

According to Kruger *et al.*,⁷¹ the “rigid refusal” on the part of the judiciary to recognise the “commercial reality” of the “group structure . . . calls for special care”. Kruger *et al.* cite several court cases as examples of where the taxpayers (companies in a group) had incurred expenditure for the benefit of other group companies, yet the expenditure was considered not to be in the production of the taxpayer’s income and therefore disallowed.⁷² In the opinion of Kruger *et al.*:⁷³ “South African courts

69 *Ackermans Ltd v C: SARS* 2010, 73 SATC 1.

70 Ger. B. and Chong, J. “Sale of Business Having Contingent Liabilities: Revisited”. 2011. *De Rebus*; Silke, J. “Contingent Liabilities”. 2011. *Tax Planning Corporate and Personal*. Vol. 25(5).

71 Kruger, D., Stein, M., Dachs, P. and Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 11.

72 *ITC 1124*, 31 SATC 53, *Solaglass Finance Company (Pty) Ltd v CIR*, 1991 SA 257 (A), 53 SATC 1, *CIR v Sunnyside Centre (Pty) Ltd*, 1997 SA 68(A), 58 SATC 319.

73 Kruger, D., Stein, M., Dachs, P. and Davey, T. 2012. *Broomberg on Tax Strategy*, 5th edition. Durban: LexisNexis at 11.

and law makers have obstinately refused to recognise the existence of ‘groups’ of companies for tax purposes.” The answer to this dilemma seemingly lies in a change in legislation to provide rules for the taxation of an integrated group. It would also put a stop to artificial transfer pricing to shift profits from one company to another in a group structure.

Conclusion

This article has argued that the *Niko* decision is correct in the context of a true lock-stock-and-barrel sale, but that there were many factors indicating that, in reality, *Niko* was not disposing of anything. The fact that *Niko*, after the transaction, still held 75 per cent of the shares in the company to which the stock had been transferred, indicates that this was no ordinary lock-stock-and-barrel sale.⁷⁴ If this transaction had taken place today, *Niko* would probably have enjoyed the relief currently provided for by the corporate rules in terms of section 42 of the Income Tax Act.⁷⁵ The balance of the newly formed company’s shares was taken up by outside parties in the shipping industry.⁷⁶ By entering into this transaction, *Niko* was probably aiming to extend his business of selling second-hand shipping spares by taking on partners in the shipping industry (buyers of shipping spares). The fact that *Niko* remained actively involved in the company also indicated that he was not disposing of his business outright.

Where assets are transferred from one business entity to another and both entities are owned by the same taxpayer, the economic reality of the transaction is that no profit is realised. To extract tax on such transfer of assets at that stage would be inequitable. Recognition of the economic unit has become increasingly important as many businesses operate within a group of companies.

The *Niko* case was a landmark case in the sense that the decision changed the prevailing practice of regarding a lump-sum payment on a lock-stock-and-barrel sale of a business as a capital receipt. The judgment meant that these lump-sum payments would in future need to be allocated to the various assets that were disposed of, with the result that part of the proceeds may be of a capital nature and part of a revenue nature. Despite the correctness of this decision that was in accordance with the strict and literal approach to the interpretation of statutes, it is submitted that the

⁷⁴ *Niko* acquired 9 374 of 12 500 shares. *CIR v Niko*, 1940 AD 416 at 417.

⁷⁵ No. 58 of 1962.

⁷⁶ The balance consisted of 3 126 (12 500 less 9 374) shares and was taken up by A.L.B. de Gersigny (1 563 shares) and C.P.D.B. de Gersigny (1563 shares). *CIR v Niko*, *Super* at 417.

court's decision is in conflict with economic reality in that the transaction was not a true lock-stock-and-barrel sale, but a transfer from one business entity to another, both entities being substantially held by the same person, J. Niko. No realised gain (whether of a capital or revenue nature) resulted from the transaction, other than possibly 25 per cent of the profit on the "sale" of the trading stock. However, J. Niko's sole trader business would have included the amount of £1 954 used in Niko's final assessment as sole proprietor in income, while the stock figure of £5 279 would have been deducted by the newly formed company, thus a net combined gain at the expense of the fiscus.

The *Niko* decision has also been criticised in this article in terms of the established principles of a good tax system – neutrality and equity. It was shown that the transfer of assets between divisions of a company attracts no tax consequences, whereas a transfer of assets from one entity to another (including within a group context) did not enjoy this neutrality and that this is therefore inequitable. It was acknowledged that partial relief has since been granted in terms of sections 42 to 47 of the Income Tax Act⁷⁷ for transfers of assets to a company in return for shares in the company, under certain circumstances, and for transfers within a group. However, the need was identified for the recognition of a group of companies as a single economic unit for tax purposes, in line with other tax jurisdictions.

It is submitted that the real need, however, is for the legislature to intervene and introduce equitable legislation that recognises the economic reality of transactions within a group structure and introduce an integrated group tax system in South Africa.

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⁷⁷ No. 58 of 1962.

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