Pyott case: A lasting deposit for our tax heritage

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ABSTRACT

Pyott Ltd v CIR is generally regarded as the seminal case in South Africa on the tax treatment of deposits received on containers that may be returned at a later stage for a refund. This article analyses the tax treatment of deposits, prepayments and advances from a gross income point of view, as well as the possibility of claiming a deduction for the contingent liability to refund such deposit.

The main objective of this article is to discuss the judgment in the Pyott case and establish whether the principle enunciated that deposits, received in respect of returnable containers, are taxable in full once received, can also be extended to receipts of deposits, prepayments and advances where no returnable container is involved.

The conclusions reached are that the principles laid down in the Pyott case are still relevant today, apart from possible relief which may now be claimed under the subsequently introduced section 24C. Where no container is involved, beneficial ownership must first be established before such deposit, prepayment or advance becomes taxable, taking into account the specific provisions of legislation such as the Rental Housing Act and the Consumer Protection Act. The research has also shown coherence in the treatment of deposits for income tax purposes and other taxes, such as value-added tax.

Key words: deposits, prepayments and advances, beneficial ownership, contingent liability, Consumer Protection Act, Rental Housing Act

From as far back as 1886 in South Africa, if you heard the name “Pyott”, you immediately thought of biscuits. Many children were given a treat of an Iced Zoo biscuit for being well behaved or doing well at school while adults indulged in...
Romany Cream biscuits at tea time. A Salticrax biscuit with a savoury topping is still a favourite snack, especially at cheese and wine parties or predinner drinks. These three name-brand biscuits were manufactured by Pyott Limited until the company was taken over by Bakers Limited in 1983, and even today, more than a hundred years after the first Pyott’s biscuit came out of the oven, they are as popular as ever.

The setting of the Pyott case is the Second World War, a most difficult historical period for South Africa and, indeed, for the world. During this time, Pyott Limited unwittingly became involved in what is now regarded as one of the seminal tax cases in South African tax law on the taxability of deposits on containers. The main question raised related to whether a deposit, received by a taxpayer for a container that could be returned later by the customer and the deposit refunded, should be included in “gross income” as defined in section 7 of the Income Tax Act No. 31 of 1941, a definition that is essentially now embodied in section 1 of the present Income Tax Act No. 58 of 1962 (“Income Tax Act”).

The case, which went all the way to the Appellate Division of the Supreme Court of South Africa, now known as the Supreme Court of Appeal, was decided in 1945 and was reported as Pyott Ltd v CIR. The decision was handed down by Davis AJA, with Watermeyer CJ and Tindall, Feetham and Greenberg JJA concurring, and has set a precedent for the tax treatment of deposits on containers.

Although the Pyott case is regarded as the seminal case on the taxability of so-called “deposits” generally, it only dealt with deposits on containers. The question, however, is can the principle of taxing deposits on containers be extended to other types of deposits received that do not involve the return of an asset? For example, was the principle, as enunciated by Davis AJA, sufficiently wide to include within its ambit an advance of funds or a deposit in terms of a construction agreement, hire-purchase agreement or in respect of the rental of property?

Very little has been written recently on the taxability of deposits, in spite of the fact that there is now a Consumer Protection Act, (“Consumer Protection Act”), a Rental Housing Act (“Rental Housing Act”) and later judicial decisions that could impact upon the general principles as set out in the Pyott case. Thus, the most important contribution that this article makes to the body of tax law is to explore, analyse and discuss the scope and ambit of what presently constitutes a taxable deposit for income tax purposes.

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1 Pyott Ltd v Commissioner for Inland Revenue 1945 AD 128, 13 SATC 121.
2 No. 68 of 2008.
3 No. 50 of 1999.
This article is a tax story. Hence, of necessity, there is a story behind the tax case that brings it to life and sets it in its historical context. This article will thus commence by briefly delving into the interesting life of the man behind the company that bore his name, the history of the company and its eventual demise when taken over by Bakers Limited, explain why biscuit tins were used as containers in which the biscuits were sold, why the deposits charged on tin containers increased dramatically and how this dramatic increase was the *novus actus interveniens* (new intervening act) that precipitated the dispute between the then Commissioner for Inland Revenue (“Commissioner”) and Pyott Limited in respect of the taxability of deposits on containers.

This will be followed by an analysis of the facts and the decision in the *Pyott* case and the identification of the *ratio decidendi* (the rationale for the decision). The notion of a “beneficial receipt” will also be discussed as it pertains to and influences the taxability of deposits generally. Any *obiter dicta* (remarks not necessary for reaching a decision) of Davis AJA will further be identified and discussed. Thereafter, subsequently decided deposit, prepayment and advance receipt cases will be analysed and discussed in the light of the *Pyott* decision, particularly those decisions that have made a contribution to and assist with defining the scope, ambit and meaning of a taxable deposit, prepayment or advance. Furthermore, the tax treatment of deposits for income tax purposes will be examined in the light of their treatment in terms of the Value-Added Tax Act4 (“VAT Act”) and related commercial legislation to establish whether these legislative provisions have restricted the taxability of deposits as determined by Davis AJA in the *Pyott* case.

Finally, this article will briefly analyse and discuss the possibility of claiming permissible deductions or allowances in terms of the Income Tax Act with regard to the contingent obligation to refund a deposit on the return of the container. Since the Court in the *Pyott* case restricted itself to consideration of the meaning of the words “actually incurred”, which is but one of the prerequisites for the deductibility of expenditure in terms of section 11(a) of the Income Tax Act, it is considered beyond the scope of this article to discuss and analyse any of the other prerequisites for the application of that section. The conclusions reached, based on the research, should confirm whether or not the *ratio decidendi* in the *Pyott* case still has relevance today for the tax treatment of deposits generally, or whether the decision should be restricted to deposits on containers only.

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4  No. 89 of 1991.
The story behind the case: The characters, institutions and the historical context

The baking and consumption of biscuits can be traced back as far as the Roman Empire when they were supplied to troops deployed in the field. By cooking the dough twice, the bakers produced a hard and dry food item that could be kept for long periods of time without deteriorating. Later, when the early British explorers went to sea for long periods, they also needed food that would not deteriorate easily. They took with them the so-called “Ship Biscuits” for sustenance and nourishment. When British biscuit manufacturers later explored the overseas markets, they found that biscuits packed into tins would stay fresh for longer. The tins were soldered along the seams and lid in order to keep air and moisture out to prevent the growth of mould.

At the young age of 10, John Pyott, born in Dundee, Scotland, in May 1862, was apprenticed as a baker. Owing to health problems, he immigrated to South Africa. In the early 1880s, in Port Elizabeth, he started out by producing sweets and cakes. Shortly after, South Africa was struck by “gold fever” and Pyott joined the “gold rush” to the Gold Fields – sometime between 1882 and 1885. Bearing in mind the rugged terrain, the distance to be covered and the fact that there was no motorised transport, he had limited alternatives at his disposal and set off by travelling from Port Elizabeth to Durban by sea. There he bought a horse for his travels to the Transvaal Gold Fields, intending to cover the remainder of his journey on horseback.

Shortly after his departure from Durban, Pyott met a much older man travelling alone in a Cape Cart – but the horse was lame. Seizing the “opportunity” that had arisen, he offered the use of his fit horse in return for a more comfortable ride in the cart. His companion turned out to be none other than Paul Kruger, who in 1883, became the fifth state president of the Zuid-Afrikaansche Republiek (“ZAR”).

It is not clear whether their meeting took place before or after Kruger became president; what Kruger was doing in Durban by himself (probably related to the ZAR’s attempts to gain access to a harbour); whether it opened doors for Pyott in his later business endeavours and personal and political achievements (which included membership of the Port Elizabeth Town Council, the Legislative Council of the

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6 Supra.
7 Supra.
8 Supra.
9 Supra.
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Upper House of Review of the Cape Parliament, the Eastern Circle to Union-making and the Board of Directors of the Reserve Bank), or what the topics of discussion were during their trip. One can only surmise.

John Pyott’s gold dreams, however, were rather short-lived. The rough way of life convinced him that this was no place for a family to have a decent life – at this stage he had a wife and a baby. He and his family thus returned to Port Elizabeth, establishing the Port Elizabeth Steam Confectionery Works (1886) and later converting the business to a limited liability company, Pyott Limited. The company expanded and sold its biscuit products throughout South Africa, using a little pixie as its trademark on its packaging. It became the best-known biscuit brand in South Africa.

Until the mid-1940s, the biscuits had largely been packaged in beautiful painted tins on which a deposit was charged, to be refunded on the return of the tin. However, storekeepers and households alike also found the tins useful for the storage of other dry food products like rice, flour and maize meal, resulting in only 25 to 30 percent of the biscuit tins being returned by the customers for a refund of the deposit originally paid.

With the advent of the Second World War, metals, particularly tin, were required for military purposes. The manufacture of ships, planes, guns and ammunition took precedence over civilian products. In the United Kingdom, the War Production Board ordered a reduction in the use of metals used for packaging and this resulted in the rationing of even canned foods. South Africa, being part of the British Commonwealth at that time, could not escape the rationing of metals.

The rationing decree also affected the distribution and selling of biscuits in tins by Pyott Limited. If there were no biscuit tins, the company’s products could not be packaged in a form that would keep the biscuits fresh. Something drastic, therefore, had to be done and it took the form of a 200 percent increase in the deposit charged on a biscuit tin to encourage customers to return these containers. Clearly, the

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company’s primary goal was securing the continuation of its primary business, the selling of its biscuits, and its goal was not to earn greater profits from the disposal of tin containers. How the company wanted to treat these refundable deposits and the way the Commissioner treated these items for tax purposes, meant that the only solution was to proceed all the way to the Appellate Division to have these issues finally settled.

The Pyott case: Facts, decision, ratio decidendi and obiter dicta

The 200 percent increase in the deposit on the tin containers had the desired effect with a dramatic increase in the number of tins being returned for a refund by its customers – from about 30 percent prior to the war, when the deposit was relatively low, to some 90 percent after the increase had been imposed. As a result, the company no longer considered these charges to be part of its distributable profits, as had previously been the case. Thus, in its financial statements for the year ended 30 June 1941, an amount of £9 000 was shown in the balance sheet as a “provision for allowances on tin containers returnable”.

The Commissioner treated these deposits received on the containers as part of the gross income of the company, but disallowed any deduction regarding the contingent liability that arose to refund these deposits on the return of the containers. This was in spite of the fact that a 90 percent rate of return was expected. The company appealed the decision of the Commissioner to the Special Court for Hearing Income Tax Appeals, but this court upheld the assessment.

This led to the company appealing to the Eastern Districts Local Division of the Supreme Court, which was called upon to decide the following three issues:

- Whether the amount of income (if income at all) was the amount charged (the deposit), less the amount of obligations undertaken (the potential refunds to be made)
- Whether the company was entitled to account for the liability, or whether this was forbidden by section 12(e) (the equivalent provision now embodied in section 23(e) of the present Income Tax Act), which prohibits accounting reserves from being deducted
- Whether the transaction was neither capital nor income.

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15 Pyott supra 123.
16 Pyott supra 123.
17 Pyott supra 122, 123.
18 Pyott supra 122.
The Eastern Districts Local Division of the Supreme Court confirmed the Special Court’s decision and on further appeal, Davis AJA, in a unanimous decision of the Appellate Division of the Supreme Court, held that:

1. The appellant’s attempt to rely on the Lategan\(^{19}\) decision by arguing that the “total amount” referred to in the definition of gross income must first be valued before it can be included, was rejected. A sale for cash is a sale for ready money – it can only be included at its face value,\(^{20}\) it is only other forms of property (non-cash) that must be valued.\(^{21}\) There can be no “obligation which ‘attaches’ to cash”\(^{22}\) that can require a reduced inclusion.

2. The Income Tax Act lays down what is to be taxed, even if, in doing so, the principles of sound accountancy and English case law supporting the making of such a provision, are disregarded (following the earlier decision in the George Forest Timber\(^{23}\) case).\(^{24}\) The Income Tax Act and its counterpart in England differ in the sense that “profits or gains”\(^{25}\) (accounting concepts) are taxable in England, whilst South Africa has an artificial and purely statutory definition of taxable income, which is not necessarily synonymous with “profits or gains”. It is interesting to note that the Income Tax (Consolidation) Act No. 41 of 1917 had earlier specifically scrapped the definition of income as meaning “profits or gains”. What has to be ascertained is “taxable income”, and this must be done in the manner prescribed by the Income Tax Act and in no other manner. In addition, cases that have been decided in foreign countries, where the definition is not identical to local legislation, cannot be of assistance in interpreting such definition\(^{26}\) (which follows the decision in the Delfos\(^{27}\) case). The provision for refunds on containers was held to be a reserve out of income to provide for a contingent liability, and its deduction was specifically prohibited by the equivalent provision now contained in section 23(e)\(^{28}\) of the Income Tax Act.

3. The deposit cannot be “non-capital” and yet “not income” – this is a halfway house of which Davis AJA had no knowledge\(^{29}\) – it must either be “capital” or

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19 Lategan WH v CIR 1926 CPD 203, 2 SATC 16.  
20 Pyott supra 125.  
21 Pyott supra 126.  
22 Pyott supra 126.  
23 CIR v George Forest Timber Co Ltd 1924 AD 516, 1 SATC 20.  
24 Pyott supra 126.  
25 Pyott supra 126.  
26 Pyott supra 127.  
27 CIR v Delfos 1933 AD 242, 6 SATC 92.  
28 Previously section 12(e) – Pyott supra 127.  
29 Pyott supra 126.
“income”. Seeing that the taxpayer had already conceded that the proceeds were not capital in nature, the judge, by implication, held that the proceeds were revenue in nature.

The appeal was thus dismissed.

Davis AJA made an interesting comment in relation to the company’s contention that the deposits on containers were “trust moneys” and could therefore not form part of its income. His *obiter* observation on this point was that, if these deposits had been put into a separate trust account, out of the taxpayer’s control, these amounts might not have been taxable. This is due to the fact that a trustee acts in a fiduciary capacity, whereby an asset or money is received and held in trust on behalf of or for the benefit of another. It is for this reason that deposits made by purchasers for property to be purchased and placed in a trust account, are not considered to be taxable at that stage. Only on subsequently applying it as part of the consideration for the transaction (and no longer being held as trust funds) can it become taxable for the seller by way of an inclusion in “gross income” or “proceeds” for capital gains tax purposes.

In effect, the decision therefore unequivocally and clearly states the position with regard to the taxability of the proceeds from deposits on returnable containers. It also establishes the position regarding the non-deductibility of the contingent liability arising to refund the deposits on the return of these containers, as section 23(e) prohibits the deduction of income that is carried to any reserve fund or which is capitalised in any way.

In taking the analysis and discussion further to decide whether the principle laid down in the *Pyott* case dealing with the taxability of deposits on returnable containers, could be expanded to include, for example, deposits, prepayments and other advances that do not involve an asset to be returned for a refund, it is necessary to first examine the concept “beneficiality”.

The concept “beneficiality” in South African tax law

Before an amount can form part of “gross income”, it must constitute a beneficial rather than merely a physical receipt. Whether a taxpayer has a beneficial interest in the receipt will ultimately depend upon the intention of the respective parties to a transaction (such as the terms and conditions applying and the capacity in which an amount is received), the circumstances of the case and the impact of commercial legislation.

30 *Pyott* supra 126.
In *Geldenhuys v CIR*, a widow carried on farming operations in the Karoo. When her husband died, she accepted a usufructary interest created under their mutual will, which provided that their children would be appointed sole heirs of the estate, while she would merely have the use of the assets during her lifetime. Included in the joint estate and thus subject to the usufructary interest, was a flock of sheep, which the widow later had to sell because of a drought in the area. The proceeds were deposited in her personal bank account, but the court held that this did not constitute “gross income” in her hands since the number of sheep remaining at the date of sale was smaller than when her usufruct had commenced. Hence there was no fruit (progeny) for her to share in. At the end of the usufructary period, in her case on her death, her estate had to return to the heirs either the number of sheep still held by her under the usufruct or the cash equivalent. Accordingly, on the sale of the sheep, she did not receive the proceeds on her own behalf and for her own benefit – the meaning now widely attributed to the term “received by” for the purposes of the “gross income” definition.

In *Holley v CIR*, the court gave a similar decision in respect of a *fideicommissum* created in favour of a widow. The amounts received by the taxpayer in his capacity as fiduciary were thus not beneficially received by him and could not form part of his gross income.

See also *Hiddingh v CIR* and *Rishworth v SIR* from which a distinction can be made between the disposal of income after its beneficial receipt or accrual in favour of a taxpayer and the disposal of a right to future income before its beneficial receipt or accrual.

The taxpayer in *CIR v Witwatersrand Association of Racing Clubs* organised a race meeting and declared that the proceeds from the meeting were to be divided amongst two non-profit (tax exempt) charities. Much to its surprise, the Association was held liable for normal tax on such proceeds, notwithstanding the moral obligation which rested upon it to distribute the proceeds in accordance with its declared intention. The court held that the Association had acted as the principal in organising the race meeting, rather than as the agent merely receiving the moneys on behalf of

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31 *Geldenhuys v Commissioner for Inland Revenue* 1947 (3) SA 256 (C), 14 SATC 419.
32 *Geldenhuys* supra 430 (of 14 SATC 419) – note that the judgment in Geldenhuys’ case referred to “on his own behalf for his own benefit” and not “on her own behalf and for her own benefit”.
33 *Holley v Commissioner for Inland Revenue* 1947 (3) SA 119 (A), 14 SATC 407.
34 *Holley* supra 408 (of 14 SATC 407).
35 *Holley* supra 417.
36 *Hiddingh v Commissioner for Inland Revenue* 1941 AD 111, 11 SATC 205.
37 *Rishworth v Secretary for Inland Revenue* 1964 (4) SA 493 (A), 26 SATC 275.
38 *Commissioner for Inland Revenue v Witwatersrand Association of Racing Clubs* 1960 (3) SA 291 (A), 23 SATC 380.
the charities. Thus the proceeds distributed to the charities resulted in a disposal of income subsequent to its beneficial receipt or accrual and were included in the gross income of the Association, but with no deduction being permissible as the proceeds distributed were akin to a donation.

These cases establish an important tax principle: once a revenue amount is beneficially received by or accrued to or in favour of a taxpayer, it must be included as gross income, irrespective of its subsequent payment to some other person. The only way for it not to be included in the taxable income of a taxpayer is where it either qualifies for an exemption or an allowable deduction or an allowance can be claimed against it. Accordingly, where a deposit on a container is received beneficially (as in the Pyott case), it will constitute gross income, irrespective of the contingent obligation to repay it once the container is returned.

Whether the principles enunciated in the Pyott case were expanded by the judiciary to include deposits or advances, even where no underlying asset has to be returned for a refund, is discussed below.

Subsequent cases dealing with deposits and related receipts

In both Brookes Lemos Ltd v CIR and in Greases (SA) Ltd v CIR, the courts followed the decision in the Pyott case. The courts held that the respective taxpayers were not trustees for the deposits received on containers because in both cases they used the deposits on the containers in their general day-to-day operations. In neither of these cases nor in the Pyott case was there an absolute obligation to return the containers to the taxpayers.

In ITC 707, no container was involved – instead, an undertaker carried on a funeral insurance business and, in addition, conducted a prepaid funeral scheme for persons not accepted in the insurance scheme. This resulted in the taxpayer receiving payments in advance for funeral services only to be rendered in the future. These prepayments were held to be “gross income” because they were not put into a separate trust fund and the taxpayer had dealt with these moneys as if they were his own property, thus constituting a beneficial receipt. While this finding might once again have violated accounting principles, the prepayments were still held to be taxable. The decision in this case is discussed again later in this article when dealing with...

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39 Brookes Lemos Ltd v Commissioner for Inland Revenue 1947 (3) All SA 137 (A), 14 SATC 295.
40 Greases (SA) Ltd v Commissioner for Inland Revenue 1951 (3) SA 518 (A), 17 SATC 358.
41 ITC 707 1950, 17 SATC 224.
the Consumer Protection Act and the possibility that, if decided today, the decision would have differed.

During a period of sabbatical leave taken to do research, a university lecturer in *ITC 1346* resigned his position. On resignation, he was obliged, in terms of his employment contract, to refund the six-month salary he had received while on leave. The lecturer argued that the salary for this period was neither “received by” nor “accrued to” him owing to the contingent obligation to repay it in the event of his resigning. The court, however, held that the contingent liability to repay the salary did not have the effect of excluding the salary received from gross income. Subsequently, section 11(1a) was introduced into the Income Tax Act and now at least provides for relief in the form of a deduction once the amount has been refunded by the employee.

These latter two cases support the taxability of deposits, prepayments and other advances beneficially received, even if not in respect of a returnable container. However, it is submitted that these decisions do not imply that all deposits, prepayments or advances, once received, will necessarily constitute “gross income”. In *C v COT* the company sold fuel and operated a service station in Zimbabwe. Included among its customers were those who purchased fuel for their fleets of vehicles for which they paid on a monthly basis. After rejecting the idea of obtaining a bank loan to fund the supply of the fuel, the company offered these fleet owner customers the option of either paying cash for purchases, or continuing to pay their fuel bills monthly, after making a deposit amounting to one-twelfth of their annual purchases.

All deposits were paid into the company’s only bank account, and these funds were utilised to purchase fuel and meet other expenses of the business – a situation similar to the deposit cases discussed. These deposits were included as part of its creditors on the balance sheet and remained there until the individual customer had closed his account and the deposit had been refunded. The Supreme Court of Zimbabwe held that such deposits did not constitute gross income, but rather working capital to be equated with a loan for which there was a definite (non-contingent) liability to repay. The absence of any liability to pay interest on these “loans” was explained by the benefit the customers enjoyed in not paying interest on the value of purchases for a period of 30 days.

This decision, although only of persuasive value since it originated in Zimbabwe, aligns with the *Special Board Decision No. 166* where individual lessors received rental deposits, reflected as current liabilities and refundable upon the expiry of the

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43 *C v COT* 1984 (3) SA 210 (ZS), 46 SATC 57.
44 *Special Board Decision No. 166* (Germiston Special Board, 18 March 2002) 37.
respective leases. They were entitled to deduct from the deposits to be refunded any amounts owing to them by the respective lessees at the end of the lease period. The Commissioner contended that these deposits constituted “gross income” as they were paid into the taxpayers’ respective business banking accounts. In his ruling, the Chairman of the board, Mr HV Vorster, held that there was no contingency attached to the taxpayers’ obligation to refund these deposits. This feature alone distinguished this case from the container deposit cases already discussed. These rental deposits could not be distinguished from borrowed money. While the Commissioner contended that the taxpayers’ right to set off established claims against the tenants’ deposits meant that the obligation to repay was not absolute, this overlooked the fact that, where set-off applied, the obligation to repay was discharged only to the extent of such set-off. The right of set-off did not render the taxpayers’ obligations to repay these deposits as conditional.

In a similar vein, the court in *CIR v Genn & Co (Pty) Ltd*,45 had earlier held that amounts or articles borrowed for the use of a business do not constitute “receipts” to the borrower.46 It is not every obtaining of physical control over money or money’s worth that constitutes a receipt for the purposes of “gross income”. At the same time, if the borrower is given possession, he or she falls under an unconditional obligation to repay it. What is borrowed does not beneficially become his or hers.47 However, in the *MP Finance Group CC*48 case, the court held that investments received under an illegal pyramid scheme, a scheme that was insolvent *ab initio* (from the start), were nonetheless taxable as the perpetrators of the scheme had treated these deposits as in the nature of income and as its own funds.

While this decision has been and should be subject to severe criticism – it does not take into account the fact that the investors have lost part of their investments owing to the fact that SARS is taxing the recipient on “receipt” of these investments – the court’s sentiments indicate support for the inclusion of unconditional refundable deposits, which are illegally treated as income and part of the taxpayer’s own funds, in the taxpayer’s “gross income”. Although the constitutional principles involved, such as the right not to be arbitrarily deprived of one’s property (section 25 of the Constitution of the Republic of South Africa, 1996) were not argued or even discussed in the case and may have resulted in a different decision, such a discussion is considered to be beyond the scope of this article.

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45 *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113.
46 Genn supra 114 (of 20 SATC 113).
47 Genn supra 123.
It is submitted that the principles enunciated in the Pyott case have been religiously followed in subsequent cases, especially where the deposits relate to containers that may be returned for a refund. If there is a mere contingent obligation to refund such deposit, this will imply that a beneficial receipt has in fact taken place. However, where the deposit is more akin to a loan with a definite and unconditional liability to refund it (unless illegally treated as the income of the taxpayer) as found in the fuel deposit (C v COT\(^{49}\)) or the rental deposit (Special Board Decision No 166\(^{50}\)) cases, these deposits are not included in “gross income” because of the absence of a beneficial receipt.

As the general definition of “gross income” specifically excludes receipts or accruals of a capital nature, it is clear that the decisions in the cases already discussed, cannot extend to deposits, prepayments or other advances relating to assets which are capital in nature in the hands of the seller. However, in the absence of specific legislation, as is the case where the Consumer Protection Act or other legislation applies, a portion of such capital receipt may be included in the taxpayer’s taxable income in terms of section 26A read together with the Eighth Schedule (taxation of capital gains) of the Income Tax Act. Any further discussion on the aspect of capital receipts, however, is considered to be beyond the scope of this article.

Having explored the relevant case law in relation to the general scope and ambit of the taxability of deposits, prepayments and other advances for income tax purposes, it is now considered necessary to analyse, discuss and compare the income tax treatment of deposits to the treatment for value-added tax purposes as well as the possible impact of specific commercial legislation. Section 35A of the Income Tax Act will also be examined in this light.

### Value-added tax and section 35A of the Income Tax Act

Section 7 of the VAT Act provides that VAT is levied, \textit{inter alia}, on the supply of goods and services in the course or furtherance of an enterprise. Theoretically, there should thus be a correlation between the treatment of deposits received by business enterprises for income tax and VAT purposes, but is this really the case?

The VAT Act (section 1) defines the term “consideration” as, \textit{inter alia}, including any payment made or to be made, including any deposit on a returnable container, whether in money or otherwise, in relation to the supply of goods or services. The

\(^{49}\) Supra.

\(^{50}\) Supra.
definition further specifies that any deposit, other than a deposit on a returnable container, whether refundable or not, shall not be considered as payment for such supply unless and until the supplier applies the deposit as consideration for the supply, or such deposit is forfeited. Thus, while a deposit on a returnable container is specifically included as part of the consideration that is subject to VAT, any other type of deposit will be excluded from the consideration and not be subject to VAT until such time that it is applied as part of the consideration for the transaction, or such deposit is forfeited.

Where a deposit serves the purpose of providing security only and is definitely refundable, it should be akin to a loan and neither gives rise to any beneficial receipt nor forms part of the consideration for a supply for VAT purposes. Unless and until it is either applied as part of the consideration for a transaction, or forfeited, it cannot be subject to VAT or be included in “gross income” for income tax purposes. All deposits form part of the consideration and are subject to VAT, other than those classified as providing security only (which are definitely refundable), prepayments and advances.

In support of the contention that refundable security deposits are not taxable, reference can also be made to section 35A of the Income Tax Act. This section provides for a withholding tax on the proceeds payable to a non-resident seller in respect of the disposal of immovable property situated in the Republic. The withholding tax does not apply in respect of any deposit paid by the purchaser for the purposes of securing the disposal of such immovable property, until the agreement for that disposal has been entered into. It appears that such deposits can only become subject to the withholding tax once applied as part of the payment for the sale by setting it off against the outstanding balance. The treatment of a security deposit for the purposes of section 35A thus also closely resembles its respective income tax and VAT treatment.

Commercial legislation that impacts upon a beneficial receipt

Commercial legislation can impact directly upon the question of whether a beneficial receipt has in fact taken place. To illustrate this, the Rental Housing Act provides that a landlord is obliged to invest any deposit received from a tenant in an interest-bearing account with a financial institution and, at the end of the lease agreement, to pay the tenant interest thereon at the rate applicable to such account (section 5(3)(d)). While the landlord may apply or set off such deposit and interest earned towards the settlement of all amounts for which the tenant is liable under the lease agreement, including the reasonable cost of repairing any damage caused
by the tenant and replacing lost keys, the remaining balance, if any, must be paid over to the tenant (section 5(3)(g)).

This, no doubt, implies that such deposits are held purely for security purposes and do not become the property of the landlord when the deposit is made. Rather, the deposits remain the property of the respective tenants and are to be refunded with interest thereon. Only once and to the extent subsequently set off against amounts due by the tenant, can the deposit become beneficially received by and, thus, “gross income” of the landlord. This supports the ruling in Special Board Decision No. 166 and the decision in C v COT and the same principle should thus apply in the case of other security deposits received. There are no comparative VAT implications, as the supply of residential accommodation in a dwelling is an exempt supply (section 12(d)).

The Consumer Protection Act, in turn, deals with a variety of commercial transactions. Lay-by transactions where a supplier agrees to sell specified goods and accepts payment in periodic instalments while holding such goods until the consumer has paid the full price (section 62(1)), is but one example. This section further provides for these instalments to remain the property of the consumer until the goods have been delivered to the consumer. Until that stage, the instalment is effectively treated as a security deposit. If the supplier should, for a reason beyond his or her control, not be able to deliver such goods to the consumer, these instalments must be refunded to the consumer with interest (section 62(2) of the Consumer Protection Act). Section 62(4) of the same Act, however, provides for situations in which a termination penalty can be levied and deducted from the amount to be refunded – a situation similar to that envisaged by the Rental Housing Act.

These provisions can possibly impact on the income tax treatment of lay-by agreements because, normally, there cannot be any beneficial receipt or accrual in respect of a sale until delivery has taken place and the quality and quantity of the goods have been accepted by the purchaser and ownership has passed into his or her name. Furthermore, such treatment would follow the provisions of the VAT Act as lay-by agreements are not deemed to represent a supply of goods or services for VAT purposes unless and until the goods have been delivered to the purchaser (section 8(4)(a)). Any amount retained on termination of the agreement will be deemed to be a charge for services rendered by the supplier (section 8(4)(b)) and take place when

51 Supra.
52 Supra.
the agreement is terminated (section 9(2)(c)). Only on delivery of the goods or on termination of the agreement does a supply and beneficial receipt take place.

Surprisingly, SARS holds a different view by stating in Interpretation Note No. 48\(^5\) that section 24 of the Income Tax Act also applies to lay-by agreements of not less than twelve months (no mention is made of the treatment of lay-by agreements covering less than twelve months). In short, section 24 applies to “credit agreements” where ownership will only pass in favour of the purchaser upon or after the whole or a certain portion of the full consideration has been received by the seller. Section 24(1) then provides that the full consideration (excluding finance charges) will be deemed to have accrued on the date of concluding such agreement, notwithstanding that ownership has not passed in favour of the purchaser.

It is submitted that SARS’ view on this aspect ignores an important distinction between section 24 “credit agreements” and lay-by agreements. This inevitably raises doubt about the merits of the suggested SARS treatment of lay-by agreements, which clearly should fall outside the scope of section 24. First and foremost, property under section 24 “credit agreements” is delivered or made available to the purchaser on or soon after the conclusion of the agreement. This is in direct contrast to lay-by agreements where the goods are only delivered after full payment has been made. The only similarity may be that ownership will only pass once full payment has been made.

Interpretation Note No. 48 further attempts to draw a parallel between section 24 “credit agreements” and “instalment credit agreements” as defined in section 1 of the VAT Act by stating that section 24 applies in the case of an “instalment credit agreement”. While there may be some overlap between these agreements, they are clearly not identical in that “instalment credit agreements” also comprise transactions where ownership has already passed on delivery of the goods, as well as certain lease agreements. It is submitted that such agreements do not fall under section 24 “credit agreements”.

Returning to the suggested treatment of lay-by transactions and its similarity to both “credit agreements” and “instalment credit agreements”, the definition of an “instalment credit agreement” clearly makes reference to “delivery to or the use, possession or enjoyment” (paragraph (a)(iv)(aa)) and “return of those goods” (paragraph (a)(iv)(bb)). No doubt, delivery is once more envisaged and ultimately

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53 A copy of Interpretation Note No. 48 is contained, inter alia, in 2013/14 SAICA Legislation Handbook Volume 2 (LexisNexis (2014)) at 438.
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required in order to meet this definition. The levying of finance charges by the supplier on these transactions as well as in the case of “credit agreements” further presupposes delivery. Otherwise, why would the purchaser be prepared to pay the finance charges if possession of the article is lacking? By contrast, lay-by agreements provide for the payment of interest, not to the supplier, but in fact to the purchaser on instalments made, where the supplier is unable to effect delivery. This, it is submitted, is a different situation altogether.

Reference is further made in Interpretation Note No. 48 to the special VAT rules regarding “instalment credit agreements” – for example, the time of supply is the earlier of delivery, or receipt of payment of any consideration. This, however, ignores the special time of supply rules for lay-by agreements as already indicated. To support the submission that these transactions cannot be grouped together, the trading stock provisions of section 22 will effectively give rise to double taxation, notwithstanding limited relief via a debtor’s allowance (section 24(2)) or allowance for future expenditure (section 24C) should lay-by agreements be taxed in accordance with section 24. This is because such lay-by items remain in the hands of the supplier, who retains ownership therein (there is no delivery to the purchaser) for the duration of the agreement and which will, apart from the deemed accrual under section 24, require an add-back to income by way of a section 22 inclusion in closing inventory for the supplier. An amendment to Interpretation Note No. 48 clearly seems necessary in order to draw a proper distinction between “credit agreements” and “instalment credit agreements” and bring the tax treatment of lay-by agreements into line with reality and, of course, the law relating to lay-by agreements.

Where a consumer is required to make an advance payment in respect of services that will only be rendered more than 25 business days later, section 64(1) of the Consumer Protection Act specifies that such advance payments will remain the property of the consumer. The supplier is merely allowed to make a charge against it (once a month in advance) for a pro rata portion of the ensuing month’s services (section 64(2)).

In ITC 707,54 as already discussed, the undertaker was taxed in full on receipt of payments for services only to be performed later. In this case, the terms and conditions agreed upon between the parties provided that, in the event of failure to pay the monthly contribution within 90 days, all previous payments would be forfeited. Amounts thus effectively became beneficial receipts, once received, and did not enjoy the protection that is now offered by the Consumer Protection Act. Currently, such

54 Supra.
advance amounts will remain the property of the consumer and, it is submitted that in the light of the Consumer Protection Act, there can no longer be a beneficial receipt before the month in which such services are rendered. If this is the true legal position, then it is submitted that *ITC 707* would now be decided differently.

The treatment of deposits in respect of containers, pallets or similar objects is covered separately in section 66 of the Consumer Protection Act. Unlike lay-by agreements and advance payments for services to be rendered, there is no stipulation that such deposit must be treated as the consumer’s property. By implication it must therefore become the property of the supplier. This treatment in terms of the Consumer Protection Act, once more, seems to support the income tax and VAT treatment of deposits on containers.

Although it is considered to be beyond the scope of this article to discuss in detail section 11(a) of the Income Tax Act with regard to the deductibility of the contingent liability for a refund arising on the receipt of a deposit on a returnable container, it is nevertheless considered necessary to briefly discuss the requirement “actually incurred” in order to obtain a holistic picture of the tax treatment of deposits received in respect of containers. The next paragraph will thus explore this area before proceeding to analyse the possible allowance that may be claimed in terms of section 24C, a provision subsequently introduced into the Income Tax Act to alleviate the “unfairness” of taxing certain deposits, prepayments and advances received, without allowing a corresponding deduction for future liabilities to incur expenditure arising in terms of the agreement.

**Meaning of “actually incurred” for the purposes of section 11(a)**

In the *Caltex Oil* case it was held that expenditure “actually incurred” means all expenditure for which a liability has been incurred during the year of assessment, whether or not the liability has been discharged during that year. If there is no definite and absolute liability during the year of assessment to pay an amount, expenditure has not actually been incurred (*Nasionale Pers* case). If a conditional obligation is stipulated in an agreement and the condition is fulfilled only in the following year of assessment, the resultant expenditure is deductible only in the latter year because there is no unconditional legal obligation in existence for the first year

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55 Supra.  
56 *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* 1975 (2) All SA 222 (A), 37 SATC 1.  
57 *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste* 1986 (3) SA 549 (A), 48 SATC 55.
(Edgars Stores\textsuperscript{58} case). Contingent liabilities, such as the obligation to repay deposits on returnable containers, therefore do not immediately give rise to expenditure as being “actually incurred”. Only on the return of the container will a definite legal liability come into existence (see the Pyott case).

**Section 24C of the Income Tax Act**

The inclusion of deposits, prepayments and advances beneficially received in gross income, whilst disallowing potential expenditure obligations to be incurred under the relevant contract at a later stage, leads to a “timing mismatch” between the recognition of income and the claiming of expenditure incurred in earning it. Section 24C (introduced in 1980) effectively permits an exception to the “actually incurred” requirement of section 11(a), as well as section 23(e), which prohibits the deduction of provisions, by providing for an allowance to be claimed in respect of future expenditure to be incurred. This allowance is added back to income in the following year of assessment, when a new allowance is calculated in respect of deposits, advances or prepayments received, if there is still expenditure to be incurred in the future.

Before granting the section 24C allowance, the Commissioner must be satisfied that amounts received as a deposit, prepayment or advance will be used in whole or in part to finance such future expenditure in the performance of obligations under the relevant contract. If not so satisfied, this allowance will not be granted. There must therefore be a clear measure of certainty that such expenditure will, in terms of the contractual obligations, be incurred in a future year. According to SARS’ Second Draft Interpretation Note\textsuperscript{59} in this regard, only expenditure that has a high degree of probability and inevitability, will be taken into account. “Future expenditure”, in terms of the definition, includes expenditure that will in future be allowed as a deduction or give rise to the claiming of an allowance.

A provision for future warranty claims expected to be instituted against the taxpayer was disallowed in *ITC 1601*\textsuperscript{60} as the court was not convinced that there was a clear measure of certainty that such expenditure was quantified or even quantifiable. This contingent liability was further, at least partly, recoverable from its suppliers and the deduction was thus prohibited by section 23(e) of the Income Tax Act. In addition, the taxpayer, despite several requests, failed to provide the additional information

\textsuperscript{58} Edgars Stores Ltd v Commissioner for Inland Revenue 1988 (3) SA 876 (A), 50 SATC 81.

\textsuperscript{59} Second Draft Interpretation Note on Section 24C.

\textsuperscript{60} *ITC 1601* 1995, 58 SATC 131.
requested by the Commissioner. Accordingly, it was held that the taxpayer had failed to discharge the onus of proof in showing that the Commissioner did not exercise a proper discretion in reaching his decision.

*ITC 1697* involved a share block company that operated a timeshare scheme. Its levy income was fully tax free and at least a portion of the investment income could also qualify for exemption, provided and to the extent that the company’s deductions relating to the earning of levy income exceeded such levy income. In calculating the extent to which its allowable deductions exceeded its levy income, the company claimed a section 24C allowance which the Commissioner disallowed. The court found the Use Agreement between the taxpayer and its members to be an ongoing contract, which obliged members to pay levies, while the company had to fulfil its obligation to administer the scheme and maintain its fixed and movable property. Accordingly, the court held that the company’s liability for future expenditure was unconditional and the Commissioner was found not to have properly applied his mind to the matter.

Based on the above, it is submitted that obligations, such as those which arose in the *Pyott* case, if decided today, may possibly qualify for relief under section 24C. Where, based upon past experience, the taxpayer can show a definite trend, which is bound to continue in the future, there should be a clear enough measure of certainty about the incurrence of such expenditure to meet the requirements of section 24C of the Income Tax Act. In support of this contention, it was noted by the judge in the *Pyott* case that 90 percent of its customers returned the biscuit containers for a refund, after the deposit charge had increased by 200 percent. Proper records and information will help to convince the Commissioner about the merits of the case and discharge the onus of proof that the future refunds have a “high degree of probability and inevitability” (as required in terms of this Second Draft Interpretation Note) and that the deposit refund qualifies for the section 24C allowance.

**Conclusion**

The objective of this tax story was twofold:

- to make a contribution to the teaching and learning of tax principles by telling the story of the *Pyott* case and placing the case in its historical context, thus enabling a more accessible and interesting journey of discovery for the tax scholar; and

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61 *ITC 1697* 1999, 63 SATC 146.
62 Supra.
63 Supra.
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- to revisit the tax principles as enunciated in the *Pyott* case in relation to the taxability of deposits on returnable containers – both from the point of view of “gross income” and the deductibility of the contingent liability to repay the deposit on the happening of an event – and establish whether the principles so laid down can be extended to deposits, prepayments and advances where no returnable container is involved.

In order to achieve this latter objective and thereby make a contribution to the body of knowledge in the field of tax law, the research entailed an analysis and discussion of the decision in the *Pyott* case and subsequent related case law, the treatment of deposits for the purposes of other taxes and commercial legislation introduced to protect the consumer.

For a deposit to be included in “gross income”, it must be received by the taxpayer “on his own behalf and for his own benefit” (see *Geldenhuys*64) rather than a mere physical receipt. Any receipt on behalf of or for the benefit of another person (for example, where it is held in trust) means that there is no beneficial receipt or “gross income” arising. Whether a taxpayer has a beneficial interest in a receipt will ultimately depend upon the intention of the respective parties to a transaction (such as the terms and conditions applying and capacity in which an amount is received), the circumstances of the case and the impact of commercial legislation.

Once a revenue amount is beneficially received by or accrued to or in favour of a taxpayer, such as a deposit charged on a returnable container, it must be included in “gross income”, irrespective of its subsequent payment to some other person or the possibility that it may in certain contingent circumstances, such as the return of a container, ultimately become refundable. The principle of beneficial receipt can be extended to any “deposit” received in the form of an initial payment for goods delivered to the purchaser, which actually forms part of the consideration for a non-capital transaction. This principle would further apply in the case of such a “deposit” being made on an asset which is capital in the hands of the seller in order to establish the “proceeds” for capital gains tax purposes.

Nevertheless, the case of *Pyott* and subsequent court decisions indicated that a deposit should not be judged merely on its “label” or accounting treatment. Thus where a deposit, prepayment or advance is received for security purposes with a definite liability to refund it, such deposit, prepayment or advance is more akin to a loan (*C v COT*65) and does not constitute “gross income”. Only once and to the

64 Supra.
65 Supra.
extent such deposit, prepayment or advance is subsequently set off against an amount due by the other party, can the amount set off be regarded as beneficially received. However, the receipt of a refundable deposit, prepayment or advance, which is thereafter illegally treated by the taxpayer as income and as his own (MP Finance66), may not always save the recipient from being taxed on such receipt.

This research also highlighted the fact that certain commercial legislation, such as the Rental Housing Act and the Consumer Protection Act, can impact directly on whether a deposit has been beneficially received and thus constitutes “gross income”. For example, all deposits received by a lessor in respect of rented properties must, in terms of the Rental Housing Act, be held in a “trust account” until either is set off against amounts owing at the end of the lease period or refunded to the lessee. Accordingly, such deposits are not included in “gross income” as there cannot be any beneficial receipt before such set-off, if any, has taken place.

Interpretation Note No. 48 was also analysed and found to be out of line with the Consumer Protection Act, specifically in relation to lay-by agreements. Ultimately, an amendment to SARS’ Interpretation Note No. 48 appears to be necessary to bring the tax treatment of lay-by agreements into line with the Consumer Protection Act as well as limit the application of section 24 of the Income Tax Act to only “credit agreements” as described in that section.

Whilst a deposit on a returnable container falls within the ambit of “gross income”, the taxpayer cannot claim any deduction in terms of sections 11(a) read together with 23(e) of the Income Tax Act in respect of the contingent liability to refund the deposit, should the container be returned. No expenditure would be “actually incurred” before the return of the container. Nevertheless, relief may now be possible under section 24C of the Income Tax Act, provided the taxpayer can show by way of a clear enough measure of certainty that future expenditure will have to be incurred in terms of the contract to earn such income.

In conclusion, it can be submitted that the general principles as enunciated in the Pyott case with regard to the taxability of deposits and deductibility of refunds for the return of containers, are still relevant today. However, where no container is involved, beneficial ownership must first be established before such deposit, prepayment or advance payment becomes taxable, always taking into account the specific provisions of legislation such as the Rental Housing Act and the Consumer Protection Act. The research has also shown that there is coherence in the treatment of deposits for income tax purposes and value-added tax.

66 Supra.
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