The impact of the Brummeria Renaissance case in determining whether the receipt of an interest-free loan results in gross income accruing to the borrower

by
Sybrand Abraham Smit

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Supervisor: Professor C J Van Schalkwyk

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SUMMARY

The September 2007 decision of the SCA in *C: SARS v Brummeria Renaissance (Pty) Ltd and Others* has proven to be one of the most contentious tax cases ever decided by a court in our jurisdiction. Questions surrounding the interpretation of the judgment and the likely scope of its application are some of the most widely debated matters in South African tax circles ever since the judgment was delivered.

In this research paper a study is undertaken into the income tax treatment of an interest-free loan receipt. The position as it stood prior to the SCA decision is first analysed with particular reference to the legal nature of a contract for the loan of money and the tax court decision in ITC 1791. The discourse continues with a critical discussion of the *Brummeria judgment* in order to extract the *ratio decidendi* thereof.

The ambit of application of the extracted binding principles to selected interest-free loans (encountered most often in practice) is considered, drawing on views expressed by numerous South African tax experts as well as the Revenue Authority's own stance in this regard, as enunciated in their Draft Interpretation Note dealing with the right to use loan capital interest-free.

As a final application a study is undertaken into the possible arguments available to tax subjects to refute an assessment for income tax raised on them by SARS on the basis of the binding principles enunciated by the SCA in *Brummeria*. It is concluded that initial fears regarding the potential wide-ranging impact of the decision, though justified, may have been over-anticipated as strong grounds exist to argue that the scope of the judgment's application is not likely to extend wider than the type of legal construction found in the case itself, namely where an interest-free loan is received in consideration or as a *quid pro quo* for some or other revenue supply.

OPSOMMING

Die beslissing van die Hoogste Hof van Appèl ("HHA") in *C: SARS v Brummeria Renaissance (Pty) Ltd and Others* gedurende September 2007 blyk een van die mees omstrede belastingsake te wees wat tot nog toe in ons jurisdiksie beslis is. Kwelvrae rondom die interpretasie van die uitspraak sowel as die waarskynlike omvang van die toepassing daarvan is van die aangeleenthede wat die wydste gedebateer is in Suid-Afrikaanse belastingkringe in die onlangse verlede.

In die studie word die inkomstebelasting hantering van die ontvangs van 'n rentevrye lening ondersoek. Die regsposisie voor die beslissing van die HHA word eers ontleed met spesifieke verwysing na die regsaard van 'n kontrak vir die leen van geld en die beslissing van die spesiale inkomstebelasting hof in ITC 1791. Die verhandeling gaan voort met 'n kritiese bespreking van die *Brummeria uitspraak* ten einde die *ratio decidendi* daarvan te ekstraheer.

Die bestek van die toepassing van die saak se bindende beginsels op uitgesoekte rentevrye lenings (wat die meeste in die praktyk teëgekom word) word oorweeg. In dié verband word verwys na die menings van verskeie Suid-Afrikaanse belasting-deskundiges, sowel as die Ontvanger van Inkomste se eie seining in hierdie verband, soos uiteengesit in hul Konsep Interpretasienota met betrekking tot die reg om leningskapitaal rentevry te gebruik.

In die laaste instansie word 'n ondersoek geloods na die moontlike argumente wat belastingpligtiges sou kon aanvoer om 'n inkomstebelasting-aanslag gegrond op die bindende beginsels neergelê deur die HHA in *Brummeria*, te weerlê. Dit word bevind dat aanvanklike vrese aangaande die trefwydte van die beslissing, alhoewel geregverdig, moontlik oorversigtig was, aangesien daar sterk gronde is om te argumenteer dat die omvang van die uitspraak se toepassing waarskynlik beperk is tot die soort regskontruksie wat in die saak self aangetref word, naamlik waar 'n rentevrye lening ontvang word in ruil vir of as *quid pro quo* (teenprestasie) vir een of ander lewering van 'n inkomste aard.

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ABBREVIATIONS AND TERMINOLOGY

“the Act”	-	the Income Tax Act, No. 58 of 1962 (as amended);
“CIR”	-	Commissioner for Inland Revenue
“C: SARS”	-	Commissioner for South African Revenue Service
“SARS”	-	the South African Revenue Service
“SATC”	-	the “South African Tax Cases Reports”, as published by Butterworths;
“SCA”	-	Supreme Court of Appeal;

All references to relevant page numbers are to the pages in the SATC, except if the context indicates otherwise.

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1 CHAPTER 1: INTRODUCTION

1.1 Background and problem statement

For years it had been believed - and has tax law been applied in such a manner - that the grant of an interest-free loan would in general not have any adverse income tax consequences for the recipient of such a loan.

The decision of the Supreme Court of Appeal ("SCA") in the landmark case of *C: SARS v Brummeria Renaissance (Pty) Ltd and others* ("the Brummeria case") has left the general consensus concerning the *status quo* in some disarray. The court found that the granting of a right to use loan capital interest-free confers on the recipient/borrower a taxable benefit which is to be included in gross income as being a right capable of being valued in money accruing to the taxpayers.

It is unclear what the likely scope of the decision's impact will be. Commentators' views vary between the narrowest fact specific application to the most wide-ranging general application to all interest-free loans.

There are of course instances, as in the case of an interest-free (or low interest) loan in an employer-employee relationship and as in the case of the deemed income provisions of section 7 of the Income Tax Act ("the Act"), where the legislator has laid down very specific rules pertaining to the treatment of interest-free loans in certain factual circumstances. This paper is however not focussed on the impact of the *Brummeria case* on the type of transactions that the law already addresses pertinently. Rather, the focus hereof is on how the interest-free loans most commonly encountered in practice are treated in the hands of the borrower, for income tax purposes.

The specific problem statements to be examined and answered can be summed up as follows:

- Taking cognisance of the legal framework within which loans, including interest-free loans operate, what is the likely scope of the *Brummeria case*'s impact on the income tax position of recipients of selected types of interest-free loans?

- In case of a SARS attack on a borrower on strength of the *Brummeria case*, what are the possible arguments to be advanced on behalf of the taxpayer involved to successfully thwart the Revenue's attack?

1.2 Aims

The objectives of the instant research paper therefore are the following:

- To come to a reasoned conclusion regarding the correct income tax treatment of selected interest-free loans in the hands of the borrower.

- To conduct a critical exposé of the SCA judgment in *Brummeria* in order to extract the *ratio decidendi* (or reasons for the court's judgment), leaving aside the so-called *obiter dicta* (remarks or conclusions drawn in passing, merely incidental to the court's ultimate finding).

- In applying the general principles of South African law (the common law, statute law, judicial precedent as well as secondary sources of interpretation) and the *ratio decidendi* of the *Brummeria case* specifically, to selected types of interest-free loan transactions, to determine the impact of the *Brummeria judgment* on interest-free loans in general in the hands of a borrower.

- To suggest possible routes of escape for a borrower taxpayer hit by a SARS attack on strength of the *Brummeria case*.

1.3 Survey of relevant literature

The crisp issue to be addressed in this paper is of course, as was the case in the *Brummeria judgment*, whether due to the receipt of an interest-free loan (a loan carrying no interest or a loan without any obligation to pay interest) a borrower becomes entitled to or there accrues to him an amount otherwise than in cash, as envisaged by the definition of gross income in section 1 of the Act.

Pre-existing case law made it clear that the receipt of loan capital does in itself not give rise to a taxing event for purposes of the 'gross income', as the receipt is subject to the repayment of an equal amount of money/capital at some time in the future.[1] The Commissioner for the South African Revenue Service ("C:SARS"), although initially trying to assess the taxpayers on this basis, in the end argued and successfully assessed the taxpayers on the ground that the right to retain and use the loan capital *interest-free* constituted an *amount* with an ascertainable money value, which accrued to the taxpayers.

Since the handing down of the judgment, several commentators and tax experts have publicly aired views on the probable scope or range of impact of the *Brummeria case*. These include, amongst others, Professor Emile Brincker, Professor Henry Vorster, Marius van Blerck, Chris Cilliers, David Clegg and David Meyerowitz, S.C.

Reactions from the legal fraternity have been wide-ranging and a general dissensus seems to prevail among writers, most notably those mentioned

[1] *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd*, 20 SATC 113 at 122; *Commissioner for Inland Revenue v Felix Schuh (SA) (Pty) Ltd*, 56 SATC 57 at 69.

above. In writer's view there has developed two clear 'schools of thought' regarding the scope of the *Brummeria judgment*'s application.

On the one hand there are those commentators and experts who are of the view that the factual basis of the case is of paramount importance, to such an extent that it is rendered distinguishable from the majority of hypothetical and/or practical manifestations of interest-free loan transactions. Writers who seem to favour this interpretation include Brincker, Vorster and Van Blerck.

On the other hand there is also the view that the judgment in the *Brummeria case* is a principled one capable of general application across the range of possible applications of interest-free loans. This school is propounded by *inter alia* Cilliers and Clegg, who beckon that there is, on a close reading of the judgment, no clear reason why it should not be possible for SARS to apply the decision across the board.

SARS has waited for just over a year (October 2008) before making some form of stance on the issue by releasing a Draft Interpretation Note on the application of the *Brummeria case*, wherein the right to use loan capital interest-free is under the magnifying glass. First indications are that SARS favour the interpretation of the first-mentioned school of thought alluded to above. This is of course excellent news to taxpayers and tax advisers alike. However, in the recent Income Tax Case No. 1830 (70 SATC 123) one of the South African tax community's worst fears was realised in that SARS argued against its own Interpretation Note No. 33 (the contents of which is irrelevant for present purposes) and successfully assessed the appellant to tax as a result. The court in that matter made it plainly clear (at the top of page 132) that –

> *"... the Commissioner <u>cannot (and clearly did not intend to)</u> change the law by making concessions to address unintended results."* (emphasis added)

This serves to highlight to what extent an Interpretation Note of the Revenue authority is likely to be of assistance in finding a solution to a matter of uncertainty in the interpretation and application of a particular statutory provision.

1.4 Importance of the research

In the light of the above-mentioned, it is submitted that the research to be carried out and concluded upon herein is of the utmost importance in coming to a definitive answer to the burning issues (see 1.2 above) coming to the fore as a result of the *Brummeria judgment*.

1.5 Research design

The type of research carried out in order to achieve the aims set is a mixture of both basic research and applied research. In the first instance writer will endeavour to identify the *ratio decidendi* borne out by the SCA's decision in the *Brummeria case*, followed by an exploration into the correct application (in writer's opinion) of the binding principles of the judgment and how this would likely impact on selected practical manifestations of interest-free loan transactions.

The research method followed is the so-called historical method, involving a study of the following sources, namely:

- Relevant South African legislation;
- Relevant South African case law;
- Opinions enunciated in articles written by, as well as addresses delivered by, South African tax experts and commentators; and
- Legal analyses by experts in the field of law and tax contained in textbooks and similar publications.

1.6 Framework for the proposed study

1.6.1 Chapter 2: The legal framework within which interest-free loans operate for purposes of the gross income definition

This research paper commences with an analysis of the provisions of the Income Tax Act relevant to the main issues to be addressed by the paper as a whole. All proposed conclusions will be sourced in the general charging provision of the Act, namely the gross income definition in section 1, as this section formed the basis of the dispute between the Commissioner and the companies assessed to tax in the *Brummeria case*.

The chapter further looks at the legal nature of a loan for consumption, the contract type to which a loan of money belongs and what the importance hereof is in the view of the taxability of loans. The income tax treatment of interest-free loans in the hands of a borrower, before the advent of the SCA's decision in the *Brummeria case*, will thereafter be discussed in detail. In the final instance cognisance will be taken of the tax court's decision that preceded the Commissioner's appeal to the SCA.

1.6.2 Chapter 3: A critical discussion of the Brummeria case - extracting the *ratio decidendi* in order to determine the likely scope of application

In this chapter the decision of the SCA in the *Brummeria case* will be put under the proverbial spotlight. The court's judgment will be summarised, whereafter it will be considered what parts of it comprise the so-called *ratio decidendi* (the courts findings on the issues to be decided upon and the reasons for such findings) and which constitute mere *obiter dicta* (comments made or opinions expressed by the court which do not bear on the issues for decision or the findings *qua* those issues).

A critical discussion of the case will also be undertaken in order to highlight certain marked difficulties borne out by the judgment. SARS's view regarding the binding principles to be extracted from the case will also be examined before coming to a reasoned conclusion regarding which statements of the court has the power of *stare decisis* (binding on cases heard in lower courts).

1.6.3 Chapter 4: The impact of the binding principles of the Brummeria case and the application thereof to selected interest-free loans (and consequent treatment – *post*-Brummeria)

In this chapter the specific types of interest-free loans observed most often in practice will be identified. The opinions of the most publicised tax experts and commentators on the *Brummeria case* will then be examined in order to set out the general consensus (if any) of the taxing fraternity in South Africa regarding the likely scope of application of the SCA's judgment.

The interpretations of these experts will be grouped into popular views or 'schools of thought'. SARS's view in this regard, i.e. of the width of *Brummeria's* application, will also be taken onboard and a final conclusion reached regarding the likely reach of the *ratio* in the case as it applies to interest-free loans in general.

1.6.4 Chapter 5: Arguments against a possible SARS-attack on the basis of Brummeria

The final scope of enquiry will be to assess what arguments would be available to the borrower of an interest-free loan, assessed to income tax on the basis of the *Brummeria judgment*, in order to successfully defend such an assessment in a tax court or higher-ranking tribunal. The enquiry will focus on two possible assessments, one based on a limited scope interpretation of the decision in *Brummeria*, the other an assessment based on the widest-ranging interpretation of the judgment, i.e. to all interest-free loans in general.

The arguments against both a narrow-scoped and a wide-scoped attack will be explored in separate discussions, sourcing back each argument to the basis of taxation, namely the gross income definition.

1.6.5 Chapter 6: Conclusion

In conclusion a synopsis will be made of the research undertaken throughout the course of the discussion as a whole. The aims set for the research paper will be revisited and the conclusions reached in the aforegoing chapters of the discussion applied to the various research objectives. The impact of the *Brummeria Renaissance case* in the treatment of interest-free loans in the hands of the borrower, for purposes of the gross income definition will be finally concluded upon.

1.6.6 Chapter 7: Bibliography

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2 CHAPTER 2: THE LEGAL FRAMEWORK WITHIN WHICH INTEREST-FREE LOANS OPERATE FOR PURPOSES OF THE GROSS INCOME DEFINITION - The income tax treatment of interest-free loans in the hands of the borrower *pre-*Brummeria

2.1 Gross income definition – Section 1

Income tax is charged in terms of the Income Tax Act and as such it is charged on the taxable income of residents and non-residents of South Africa. Pre-determined rates of tax – differing according to the type of tax subject it applies to, i.e. a natural person or trust or company (including close corporations) – are applied to every tax subject's taxable income to arrive at an annual liability for income tax.

The framework within which a person's annual taxable income is calculated can be represented as follows:

	Gross income (s 1)
Less	Exemptions (s 10)
Equals	Income (s 1)
Less	Allowable deductions (ss 11-19, 23 *et al*)
Add	Taxable capital gains (s 26A, Eighth Schedule)
Less	Assessed loss brought forward if applicable (s 20)
Equals	Taxable income (s 1)

Plain to see from the above is the major importance of what constitutes the 'gross income' of a person. It is the pool of taxable rewards from which all allowable exemptions and deductions are subtracted in order to come to the amount on which income tax can and must be levied.

The definition of 'gross income' in section 1 of the Act reads as follows:

> ***"gross income"***, *in relation to any year or period of assessment, means–*
>
> *(i) in the case of a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or*
>
> *(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,*
>
> *during such year or period of assessment, excluding receipts or accruals of a capital nature...*

The definition then continues to give an extended list of items (receipts and accruals) which are specifically included in the definition of gross income, notwithstanding the fact that it may otherwise not have constituted gross income on account of the fact that it does not meet each of the defining criteria (components) of 'gross income'.

For purposes of the instant discussion, writer will be taking cognisance of neither the treatment of receipts and accruals of non-residents, nor any of the specific inclusions listed in the gross income definition. The particular scope of the matter dealt with herein will be limited to the interpretation and application of the following parts of the definition, namely:

- the total amount in cash or otherwise
- received by or accrued to or in favour of a person
- excluding receipts and accruals of a capital nature.

In order for an item of income (here used in layman's terms) to constitute 'gross income' in the determination of a tax subject's liability for income tax in South Africa, the above-mentioned criteria will all have to be satisfied. Even if only one is not met, the tax subject goes free, i.e. is not caught in the tax net.

Amounts in cash or otherwise

For a particular receipt or accrual to constitute 'gross income' in the hands of a tax subject it must be an *amount*. Seeing as the meaning of this term is not defined by the act, one has to turn to case law – i.e. identify the interpretation given it by our national courts – to ascertain its meaning and the ambit of its application.

One of the first cases decided on this topic was the 1926 decision of the Cape Provincial Division of the High Court in *Lategan v CIR*[2]. Judge Watermeyer, delivering a unanimous decision states at 19 that:

> *" "Income" … was what a man earned by his work or his wits or by the employment of his capital. The rewards which he got might come to him in the form of cash or of some other kind of corporeal property or in the form of rights."*

He continues to say that the word "amount" had to be given a wider meaning so as to encompass both receipts and accruals sounding in money (cash) as well as the value of every form of property (whether corporeal or incorporeal, including debts and rights of action) earned by the taxpayer, i.e. otherwise than in cash – *which had a money value*. (own emphasis)

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[2] *W H Lategan v CIR*, 2 SATC 16.

The Appellate Division first touched on this in a split judgment in 1933[3], Chief Justice Wessels, finding with the majority in that instance, enunciating his views as follows:

> *"The tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not money's worth or cannot be turned into money, it is not to be regarded as income (Tennant v Smith, 1892 AC 150; St. Lucia Usines Co v Treasurer of St. Lucia, 1924, 93 LJPC 212)."*

Several years later the court had an opportunity to revisit and pronounce on the interpretation of this part of the gross income definition once more, in the case of *CIR v People's Stores (Walvis Bay)(Pty)Ltd*[4]. Appeal Judge Hefer confirms the correctness of the judgment of Watermeyer J in *Lategan's case* and after finding authority (in three other cases of the court) for applying an extended meaning to the term *amount*, pronounces that "…*income in a form other than money must, in order to qualify for inclusion in the 'gross income', be of such a nature that a value can be attached to it in money*." The court then follows this up with the quoted extract from the *Delfos case* and concludes on this issue that as the debts which accrued to the taxpayer could be turned into money[5], it merited the inclusion thereof in gross income.

The next matter to be decided in this milieu was that of *Stander v CIR*[6]. The court at 623, with reference to *ITC 701*[7], remarks that Conradie J in

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[3] *CIR v Delfos*, 6 SATC 92.
[4] 1990 (2) SA 353 (A).
[5] *People's Stores* at 367.
[6] 1997 (3) SA 617 (C).
[7] (1950) 17 SATC 108.

last-mentioned matter rejected the argument that only benefits which a taxpayer can turn into money has a money's worth, on the grounds that a service which is available in the market place has a value attached to it by the market. Such market value would be the value of the benefit enjoyed by anyone availing himself thereof. The court (in Stander) furthermore rejected the submission of counsel for the Commissioner that in order to determine money's worth an objective value had to be placed on the award received by the taxpayer. The court finally concluded on this issue by finding that:

> *"Whatever it cost Delta, or whatever a person who wished to go on such a trip would have had to pay for it, does not constitute an amount which can be said to have money's worth in Stander's hands."*

The court therefore applied a subjective approach in determining whether the receipt in question had money's worth for the specific taxpayer. As it could not be encashed by him it was found not to constitute an amount.

In somewhat stark contrast hereto stands the majority decision of the Appellate Division in *Ochberg v CIR*[8]. In this case the taxpayer, being the sole shareholder of a company (except for 6 of the 5107 ordinary issued shares), was issued with a number of bonus/capitalisation shares as consideration for services rendered and for the use of premises. The taxpayer admitted that if the shares had been received by another person, it would have constituted income and could not have been a receipt or accrual of a capital nature.

[8] (1931) 5 SATC 93

The argument made by the taxpayer, however, was that he derived no benefit from this receipt and that there was therefore no (gross) income. The majority of the court's response hereto is found on 97, delivered by chief justice De Villiers:

> *"… in determining whether the amount is income or capital this circumstance [i.e. the presence or absence of any real benefit to the taxpayer] does not affect either the nature of the transaction or the nature of the value received. … any receipt constitutes income with the single exception of a receipt or accrual of a capital nature. … Whether and to what extent the person may have benefited by the receipt of the income is irrelevant…"*

And at 98:

> *"The fact is the law is not concerned with the amount of the benefit accruing to a person from a certain income. It is sufficient to determine that what the appellant has received is income and not capital."*

The two dissenting Appeal Judges, Wessels and Stratford, came to their decisions on broadly the same terms, namely that the appellant's estate had not been enriched by the transaction *in casu* and as a result it cannot be said that any amount has been received by or accrued to him. Both judges mention that the substance of the transaction has to be taken into account and not merely its superficial appearance. Appeal Judge Stratford indicated in no uncertain terms that the value or nature of the consideration given by the appellant for the issue of shares to him is wholly immaterial in the determination of whether an amount has been received or accrued to him. The learned judge felt himself bound to look at the real nature of the issue and its value to the appellant and surmised that he could not agree with the reasoning of the majority that the value of the issue has to be looked at in the abstract regardless of *its value to the recipient* (own emphasis).

Without entering into an at all lengthy or in depth discussion of substance over form, if this judgment is anything to go by, it seems clear that when considering whether an amount has been received by or has accrued to a tax subject, it is the *legal* substance of the transaction entered into and not the commercial substance thereof that is of importance. If the tax subject intends for a specific transaction to have effect according to its purport, it is not up to the court to enter into a complete exposition of the tax subject's individual financial position apart from the transaction itself in order to ascertain whether he has in fact been enriched by the transaction and if indeed, to what extent his estate has been increased.

It is submitted that the majority of the court in reality took a two tier approach in determining the amount received by the taxpayer in *Ochberg's case* and such approach can be enunciated in the following terms. Once it stands firm that there was a receipt or accrual, the first question to be answered is whether the receipt or accrual *in casu* is otherwise than in cash? Put differently, if what has been received by or has accrued to the taxpayer is not money, what is it that he has received? If a contractual right, then it is the *legal* substance or nature of that right that is of the essence.

The second tier of enquiry, once the first has been answered in the affirmative, would then be to place a money value on the non-cash receipt or accrual, if indeed the right received is of such a nature that a value can be attached to it in money. If the right or other non-cash receipt is incapable of valuation, the enquiry is halted at this second hurdle and no *amount* is received or accrues for purposes of 'gross income'. This being said, one is to bear in mind the finding of Hefer JA on 364 of *People's Stores* that although the valuation may be considerably complex, it does not detract from the principle that all income having a money value must be included. His further reasoning[9] then takes cognisance of the above postulated two tier approach alluded to by writer, namely that once it stands firm that a right has been acquired by the taxpayer, the value thereof has to be determined to arrive at *the amount* to be included in gross income.

In the determination of whether a receipt would qualify as an *amount* for 'gross income' and the value of such receipt, as well as in the later enquiry into the capital or revenue nature thereof, the consideration (the nature thereof) given by the tax subject in return for the receipt is of major importance. The receipt itself is consideration for the tax subject's rendering of service or the productive employment of his capital or his reward for a business or profit-making scheme carried on by him.

Received by or accrued to or in favour of a person

The second part of the gross income definition which is of particular relevance for the instant enquiry is the concepts of receipts and accruals. The wording of the definition is such that an amount is only to be taxed at the earliest of when it has been received by or accrued to the tax subject – if due weight is attached to the word *or* between the two taxing events. [The decisions of the Appellate Division in the cases of *Delfos*[10] and *SIR v Silverglen Investments (Pty) Ltd*[11] is authority for this interpretation.]

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[9] At 365.
[10] See footnote 3 above.
[11] [1969 (A)], 30 SATC 199.

Receipt, in our law does not envisage a unilateral receipt[12]. It has to flow from a bilateral agreement (contract) or other *obligationes causans* ("verbintenisskeppende oorsaak").

Certain bilateral or contractual receipts do however not constitute receipts for the purposes of 'gross income'. One such example, of some relevance to the present discussion, is the receipt of a loan. In the Appeal Court decision in *CIR v Genn & Co (Pty) Ltd*[13] a unanimous court finds that all loans (receipts thereof, that is) are essentially and necessarily of a capital nature (122 of the judgment). The court then elaborates on this finding by stating:

> *"I have grave doubts whether this argument does not fail at the outset on the ground that borrowed money is not received nor does it accrue within the meaning … of the definition of 'gross income' … It is difficult to see how money obtained on loan can, even for the purposes of the wide definition of 'gross income', be part of the income of the borrower … [123] At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed. … a borrowing, by its very nature, involves a correspondence between what is obtained and the obligation to repay or redeliver."*

[12] Huxham&Haupt, *Notes on South African Income Tax* [27th Edition] at 20.
[13] [1955 (A)], 20 SATC 113.

Whether the court intended for the above quoted passage to form part of its reasons for judgment (*ratio decidendi*) and whether the learned judge of appeal was merely expressing an opinion in passing (*obiter dictum*), writer is hesitant to conclude on. What has however been confirmed by the passage of time and through subsequent reliance on *Genn's case* is that this passage has been accepted as correctly reflecting the treatment of a loan receipt for the purposes of the gross income definition. When the court in *CIR v Felix Schuh (SA)(Pty) Ltd*[14] was again faced with the same question as in *Genn*, it found no difficulty in pronouncing that the loan and corresponding obligation to repay it have by themselves no fiscal consequences as the loan is a so-called 'neutral factor'.

This treatment of a receipt of loan capital was accepted as correct in the *Brummeria case* and can it therefore be regarded as one of the few places of secure footing with regards to the treatment also of interest-free loans in the hands of their recipients – as regards the receipt of the loan capital.

Accrual, on the other hand, (in simple terms) deals with *when* a right to a future receipt, can in itself constitute a gross income event. When an *amount* can be said to have *accrued to* a tax subject has been the focus of many a judicial pronouncement over the past century. These cases, most of which have already been referred to above, are that of *Lategan*, *Delfos* and *People's Stores*[15]. The first-mentioned case laid down the principle that the term 'accrued to or in favour of any person' meant *that* to which the person has become entitled. In *Delfos* uncertainty arose around what the correct interpretation was, as the court was divided

[14] [1994 (A)], 56 SATC 57 at 69.
[15] See Footnotes 2, 3 & 4 above.

around the correct meaning to be attached to this term. The majority however confirmed the correctness of the interpretation given in *Lategan*. There was thus some uncertainty as to whether the intended meaning of ‘accrued to’ was ‘has become entitled to’ or whether it rather had to be interpreted to mean ‘due and payable’.

Conflicting views prevailed until the advent of the third-mentioned decision, that of *People’s Stores*, wherein at last our Supreme Court brought finality by siding unanimously with the principle laid down in *Lategan*. Thus, accrual will take place at the earliest moment in time at which a tax subject has an unconditional entitlement to an amount in terms of whatever transaction. As soon as all conditions have been met it matters not that a specific debt may not be payable (claimable) at once – as it may be affected by a time clause allowing the tax subject to only take steps in recovery of the amount from a set date some time in the future.

Although the present value of an accrued debt, which only becomes payable at some future date, may be significantly lower than the face value thereof, the legislator subsequent to the *People’s Stores decision* inserted a proviso to the gross income definition, compelling tax subjects from that point forward to include those amounts to which they have become entitled to during a year of assessment at its face value.

Excluding receipts and accruals of a capital nature

As this part of the gross income definition was not dealt with in the *Brummeria judgment*, although a last gasp effort was made by the taxpayers to raise this point, the discussion of this part will merely be dealt with by writer in a cursory manner.

In general, receipts and accruals that are of a capital nature are not included in the calculation of a person’s gross income, except in so far as the Act compels the specific inclusion of such items in paragraphs (a) to

(n) of the gross income definition. All receipts and accruals of a tax subject fall into either of these two categories – it is either of a revenue nature or of a capital nature. In cases of uncertainty one of the well-known ways to determine what is income and what is capital is to ask what constitutes the tree and what is the fruit of the tree? In this analogy, of course, whatever can be classified or identified as the tree, i.e. the income-producing structure or business operations - that is capital. That which is identifiable as fruit of the income-producing structure or assets – such is income or of a revenue nature.

When it comes to determining the capital nature or otherwise of assets, the enquiry becomes slightly more involved. The best way to illustrate this is to take the example of a sale of residential property. Surely the proceeds from such a sale would make for a capital receipt? But what of the case where a person is involved in a business undertaking of which the main objective is the buying of and selling residential property at a profit, i.e. a property trader. Matters take on a different complexion in such cases as the person arguably would not hold the property merely as capital assets to realise at the highest possible gain. Rather, the property itself is its trading stock, bought and sold on a regular turn-over. In such person's hands the property would likely be of a revenue nature and the proceeds from its sale would constitute income.

It is therefore clear that the main determining factor in the enquiry into the nature of a particular receipt or accrual is the intention of the tax subject dealing with the asset. Factors that will be taken into account by a court in determining whether a receipt is of a capital or revenue nature is *inter alia* the taxpayer's testimony of his intention, seen in the context of the surrounding facts and circumstances, the length of time the tax subject has held the asset, the frequency of the tax subject's dealings in a particular kind of asset, the nature of the asset concerned, the nature of the tax subject's business and the reason for selling the asset.

2.2 Loan for consumption – the nature of the legal creature

Two types of loan are known to the South African legal system, namely loan for use (*commodatum*) and loan for consumption (*mutuum*). As is clear from the bracketed terms, both these manifestations of the loan concept have their roots in Roman law and would have been incepted into South African law via the 17th century Roman-Dutch common law.

The major distinction between the two types of loan contract is that in the case of a loan for use the borrower is obliged to return the exact same thing lent to the lender at the end of the loan term, whereas under a loan for consumption the object of the contract is some fungible thing, which the borrower is at liberty to consume. He is merely bound to return the same type of thing borrowed and of equal value.

Because of the particular nature a loan for consumption, the thing lent must be something with equivalents that consists of units which can be counted, weighed or measured. The most common example of such a loan is a loan of money. The legal content of a loan for consumption is that the lender both puts the borrower in possession of the thing, but also transfers ownership in the thing to the borrower, thereby legally entitling him to consume it.[16]

In the matter of *Cactus Investments v CIR*[17] the Supreme Court of Appeal, dealing with loans for consumption, said that as it "*… brought about that each borrower became the owner of the money received, the interest cannot be compensation to Cactus for the use of Cactus's money.*"

[16] Joubert, D.J. Loan. *The Law of South Africa*. Volume 15. First Reissue at 272.
[17] [1999 (A)], 61 SATC 43

Having already touched on the concept of interest, it is of the utmost importance for present purposes to acknowledge the fact that at common law a loan of money was gratuitous, subject to an exception, namely that the lender could stipulate, i.e. specifically contract (*accidentalia*) for the payment of interest. As such the interest obligation constitutes a reward for transferring ownership in his money to the borrower, at all times subject to the borrower's obligation (one of the *essentialia*) under the contract to return legal tender of the amount lent to him. The important point to be gathered from this exposition is that unless agreed to (i.e. contracted for), the lender has no right to claim interest from the borrower and the borrower is under no obligation to remunerate the lender in this manner. South African statutory law furthermore recognises this established common law principle. The exception to the preceding principle is so-called interest *a tempore morae* or *mora* interest, which starts to run from the time that a debt, being already due and payable has been demanded from the debtor and notwithstanding such demand, the debtor fails to discharge his indebtedness. This type of interest obligation can only be invoked in the particular circumstances mentioned and forms a statutory departure from the common law principles of interest entitlement. It is a penal measure and thus irrelevant for purposes of the present discussion.

To put into context then the interest-free loan – an interest-free loan is a consensual contract for the loan of money (a loan for consumption) to which no stipulation for interest has been added, either through the parties agreeing that interest will not be charged or by the lender not insisting thereon or by it merely not being dealt with in the contract of loan. Seen from the point of view of the borrower, he receives the lender's money without the added obligation of having to remunerate the latter for being bereft of a specific amount of money for the period of the loan contract. Seen from the lender's point of view, he has parted with his money, having transferred ownership therein to the borrower, and has no other rights, like a right to receive interest, other than the right to have an amount equal to the loan capital transferred to the borrower, repaid to him at the end of the period of the loan contract.

2.3 The treatment of interest-free loans in the hands of the borrower for purposes of the 'gross income' definition – *pre*-Brummeria

Prior to the decision of the Supreme Court of Appeal in *Brummeria's case*, it had been steadfastly believed that the receipt of an interest-free loan did, in general (i.e. not taking into account for example the specific provisions of section 7 of the Act and paragraph 2(f) and 11 of the Seventh Schedule of the Act), not have any adverse income tax consequences for the borrower. Subsequent thereto there are very few tax subjects and even their trusted advisers who have certainty about what to believe and how strongly to believe therein. This burning issue will be discussed in detail in Chapters 4 and 5 of this paper. The rest of the current chapter however will be dedicated to a discussion of the *status quo*.

The question to be answered therefore is whether the conclusion of a loan contract or the receipt of money on loan account constitutes or could give rise to an *amount, in cash or otherwise, received by or accrued to or in favour of the borrower/recipient*? And if answered in the affirmative, whether it would not constitute a *receipt or accrual of a capital nature*?

Firstly in this regard, the principle laid down in two previously cited cases, namely *Genn* and *Felix Schuh*, is of primary importance. As indicated above[18] it is generally accepted by the courts and therefore also by the

[18] Under the discussion of *Received by or accrued to* in 2.1.

tax public and the *fiscus* that the receipt of loan capital does not constitute a receipt or accrual for purposes of 'gross income'. This is so for a couple of reasons, namely that loans are of its nature essentially or necessarily a capital receipt and – probably the much more important reason – as the receipt is at all times coupled with the obligation to repay the amount so received. If it was to be included in gross income and assuming the repayment obligation was to be an allowable deduction, these two events would happen simultaneously, as the obligation to repay would be unconditional as of the moment of receipt.

In *Lategan's case* it was found that in order for a receipt or accrual otherwise than in cash to qualify for inclusion in gross income – being an *amount* – it must constitute the value of (every form of) property, whether corporeal or incorporeal, including debts and rights of action – which had a money value.

It is submitted that what should be evident from the above reference to the so-called *Lategan* principle is that in order for a receipt or accrual otherwise than in cash to constitute an a *amount*, capable of inclusion in gross income, it must firstly be property and secondly it must have a money value or it must be possible to attach a value to it in money. Jansen van Rensburg[19], addressing the concept of 'amount' in her article on this issue, is of a similar persuasion and deals in some detail with the meaning of property[20]. A person's "property" is determined by taking account of the subjective rights that he holds. The rights of a person that are of particular relevance in the context of 'gross income' are real rights

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[19] Jansen van Rensburg, E. Commissioner, SARS v Brummeria Renaissance (Pty) Ltd and Others: Does the Judgement Benefit an Understanding of the Concept "Amount"? *Stellenbosch Law Review*, 2008 1, 34 – 50.
[20] At 39 – 42 and sources cited there.

(*ius in rem*) and personal rights (*ius in personam*). Real rights include ownership of corporeal and incorporeal things, whereas personal rights are rights to a performance (such as to delivery or to some *ommissio* or *commissio*).

A person obtains personal rights (rights to performance) *inter alia* from contracts. In the case of a loan contract the borrower acquires a personal right to claim payment of the loan amount (for the lender to transfer the ownership in the money to him). At the conclusion of the contract such right would accrue to him, but the right would be encumbered with the obligation that on receipt of the loan capital he becomes indebted to the lender to repay to him an equal amount of money at the end of the loan period. This accrual would then be followed by the receipt of the amount/ownership of the money coupled with the repayment obligation. If this would have constituted an amount for purposes of gross income, such amount would only have been included in the borrower's gross income once, at the earliest of accrual or receipt.

As to the capital or revenue nature of a receipt of loan capital (whether interest-bearing or interest-free) it has to be said that in the majority of cases encountered in the market place, such a receipt – assuming for the moment that it could constitute a receipt at all for purposes of both the gross income definition and CGT (contrary to the *ratio decidendi* in *Genn*) – would constitute a capital receipt. If adjudicated from the point of view of the lender – who, in layman's terms, is in reality putting out his money at usury (i.e. he has a debt claim) – this right to repayment would constitute a capital amount if it is held as an investment by him. Similarly, the borrower receiving the loan moneys to conduct an outlay of his income-producing structure would be receiving it on capital account. As noted in the discussion above[21] it is important to note the nature of the performance (contractual obligation) of the borrower in return for which the loan has been given as consideration, if such exists, as this could impact on the revenue or capital nature of the receipt. However, many interest-free loans in commerce are not granted in exchange for something else (as consideration or a so-called *quid pro quo*) and should this complication not necessarily impact that heavily in practice.

Consider then what implications interest or rather, the absence of an obligation to pay interest would have in this context. If the loan was indeed interest-bearing, the probable treatment thereof would have been that the borrower would have been able to claim a deduction under section 11(a) of the Act for interest paid or payable. In other words the only effect the loan contract, coupled with the stipulation for interest, would have on the tax subject's calculation of taxable income is a deduction of an allowable expense (say in the amount of R*x*). He would of course have been able to do with the amount of loan capital as he pleased (seeing as he would have become the owner thereof[22]) and as a result something would probably be earned by him – included in gross income – whether in the same year of assessment or in some future year, although these earnings may not necessarily be identifiable and capable of being linked (causally) to annual interest expenses.

If on the other hand the loan is made to the borrower free of any obligation to pay interest at some agreed annualised rate on the outstanding amount of the loan, can it be said that an *amount (of a non-*

[21] Under the discussion *Excluding receipts and accruals of a capital nature* in 2.1.
[22] Bearing in mind the legal nature of a loan for consumption discussed above.

capital nature), otherwise than in cash has accrued to or has been received by the tax subject? Writer's unqualified (as yet) answer hereto would be a resounding 'no'. Merely looking at the effect thereof on 'gross income' should, in writer's view, in itself be adequate to dispel any uncertainty in this regard. The influence of an interest-bearing loan on taxable income is (refer paragraph above) negative R*x*. The influence of a loan free of the obligation to pay interest does not afford the borrower such a deduction against income, i.e. income is not decreased by an interest cost equal to R*x*, as the borrower has no such contractual obligation. Thus the interest-free loan has a zero annual influence on the calculation of the borrower's taxable income over the period of the loan contract. The matter will be developed upon throughout the course of this discussion.

At this juncture it is important to note that not all rights received by or accrued to a tax subject have a money value or merits an inclusion into gross income. So for instance where a company leases a building from the owner thereof the income tax implications is rather straightforward. The owner (or lessor) productively employs his capital to work for him, by giving a right of use thereof to the lessee at a monthly consideration in the form of rent. This rental income is then included in the lessor's gross income.

The treatment of the right of use received by the lessee has similarly been unchallenged to date. The receipt of the right of use, although undoubtedly received by the lessee – for if such right has not been legally transferred to the lessee under the contract of lease the lessee would be in unlawful occupation thereof and would not be able to defend an eviction application against it by the lessor – is either not included in the gross income of the lessee or if indeed included, is included at a value of zero. The lessee, under the contract also incurs a monthly obligation to remunerate the lessor for the right of use. This monthly rental is allowed as a deduction against the lessee's income to the extent that the property is used in the production of income.

If the lessor and lessee in the above example were to be companies in the same group and South Africa operated a system of accounting for tax on a consolidated basis, the net effect of the above postulation (for income tax) would have been zero. Similarly, it is open to the parties to – instead of entering into a lease agreement – agree to a loan for use (*commodatum*) whereby the owner places the building at the borrower's disposal and there is neither the right to claim remuneration for the lender, nor the obligation on the borrower to pay anything to the lender for the right of use. In such a case, surely the net effect for income tax would be the same as under the contract of lease, i.e. zero – no rental income, no rental expense and the receipt of the right of use by the borrower which is either not included in gross income or if so included, then at a zero value. Surely it could not be right to say that in the case of a loan for use the borrower is obliged to include as gross income an amount equal to a market related rental he would have been obligated to pay, but did not have to pay because the agreement was one of loan and not one of lease?

For the same token – if a loan is not interest-bearing (i.e. the lender has no contractual right to interest income and no interest deduction applies for the borrower), does the borrower receive or does there accrue to him an amount in cash or otherwise (i.e. property), not of a capital nature? As Jansen van Rensburg (2007:46) points out:

> *"The "benefit" of not having to pay interest is neither a personal right nor any other form of property. It thus cannot constitute an amount for purposes of the definition of "gross income", irrespective of whether or not it has value."*

Refer also to the discussion above of the decision of the Appellate Division in *Ochberg*[23] concerning the relevance of the benefit test for purposes of the gross income definition.

Under South African common law the charging of interest is not one of the *essentialia* of a loan of money, nor one of its *naturalia*. If thus not provided for contractually between the parties, no right (lender) and no obligation (borrower) ensue. There is also no such statutory obligation to pay interest, which the parties are allowed to contract out of, thereby affording the borrower a "right not to pay interest". This is plainly not the position in South African law and for this reason alone, the absence of an agreement regarding interest does not somehow translate into an amount of money received by or accrued to the borrower under a loan for consumption.

Viewed from a slightly different perspective, but still in keeping with the legal nature of a monetary loan, the borrower cannot be said to have a continuous right against the lender, entitling him to compel the lender to keep the loan capital at his disposal over the whole course of the loan period. If this had been so there may have been an argument to be made that this enforceable right to performance that the borrower holds against the lender has a money value and is therefore susceptible for inclusion in gross income – although this would still not resolve the anomaly regarding the double taxation that would result in the hands of the borrower (when comparing the interest-free loan to one bearing interest).

Rather, the position under our law is that by giving a loan for consumption the lender transfers ownership in the money (thus including all the

[23] Discussed under *Amounts in cash or otherwise* in 2.1.

competencies included in ownership) and in so doing dispenses with his only obligation under the contract, which is to give the borrower his money. Once parted with and received by the borrower, the lender has no more rights thereto. It has now become the borrower's money. Ownership in the amount of money has been transferred. The lender is left with a contractual right to receive an equal amount of currency at the end of the loan period. He receives this right at the moment of transferring his money to the borrower. It does however only become due and payable and thus enforceable (although unconditional from day one) at the end of the agreed loan period.

2.4 ITC 1791[24]

The controversial decision by the Supreme Court of Appeal in the *Brummeria Case* was preceded by the judgment of the Gauteng Income Tax Special Court in *ITC 1791*. The judgment of Goldblatt J, on behalf of the court (Mr I B Skosana was the Accounting Member and Mr M C van Blerck, the Commercial Member) confirmed the view held above regarding the treatment in the hands of the borrower, of a receipt of loan capital devoid of an interest obligation, for purposes of the gross income definition. The facts of the case (i.e. *Brummeria*) is of major significance, to a lesser extent for the Special Court decision, but certainly so for the conclusion reached by the SCA. It is also crucially important in the context of the discussion to follow and will it therefore be dealt with in some detail below.

The Appellants, Brummeria and two other private companies, were developers of retirement villages. During the years of assessment

[24] [2005] 67 SATC 230.

relevant to the appeal the appellants entered into agreements with potential occupants of units to be constructed in retirement villages. The provisions of the agreements, relevant for present purposes, were that the appellants obtained interest-free loans from occupants (to finance the construction of retirement units), in return for or as consideration for which the appellants granted to the lenders lifelong occupation rights to the units, although ownership of the units remained with the appellants at all times. In addition hereto the parties agreed that the appellants would be obliged to repay a specific loan upon the earlier of cancellation of the agreement or the occupant's death.

The Commissioner initially assessed the appellants on their net loan receipts for the relevant year of assessment. These assessments were withdrawn only to be replaced by revised assessments. The basis of the latter was that a benefit had been received by the appellants, namely the right of use of interest-free loans, which benefit constituted an amount otherwise than in cash that was taxable as 'gross income'. The Commissioner determined the (annual) value of the amount identified by him by multiplying the average amount of loan capital held by the appellant by the average market related interest rate (prime overdraft rate) for that year and subjected it to tax in the relevant years.

The appellants' grounds of objection (such as is relevant for this discussion) were that they had not received any amount for the purposes of 'gross income'. The salient grounds of assessment in the Commissioner's statement in terms of the tax court's rules, were the following:

*"In the case of a developer conducting a housing scheme for retired persons, the **capital** of the developer is the **property units**. The property units are **employed** in its business by either:*

***selling** the units under sectional title to the purchasers; or*

granting the use *(occupation) of the units to the occupiers by way of selling life rights to the occupiers.*

The ***quid pro quo*** *which the developer received in return is, respectively:*

the ***selling price*** *obtained from the purchasers, in respect of the disposal of the units under sectional title; or*

the ***benefit of the rights to interest free loans*** *obtained from the occupiers, in respect of the disposal of the life rights to occupy the units.*

The benefit received in exchange for the provision of occupation rights ***has an ascertainable money value*** *and accordingly falls within the definition of "gross income" of the Act."*

The court, after citing the gross income definition, referred to the *Lategan principle*[25] and the affirmation thereof in the *People's Stores case.* The court's ruling on the issues to be decided is found in paragraphs 12 through 15 of the judgment. The gist of their finding can be summed up as follows (actual wording of the judgment in quotation marks and italicised):

The court found that the Commissioner's assessment was based on notional income which does not fall to be included in gross income. According to the court the *"rights"* allegedly obtained by the appellants were not rights capable of transfer or cession. The inference to be drawn from the fact that the court found it necessary to denote the word "rights" in quotation marks is that they were not of the opinion that the notional

[25] Paragraph 8 of the judgment.

benefit sought to be taxed by the Commissioner were indeed rights in the ordinary meaning of the word, writer submits.

The court's views on the legal nature of a monetary loan[26] do not in all respects accord with writer's exposition thereof in 2.2 above, but the court did remark that the *"[p]ossession of money cannot in itself earn income as it is merely an income producing tool which may be used by the possessor to earn income but need not be so used. What the Commissioner has attempted to do is to treat the opportunity to earn income as income."* In paragraph 15 of the judgment the court accepts on the basis of the decision in *Genn* that the obtaining of loan capital constitutes a receipt, although of a capital nature.

With regards to the absence of an interest obligation the court expressed the opinion that if such an aspect of a loan makes it more valuable to the borrower, this would merely affect the potential *utility* (i.e. usefulness to earn income in the future) of the capital receipt in his hands, but does not in itself increase gross income. The court then develops this point to make it clear that a low interest rate or no interest would have the effect of making the borrower's future taxable income higher than it would have been, had the loan been interest-bearing at all or if it had borne interest at a higher (market related) rate.

On these premises the court found in favour of the appellants and set aside the assessments by the Commissioner.

Writer does not find it useful to express an opinion on the correctness or otherwise of the tax court's decision as, so it is submitted, it is not

[26] See paragraph 13 of the judgment.

material to the focus of this paper (it is arguable, though that these principles could still find application in later cases). Also, as the income tax treatment of the receipt of an interest-free loan has been dealt with comprehensively elsewhere[27], such opinion would not at this stage add anything of value to the discussion.

2.5 Conclusion

It is submitted that the correct treatment of a loan of money and of the presence or absence of an agreement regarding the payment of interest (or an agreement that no interest will be charged, for that matter) in the hands of a borrower has to be evaluated within the wide, though strict confines of the gross income definition. This is undoubtedly so as the ground principle for the interpretation (and thus the application) of fiscal legislation enunciated in the case of *CIR v George Forest Timber Co.*[28] and alluded to in the *Delfos case* (at 253) must be accepted as sound:

> *"… if the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be."*

In the case of a receipt or accrual otherwise than in cash, such as a debt or right, the legal substance or nature of such right is of crucial importance in determining the taxability of the receipt. When dealing with

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[27] See 2.3 above.
[28] 1924 AD 516 at 531.

an interest-free loan, the absence of an obligation to pay interest, cannot be said to translate to the *receipt or accrual of an amount otherwise than in cash* for gross income. The fact that the tax subject will not have an allowable deduction (interest expense) to diminish his taxable income for a particular year of assessment means that the net amount of his taxable income will – taking a pragmatic view – already be higher in the amount of the interest deduction unavailable to him. In such circumstance he will therefore already be effectively taxed on the absence of an obligation to pay interest on the loan.

With the above in mind and the treatment of the Income Tax Special Court of the *Brummeria*-facts dealt with, writer will in the following chapter proceed to do a critical analysis of *Brummeria* with a view to determine its true *ratio decidendi* (i.e. its power to bind subsequent cases).

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3 CHAPTER 3: A CRITICAL DISCUSSION OF THE BRUMMERIA CASE - extracting the *ratio decidendi* in order to determine the likely scope of application

3.1 The *Brummeria judgment*

The matter of *C:SARS v Brummeria Renaissance (Pty) Ltd*[29] came before the SCA on appeal from the Johannesburg Tax Court's decision in *ITC 1791* (as discussed above). The court's decision on the issues of critical importance to the focus of the present discussion, span the whole of 12 paragraphs[30].

Firstly, as indicated above, it has to be stressed that the factual setting of the case is of the utmost importance in adjudicating on how the judgment is to be interpreted as well as what the ambit of its application is likely to be. The facts of the matter having been dealt with in the aforegoing chapter, writer now moves to discuss the court's findings pertaining to the application of the law to those facts.

Cloete JA, delivering a unanimous decision of court, started off by pointing out that the Commissioner did not seek to tax the actual receipt of loan capital and expressed the court's opinion that such receipt cannot be seen as a receipt for gross income purposes, citing the cases of *Genn* and *Felix Schuh* in support of this finding. It would therefore be safe to accept, writer submits, that the court has hereby confirmed that the receipt of a loan of money is excluded, not merely on the basis of its apparent capital nature. It fails the test on an earlier hurdle, namely the receipt-accrual part of the definition.

[29] [2007] SCA 99 (RSA), 69 SATC 205.
[30] See paragraphs [8] to [19].

The court identifies the right that the Commissioner sought to tax as "the right to retain and use the loan capital, interest-free", which right, so the argument went, had an ascertainable money value and which had accrued to the companies.

In order to give effect to one of the tax court's rules of court, which Brummeria ("the appellants") had failed to comply with, the court refused to hear a belated attempted argument by the appellants that the right the Commissioner had assessed was of a capital nature.

In paragraph [9] of its judgment the court came to the crisp issue, which is also the focal point of this paper. It denotes this issue as being *"whether the rights to use the loans interest free constituted '**amounts**' which '**accrued to**' the companies*". The court confirmed the correctness of what was said by the courts in *Lategan*, *People's Stores* and *Cactus Investments* in so far as it laid down the interpretation to be given the above two parts (expressed in bold) of the gross income definition.

As early as paragraph [12] of the judgment, the court pronounces on the issue to be decided. Its finding in this regard reads as follows:

> *"… the right to retain and use the borrowed funds without paying interest had a money value, and accordingly [ ] the value of such right must be included in the companies' gross incomes for the years in which such rights accrued to the companies."*

The rest of the judgment (that part of it relevant to the issue under discussion) is devoted to the court's reasoning for the decision it came to.

The very first assertion made by the court was that the making of an interest-free loan constitutes a continuing donation to the borrower – conferring a benefit on him. As authority for this statement the court cited the case of *CIR v Berold*[31]. Berold's case was of course decided in the context of legislation similar to the current section 7(3) of the Act. The taxpayer in this case had sold a large number of valuable assets on credit and furthermore did not charge any interest on the purchase price. According to the court the taxpayer in effect lent the purchase price to the purchaser (borrower) and stated that *"… as long as he refrained from compelling Luzen to repay that sum, there was a continuing donation by him to Luzen of the interest on that loan."*

It is submitted that the above quoted extract, as it was expressed in the sphere of section 7's deemed income rules, should not find any application in the context of the gross income definition, to determine whether an amount has been received or has accrued to a borrower of an interest-free loan. In any event, it seems that the main purpose of the court's reference to *Berold* was to make the point that the failure on the part of the lender to charge interest on a loan could be construed as a benefit in the hands of the borrower. This may or may not be found to be so in a given set of facts and circumstances under section 7(3).

The court then took somewhat of a leap in its reasoning. From having just asserted that the absence of an interest obligation could be a benefit, the immediate next conclusion reached was that in the modern commercial world a right to retain and use loan capital interest-free is a valuable right. What to writer's mind was not considered is the interim question, namely whether this "right to retain and use loan capital interest-free" is a right

[31] 1962 (3) SA 748 (A), 34 SATC 729.

which constitutes *property* in the hands of the appellants (in accordance with the *Lategan* principle).

As discussed at length in the previous chapter, not every right or receipt of a tax subject will necessarily constitute an amount otherwise than in cash, i.e. a right which must be included in gross income. It does not go without saying that if a certain contractual obligation is not laid on a tax subject, that such absence of an obligation constitutes a subjective personal or real right in his hands. Even more so, writer submits, if such obligation is something which would not exist except if the parties called it into life by contracting therefore, as in the case of interest on a loan, where neither the common law nor statute compels the charging of interest on a loan of money.

Having accepted that the right the Commissioner sought to tax was a right such as necessitates inclusion in gross income, the court turned to the second leg of the *Lategan* principle – whether the right has a money value or is of such a nature that a value can be attached to it in money.

The court considered the appellants' submission that the rights assessed by the Commissioner could not be turned into money and could therefore be distinguished from the court's decision in *People's Stores*. This submission was based on the Cape High Court's decision in *Stander*. In dispelling their argument the court found that the question whether a receipt in a form other than money has a money value is the primary enquiry and its susceptibility to be turned into money is but a way of coming to an answer to the primary question.

The court thus affirmed the approach adopted in the *Ochberg case* regarding the nature of the test for the valuation of rights (i.e. receipts otherwise than in cash). Granted, the question in the last-mentioned case was slightly different from the issue in *Brummeria*. That court was faced with an argument that the taxpayer did not derive any benefit from the share rights received and consequently had not received *an amount*. As was the case in *Brummeria*, the court in *Ochberg* came to the conclusion that an objective test had to be applied to determine whether the receipt of a right had a money value. If, because of the appellant's specific circumstances, the right would have little value in *his* hands (in economic terms) or if he was unable to convert it into money, such considerations would be of no consequence to the enquiry of the court.

Stander's case was accordingly rejected and the principles formulated therein held to be incorrect in so far as it contradicted the court's findings. For the same reasons the *ratio* of Conradie J's judgment in *ITC 701* was found to be the correct interpretation of the law. The court, still in dealing with the basis for the taxability of receipts and accruals otherwise than in cash, then quoted a statement by Hefer JA in *People's Stores* in support of its findings. The relevant part of the quotation reads:

> *"It is hardly conceivable that the Legislature could not have been aware of, or would have turned a blind eye to, the handsome profits often reaped from commercial transactions in which money is not the medium of exchange. Consider, for example, the many instances of valuable property changing hands, not for money, but for shares in public or private companies; or share-croppings agreements, dividends in the form of bonus shares, or <u>remuneration for services in the form of free or subsidised housing</u> and the use of motor vehicles. These are only a few of the many possible illustrations that readily come to mind and which, as we know, have not been overlooked by the Legislature."*

In dispelling the appellants' argument that the above underlined phrase should be interpreted to mean that only benefits falling within the provisions of paragraph (i) of gross income and the Seventh Schedule to the Act, are taxable, the court formulated its answer as follows:

> *"Those provisions were inserted into the Act not because such benefits are not otherwise taxable, but to put beyond doubt what benefits are taxable and, equally important, to determine how their value is to be assessed for the purpose of calculating the tax to be deducted by an employer from an employee's remuneration."*

Having agreed with the Commissioner's submissions and rejected those of the appellants, the court then shifted the focus of its reasons for judgment to the contrary findings made by the tax court *a quo*. The SCA rejected the finding that the Commissioner had assessed the appellants on notional income. The court remarked[32] that the appellants were assessed on the basis of the benefit inherent in the right to use the loans *without having to pay interest on them* (own emphasis). According to the court no double taxation would arise if the appellants had invested the loan monies to earn an interest yield, as in such a case two separate receipts or accruals of gross income would result.

3.2 The *ratio decidendi*

It is important to determine whether the SCA's judgment in the *Brummeria case* has developed the law relating to the interpretation of the phrase *an amount otherwise than in cash received by or accrued to* a person. And if so, to what extent has it done so and what would be the ambit of its application.

In order to come to definitive answers with regards to the above-mentioned, one needs to first establish what parts of the judgment amounts to *ratio decidendi* – the court's reasons for judgment – and which are merely *obiter dicta* – comments made or views expressed by the court in the course of its reasoning but which does not relate directly to the decision come to on the issues addressed by the court. The *ratio decidendi* would usually be binding on later court cases dealing with the same questions of law, except if such later cases are distinguishable on its particular facts. This binding power of decisions of higher courts on cases heard in lower courts is referred to as the principle of *stare decisis*. The *obiter dicta* of a particular judgment however do not have any binding power over lower courts. Hence the importance of distinguishing clearly between the two.

Writer does not consider the court's assumption that the right *in casu* was necessarily a 'right' for purposes of gross income, as one of its binding pronouncements. This matter was not argued before the court at all. Neither was it addressed specifically by the court in its judgment. It therefore remains an issue open for argument in any future case. Writer will discuss this issue in some more detail below[33].

The first point that the court specifically decided upon was whether the right *in casu* had an ascertainable money value or was capable of being valued in money. Writer submits that pinning a monetary value on an accrued right will be possible in most cases. This would be the case an account of what was said in *People's Stores* with reference to *Lace Proprietary Mines Ltd v CIR*[34], namely that although the valuation may sometimes be a matter of considerable complexity, this would not detract from the principle that all income having a money value must be included in gross income. Further authority for the above assertion is the *ratio* of the courts' findings in the cases of *Ochberg* and *ITC 701*. Finding a monetary value for the accrual of a right of a revenue nature will henceforth be an objective enquiry. Thus, even if the only valuation

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[32] At paragraph [18].
[33] See 3.3 below.

available is the value of a right in the open market, this would be a sufficient method of valuing the specific right in question.

As Van Blerck puts it on the second page of his analysis of the judgment[35]:

> *"Once the SCA overlooked the key point in (a)* [whether the arrangement constituted a right accruing to Brummeria]*, the answer to point (b)* [whether that right was capable of being valued in money] *was a slam dunk. Since the only serious contention before the SCA was the determination of the ascertainable money value of the apparent interest-free 'right', and since SARS came up with a calculation acceptable to the judge, and which was not disputed by the taxpayer, that was that."*

To amplify this point even more, *Brummeria* has now once and for all done away with what was previously perceived to be a requirement for a right to qualify as gross income, namely that the taxpayer had to be able to turn into money the receipt or accrual in question. *Stander's case* and *Delfos* to the extent that it could be interpreted to hold a view contrary to the accepted principles laid down in *Lategan, People's Stores* and *Cactus Investments*, have been overruled and should no longer be able to assist tax subjects in this regard.

Brummeria has arguably not done anything to extend the accepted interpretation of the term *accrued to or in favour of* in the gross income definition.

The part of the judgment relating to paragraph (i) of 'gross income' and the Seventh Schedule of the Act, it is submitted, does not strictly form

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[34] 1938 AD 267 at 279-81.
[35] *Brummeria Case – Some Observations*. Discussion notes delivered at the South African Fiscal Association seminar, Cape Town, 20 November 2007.

part of the *ratio* of the decision as it did not bear either directly or indirectly to the question of law to be answered by the court. Even if it was possible to establish an indirect link between the remark of the court in this regard and the decision to which the court ultimately came to on the issues before it, it is further submitted that such link is remote to such an extent that it would not be binding on a court dealing with the same issues in a subsequent case.

The most controversial statement of the whole judgment, in writer's opinion, is found in paragraph [12] thereof and reads as follows:

> *"Indeed, it can hardly be doubted that, in the modern commercial world, a right to retain and use loan capital for a period of time, interest-free, is a valuable right."*

Whether this statement can be said to be part of the *ratio decidendi* or not, is not wholly clear to writer's mind. Were it not for the court's rather circumspect introduction to the remark, i.e. *"Indeed, it can hardly be doubted that,…"*, it might have been less difficult to determine whether this statement is part of the *ratio* of the decision. For one, respected tax expert and senior counsel, David Meyerowitz, is of the opinion that this pronouncement by the court does not form part of the *ratio decidendi* of *Brummeria*[36]. Writer respectfully supports this view. The question whether the alleged right sought to be taxed by SARS was indeed a 'right', in the sense of *an amount otherwise than in cash* necessitating inclusion in gross income (see *Lategan's case* with regards to which non-cash receipts and accruals would constitute an amount for gross income[37]),

[36] *The Taxpayer*. Editorial - Brummeria: How much of the judgment is stare decisis and how much obiter dicta?. Volume 57(4), April 2008 at 62.
[37] Discussed in previous chapter under 2.3.

was not one of the issues in dispute and as the court was not requested or obliged to rule thereon, writer submits that the above controversial quotation does not form part of the court's findings and/or reasons for judgment.

The other line of reasoning which caused somewhat of a disturbance to writer's mind was the SCA's answers to the tax court's findings. These pronouncements were in effect an application by the court of its own reasons for the decision it came to on the issues, to certain conclusions reached by the tax court. These *dicta* do therefore not have the strength of *stare decisis*, but will nonetheless be available to litigating parties in future when in need of authoritative ammunition to dispel of the issues of notional and double taxation in a factual setting similar to that of *Brummeria*.

3.3 A critical discussion of the SCA's decision in the *Brummeria case*

Before coming to a discussion in the next chapter of what the likely impact of the Brummeria judgment would be on the income tax treatment of interest-free loans in the hands of the borrower, it would be prudent to take a critical look at the SCA's decision as a whole. The purpose herewith is to highlight what writer perceives to be the most crucial matters to bear in mind in determining the ambit of the judgment's impact.

Drawing on the discussion in the previous chapter regarding the legal nature of loan for consumption – the contract type that the South African monetary loan belongs to – as well as the interpretation given to the respective parts that make up the 'gross income' definition, the following remarks are of key significance:

- The SCA did not venture into an enquiry into whether the rights on which the Commissioner based his assessments indeed constituted rights that are susceptible to inclusion in gross income.

It should be borne in mind that the appellants did not raise this as an issue to be decided upon by the court. Had they done so, the decision may have been substantially different.

- The court would then have had to take cognisance of the fact that in a contract for the loan of money, which is governed by the common law, the borrower in reality becomes the owner of the monies lent at the moment of receipt thereof. Included in the right of ownership is, amongst a host of other competencies, the basic freedom of every owner of a thing to do with or use the thing (in this case money) as he/she pleases. In the case of a loan of money no separation exists between ownership and rights of use enjoyed by the borrower. Take for example the case where someone acquires ownership of a residential property. Included in his ownership right is the competency to make use of his property. If he should choose to live in it, i.e. use it as his place of residence, such use would not have any fiscal implications for him. If however on the other hand he should choose to employ the property in his residential letting business, concluding a lease contract with a tenant who remunerates him for the right of use, he (the owner) would be taxable on the rental income received.

- Without employing his capital in the above-mentioned manner, the owner would not be open to an attack from the Revenue on the basis that apart from receiving ownership in the property (most likely a capital receipt), he has also received a further benefit, namely 'the right to use the property as his place of residence without having to pay any rental'. There is only one receipt by the owner – he receives the right of ownership in the property. Included therein are all the competencies intrinsic to or inherent in ownership. As owner he can use, alienate, destroy or do nothing with his property.

- In the same manner the recipient of loan capital becomes owner thereof. There is no separate, further receipt at some other point of a right to use the loan. As owner of the money he has the right to use it and this competency was included in the receipt of the loan capital, which the SCA in Brummeria acknowledged is not a receipt for the purposes of gross income. Bearing this in mind, writer submits that the critical part of the right identified by the SCA, namely *the right to retain and use the borrowed funds <u>without paying interest</u>*, is not the first part, but indeed the last (underlined phrase). It is the fact that the taxpayer did not need to pay interest on the borrowed funds which caused the receipt to be a taxable one, allegedly falling into the gross income of the appellants.

- As discussed in the previous chapter, there rests no obligation on a lender – neither in the common law, nor from statute – to charge interest when lending out money. If the parties to a loan contract therefore agree that the loan would not be interest-bearing, they have merely stated the default position, because if they did not have an agreement with regards to interest, the law would have imputed to their arrangement the same consequences. A loan of money, which does not make provision for the charging of interest, would be non-interest bearing (interest-free).

- Writer finds it difficult to accept that if an obligation, which would not otherwise have been present (or part of an agreement at all) had it not specifically been contracted for, were to be absent from a contract of loan, how this could automatically translate into the *receipt* of a *right* by the borrower of *an amount* equal to that which he would have been obliged to pay had he been obligated to pay it[38]. No doubt, seen in the context of a capitalistic commercial world, the terms of such agreement would be seen to be to the benefit of such borrower. But such benefit, which is based on the absence of the obligation to pay interest, it is submitted by writer, would not necessarily equate to the *receipt* of a *right* for the purposes of 'gross income' by the borrower[39].

- The critical view taken by writer in the above two bulleted points deals with matters not argued before and thus not specifically addressed by the SCA, but they are nonetheless crucial in coming to a definitive understanding of the merits and scope of the SCA's decision. As the SCA's enquiry was based on the assumption that there was a right for purposes of the gross income definition, which right accrued to the appellants – such receipt being a receipt for the purposes of 'gross income' – their enquiry really only commenced thereafter. Writer therefore agrees with the court's reasoning from that point on and thus with the finding of the court on the facts, although writer does not necessarily agree with the income tax treatment ultimately afforded to the appellant borrowers.

3.4 SARS: Draft Interpretation Note[40]

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[38] For support for this view see Van Blerck *supra*, page 2.

[39] For the meaning of 'right' and 'property' in this context see the discussion relating to the *Lategan case* under 2.3 above.

[40] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) – THE RIGHT TO USE LOAN CAPITAL INTEREST-FREE*. October 2008. SARS, Legal and Policy Division.

During October 2008 the Revenue authority issued a Draft Interpretation Note with regards to the *Brummeria Case*, the focus of it being the correct treatment of 'the right to use loan capital interest-free' for purposes of the definition of 'gross income' in section 1 of the Act. On page 2 of the draft note[41] SARS gives its interpretation of what it perceives to be the *ratio decidendi* of the judgment. It singles out the following principles:

- the case is authority for the proposition that the right to use loan capital interest-free *has a monetary value*. Writer has already aired his views on this issue in the critical discussion of the decision (in 3.3 above);

- although the right *in casu* cannot be alienated or turned into money, such state of affairs does not negate the fact that the right has a money value. An objective, not subjective, test should be applied to determine whether the receipt has a money value and if so, what the value of the receipt is. The case of *Stander* on this point was overturned;

- the principles enunciated in the cases of *Lategan*, *People's Stores* and *Cactus Investments* were confirmed to correctly reflect the interpretation of the law;

- it is not necessary that a benefit of this nature fall within the provisions of paragraph (i) of 'gross income' in order to render it taxable.

[41] Under point 3.

In point 4[42] the Revenue concedes that the judgment of the SCA in *Brummeria* did not specifically deal with (and can therefore not be cited as authority):

- whether the accrual in question was of a capital nature,
- the timing of the accrual; and
- the valuation method applied by the Commissioner.

3.5 Conclusion

The discussion undertaken in this chapter has borne out the binding principles to be gathered from the *Brummeria judgment*. These principles, which are a mixture of the court's findings on the issues brought before it for decision and the reasons given by the court for coming to such findings (the *ratio decidendi*) have power to bind lower courts by virtue of the application of the maxim *stare decisis*. The extent of the application of these principles is a matter of interpretation. How to interpret the decision of the SCA has been the topic of many a discussion between tax experts and has also been addressed in multiple articles and papers by commentators and practitioners. In the next chapter of this discussion writer will endeavour to draw the lines around the likely range of the judgment's application.

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[42] On page 3.

4 CHAPTER 4: The impact of the binding principles of the Brummeria case and the application thereof to selected interest-free loans (and consequent treatment – *post*-Brummeria)

4.1 Introduction: Manifestations of the interest-free loan

The main and most important question that needs to be answered following the decision of the SCA in *C: SARS v Brummeria Renaissance (Pty) Ltd*, is how it is to be interpreted and what its likely scope of application will be. How wide-ranging is its impact going to be?

Various commentators and experts in the field of tax practice have over the course of the past year braved the uncertain waters to stake their views of this particular matter. In coming to an ultimate conclusion of his own, writer will now endeavour to put forward the opinions expressed by some of the leading minds of the South African tax practitioners' fraternity. Most of the opinions expressed can be grouped into two wide 'schools of thought' regarding the implications of the *Brummeria case*. On the one hand there are those who believe (or who fear) that it is an 'in principle' decision, capable of wide import and applicable to the whole range of interest-free loan transactions encountered in practice. On the other hand there are those who are of the opinion that the decision has to be confined to its own particular set of facts and that it would only be applicable to cases with a similar factual and contractual setting.

Whatever the correct interpretation, one thing both schools of thought hold in common, namely the concern regarding how (to what extent, if at all) the principles coming out of the judgment in *Brummeria* will impact upon the most common manifestations of interest-free loans in commercial transactions. Will the Revenue attempt to apply these principles on a wider scale?

Some of the types of interest-free loans regularly observed in practice that require consideration in view of the judgment, are the following:

Loans between family members: Most notably these include borrowings flowing from a father to an adult child. The underlying motives for such loans are usually the offering of financial assistance to enable the child to set up a business or to further develop an existing one or to fund an academic education. In other circumstances it might purely be a measure to maintain the child during a time of personal financial difficulty or to finance a basic necessity, e.g. the acquisition of a primary residence or motor vehicle.

Shareholder loans or loans by members to a close corporation: This application of the interest-free loan is a well-known and highly popular mechanism used by business men in the small business milieu to capitalise their businesses. This method of funding business operations is regularly preferred above taking up equity in the enterprises concerned as it represents a much less cumbersome way to in future extract funds out of the business. In the case of equity, the business owner as shareholder of his company or member of a close corporation is confronted with stringent company law rules to either repay capital or declare dividends and is hit by an extra taxing charge in the form of either secondary tax on companies ("STC") or dividends withholding tax ("DWT"). Although this method of funding corporate operations is contra-productive in a sense for the Receiver of Revenue (on account of the foregone potential STC or DWT), it is nonetheless widespread in practice and accepted by Revenue. Its use is usually a welcome stimulus to commercial growth in South Africa, which in the long run should translate to a stronger economy and higher levels of aggregate taxable business profits.

Interest-free loans by the founder/donor of an *inter vivos* trust: It is often encountered in practice that the founder of a trust would transfer a valuable asset (e.g. shares or immovable property) out of his personal estate to the trust on loan account. Alternatively, the founder would transfer monies, i.e. make a loan for consumption to the trust in order to capitalise the trust and for it in return to invest the money in order to grow its income earning capacity.

Intra-company interest-free loans (between group companies): The use of interest-free loans or loan accounts to transfer holdings or assets between companies forming part of the same corporate group is a further common occurrence. Group holding companies often extend interest-free loans to operating subsidiaries to strengthen their capital structure in order to expand their business operations. Other popular reasons for extending an interest-free loan in this milieu are to provide ad-hoc financing to enable the subsidiary to acquire some or other critical asset / business enterprise or during an initial loss making period of a new venture.

With the exception of the two mentioned examples of interest-free loans creating an income tax liability at the moment of transacting for the loan, i.e. situations covered by either section 7 of the Act or paragraph (i) of the gross income definition read with the Seventh Schedule of the Act, interest-free loan transactions (including the above-mentioned four categories) had up until the decision in the *Brummeria case* not attracted any adverse fiscal consequences.

As Spring[43] notes, with reference to tax adviser, Costa Divaris:

> *"Under the income tax law there is no provision deeming interest to accrue on such a loan* [i.e. an interest-free loan]*. Nor does such loan involve a donation for donations tax*

[43] Spring, M. 1998. A most effective tax-saving strategy. *Business Times.*

purposes. Specific legislation would be required to change this position, whose validity is widely accepted."

To draw nearer to a conclusion regarding whether the judgment in *Brummeria* will have the effect of upsetting the views held above, the two 'schools of thought' which have developed around the scope of its applicability will now be examined with reference to its major exponents.

4.2 The 'in principle' school

Ernest Mazansky, Tax Director at Werksmans Tax is of the view[44] that even though the right to use interest-free loan capital would, in the normal course, give rise to an amount accrued, it should in the majority of cases be excluded from gross income on the basis that it constitutes a receipt of a capital nature. Mazansky's view therefore seems to be in favour of an application of the *Brummeria* principles to all interest-free loans, but so he argues, this would usually only lead to tax in the borrower's hands if the loan had been granted as *quid pro quo* for the supply by borrower of goods, services or other similar trade facility.

Professional services editor for Business Day, Sanchia Temkin, in an article posted during October 2007[45] relays the views of University of Kwa-Zulu Natal tax expert, Bob Williams, who is reported to have said that the judgment in *Brummeria* did not lay down a rule that all interest-free loans would give rise to a tax liability for the borrower. According to Williams an income tax liability will only ensue if the interest-free loan is a benefit of a revenue nature to the borrower, for example where it is

[44] See page 2 of his article: Mazansky, E. To which extent is an interest-free loan taxable? October 2007.
[45] Ruling proves interest-free loans still a taxing issue. *Business Day.* 9 October 2007.

received in the course of carrying on a business or in the course of a scheme of profit making.

Professional services firm, PricewaterhouseCoopers, aired a view in their monthly tax publication, Synopsis, for October 2007. The following extracts are of relevance[46]:

> *"The Brummeria judgment does not lay down a blanket rule that an interest-free loan is always a taxable benefit in the hands of the borrower." … It is submitted that the presence or absence of a quid pro quo for the loan is not the critical issue. What is decisive is whether the benefit in question* [the value of the right to have the use of the money without paying interest] *is of a revenue or capital nature."*

The article later on refers to the double taxation which would result in the hands of the borrower by applying the *Brummeria* principle and as a result a plea is made for a distinction to be drawn between an interest-free loan received as remuneration for the supply of goods or services and those received without consideration.

Cilliers[47], on page 185 of his article, remarks that the *ratio* of the case appears to lie largely at the level of principle as it was not really dependent on the peculiar facts of the case and further[48]:

> *"… To those who (like me) see in Brummeria an in-principle decision rather than one that can readily be confined to its*

[46] Quoting from page 4 of the publication.
[47] Brummeria Renaissance: The Interest free Cat among the Borrower Pigeons. *The* Taxpayer, Volume 56(10), October 2007, 184 – 189.
[48] At 189.

own facts, its impact, at first blush at least, appears to be almost incredibly far-reaching."

In *Taxation Principles of Interest and other Financing Transactions*[49] the editor refers to the views aired by Ernst & Young National Technical Director, David Clegg, namely that there was no apparent technical reason why the principles established in the *Brummeria case* should not be applicable to all forms or arrangement, both commercial and private.

4.3 The '*quid pro quo*' school

Silke[50] discussing barter and exchange transactions[51] says that where an asset is exchanged for another, the value of the new asset would be gross income if the old asset was held as trading stock and as so long as the new asset constitutes an amount received or accrued with a money value. On 2 – 23, in discussing the facts of the *Brummeria case*, the assertion is made that the life-long right to occupation was the *quid pro quo* for the continuing making of the loan. Although technically unsound with regards to the ongoing making available of the loan and legal nature of a loan for consumption, this source is of the view that the arrangement in *Brummeria* was one of exchange and that the tax liability of the borrower arose as a result of the parties' specific arrangement to this effect.

Temkin, in the same article referred to above[52], reports the opinion of Anton Kriel, tax director of BDO Spencer Steward. Kriel remarks that the facts resulting in the judgment were very specific and that they clearly

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[49] Brincker, TE. 2008. A-1 – A-22. Issue 5. LexisNexis at A-15.
[50] De Koker, A.P. *Silke on South African Income Tax.* Electronic version. Updated June 2008.
[51] At § 2.16.
[52] Refer footnote 45 above.

indicate a barter transaction had been entered into between the parties. Consequently, Kriel is of the view that a loan without a *quid pro quo* would be safe from any income tax liability.

Van Blerck in his analysis of the implications of *Brummeria* remarks that SARS is likely to attempt to tax interest-free loans where there is a clear *quid pro quo* for the loan and such *quid pro quo* appears to be a receipt of a revenue nature in the hands of the borrower.

Professor Henry Vorster[53] airs the view that *"… the Court did not establish any new principle or approach to interest-free loans."* According to him the factual and contractual (*quid pro quo*) circumstances distinguishes it from other interest-free loan transactions (most notably those listed above by writer). Vorster takes his point further by noting that even if there were an income tax relevant benefit derived by a borrower from an interest-free loan, such benefit would be of a capital nature.

Professor Emile Brincker holds the opinion that the reach of the SCA's judgment[54] is not as extensive as initially anticipated by many. According to Brincker the case is quite fact specific on account of the *quid pro quo* for the granting of the loan and would thus not be readily applicable to all interest-free or low interest rate loans.

4.4 SARS: Draft Interpretation Note[55]

In point 5 of their draft note the Revenue authority gives their views as to the ambit of application of the binding principles from the SCA's decision

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[53] *SAFA Brummeria Seminar*. Discussion notes delivered at the South African Fiscal Association seminar, Cape Town, 20 November 2007.

[54] To which extent is an interest-free loan taxable? October 2007. Available: http://www.problemsolved.co.za/newsletter/briefs/tax Oct07IntFree.html

[55] See 3.4 above.

in *Brummeria*. Their **first assertion** is that the judgment will find application where benefits in a form other than money are granted in exchange, i.e. as *quid pro quo*, for goods supplied, services rendered or any other benefit given. It thus confirms that where an interest-free loan is given as consideration for the revenue earning activities of a borrower – whether it be the selling of trading stock or the rendering of a service – the receipt of the interest-free loan will result in an amount accruing to the borrower.

SARS **furthermore** concedes that the use of the weighted average prime overdraft rate in order to determine the value of the right to use loan capital interest-free is not necessarily the most appropriate method of calculating the value of such right. They specifically indicate that:

> *"Each case should be evaluated on its own merits and all facts and circumstances … should be taken into account in the valuation."*

SARS did not want give any guidance or lay down any guidelines with regards to the timing of the accrual as regards interest-free loans generally and merely state that it should be determined in accordance with the general principles of our law, having due regard to the facts and circumstances of each individual case.

More important is SARS's pronouncement on the application of the *Brummeria* principles in the context of loans between group companies and loans by shareholders to their companies. In this regard SARS remark that these loans may only be affected by the *Brummeria case* to the extent that the interest-free loans are received in exchange for (thus as *quid pro quo* for) services rendered or goods supplied by the borrower to the lender. In the opinion of SARS these loans will mostly be granted in a capital context and would therefore not be hit by the judgment.

4.5 Conclusion

The SCA's decision in the *Brummeria case* has the potential to find application in the widest possible sense, that is, to all interest-free loan transactions encountered in the market place as well as in the private sphere. The main reason for the risk of this potential across-the-board application is the fact that the wording of the SCA's judgment is couched in such general terms that it is difficult to justify the limitation thereof to the very specific factual bounds within which the decision was delivered. As a result, any enquiry into the correct or most likely interpretation of the judgment becomes an equally difficult task. One's interpretation of the judgment would of course furnish one's evaluation of the ambit of its application.

It is therefore no wonder that the taxing fraternity finds itself divided on this issue, as clearly observed from the expert opinions cited above[56]. The division centres around the question of whether the judgment could be or should be confined to its own particular facts or if there is scope to apply it to all interest-free loans.

The major problem for all tax subjects and practitioners – with regards to the application of *Brummeria* to interest-free loans in general – is the court's statement in paragraph [12] of its judgment, which reads:

> *"Indeed, it can hardly be doubted that, in the modern commercial world, a right to retain and use loan capital for a period of time, interest-free, is a valuable right."*

If it is accepted that this statement is part of the court's *ratio decidendi*, then, writer submits, *Brummeria* could have a major impact on interest-

[56] See 4.2 and 4.3.

free loans in general. It would then be difficult to argue – accepting that the ‘right to retain and use loan capital interest-free’ could be a separate *right*[57] received by or accrued to the borrower of an interest-free loan – that such *right* does not accrue to all tax subjects borrowing money interest-free.

One would be able to make an argument at such point that the *Brummeria case* was decided in the context of a *quid pro quo* of a revenue nature being given by the borrower, in return for which he received the interest-free loan. This should be a strong argument and writer is inclined to agree with the experts who espouse it, especially in the light of the revenue authority’s Draft Interpretation Note – which adds more weight to the argument. An addition, it would be possible, in certain circumstances, to argue that the borrower’s receipt or accrual is of a capital nature.

In the discussed above[58] writer has given his considered opinion of what constitutes the *ratio* of the judgment and is writer for the most part in agreement with the binding principles identified by SARS in their Draft Interpretation Note[59]. Notwithstanding his previously expressed misgivings, writer will accept, for purposes of the discussion to follow (and to take a conservative approach), that the quoted extract from the case (above) is indeed one of the decided binding principles of the case. In applying the principles stated in the Draft Interpretation Note to the four classes of ordinary or every day interest-free loans, namely shareholder loans to companies, inter-company loans in a group, loans within a family

[57] For writer’s rejection of this argument see 3.3 above.
[58] See 3.2 and 3.3.
[59] See 3.4 above.

context and those made to *inter vivos* trusts, writer draws the following conclusions:

The first principle, namely that 'the right to use loan capital *interest-free* has a monetary value' ("the right") will only have an impact if in a tax appeal against an assessment by SARS on this ground, the Commissioner would be able to prove that the right does indeed have an independent existence from the granting of the loan/receipt of (the ownership in) the loan capital. And even then – if the tax subject is hit by this principle – a further argument can be made that although such right exists independently from the ownership rights in the loan capital, which right has a monetary value, such right cannot be said to have been received by or accrued to the tax subject, as the absence of an obligation to pay interest does not automatically translate to a receipt or accrual in the hands of the borrower. The latter argument would be much weaker once the former has fallen. The last resort would be (as discussed above) to argue that there is no *quid pro quo* situation present in the tax subject's set of facts and circumstances and/or that the accrual is of a capital nature.

The second principle – how to ascertain whether a receipt or accrual has a money value – would of course have an adverse impact on the borrower of an interest-free loan who is assessed on this basis. No longer is an argument available to a tax subject that no money value exists to the extent that the right in question cannot be turned into money. *Brummeria* has arguably overturned *Stander* in this regard and confirmed that the test for placing a value on a receipt otherwise than in cash is an objective one (per *Ochberg* and *ITC 701*). There may however be room for an argument that the value of a right may be less if it cannot readily be turned into money.

The third and fourth principles[60] would not have an impact on the income tax treatment of a borrower of an interest-free loan as the third amounts to a mere confirmation of the interpretation of the law as it stood prior to *Brummeria* and the fourth is not applicable to it.

Writer is therefore of the opinion that such binding principles (i.e. SARS' interpretation of the *ratio decidendi* in the *Brummeria case*) would only have the effect of bringing every day interest-free loan transactions into the sphere of taxability to the extent indicated above.

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[60] Refer two bullet points on page 48 under 3.4 above.

5 CHAPTER 5: Arguments against a possible SARS-attack on the basis of Brummeria

In the above chapters writer has investigated and drawn conclusions regarding some of the most contentious issues that have been plaguing the South African tax world since the advent of the SCA's judgment in the *Brummeria case*. Writer has expounded and established his opinion on how amounts otherwise than in cash which may have been received by or accrued to a particular tax subject are to be treated in the context of an interest-free loan receipt (which is of course not a receipt for gross income purposes[61]) and in the light of the principles enunciated by the court in *Brummeria*.

The question however still beckons as to what a tax subject, hit by an assessed by SARS on the basis of the principles laid down in the judgment, will be able to argue in order to successfully avert such an attack. The answer hereto is two-fold. The size and weight of the tax subject's arsenal will depend on the gravity of the attack launched against it, i.e. whether the assessment to tax is based on a limited scope interpretation of the judgment or rather a wide-ranging application of the judgment.

5.1 Limited scope attack

In the first instance it may be the case that SARS assesses the tax subject on the basis that its factual and contractual circumstances mirror the position of the companies in the *Brummeria case*.

For purposes of the discussion, the following example will be used:

[61] See discussion above with reference to *Genn* and *Felix Schuh*'s cases under *Received by or accrued to or in favour of a person* in 2.1.

Company A made an interest-free loan available to financially struggling Company B (assume that a possible group relationship is irrelevant for present purposes). In return for the loan, Company B (e.g. a retail clothing store) rewarded Company A with a right – a first option to buy Company B's business as a going concern if the interest-free loan proves to not have the desired effect of lifting Company B out of tumultuous financial waters. Assume for present purposes that the option price would be such that a benefit more or less equal to the interest-free benefit would apply to the lender. The loan was made in 2004 and was for an amount of R1,000,000. Company B's financial year-end is 28 February.

In March 2005 the Commissioner assessed Company B for tax on the loan capital receipt from Company A. Company B objects to this assessment, citing the cases of *Genn* and *Felix Schuh* as authority that this receipt is not a receipt for purposes of the 'gross income' definition. The Commissioner accordingly withdraws the assessment.

During November 2008 Company B receives a revised (additional) assessment for income tax from the Commissioner. The assessment states that Company B has received amounts otherwise than in cash, which is the right to use and retain the loan capital without having to pay interest thereon. This benefit, so the grounds of assessment read, was received in exchange (i.e. as a *quid pro quo*) for the supply by Company B to Company A of a first option to purchase the business of Company B if they should decide to sell it.

Based on the principles laid down by the SCA in the *Brummeria case*, SARS argues that the benefit received by Company B has a money value which has accrued to Company B on an annual basis in an amount equal to the calculated value determined by multiplying the outstanding loan amount with the weighted prime overdraft rate of banks. The calculation is therefore: R1,000,000 X annualised overdraft rate, for each year of assessment, i.e. 2005 – 2008.

Writer assumes for present purposes that the parties agree that the *Brummeria case* finds limited application – i.e. only to *quid pro quo* situations. Writer further assumes that the controversial statement in the case, referred to above, is part of the case's *ratio decidendi* and is binding on the tax subject. What arguments can be advanced in an appeal against a rejected objection to the assessment?

Firstly, the tax subject would be well advised to take cognisance of the principles that stand firm, i.e. which cannot be disputed as the *ratio* of the Brummeria case has dispelled therewith. These can be summarised as follows:

- There is a non-cash right (i.e. property for purposes of gross income) to interest-free funding.
- The right can be valued in money, has an ascertainable money value.
- The right has accrued to the company in consideration (exchange) for – i.e. as *quid pro quo* for – the right of first option to purchase the business of Company A. (There is therefore no doubt that Brummeria applies.)

The arguments to be made on behalf of the company could be the following:

In the **first instance** it would be prudent to challenge the timing of the accrual to the company. Thus, not disputing that there was an accrual of a right to the company, but rather arguing that such right accrued once and for all to the company on receipt of the loan capital. The basis of such argument would be the legal nature of a monetary loan. As discussed in chapter 2[62] the only obligation that a lender has in terms of a loan of money, is to transfer ownership in the money to the borrower. By transferring the ownership in the loan capital, it transfers all the rights or competencies that make up the bundle of all-encompassing rights that comprises 'ownership'.[63] Once it has performed in accordance with this obligation it has no further obligations to fulfil in terms of the agreement.

By taking cognisance of the lender's obligations in terms of the contract it is clear that there cannot be an annual accrual of a right (the right to use and retain loan monies interest-free) to the borrower as its rights under the contract are merely the flipside of the lender's obligations. Its rights can therefore not be more than or different at all for that matter from the lender's obligations. To put it slightly differently, the borrower has received all the competencies included in the bundle of rights comprising ownership, the right to retain and use the loan capital as well, at the point in time when he received the loan capital.[64]

If this reasoning were to be accepted it should stand on firm ground that the right in question has accrued in full to the borrower at the date of receipt of the loan capital, that is at the very beginning of the contract term or loan period – in 2004. The company would then be in an excellent position to argue that the Commissioner is precluded from raising all of the assessments (for each of the years of assessment from 2005 to 2008) by virtue of the fact that it has prescribed in terms of section 79(1) of the Act. The company's argument is not that it had not received the

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[62] Under 2.2.
[63] *The Taxpayer*. Editorial - SARS v Brummeria: An economic disaster. Volume 56(9), September 2007, 161 – 163 at 163.

right that the Commissioner is seeking to tax. Rather, its argument is to the effect that it received the right in the very first year of assessment, for which the Commissioner's right to assess has prescribed, as explained hereunder.

Section 79(1) dictates that the Commissioner shall not be allowed to raise an assessment if more than three years have elapsed since the date of the (original) assessment. The period can only be extended if the taxpayer was the cause for the Commissioner missing his deadline, by making himself guilty of fraud, misrepresentation or non-disclosure in connection with the amount sought to be taxed. As the last-mentioned three circumstances are assumed not to be present in this case and seeing as *Brummeria* specifically confirmed the application of section 79(1) in a case similar to the example under discussion, the company should have a strong case to successfully appeal against the assessment.

A **second argument** to be advanced on behalf of the taxpayer in these circumstances is that the valuation by the Commissioner of the right in question was wrong. To quote Meyerowitz in this regard (delivering a critique on the decision in *Brummeria*):

> *"… an objective valuation of the right would have to take into account the fact the right carried with it the obligation to provide the lender with a life right, there would, in our opinion, have been no escape from the conclusion that the value of the right would be the difference, if any, between the market value of the use of the capital and the market*

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[64] Also discussed in *Taxation Principles of Interest and Other Financing Transactions* at A-14, with reference to the views of Van Blerck, M C.

value of the right of occupation during the existence of the loan.”[65]

Mazansky[66] remarks in this regard that the value of the benefit is dependent upon the usefulness thereof to the borrower. According to him, in circumstances where the loan is repayable on demand or on short notice, the value of the benefit would necessarily be considerably less in the hands of the borrower. There is certainly merit in this view and an argument along these lines, if the particular loan terms allowed for it, would be a useful defensive weapon in the arsenal of a beleaguered borrower.

Cilliers also draws attention to this issue in his article[67] and notes that the prime overdraft rate may not be the rate at which the borrower would have been able to attain financing in the market – had he not been lent the funds at zero interest. The fact is that the borrower may have been able to obtain financing in the market at a rate several basis points below the prime overdraft rate of banks, meaning that borrowing at zero interest would not have a value to him which relates to the difference between the prime rate and a zero interest rate. Cilliers refers to this way of valuing the right as the ‘cost saving’ approach.

It is likely that the above argument will be challenged by Revenue, namely that the *Brummeria case* has confirmed the principle enunciated in cases like *Ochberg* and *ITC 701* that the determination of the value of a non-cash accrual follows an objective test, not a subjective one. This may be the case, but a better market equivalent would still be to look at

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[65] At 162.
[66] Refer footnote 44 above.
[67] Refer footnote 47 above.

the best interest rate a person of the same credit (risk) profile as the company concerned would be able to fetch in the market. It is a specific company who is receiving the alleged right. It is a specific company that the Commissioner seeks to assess to income tax. It is submitted therefore that only in the case where no other valuation of the specific right is available or possible, or if the parties are unable to agree over the valuation, should an unrelated market equivalent be looked at to find a value for the right *in casu*.

The more objective approach advocated by Cilliers is a so-called 'investment opportunity' approach. Such approach would seek to value the right accrued to the company with reference to the interest rate which the company would have received had it invested the loan capital in an interest-bearing investment. Although this approach differs from the one applied by the Commissioner in the *Brummeria decision*, it is arguably more defensible as it is likely more objective, rendering ineffectual and ruling out subjective factors such as the creditworthiness of the company whilst still providing a fixed benchmark in the market, available to and thus applicable to all tax subjects.

A **third possible argument** available to the company is that the right accrued is of a capital nature. In an exchange situation the supply in return for which the tax subject has received the non-cash right is of critical importance in determining the nature of the receipt. The company (B) supplied the lender (A) with a first option to buy its business. Writer has difficulty in seeing how this supply could fit into one of the established moulds of revenue activities such as capital productively employed, the carrying on of a business, carrying out a scheme for profit-making or a supply of trading stock. If of course the business of Company B was to trade in businesses and rights thereto, the position may be different. But in the specific factual and contractual circumstances Company B, it is submitted, would be able to present a strong argument that the receipt or accrual is of a capital nature, notwithstanding the fact that it was obtained as a *quid pro quo*.

All three of the above-mentioned arguments were not brought before the court (at all or timeously) in the *Brummeria case* and consequently the court did not have an opportunity to rule on them. SARS specifically mention these issues in their Draft Interpretation Note and furthermore specifically address them therein.[68] SARS's comments in this regard seem to try and accommodate the taxpayer on all accounts and if either one of the arguments expounded above were to be adopted in factual circumstances similar to that in Company B's case, it would arguably be looked upon favourably by the courts.

5.2 Absolute defence

A situation may present itself where a shareholder makes an interest-free loan to its private company with the intention of capitalising, e.g. to give it a financial boost to fund the expansion of the latter's business operations. For the same token a father may make an interest-free loan to his son to enable him to buy a flat or car. Another example could be where a holding company makes funds available to its operating subsidiary, without charging interest on the monies advanced. In these cases (writer assumes) there is no reciprocal performance formally required of the borrowers.

What arguments could such a private company, son or subsidiary offer in defence to an assessment by the Commissioner on the basis that there has accrued to it a right to retain and use borrowed funds on an annual without having to pay interest thereon? This accrued right, so the assessment reads, constitutes an amount for 'gross income' purposes as it has an ascertainable money value.

As most of the arguments in defence have already been raised and expanded upon by writer to a greater or lesser extent in the discussion above – and have been endorsed by various sources as authority for the views held – the following discourse will be undertaken with as little as possible reference to authority.

The **first argument** to be advanced by the tax subject in one of the circumstances alluded to above, would be that the right sought to be tax is not *an amount otherwise than in cash* for the purposes of 'gross income'. The basis for this argument is the basic legal nature of a loan of money (loan for consumption). A loan of money does not carry an automatic stipulation for interest. If the parties to the loan contract fail to contract for interest to be paid on the monies lent or it they agree that the loan will not be interest-bearing or if the lender unilaterally decides not to charge interest on the loan capital – In all such cases, interest will not be due. There is nothing in the common law, which determine the legal nature of the contract and the parties' reciprocal rights and duties, or in South African statutory law which prescribes the charging of interest on a monetary loan.

Lategan's case found, in relation to the term *amount* in the gross income definition, that it had to be understood in a wide sense – to include both cash receipts, as well as *"every form of property earned by the taxpayer, whether corporeal or incorporeal, which had a money value … including debts and rights of action."* Where in the case of an interest-free loan, as is under discussion at present, a borrower receives loan monies (a non-receipt for 'gross income') and such agreement is void of an agreement regarding interest, writer submits, borrower does not receive a 'right' (in

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[68] Refer points 4, 5.1.1, 5.1.2 and 5.3 of the Draft Interpretation Note.

the sense of ‘property’)[69] to use the loan capital without having to pay interest thereon. The agreement is merely silent as to a potential obligation that could have applied, but does not necessarily have to be laid upon the borrower. It has not received any right or benefit as no right or benefit was ever called into existence to be given or transferred to the borrower. If this argument was to be upheld by the court to which the tax subject directs its appeal, it would have successfully objected to the assessment raised upon it and could the enquiry be halted at this very early stage without the need for further examination.

Apart from the benefit not being a right and hence not an amount, the above argument also has the potential to operate on another level of the gross income definition, namely the receipt/accrual level. If the right sought to be taxed is not one which legally exists, how can it be received by or accrue to the tax subject? Also, in dealing with receipts and accruals, the argument can further be made, based on the particular legal nature of a loan for consumption, that the right to use loan capital cannot accrue to a borrower on an annual basis.

In a loan for consumption the lender transfers ownership in the monies lent to the borrower. The borrower, as owner of the money from that point onwards, has all the competencies or freedoms of any owner to do with its property as it pleases. Included in the transfer of ownership in the loan capital is the right of the owner to use the money. This competency of ownership is not separate, independent or divisible from ownership in this context and it is clearly not correct in law that the lender transfers all the benefits of ownership to the borrower, except the right to use the money.

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[69] Refer discussion under 2.3 above.

For the above-mentioned reasons the right to use the money does not accrue to the borrower on an annual basis. It receives it as part of becoming owner of the money at the moment the loan capital is transferred to it. Because the lender has at such point done away with all its obligations in terms of the contract, there is no continual obligation on it to make the loan capital available to the borrower on a continuous basis for the duration of the loan period.

The thrust of the above arguments can be well illustrated by way of the following example:

Mr X buys a house A from Mr Y. He thus becomes the owner thereof. The contract between the parties stipulates that Mr X is obliged to supply Mr Y with a house of equal size and value (house B) in 12 months time. For the 12 month period following Mr X's acquisition he lives in house A. He is not expected to include in his gross income a right equal to the economic value or benefit of not having to pay rent on the house. Why not? He does not acquire the right to use the house because it is his house and the right to use it is his. Also he is not obliged to pay rent to Mr Y, because Mr Y is not obliged to charge him rent, although it may be possible for the parties to agree that Mr X pays Mr Y an amount of money monthly – to be used by Mr Y to obtain accommodation for himself over the 12 month period – while Mr Y waits to receive his own house to live in (house B) from Mr X. This illustration, though not likely to be an arrangement commonly entered into, writer submits, is a true reflection and comparable of the legal relationship between a lender and a borrower under a loan for consumption and also gives a perspective on it being interest-free.

Should both of the first two arguments fail, the borrower will have to accept that there is an *amount*, because the decision in *Brummeria* was clear in its rejection of *Stander's case* and confirmed that the valuation of a right involves an objective test. There is thus no room for an argument that the right has no money value as it is not possible for the borrower to turn it into money.

Writer has already dispensed with three other arguments, namely that of the timing of the accrual, the valuation thereof and whether it is of a capital nature. Writer is not of the view that the binding principles enunciated in the *Brummeria judgment* would only be applicable in the case where there is a *quid pro quo* for the receipt of the interest-free loan, but it however seems probable that SARS would only want to invoke the principles established in the case in the *quid pro quo* milieu[70] as the four manifestations of interest-free loan transactions indentified, could arguably prove to be of a capital nature.

5.3 Conclusion

Throughout the course of the above discussion writer has endeavoured to show, and submits, has been able to successfully establish that in the case of a borrower of interest-free loan capital, there exist strong grounds on which to defend an assessment for income tax on the basis of the *Brummeria judgment*.

Both in the case of a limited scope application of the principles in *Brummeria* as well as instances of a wide-ranging application thereof, tax subjects should have sound, reliable cases to put forward in defence of assessments based thereon.

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[70] Especially in the light of their Draft Interpretation Note.

6 CHAPTER 6: CONCLUSION

The discussion above has attempted to address the following aims:

The first objective sought to be met by writer through the course of this discussion was to establish what the correct or at least the accepted income tax treatment of interest-free loans in the hands of a borrower, has been up until the decision of the SCA in *Brummeria*. Writer has shown this treatment to be dependent on and predicated upon the specific legal nature of a contract for the loan of money – a type of the legal figure 'loan for consumption' or *mutuum*.

The conclusion reached in this regard is that an interest-free loan, would *in general* not have any adverse income tax consequences for the borrower. Such conclusion has been confirmed by the Johannesburg tax court's decision in the appeal that preceded the SCA judgment.

The discussion above has further attempted to draw a conclusion or conclusions regarding what parts of the SCA's decision in *Brummeria* could be said to represent the binding principles of the case. An in depth study was undertaken of the judgment and a conclusion was reached with regards to which statements of the court formed part of its *ratio decidendi* and which were mere *obiter dicta*. Writer also took clear cognisance of the opinion communicated by the Revenue authority[71] regarding their interpretation of the case and what they perceive the binding principles enunciated therein to be. It was concluded in this regard that the binding principles of the court's judgment were not as severe and as far-reaching as was originally feared by many. Rather, the severity of the judgment hinged upon whether the most controversial statement in the judgment formed part of the binding pronouncements of the court. Writer's conclusion was that this statement did not fall within the court's *ratio decidendi* and does not have the strength of *stare decisis*.

Once the binding power of the judgment had been identified, writer conducted a study into the likely ambit or scope of the *Brummeria judgment's* application to other interest-free loans – those encountered most often in commercial and private transactions. The opinions of various tax experts were consulted and it was revealed that two broad schools of thought had developed among the ranks of the leading tax experts and commentators in the country. Some saw in the *Brummeria judgment* an 'in principle' decision, whilst others were adamant that it would be confined to factual circumstances equivalent to those prevailing in the case itself. Practitioners propagating the second view were convinced that the judgment would only find application in circumstances where the interest-free loan was received as *quid pro quo*, i.e. as consideration for or in exchange for, some supply by the borrower which is of a revenue nature. SARS's views in this regard were also alluded to.

Writer, although not committing himself to one of the crystallised broad opinions did draw a conclusion with regards to the potential impact of the binding principles of the case on interest-free loans in the hands of a borrower in general. It was found that the impact of the case on these loans may arguably be minor, as the factual circumstances in *Brummeria* was one of the strongest factors leading to the ultimate taxability of the benefits flowing from the receipt of the loan without having to pay interest thereon. As most of the commonly encountered interest-free loans in practice are not couched in such a factual situation, it should prove unaffected by the Brummeria case.

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[71] By way of Draft Interpretation Note released during October 2008.

In the final instance writer sought to identify which arguments could be available to a particular tax subject who has been or could be assessed for tax by the Revenue Authorities on the basis of the *Brummeria judgment*, in order to successfully object to such assessment. Assessments based on two different interpretations or applications of the case were considered – one a limited scope application and the other a wide-ranging application of the judgment, whereby the Commissioner would seek to tax any interest-free loan. The arguments advanced drew on principles articulated by writer throughout the course of this paper and it was concluded that in both scenario's, but especially so in the case of a wide-ranging attack, the borrower involved would be able to make a strong case, either to have the assessments set aside altogether or to have them significantly reduced or adjusted because of timing and/or valuation issues.

Writer believes that the above discourse has reached the aims set therefore and has come up with meaningful answers in relation to the implications of the *Brummeria Renaissance case* for those interest-free loans encountered most often in the commercial world, such as inter-company loans and shareholder loans to a companies, as well as in the private sphere, i.e. loans between family members and from the founder to an *inter vivos* trust. The conclusions reached throughout the course of the discussion has shown that fears regarding the potentially devastating implications of the judgment for the borrower in an interest-free loan transaction are not necessarily founded on sound legal doctrine and that a prudent understanding and application of the law should in many cases safeguard a borrower assessed for income tax on strength of the *Brummeria case* from being hit by an income tax liability.

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