THE VALUATION OF AMOUNTS FOR THE PURPOSE OF INCLUSION IN GROSS INCOME

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DECLARATION

I hereby declare that this dissertation is entirely my own work.

Signed: .....

Date: .....

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Abstract

The present research investigates the valuation of amounts for the purpose of inclusion in gross income. Because the gross income definition in section 1 of the Income Tax Act includes "amounts in cash or otherwise", valuations are often required in order to establish a value in money terms for amounts received or accrued in a form otherwise than in cash. The basis on which these valuations are made can vary and the courts have frequently been called upon to decide on the correct method of valuation.

There has been an ongoing debate in the courts as to whether a strict objective approach or a more flexible subjective approach should be adopted when valuing an amount in a form other than cash, which was finally settled in the decision by the Supreme Court of Appeal in *CIR v Brummeria Renaissance (Pty) Ltd*, which held that an objective approach must be followed. The present research will demonstrate how the strict rule of interpretation tends to result in purely objective valuations as it requires that the ordinary grammatical meaning of words be applied and does not allow the court to consider the purpose of the legislation or introduce any subjectivity based on the circumstances of each individual taxpayer and the facts of each particular case, which a purposive interpretation approach does. The purposive approach to interpretation is therefore more closely aligned with the subjective approach to valuation. Both the objective and subjective approaches to valuation have advantages and disadvantages, which are addressed in the research.

The need for certainty in taxation was articulated as early as 1776 by Adam Smith in his *Wealth of Nations*. The objective approach appears to create a level of consistency as all income received by a taxpayer is effectively taxed as if received by a third party in an arm's length transaction. The approach has led to unfair decisions at odds with economic reality and generally accepted accounting principles, which could be challenged on the basis of a lack of equity and fairness as required by the Constitution of the Republic of South Africa. The research demonstrates that an objective method of valuation is neither fully objective nor appropriate in certain circumstances, while a subjective approach may be more appropriate as it ensures that each taxpayer's individual rights are protected. Although the subjective approach successfully addresses the issue of fairness, it threatens to introduce an unacceptable level of inconsistency and is, in reality, not always administratively feasible. The present research concludes that a trade-off between fairness and consistency is often necessary.

Key words:

valuation, gross income, literal, purposive, objective, subjective, equity, fairness, consistency

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CHAPTER 1: INTRODUCTION

1.1 Context

For an amount to be subject to taxation in South Africa it must first satisfy the requirements of the definition of "gross income" in section 1 of the Income Tax Act 58 of 1962 (hereinafter referred to as "the Income Tax Act".) The definition provides as follows:

> In relation to any year or period of assessment, in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, or, 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 terms of the gross income definition are not expressly defined by the Income Tax Act and thus the courts have often been called upon to give meaning to the definition. In order to be included in "gross income", there needs to be "an amount in cash or otherwise". Due to the fact that not all amounts to be included in gross income are received "in cash", valuations are required for tax purposes in many circumstances in order to establish a value in monetary terms. The basis on which these valuations are made can vary and the courts have frequently been called upon to decide on the correct method of valuation. Legislators have also recognised the existence of a problem with the valuation of an amount in a form other than cash and this was evidenced by the introduction of paragraph (i) into the definition of "gross income", together with the Seventh Schedule to the Income Tax Act to provide guidance for the valuation of employment benefits provided in a form other than cash.

There has been ongoing debate in case law concerning whether a strict objective approach or a more flexible subjective approach should be adopted when valuing an amount in a form other than cash (*Ochberg v Commissioner for Inland Revenue* 1931 AD 215, 5 SATC 93, *Commissioner for Inland Revenue v Lydenburg Platinum Ltd* 1929 AD 137, 4 SATC 8, *Lace Proprietary Mines v Commissioner for Inland Revenue* 1938 AD 276, 9 SATC 349, *Stander v*

Commissioner for Inland Revenue 59 SATC 212, (C), 1997, *Commissioner for Inland Revenue v Butcher Brothers (Pty) Ltd* 1945 AD 301, 13 SATC 21, *Commissioner for the South African Revenue Services v Brummeria Renaissance (Pty) Ltd and Others* (2007) SCA 99 (RSA); 69 SATC 205.)

According to Goldswain's (2008), interpretation, in the context of fiscal legislation, is the cornerstone on which revenue authorities can assess and collect taxes and correspondingly is the foundation on which a taxpayer's rights are built. Taxing statutes merely lay down the general principles to be applied and thus the responsibility falls on the judiciary to interpret those provisions and apply the law in a way that is sensible and pragmatic. D'Ascenzo (2008: 384) quoted the Review of Business Taxation where, in discussing the function of the judiciary, it was stated that:

> The judicial system therefore has an important role in the interpretation, development and application of the taxation law. Judges do not merely interpret the tax law. They are seen to create the working law, case by case. Accordingly, judges have a critical influence in the system of working tax rules and the construction of many detailed provisions. Their constructions are important to the integrity of the tax system and its base and to the development of key tax concepts.

Williams (1978) expresses the opinion that tax law is very complex, as opposed to other general law and is highly specialised both in nature and legislative process. The Income Tax Act is described by Williams as a series of somewhat unrelated enactments which are extremely detailed and frequently amended. Income tax legislation consists of a number of provisions which overlap, intersect and occasionally appear to contradict each other. Because the Income Tax Act itself is relatively self contained and has a logic of its own that makes non-tax presumptions and non-tax definitions difficult to apply in practice, Williams (1978) stresses that it is very important that the courts fulfil their responsibility to consistently apply a defensible interpretation method.

In the past, the strict rule of interpretation has been the primary method of the interpretation of fiscal legislation. Goldswain (2008) argues that this method of interpretation results in purely objective valuations as it requires that the ordinary

grammatical meaning of words be applied and does not allow the court to look to the purpose of the legislator or introduce any subjectivity based on the circumstances of each individual taxpayer.

Among judicial expressions of the doctrine that taxing statutes should be strictly construed, the leading statement is undoubtedly that of Lord Cairns in *Partington v. The Attorney-General (1869) LR 4 HL 100*, who expressed "the principle of all fiscal legislation" as follows:

> 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 spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called equitable construction, certainly such a construction is not admissible in a taxing statute where you simply adhere to the words of the statute.

This principle was again put forward in another English case, *Cape Brandy Syndicate v Internal Revenue Commission (1921) 1 KB 64,* where Rowlatt J indicated that:

> . . . in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

An alternative interpretative approach which, according to Goldswain (2008), results in more equitable decisions is the purposive theory. This approach to interpretation seeks to ascertain the intention of Parliament by reading an Act as a whole and placing into context the ends sought to be achieved and the relationship between the individual provisions of the Act. Williams (1997) avers that there is evidence in South African case law that the adoption and application of a purely objective approach, such as the literal rule described above, has given rise to patently unfair results in the past which were completely at odds with established accountancy principles and commercial reality.

Ochberg v Commissioner for Inland Revenue 1931 AD 215, 5 SATC 93 is an example of the objective approach to interpretation in relation to the valuation of an amount in the form

other than cash and the potential it creates for an unfair outcome. In this case, the taxpayer was considered by the court, for the purposes of the judgement, to be the sole beneficial shareholder of a certain company. He rendered services to the company in return for which he was allocated additional shares as consideration. The increase in shareholding did not affect his economic position in that the value of his existing shares decreased correspondingly with the subsequent increase in his shareholding. The taxpayer remained the sole shareholder of the company. Looking at the transaction from a purely objective standpoint, the additional shares had a value. However, in considering the shareholding as a whole, there was no increase in the taxpayer's individual wealth. Despite the taxpayer's argument that he had received no financial benefit, the majority of the court remained unmoved and held that the value of the shares for the purposes of taxation is "what a willing buyer and seller would pay for the shares in an open market and that the subjective value to the individual taxpayer is irrelevant." The decision is an interesting exercise in judicial logic, leading, it is submitted, to an illogical and unfair result.

According to Cameron (2008), more recently, in the case of *The Commissioner for the South African Revenue Service v Brummeria Renaissance (Pty) Ltd* the court took a purely objective approach to interpreting the legislation, resulting in a decision to tax the "right to an interest-free loan" as an "amount" despite the fact that previously notional amounts were held not be taxable. In this case, the taxpayers were three companies, each conducting the business of developing retirement villages. This entailed that the companies entered into written contracts with potential occupants of the units to be constructed in the retirement villages. In terms of these contracts, a potential occupant would make a monetary loan to a particular taxpayer company in order to finance the construction of a unit in a retirement village by that taxpayer company. The loan granted to the company did not bear interest. As counter-performance for the granting of the loan, the taxpayer companies granted the right of lifelong occupation of the relevant unit to the retiree, but ownership remained with the taxpayer company. The Commissioner included amounts representing the "benefit of the rights to interest-free loans" in the gross income of the taxpayer companies for a number of years of assessment. The "amounts" included in "gross income" were determined by applying the weighted prime overdraft rate for banks to the average amount of the

particular interest-free loan in the relevant year of assessment. The valuation method was not challenged by the taxpayers and was accepted by the Supreme Court of Appeal without further consideration. The decision in this case has been questioned by a number of tax critics such as Cameron (2008) on the basis that it does not take the commercial reality into consideration and that had the taxpayer respondents put forward a better argument, such a regrettable binding precedent would not exist. Firstly, it seems highly unlikely that the taxpayers would, if they had invested the loans, have received the prime interest rate. It is more probable that a rate slightly lower would have been received. Secondly, and most importantly, in taxing the "notional income" received by the taxpayers, the courts allowed no deduction for "notional rent expenses" (the loss of rental income on the units as a result of the contract providing for a life-right to occupy the units interest-free.) The court consistently referred to the "*quid pro quo* principle" in their judgement, yet only took into account the right to use the loan capital, disregarding the fact that the retirees had a right to rent-free occupation. As such, it is submitted, a "double taxation" occurred.

Earlier cases such as *Commissioner for Inland Revenue v Nemojim (Pty) Ltd (1983) (4) SA (A), 45 SATC 241* recognised a more subjective method of interpretation and Corbett JA had occasion to comment on the strict and objective approach as enshrined in the statement "there is no equity about tax" (*Partington supra)*:

> It has been said that "there is no equity about tax". While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the of the fiscus.

Statements such as the one above advocate a more subjective approach. Applying this approach to interpretation would mean that an individual would only be taxed on the actual value to him or her personally of property received as income rather than what the value would be to any third party. This approach, it is submitted, would address the apparent inequity in decisions such as *Ochberg* and *Brummeria.*

Supporters of the objective approach, such as Le Grange (2008) are of the opinion that the efficiency of the tax system would be enhanced by the application of objectivity in tax

valuations due to the increase in consistency in the law, as well as an individual's ability to reasonably predict the tax consequences of their transactions. The subjective school of thought is, it appears, more concerned with yielding equitable results and protecting the rights of an individual. In deciding which method is more appropriate, it is submitted that a trade-off needs to be made between the goal of the objective approach to create consistency and the subjective approach to enhance fairness.

If an objective approach is to be consistently applied in terms of the *Brummeria* decision, the valuation assigned to non-cash amounts for the purposes of inclusion in gross income will effectively be the "fair market value" of the non-cash item (In *Brummeria,* the rights were valued in terms of the prime-overdraft market interest rate.) According to Gordon (1953), the concept of "fair market value" has caused substantial debate as to whether it is in fact "fair" or "objective" at all. It appears that the term "fair market value" has wide acceptance, but its application and meaning continue to be the subject of much dispute.

Writers such as Newman (1982) have suggested alternative means of valuing non-cash "amounts" for tax purposes. One such method is that of establishing the economic utility of the non-cash item and placing a value on the item in terms of its actual usefulness to the recipient. It is submitted that this economic means of valuation is more in line with the subjective valuation technique applied in *Stander v CIR* (1997) (3) 617 (C), 59 SATC 212, which in terms of fairness and equity, is more justifiable than the *Brummeria* precedent which is now binding. The taxpayer in the *Stander* case was awarded prize consisting of a non-convertible holiday. Because of the taxpayer's inability to convert the holiday into money, the holiday was given a nil value for the purposes of taxation. Unlike *Brummeria,* where similarly, the right to the interest-free loans could not be converted directly into a cash sum, the holiday was not valued in terms of the market and included as a taxable benefit.

The Constitution of The Republic of South Africa, Act 108 of 1996 (hereinafter referred to as "the Constitution") was introduced after the election of the first democratic government in South Africa. Because of South Africa's unfortunate history with regard to the discrimination and harsh inequity experienced by many South African individuals, equality and fairness are

essential elements demanded by the new Constitution. The Constitution also requires the Judiciary to consistently interpret all legislation enacted by Parliament in terms of the requirements of the Constitution. Because the Constitution forms the Supreme Law of South Africa, the interpretation of the gross income definition and valuation of amounts for the inclusion in taxable income should embody the principles of fairness and equality established therein. In addition, the courts are also required to maintain a level of consistency when interpreting legislation so that taxpayers may reasonably predict the tax consequences of their transactions. Because the valuation of amounts received in a form other than in cash requires analysis in terms of the requirements of the Constitution, the objective versus subjective debate is complicated further in that the both fairness and consistency are constitutional requirements yet a trade-off exists between these ideals when deciding whether an objective or subjective approach should be applied.

The problem to be addressed in the present thesis arises out of the subjective versus objective debate in relation to valuing amounts in a form other than cash, for the purposes of inclusion in "gross income" and the question which approach is most appropriate in terms of the requirements of an effective tax system and the Constitution. This entails an enquiry into the appropriate interpretative principles to be applied in order to promote fairness and certainty.

1.2 Goals of the research

The goal of this research is to analyse South African case law relating to the interpretation by the courts of the term "an amount in cash or otherwise" in the gross income definition in section 1 of the Income Tax Act in order to value the amount in the context of the objective versus subjective debate and against the framework of approaches to interpreting tax statutes by the courts. In achieving the overall goal of this research, the specific objectives are as follows:

- to discuss the main interpretation methods used by the courts when interpreting tax statutes;

- to discuss the impact of the Constitution of South Africa and the Bill of Rights in the Constitution on the interpretation of tax statutes and in particular the valuation of an amount received or accrued to a taxpayer in a form other than cash for the purpose of including it in "gross income";
- to analyse South African case law relating to the interpretation by the courts of "an amount in cash or otherwise" and the valuation of non-cash benefits;
- to discuss the concept of an efficient tax system and the requirement for consistent interpretation by the courts of the tax laws governing the system;
- to explain the concepts underlying the subjective and objective schools of thought applied by the courts in interpreting tax law;
- to analyse the concept of "fair market value" as an objective means of valuation and discuss problems associated with this method of valuation;
- to discuss other valuation concerns and alternative methods of valuing non-cash assets, which could possibly address the unfairness of the precedent set in the *Brummeria* decision; and
- to conclude as to whether the objective or subjective approach is most appropriate.

1.3 Methods, procedures and techniques

The approach to be adopted for the research falls into the interpretative paradigm. This is an appropriate approach as the research seeks to describe and explain (Babbie & Mouton: 2009). A *doctrinal* methodology is applied. This methodology has been described (McKerchar: 2008) as a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to the interpretation of tax statutes and the legal rules for the valuation of amounts in a form other than cash), the analysis of the relationship between the rules, an explication of areas of difficulty and is based purely on documentary data. The research approach is therefore qualitative in nature.

The present thesis will achieve its goal by consulting relevant documentary evidence including the Income Tax Act, the Estate Duty Act 45 of 1955 and the Constitution, as well as journal articles and relevant books and other writings.

As all documentary evidence used for the purposes of this research is in the public domain, no ethical considerations arise.

1.4 Overview of the chapters to follow

Chapter 2 will address the first goal of the research by introducing and explaining the various interpretation methods applied by the courts. In comparison to general law, taxation legislation is very complex and thus the courts have often been called upon to give meaning to the statutory language used within the provisions of the Income Tax Act due to the absence of explanations and definitions therein. The two main interpretation methods which will be analysed include the literal rule, which enforces the strict meaning of the wording of statutes and the purposive approach which instead looks to the purpose of the legislation in relation to the facts of each case and allows for a broader interpretation. These interpretation methods will be analysed in terms of their levels of subjectivity. In addition to explaining how the courts interpret tax statutes, chapter 2 will also focus on the second goal of the research by explaining the impact of the Constitution and the Bill of Rights on legal interpretation and discuss whether the objective literal approach or more subjective purposive approach meet the requirements thereof.

Chapter 3 addresses the third goal of the research, this being to analyse South African case law relating to the courts' interpretation of the term "amount in cash or otherwise" of the gross income definition. The central theme of the chapter is the valuation of non-cash amounts for inclusion in taxable income. It will be explained that, because non-cash amounts are included in taxable income, assets which do not have an immediately ascertainable cash value require valuation in order to establish a monetary value upon which taxation can be levied. Case decisions will be analysed in terms of the courts' approaches to valuation. In addition, the chapter will illustrate the problems that South African courts have had in applying a consistent valuation approach. The subjective versus objective debate will form a central issue in the chapter and it will be shown that valuation methods lie at various points on a continuum, depending on the level of subjectivity or objectivity of the valuation method applied. Chapter 3 also serves to introduce a discussion

of the trade-off between fairness and consistency when deciding which valuation approach should be applied.

Chapter 4 continues to explore the third goal of the research which is to analyse South African case law relating to the valuation of "amounts" for gross income. The chapter analyses the *Brummeria* decision in detail, as this Supreme Court of Appeal case put an end to the objective versus subjective debate when it was decided that the right to interest-free loan capital must be valued objectively in terms of the market value. The facts of the case, arguments put forward by the taxpayers, shortcomings of the decision and possible alternative valuation methods which could have been applied by the court will be discussed. The possible effects of the precedent set in the case, that an objective valuation method must be applied in cases requiring the valuation of non-cash amounts, will be illustrated by explaining the decision in the case of *Vacation Exchanges International v Commissioner for Inland Revenue (*2009) JDR 0743 (WCC)*,* where employees were taxed on time-share points awarded to them as a fringe benefit*.* The possible taxability of frequent flyer miles will also be discussed as an example of another type of employee benefit which may be taxed in future as a result of the *Brummeria* precedent*.*

Chapter 5 achieves the seventh goal of the research by addressing other valuation issues and methods which could be used as an alternative to the "fair market value" approach applied in the case of *Brummeria* and subsequently in *Vacation Exchanges International.* In addition, this chapter will analyse the term "fair market value" in terms of whether or not it is truely objective and will attempt to demonstrate that it is not always possible to apply such a method as markets do not exist for every asset requiring valuation.

Chapter 6, the concluding chapter will provide a review of each of the previous chapters, highlighting the main issues discussed and conclusions reached and will also provide an explanation as to how each chapter addressed the goals of the research. It will ultimately be concluded that neither the subjective or objective approach is entirely correct. Neither approach fully meets the demands of the Constitution which requires both the consistency resulting from the application of an objective approach and the fairness promoted by the adoption of more subjective valuations. The objective approach, it appears, is more administratively feasible but tends to result in absurd decisions in certain cases. When

exploring the possibility of applying alternative methods, however, it was found that they are too subjective to be successfully applied in practice. Despite the *Brummeria* precedent requiring the application of an objective approach, the present research established that no valuation technique is fully objective and thus, the uncertainty remaining is not necessarily based on the objectivity versus subjectivity debate but rather, as to what level of subjectivity is acceptable and appropriate.

CHAPTER 2: THE INTERPRETATION OF FISCAL LEGISLATION

2.1 Introduction

In addressing the first goal of the research, this chapter will start by introducing the various interpretation methods applied by the courts. Taxation law is very complex and detailed. Many of the concepts therein are not explained or defined by the legislation and it is the responsibility of the courts to give meaning to many of the terms in the provisions of the Income Tax Act in order for the law to be applied in practice. An understanding of how tax legislation is interpreted is central to the present research concerning the problems surrounding the valuation of amounts received in a form other than cash, as the terms "total amount" and "in cash or otherwise" of the gross income definition are prime examples of terms which are not expressly defined or explained by the Income Tax Act. In this chapter, the two main interpretation methods will be analysed. The literal rule will be discussed first as this was the method of interpretation most commonly applied by the courts in early tax cases. This rule enforces the strict and literal meaning of statutory language and demands that legislation be applied as it stands. The purposive approach will then be introduced. This method of interpretation, which later became more prominent, looks instead to the purpose of the legislation in relation to each particular case and allows for a broader interpretation of the terms in the legislation. It will be argued that the literal approach gives rise to valuations based on an objective methodology, whereas the purposive approach tends to result in more subjective valuations.

The chapter will then address the second goal of the research, by discussing the impact of the Constitution of the Republic of South Africa, Act 108 of 1996 and the Bill of Rights on the interpretation of tax statutes and in particular the valuation of an amount received or accrued to a taxpayer in a form other than cash for the purpose of including it in "gross income". The interpretation methods will be analysed in terms of their ability to meet the requirements of the Constitution. It will be shown that because a trade-off exists between fairness and consistency when deciding upon a suitable valuation approach, neither methodology is able to fully meet Constitutional demands.

2.2 General interpretation of tax statutes

Before discussing the South African courts' approach to interpreting of the phrase "total amount in cash or otherwise", it is necessary to explain the overall concept of interpretation and describe the main interpretation methods applied by the courts.

It is submitted that in order for a tax system to function effectively, it is vital that taxpayers have reasonable certainty as to whether, in terms of the applicable law, they are or are not liable for income tax, or will or will not be liable for income tax if they adopt a contemplated course of action. By taxing an individual, you are essentially stripping them of a portion of their personal financial assets, to which they have a real right in terms of the law and therefore, it is important that they have a clear understanding of how their income (both cash and non-cash or in-kind benefits) will be valued for the purposes of levying taxation. Deak (1997) is of the opinion that, in South Africa, as in many other tax jurisdictions, such certainty is an ideal that is often far removed from reality. Internationally, tax statutes are notorious for their incomprehensibility and South Africa is no exception. According to Williams (1997), many key concepts and principles are completely absent from the Income Tax Act, and are thus expressed only in judicial decisions of the domestic courts and courts of other countries. The interpretation of fiscal legislation is thus crucially important in that the courts effectively give meaning to the laws which govern the tax system.

Goldswain (2008) explains that in view of South Africa's historical connections with Britain for more than a century, the former South African Union adopted a Westminster system of Parliamentary supremacy and this remained intact until the enactment of the Constitution. South African law as well as the methods of legal interpretation have, in the past, thus largely been based on English law. More recently, Canadian tax law also appears to have significantly influenced South African tax legislation. This can be evidenced by the general anti-avoidance section 80A(c)(ii) of the South African Income Tax Act which actually originates directly from section 245(4) of the Canadian Tax Act, 1985, c. 1 (5th Supp.) In the light of the influence of English as well as Canadian jurisprudence on South African tax law, it must be determined whether, in modern times, South Africa is mirroring the tax developments regarding the interpretation of fiscal legislation evident in these countries.

In the British case of *Corocraft Ltd v Pan American Airways Incorporated* (1968) 3 WLR 714 732, the concept of interpretation of legislation was explained as follows:

> In the performance of this duty the Judges do not act as computers onto which are fed the statutes and the rules of construction of statutes and from whom issue forth the mathematically correct answer. The interpretation of statutes is a craft as much as a science and the Judges, as craftsmen, select and apply the appropriate tools of their trade. They are not legislators, but finishers, refiners and polishers of legislation which comes to them in a state of requiring varying degrees of further processing.

Duff (1999a) explains that for many years the dominant approach to the interpretation of fiscal legislation in both the United Kingdom and Canada involved a strict construction, according to which statutory language was construed literally. Among judicial expressions of the doctrine that taxing statutes should be strictly construed, the leading statement is undoubtedly that of Lord Cairns in *Partington v The Attorney-General* (1869) LR 4 HL 100 (hereinafter referred to as *"Partington"*), who expressed "the principle of all fiscal legislation" as follows:

> . . . I do so upon both form and substance. I am not at all sure that in a case of this kind, a fiscal case, form is not amply sufficient; because as I understand the principle of all fiscal legislation – it is this: 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. In other words, if there be admissible, in any statute, what is called equitable construction, certainly such a construction is not admissible in a taxing statute.

In addition to the statement by Lord Cairns, it appears that the complexity involved in interpreting and applying taxation law was used as a further justification for the application of a literal approach as it was thought that establishing a deeper meaning within the statutes would further complicate the process of legislative interpretation.

The honourable Vinelott JC expressed the opinion that:

> . . . [T]ax to the judicial mind was a strange and arbitrary subject, lacking alike in logic and principle; a sorry jungle of unrelated imposts...

Further, a well-known Hamlyn lecturer, Hubert Monroe pointed out that it was not until 1874 that an appeal lay to the High Court from the Commissioners of Income Tax and stated that (Vinelott: 1982):

> . . . the topic of taxation was entirely statutory, scattered in addition over a multitude of statutes, and apparently lacking in any discernable principles. What could a Judge do but fall back on the words of so much of the statutory code as was bought to his attention. What was the plain meaning of the words used? If government was to interfere with property, pry into a man's affairs and take his money, one thing was certain – there must be clear statutory authority. If Parliament was the starting point – so be it.

Vinelott (1982) explains that according to the literal approach, instead of attempting to find and apply the underlying meaning of the wording of legislation, the actual wording was to be applied - directly as it stood. Supporters of the literal approach are of the opinion that taxpayers should be able to reasonably understand the basis upon which they are taxed, which should be conferred directly from the words of the statute as passed by Parliament after the thorough process of statutory enactment. Once law had passed through this process, it is to be applied literally as it stands and requires no further analysis.

A similar view appears in *Cape Brandy Syndicate v Inland Revenue Commissioners* (1921) 1 KB 64 (hereinafter referred to as *"Cape Brandy Syndicate")*, where Rowlatt J stated that:

> In a taxing Act, clear words are necessary in order to tax a subject. Too wide and fanciful a construction is often sought to be given to that maxim, which does not mean that the words are to be unduly restricted against the Crown in those Acts. It simply means that in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

In the past, the Canadian courts also accepted the strict approach to interpretation and applied the principle that taxing statutes had no purpose other than the collection of tax. This can be illustrated by a statement expressed by Lord Halsbury in the case of *The King v Crabbs* (1934) S.C.R. 523 that:

> In a taxing Act it is impossible, I believe, to assume any intention, any governing purpose in the Act, to do more than take such tax as the statute imposes. In various cases the principle of construction of a taxing Act has been referred to in various forms, but I believe they may be all reduced to this, that inasmuch as you have no right to assume that there is any governing object which a taxing Act is intended to attain other than that which it has expressed by making such and such objects the intended subject of taxation, you must see whether a tax is expressly imposed.

From the abovementioned views of various judges and court decisions, it appears as though internationally, the strict rule of interpretation was the first and primary means of fiscal legislation interpretation and thus, a further explanation of this method is required. The literal approach is also referred to as the plain or ordinary meaning rule. This type of construction dictates that statutes are to be interpreted using the ordinary meaning of the statute unless a statute explicitly defines some of its terms otherwise. Ultimately, the law is to be read word for word and interpretations should not divert from its true meaning. It is the mechanism that underlies the interpretive theory of textualism and, to a certain extent, originalism.

According to Lee (1999), the plain meaning rule attempts to guide courts faced with litigation that turns on the meaning of a term not defined by the statute, or on that of a word found within a definition itself. Under this rule, the judge considers what the statute actually says, rather than what it might mean. In order to achieve this, the judge will give the words in the statute a literal meaning, that is, their plain, ordinary, everyday meaning. In terms of this rule, if words are clear, they must be applied, even though the intention of the legislator may have been different or the result is harsh or undesirable to either party to the dispute. In essence, the literal rule is what the law says and not necessarily what it means.

Longquist (2003) explains that the literal rule is based on the notion that the intention of Parliament is best found in the ordinary and natural meaning of the words used. Legislation is put through a rigorous process before it is enacted by Parliament and therefore, once it becomes law, there is no need for judges to scrutinise the terms therein any further. Especially in a democratic society, where parliament has been voted into power to promote democratic societal values, supporters of this approach to legislative interpretation believe that Parliament must be taken to want to effect exactly what it says in its laws.

Although the strict and literal rule was by far the dominant approach applied by English and Canadian courts until the early 1980's, there are cases in which alternate forms of interpretation were applied. One such approach was the contextual analysis approach. This interpretative approach rejects the narrow literalism of strict construction and can be explained by a statement made by Viscount Haldane in the case of *Lumsden v Inland Revenue Commissioner* (1914) AC 877 that:

> The duty of judges, including those that impose taxation, is to adhere to the literal construction unless the context renders it plain that such a construction cannot be put on the words.

It appears that as time passed, in cases where judges experienced difficulty in strictly applying the wording of legislation, wider interpretations started to be accepted by the court. In addition, due to the callous nature of the literal rule, judges began to impose an absurdity limit on its application which meant that a statute should not be interpreted purely literally if this would lead to an absurd result. This limit was termed the soft plain meaning rule and was first introduced in the United States and has since been applied in numerous cases, an example of which is the case of *United States v X-Citement Video,* 513 U.S. 64*,* where Justice Scalia voiced his support of the limit to strict interpretation by stating that:

> . . . I have been willing, in the case of civil statutes, to acknowledge the doctrine of a "scrivener's error" that permits the court to give an unusual meaning to a word which, if given its normal meaning, would produce an absurd and arguably unconstitutional result.

In the United Kingdom, Canada and South Africa (the countries of primary interest in this research), this limit is referred to as the "Golden Rule."

The golden rule simply results in a modification of the literal rule by stating that if the grammatical and ordinary sense of the word produces an absurdity, then the court should look for another meaning of the word to avoid that result. The rule was first defined by Lord Wensleydale in *Grey v. Pearson* (1857) 10 ER 1216, who stated that:

> The grammatical and ordinary sense of the words is to be adhered to unless that would lead to some absurdity or some repugnance or inconsistency with the rest of the instrument in which case the grammatical and ordinary sense of words may be modified as to avoid the absurdity and inconsistency, but no further.

In the same vein, Blackstone (1978: 91) concluded that a statute yielding "absurd consequences, manifestly contradictory to common reason," is void, emphasizing that "where some collateral matter arises out of the general words of a statute, and happens to be unreasonable, there the judges are in decency to conclude that the consequence was not foreseen by the parliament, and therefore, they are at liberty to expound the statute by equity."

In a development similar to English law, the authority of the strict and literal doctrine was called into question by Canadian decisions such as that in *Stubart Investments Limited v The Queen* 84 DTC 6305 (1984) CTC 294 (SCC), where the majority of the court recognized that in the construction of taxation statutes the law is not confined to a literal and virtually meaningless interpretation of the Act. Instead, the words will support on a broader construction a conclusion which is workable and in harmony with the evident purposes of the Act in question.

Stubart Investments Limited v The Queen was a tax-avoidance case. The taxpayer and its affiliates had entered into transactions for the purpose of applying tax losses of one member of the corporate group to shelter income of a sister corporation. Counsel for the Minister argued, among other things, that the transactions were ineffective on the grounds that the transactions lacked a valid business purpose. The Income Tax Act did not at any time up to the 1988 enactment of the general anti-avoidance rule (now in section 245) contain any rule of general application requiring that transactions be entered into for business purposes or other non-tax purposes. Speaking for the majority, Mr. Justice Estey clearly and unequivocally rejected the existence of a general business purpose test on the basis that

> . . . [I]n certain circumstances it would conflict with Parliament's objective of encouraging certain activities for reasons of economic or social policy.

The above statement illustrates how *Stubart Investments Limited v The Queen* signalled a growing judicial willingness to consider the "object and spirit" of the Act as well as "the letter of the law."

According to Bowman (1995: 1176), this view was founded on the recognition that the Income Tax Act had grown "from a mere tool for the carving of the cost of government out of the community, to an instrument of economic and fiscal policy for the regulation of commerce and industry of the country through fiscal intervention by government."

The decision in *Stubart Investments Ltd. v The Queen,* [1984] 1 S.C.R. 536 is generally held to represent the introduction of the purposive approach to fiscal interpretation. Duff (1999b) submits that the courts have advocated the purposive approach as the primary means of interpretation in modern times based on the fact that this method of interpretation better emphasises the democratic character of the modern state. It is necessary that the new role of taxation in redistributing resources and financing the public goods and services provided by the state, and the purposes of tax statutes both to distribute these taxes in an equitable manner and to encourage specific kinds of social and economic behaviour, be reflected by the decisions of the judiciary.

According to Duff (1999b), in contrast to strict construction, which stressed the literal meaning of the statutory text and resolved ambiguities according to rigid presumptions, purposive interpretation emphasizes the reasons for which the statutory text was enacted and the objectives at which it aims, and interprets the text in light of these reasons and objectives. As Willis (1938: 16) argued in his influential article on statutory interpretation:

> . . . before you ever look at the words of the Act you have to discover why the Act was passed; then, with that knowledge in your mind, you must give the words under interpretation the meaning which best accomplishes the social purposes of the Act.

Two important cases which illustrate the change in the interpretation of legislation to one which considers legislative purpose include *Pepper (Inspector of Taxes) v Hart* (1993) AC 593 and *Internal Revenue Commission v McGuckian* (1997) 1 WLR 991, 1005. In the former case, Lord Grittith made a statement which has since impacted all areas of statute law:

> The days have long passed when the courts adopted a strict constructionist view of interpretation which required them to adopt the literal meaning of the language. The courts now adopt a purposive approach which seeks to give effect to the true purpose of the legislation and are prepared to look at much extraneous material that bears upon the background against which the legislation was enacted.

In the latter case, four years later, Lord Cooke of Thorndon further stated that:

> In determining the natural meaning of particular expressions in their context, weight is given to the purpose and spirit of the legislation. . . [I]f the ultimate question is always the true bearing of a particular taxing provision on a particular set of facts, the limitations cannot be universals. Always, one must go back to the discernable intent of the taxing Act.

Duff (1999b) explains that in Canada, the development of the purposive approach to fiscal legislation has been significantly influenced by the introduction of the Charter of Rights and Freedoms in Schedule B of Part 1 of the Constitution Act 1982 which has prompted the courts to consider the social purposes of taxation in making their judgements, ensuring that equitable and fair decisions result.

In South Africa, the main purpose of the Constitution and the Bill of Rights is to promote the democratic values of fairness and equity. Since this legislation forms the supreme law of the land, it is submitted that judges are required to ensure that their decisions satisfy the requirements of the Constitution and the Bill of Rights.

In promoting fairness and equity, the purposive approach has gained much support due to the fact that this approach takes into account both the intent of the legislator as well as the context in which the provision is applied and the individual circumstances of the particular taxpayer. The literal approach, on the other hand, does not take into account equity or fairness but rather places its sole focus on the ordinary meaning of the words, in view of the fact that Parliament chose those words in enacting the legislature and thus there is no need to look any further than the wording of provisions in order to determine their intention.

Surprisingly, like the literal approach, the purposive approach has also been challenged on the basis that it is not constitutional for a number of reasons. According to Lonnquist (2003), inquiring into the purpose of Parliament is simply not the court's job. By enquiring into the

intention of the legislator, judges are likely to apply their own subjective interpretation as to the purpose of the legislation, which may differ from case to case depending on the facts and circumstances surrounding the issue bought to court. This type of interpretation may result in a tax system where taxpayers' rights are infringed upon as they cannot reasonably anticipate the outcome of their cases due to a lack of consistency which arises when the objectivity of court decisions is compromised. The literal approach has thus been advocated in that if the words of a statute are inconsistent with its purpose it only means that the legislature was not very efficient in their task of writing the statute. It is not within in the court's power to rewrite the statute as they lack the legislative authority to do so, based on the doctrine of the separation of powers.

Lonnquist (2003) further states that the constitutional objection rests on the premise that only actual legislative text has satisfied the constitutional requirements of passage. Nothing that has not gone through the legislative process can be considered law. Thus, even if legislation contains ambiguities, the court cannot, in their endeavour to establish the purpose of the legislation, construe these in a manner which changes or amends the provision, as they would then be making law which is not constitutional.

Despite the criticism of the purposive approach, there is evidence to suggest that this approach is more fair and equitable and thus a more justifiable interpretative approach in terms of the Constitution. This approach has thus been applied in some cases notwithstanding the element of subjectivity introduced into legal interpretation when applying such a method. The purposive approach was adopted by a narrow majority of the Supreme Court of Appeal in November 2007 in *Commissioner for South African Revenue Services v Airworld CC & Another,* 70 SATC 48 (hereinafter referred to as *"Airworld"*). In this case, the Commissioner for the South African Revenue Services taxed a loan transaction in terms of the provisions of section 64C which apply to loans made to members of a close corporation, any relatives of the members or trusts of which a member is a beneficiary. The application of section 64C resulted in a loan to a trust being deemed to be a dividend to the extent that the close corporation had profits available for distribution. The taxpayers argued that, having regard to the definition of "beneficiary" for the purposes of defining "connected person" in section 1 of the Income Tax Act, it appeared the legislator intended

to draw a distinction between a beneficiary with a vested right and one with a discretionary right, in that the latter was only a potential beneficiary until the trustees exercised their discretion to confer benefits on him or her. The word "beneficiary" was considered in context by the court which ultimately held that the legislator foresore that a company or close corporation might find ways of transferring its profits to shareholders, other than by the process of distributing them directly in the form of dividends and so the "mischief" which the legislator sought to prevent by enacting section 64C was the avoidance of liability of secondary tax on companies by disguising dividend distributions as loans. On this basis, the definition of "beneficiary" in terms of section 64C was not to restricted beneficiaries with vested rights.

What is interesting to note from this case is that, despite the purposive approach being fairer than the objective approach, it does not always result in decisions favouring the taxpayer. It is submitted that the approach is not only advantageous in that it addresses equity and fairness in many tax cases but also because the approach often tends to result in decisions which are more logical and coherent. In 2007, the same year as the *Airworld* decision, the court in the case of *Commissioner for Inland Revenue Services v Brummeria Renaissance (Pty) Ltd and Others* (2007) SCA 99 (RSA) 69 SATC 205 (hereinafter referred to as *"Brummeria"*), held that in terms of valuing amounts for the inclusion in gross income, the correct approach to be applied is the objective approach.

These decisions are evidence of a level of inconsistency in court decisions in that some cases allow for the subjectivity inherent in applying statutory purpose whilst all valuation cases are now required to be approached purely objectively in terms of the *Brummeria* precedent.

The decisions made by the courts tend to lie somewhere on a continuum depending on the level of subjectivity. Decisions made based on the early literal approach lie towards the objective end of the continuum as the courts applied the most literal meaning of the statutory language. Decisions made using the purposive approach allow the court to look to the purpose of the legislative provision in question and apply the language according to the specific taxation case. Since this interpretative method results in alternative meanings of the

same statutory language, depending on the court's opinion regarding the purpose of the legislation, it is submitted that this method is closer to the subjective end of the continuum.

The present research aims to investigate the valuation by the South African courts of non-cash amounts in terms of the subjective versus objective debate. The interpretation of the term "amount" and how amounts are valued will thus be analysed with reference to relevant case law and it will be shown that an element of subjectivity is inevitable in any valuation. On deciding what method of valuation to apply in the case of a non-cash receipt, the unavoidable trade-off between fairness and consistency will be illustrated.

2.3 Constitutional demands with regard to statutory interpretation

The Constitution is the supreme law of the Republic which means that any law or conduct inconsistent with it is invalid and the obligations imposed by it must be fulfilled. The courts may now test all legislation (including new and old order Acts of Parliament) and government actions in the light of the Constitution. The interpretation of legislation in South Africa is now governed by the Constitution and must meet the requirements thereof. According to Bekink and Botha (2007), the Constitution includes an express and mandatory interpretation provision, and, statutory interpretation (like all law in South Africa) must now be conducted within the value-laden framework set out by the supreme Constitution.

Everything and everybody, all law and conduct and all traditions and perceptions and procedures are now subject to the Constitution. In the case of *Holomisa v Argus Newspapers Ltd* (1996) 6 BCLR 836 (W) 863J, Cameron J summarised this principle as follows:

> The Constitution has changed the "context" of all legal thought and decision-making in South Africa.

Section 39(2) of the Constitution has the effect that any reading of legislation by courts must promote the Bill of Rights and thus all lawyers, judges and legal drafters need to become familiar with these values.

In analysing the case, *Serious Economic Offenses v Hyundai Motor Distributors (Pty) Ltd: Re Hyundai Motor Distributors (Pty) Ltd v Smit* (2001) 1 SA 545(CC), Langa DP explained the constitutional foundation of this "new" methodology as follows:

> Section 39(2) of Constitution means that all statutes must be interpreted through the prism of the Bill of Rights. All law-making authority must be exercised in accordance with the Constitution. The Constitution is located in a history which involves a transition from a society based on division, injustice and exclusion from the democratic process to one which respects the dignity of all citizens, and includes all in the process of governance. As such, the process of interpreting the Constitution must recognise the context in which we find ourselves and the Constitution's goal of a society based on democratic values, social justice and fundamental human rights. The spirit of transition and transformation characterises the constitutional enterprise as a whole.

According to Bedink and Botha (2007), what this implies is that the courts have to interpret and apply legislation in a substantive manner. In other words, the approach to interpreting legislation that must be taken should be value-based and value-coherent.

It is submitted that if this is the case then formalistic and mechanical interpretations based on strict text-based analyses such as that in the case of *Brummeria* go against the spirit of the Constitution as the taxpayer companies in this case were effectively "double taxed" due to the valuation of their non-cash benefit, but not accounting for the notional rental income forgone by the companies in order to gain their right to the interest-free loan capital upon which taxation was levied. To justify this submission, in the case of *Matiso v Commanding Officer, Port Elizabeth Prison* (1995) 4 SA 631 (CC), the Constitutional Court explained this teleological dimension of statutory interpretation as follows:

> The values that must suffice the whole process are derived from the concept of an open and democratic society based on freedom and equality, several times referred to in the Constitution. The notion of an open and democratic society is thus not merely aspirational or decorative, it is normative, furnishing the matrix of ideals within which we work, the source from which we derive the principles and rules we apply, and the final measure we use for testing the legitimacy of impugned norms and conduct . . . we should not engage in purely formal or academic analysis, nor simply restrict ourselves to ad hoc technicism, but rather focus on what has been called the synergetic relation between the values underlying the guarantees of fundamental rights and the circumstances of particular use.

According to Paralegaladvice (2010), when discussing constitutional requirements with regard to statutory interpretation, the separation of powers doctrine requires careful consideration. Paralegaladvice (2010) explains that the separation of powers in the

Constitution means that the government's functions and power is split into three brances which are required to be completely independent of each other. These branches are as follows:

- the Legislature which drafts the laws;
- the Executive which enforces the laws; and
- the Judiciary which interprets the laws.

Of relevance to the present research is the judges' duty to interpret the laws. The Judiciary have a difficult challenge in that they are required to interpret the law without altering it or introducing new law. The application of the purposive approach tends to yield more subjective values. The approach has thus been criticised in that it introduces a significant risk that judges may unintentionally alter the law on a case-by-case basis.

2.4 Conclusion

This chapter has discussed the general principles of legislative interpretation, with the main focus being to distinguish which interpretation techniques are used to interpret fiscal legislation. In discussing the various methods used to interpret taxing statutes, it was explained that the literal and purposive approaches are the two main approaches to statutory interpretation. Literal interpretation focuses solely on the actual wording of the Act in question. It is submitted that it is more objective than the purposive approach which allows the courts to look into the purpose of the legislation, especially in situations where the wording of an act is ambiguous and unclear. The purposive approach, it is submitted, would lie further towards the subjective end of the objective–subjective continuum as it considers the context and facts of each particular case and allows for the application of a broader meaning of statutory terms. It is submitted that in terms of the objective versus subjective debate, no method of interpretation can be classified as being purely objective in that even when a judge adopts the literal approach, he or she is ultimately giving meaning to statutory language based on his or her own perceptions about what the literal meaning is. A level of subjectivity is thus inherent in any interpretation.

In addition to analysing both approaches to statutory interpretation, this chapter also considered whether either of the approaches meets the demands of the Constitution and the Bill of Rights. Both interpretation techniques appeared to have advantages and disadvantages in this regard. The literal approach improves a taxpayer's ability to readily predict the tax burden for which they will be liable as the method results in relatively consistent outcomes. The purposive approach, however, appears to consider each individual's circumstances in the process of establishing statutory purpose and thus its application results in an individual's right to fairness and equity being recognised. This approach can however be criticised in that it fails to maintain the consistency required in order for a tax system to function effectively and may threaten the separation of powers upon which our legal system is founded.

Chapter 3 will discuss fiscal interpretation in South Africa with the specific focus on the interpretation of the term "amount in cash or otherwise" in the gross income definition. The chapter will first discuss the interpretation of this term in general and will then analyse relevant case law to illustrate the practical consequences of applying a subjective approach to valuation versus an objective approach in order to conclude as to which method is most suitable . It will be shown that the objective approach has resulted in unfair decisions in the past. The case of *Ochberg v Commissioner for Inland Revenue* 1931 AD 215, 5 SATC 93 will be discussed in this regard. This case provides a clear example of where the application of an objective approach has lead to absurd results which could be challenged based on their lack of constitutionality. To explain further, this case involved a director who received a number of shares upon which tax was levied, despite the fact that the benefit he received had no effect on his personal wealth. In effect, the taxpayer was unfairly obliged to meet hi taxation burden out of other income. By literally interpreting the wording of the Income Tax Act, an "amount" was proved to exist and income tax was effectively levied thereon. The purposive approach would instead have considered the actual purpose of the Income Tax Act to tax income which results in an increase in an individual's wealth (a portion of a person's earnings must be given to the state in order to fund government expenditure.) Should a more subjective approach have been applied in such a case, it is submitted that the decision reached may have better met the requirements of the Constitution as discussed in the present chapter.

CHAPTER 3: THE VALUATION OF AMOUNTS IN A FORM OTHER THAN CASH

3.1 Introduction

Benjamin Franklin once stated that ". . . in the world nothing can be said to be certain except death and taxes." This particular quote is exceptionally clichéd and a very unoriginal way to introduce a topic which, on the contrary, has given rise to considerable uncertainty. However, on further analysis, it is interesting to note that despite its overuse, the quote is only half true. Death is certain. No person is immortal and at some stage or another, sadly, our lives will all come to an end. Conversely, it is submitted that the idea that taxes are certain is not entirely true and this chapter serves to discuss the reasons why.

Certainty, in terms of taxation, lies with the fact that at some stage or another some form of tax, whether it is income tax, donations tax, transfer duty or value-added tax will be levied upon a person. Although the imposition of taxation is definite, the basis upon which persons are taxed is not always certain. As will be demonstrated in this chapter, the courts have appeared to vary in their approach to the valuation of amounts in a form other than cash. In essence, tax is levied on an "amount" which has initially been determined by the taxpayer. But, in the event that a dispute arises, an alternative amount is then determined by the Commissioner for the South African Revenue Service (hereinafter referred to as "SARS") in terms of a particular valuation method, deemed to be reasonable by the Commissioner. Once SARS has established a monetary figure for the amount in question, the onus, in terms of section 82 of the Income Tax Act rests upon the taxpayer to prove that the valuation is incorrect.

Chapter 3 addresses the third goal of the research, this being to analyse the South African case law relating to the interpretation by the courts of "an amount in cash or otherwise" and more specifically, the valuation of non-cash amounts for the inclusion in taxable income. The valuations applied in the cases will be analysed in terms of the subjective versus objective debate which forms the central theme of the present research.

Because an "amount in cash or otherwise" is included in the definition of gross income, assets which do not have an immediately ascertainable cash value require some means of valuation in order to establish a monetary figure upon which to levy tax. The present

chapter aims to investigate the valuation approaches adopted by the courts and problems which have been experienced in determining an appropriate cash value. The decisions made in South African cases relating to the valuation of an "amount" for the inclusion in gross income will form the main theme of the chapter and it will be demonstrated that the courts have varied in their approaches to valuing non-cash amounts resulting in inconsistency and thus, uncertainty.

As a result of the diverse approaches to valuation which have been applied in the past, the present research also reflects on whether the "amounts" or "values" upon which tax is levied can ever be said to be "certain."

The need for certainty in taxation was articulated as early as 1776 by Adam Smith in his *Wealth of Nations*, where he set out the four canons of taxation as follows:

- the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state;
- the tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person; and
- every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

According to Smith (1776), every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.

There has been a long ongoing debate as to whether an objective or subjective approach should be adopted when valuing an "amount" for the purposes of inclusion in gross income. Although recently the Supreme Court of Appeal in *South African Revenue Service v Brummeria Renaissance (Pty) Ltd and Others* (2007) SCA 99(RSA), 69 SATC 205 (hereinafter referred to as *"Brummeria"*) held that an objective method, with reference to the market,

must be utilised in all cases requiring the valuation of an "amount", it is submitted that in some circumstances, an objective valuation, in terms of the market, is not always possible.

Furthermore, in a number of tax cases this approach has resulted in decisions violating generally accepted economic and accounting principles. Thus, it is suggested that tax cannot consistently be levied on a so-called objective "fair market value" and thus, a level of uncertainty remains as taxpayers cannot always reasonably anticipate or predict the basis of valuation upon which they will be taxed. Although a more subjective approach could lead to fairer tax decisions, adopting such an approach each time an "amount" requires valuation could possibly lead to further uncertainty as tax decisions would be made on a case-by-case basis. It appears that when deciding whether an objective or subjective approach is most appropriate in valuing an "amount", there is a trade-off between fairness and consistency. This trade-off threatens the courts' ability to fully meet the demands of the Constitution which requires consistent judicial interpretation as well as the maintenance of fairness.

In the present chapter, the objective and subjective means of valuation will be discussed in detail and South African case law relating to the debate between the two methodologies will be analysed. The "gross income" definition and the importance of its interpretation, particularly with regard to the terms "amount in cash or otherwise", forms the main theme of this chapter.

3.2 The interpretation of "an amount in cash or otherwise" in terms of the "gross income" definition

In the South African Income Tax Act the definition of many key concepts and principles are absent and therefore the definitions are established only in judicial decisions. It is therefore of vital importance that the judiciary adopt a defensible method of interpretation as their decisions form the basis upon which South African individuals are consequently taxed. Scholars have long suggested that the unique features of tax law, including its high level of detail, frequent revision, and largely self contained nature, require a special set of interpretative tools. In other words there has been an argument that fiscal legislation should

be interpreted differently to normal legislation and, as a result, tax cases appear to have consistently been interpreted significantly more strictly.

According to Williams (1995: 154), the interpretation of statutes concerns “the body of principles and rules used to construct the correct meaning of legislative provisions to be applied to practical situations.”

In addressing the goal of the research to explore the interpretation by the court of the term “total amount in cash or otherwise”, the gross income definition requires thorough analysis. Gross income, in relation to any year of assessment, means:

- in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such a resident; or
- 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 of assessment, excluding receipts and accruals of capital nature.

According to Williams (1995), the definition above is seriously flawed in its main purpose, namely to define the nature and scope of “income” for the purposes of the Act. Williams (1995: 195), in his criticism of the definition, poses the question: “What exactly is “gross income?” In his opinion, the mechanics of the definition are strange. According to the definition, the process of determining gross income begins with collating the “total amount” of everything that was received by or accrued to the taxpayer during the year of assessment in question. The second step in this process involves extracting those receipts and accruals of a capital nature. Thus, “income” is basically defined as the residual cash as well as “non-cash” amounts, once all capital receipts have been removed. The way in which the definition is structured implies that income and capital are mutually exclusive categories which make up a "total amount in cash or otherwise” and that everything that is not capital, is necessarily income. Income thus includes cash, non-cash, tangible and intangible “amounts.”

If the main purpose of the definition is to classify those amounts which are income and thus taxable, then it seems arbitrary that the Income Tax Act simply defines income as "that which is not capital" and provides no guidance as to how these "residual amounts" should be valued for inclusion in gross income. According to Williams (1995: 195), taken literally, this suggests that income has no distinctive characteristics of its own and is a "mere amorphous residual category."

Williams (1995) further disapproves of that fact that in interpreting the definition of "gross income", South African courts have seldom sought guidance from economics or accountancy on the meaning of fundamental concepts central to the definition which forms the basis of taxation. The result of this has been a number of decisions throughout South African tax case law which seem at odds with commercial reality due to the values which have been assigned to non-cash amounts.

On the topic of interpreting the terms "amount in cash or otherwise" of the "gross income" definition, it appears that the theme of objectivity versus subjectivity has been a hotly contested matter. It is submitted that although the Supreme Court reached the conclusion in the *Brummeria* case that the objective approach is the correct valuation method, much uncertainty remains as to the fairness of the valuation method applied by the court in this case. This uncertainty was addressed in Interpretation Note 58 (South African Revenue Services: 2010) which clarifies the approach that SARS will adopt when applying the judgement. The fact that the Interpretation Note was issued, however, does not overturn the precedent which this case has set and thus, in all taxation cases where a valuation is required, an objective approach must be applied.

As previously mentioned, in the definition of "gross income" in section 1 of the Income Tax Act, only certain terms are explained and as a result, the courts have been called upon to address the meaning of the most of the terms including "an amount in cash or otherwise", which is central to the present research. In studying earlier case law, it is interesting to note the inconsistency which prevails due to different judges adopting dissimilar views about what constitutes an "amount", when amounts should be included (timing) and how an "amount" should be valued for the purposes of taxation.

It has been established that two main methods of interpretation are applied by the courts and these are referred to as the literal approach and the purposive approach. It is submitted that the literal approach to interpretation is the most objective approach to interpretation as this approach idolises the actual text or words of a specific provision of the statue under consideration, allows for no further analysis and adopts, as its main goal, consistency in the law. It has absolutely no regard, in its most primitive form, to the purposes or the intention with which it was enacted by the legislature. The purposive approach, on the other hand, demands a more flexible approach to statutory interpretation and seeks to determine the purpose of the statute in question. This approach has been criticised based on the fact that it introduces an unacceptable level of subjectivity into legal interpretation which threatens not only the elements of consistency and certainty which the courts have sought to achieve throughout legal history, but the doctrine of the separation of powers upon which our legal system is founded. To explain further, judges have the duty to interpret and apply the law as it stands. In circumstances where the statutory language is unclear, Judges are not authorised to alter the law or create new law. In applying a more purposive approach, it is thus very difficult to maintain the separation of powers.

In chapter 2 it was suggested that, irrespective of which form of interpretation is adopted by the courts, an element of subjectivity is inherent in any interpretation and neither form of interpretation can be categorised as being purely objective in that different judges may have differing opinions on the both the wording and intention of the legislator when the particular provisions were enacted or amended. In terms of specifically interpreting the term “amounts in cash or otherwise” of the gross income definition and deciding as to whether an “amount” exists and if it does, valuing such an “amount,” the same objective–subjective continuum is evident. It appears that tax decisions regarding valuation of amounts for inclusion in gross income seem to lie somewhere on this continuum ranging from being objective in nature to being more subjective. What the present research intends to demonstrate is that in valuing an “amount”, despite the fact that the *Brummeria* precedent now requires an objective method of valuation to be adopted, subjectivity will never be completely eliminated.

In addition, despite the so called end to the objective versus subjective approach, tax cases such as *Airworld* have since been decided in terms of the purposive approach which, it has

been submitted, is fairly subjective in nature. It appears that uncertainty remains as to what level of subjectivity is acceptable in tax case decisions.

Williams (1995: 195) concludes that in the past South African Courts have, when confronted with tax questions, generally formulated a judgement via a "narrow and literalist focus on the *ipissima verba* of the Income Tax Act" which, in his opinion is "probably the most garbled, conceptually barren legislation on the statute book". In modern times however, it appears that the purposive approach has steadily gained acceptance.

Before including an amount in gross income, it is suggested that three questions must be posed:

1. Is there an "amount" in terms of the "gross income" definition which is not capital in nature?
2. How should the "amount" to be included in gross income be valued?
3. When should the amount be included in gross income? (timing)

Of most importance to the current thesis is the second question which addresses the issue of how amounts should be valued in order to be included gross income (objectively or subjectively.) In terms of the discussion of case law that follows, the research will ignore the first question in that that it is focussed on valuing amounts (which exclude capital receipts) for inclusion in gross income. It is submitted that due to fact that the timing of an inclusion in gross income may affect the ultimate valuation, tax cases relating to this issue also require analysis and this problem will be addressed in Chapter 5.

3.2.1 *WH Lategan v Commissioner for Inland Revenue* (1926) CPD 203, 2 SATC 16

When discussing the valuation of "amounts" in terms of the "gross income" definition, an early case is that of *WH Lategan v Commissioner for Inland Revenue* (1926) CPD 203, 2 SATC 16 (hereinafter referred to as *"Lategan"*) . The interpretation of the term "accrued to" in this case is also very important in terms of the timing of valuations and this will be addressed later in detail.

The facts of this case involved *Lategan,* the appellant, a wine farmer who entered into an agreement in terms of which he disposed of wine which he had produced during the year of assessment ended 30 June 1920 for a sum of £5 924. Of this sum, £3 500 was payable prior to 30 June of that year. The balance was payable in instalments thereafter. In the assessment of the appellant the Commissioner for Inland Revenue included in the determination of appellant's taxable income for the year ended the 30 June 1920, the whole amount of £5 924 receivable as proceeds from the sale of the wine. In respect of the £5 924, the taxpayer argued that the £3 500 portion of the debt payable in the future had not yet accrued to him for the purposes of "gross income" and that he was liable to tax in that year only in respect of the amounts actually received (£2 424). His argument was based on the fact that the portion of the proceeds not yet received had no value to him in the current year of assessment.

The Cape Provisional Division of the Supreme Court held that the instalments payable after the end of the year of assessment in respect of wine produced during the year formed part of the "gross income" of the appellant for that year and did have a value despite the fact that they had not yet been received, but that the debts payable in the future should be included in gross income at their values as at the 30 June of that year. In other words, the full face value of the debts should not be included in gross income as the amounts had to be adjusted (discounted) to reflect the fact that they would only be received in a later year.

In his judgement, Watermeyer J discussed the definition of "gross income" in detail. His discussion of gross income and valuing an "amount" is an important starting point in the present research and must therefore be thoroughly explained. It is submitted that Watermeyer's approach to the interpretation of the word "amount" was, essentially, purposive in nature as he looked to the intention of the legislator when legislating the definition of gross income in section 1 of the Income Tax Act.

Watermeyer J stated that a literal interpretation of the definition meant that, except in the case of employment, gross income should always take the form of money as it used the words "total amount" which implies a cash sum. In reality, however, this was not true as "total amount" did not always consist of an amount in money. "Income" was considered by Watermeyer J to be "what a man earned by his work or his wits or by some employment of

his capital." The rewards which he got may come to him in the form of cash or some other form of corporeal property or in the form of rights. The value of these amounts then formed the income of the man.

Unless the word "amount" meant something more than an amount of money, the definition given in the Income Tax Act did not seem to be wide enough to include the value of property or rights earned by the taxpayer (such as the right to receive the debts in the *Lategan* case*)* unless they were earned in terms of employment. Watermeyer J, in approaching the definition more purposively, looked to the intention of the legislature, which clearly could not have intended such a result. In Watermeyer's opinion, the word "amount" had to be interpreted widely to include not only the value of money received by the taxpayer but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which had money value. From this case, it is immediately evident that the interpretation of judges such as that of Watermeyer in this case, is of paramount importance in the application of taxation legislation in that the judges are responsible for clarifying ambiguities.

The case of *De Beers Consolidated Mines Ltd v Commissioner for Inland Revenue (Pty) Ltd* 47 SATC 229 (1922) (hereinafter referred to as *"De Beers")* illustrates a similar view to that of Watermeyer's above. In this case, a diamond mining company had a stock of diamonds on hand at the close of the income tax year ending the 30 June 1920 of some 750 000 carats. Owing to the slump in the diamond industry at the time, the company reflected these for the purposes of assessment at a nominal value of £1. Prior to this, the company usually reflected stock at the average cost of production during the period in which the diamonds were won. On this basis, the value of the diamonds would have been £750 000 and not £1. The Commissioner refused to accept the nominal valuation of the diamonds, contending that the correct basis was the cost of production or the market price, whichever was lower. The Special Court confirmed the Commissioner's assessment and it was ultimately held that receipts or accruals in the definition of "gross income" included not only money but also money's worth and that therefore the diamonds on hand at 30 June 1920 must be brought up as part of the income for the year of assessment.

If the principle in the *De Beers* case, affirmed by Watermeyer J in the case of *Lategan,* is correct then a taxpayer's "income" for the purposes of taxation included not only cash which he had received or which had accrued to him, but the value of every form of property which had been received or accrued to him, including debts and rights of action. The question which then needed to be addressed was how to value these "amounts" in order for them to be included in taxable income.

Section 21(2)(e) of the Income Tax Act (as it then was) posed a difficulty in that although it supported the notion that unpaid debts had a value and thus constituted "gross income", it stated that debts must be included at their face value and not at their actual value (in other words, it implied that discounting was not allowed), but that a deduction could be made for bad and doubtful debts in order to arrive at taxable income.

In Watermeyer's opinion, this section appeared to form an exception to the general rule discussed above that "gross income" consisted of the value of the taxpayers' earnings whatever form they might be. Watermeyer J thus expressed the opinion that the instalments payable in future had to be regarded as gross income, but that section 21(2)(e) was not applicable in that something had to be deducted from the face value of the debts to allow for the fact that they were not payable in the year under assessment. Applying, it is submitted, a somewhat subjective approach due to the consideration of the actual value to the taxpayer in the current year, the "amount" to be included was valued as the present worth of the instalments at the end of the year.

As a result of Watermeyer's decision as to the meaning of the "gross income", the words "in cash or otherwise" were added to the definition in section 1 of the Income Tax Act. The effect is that when a taxpayer provides services and gains a non-monetary reward, such as shares in the company, for example, the shares will be assigned a "cash value" by the Commissioner who will levy tax based on this valuation. It is important to recognise that after *Lategan,* anything received in return for any services rendered is treated *prima facie* as taxable by the South African Revenue Authorities.

Of relevance to the present research is that Wayermeyer utilised a somewhat subjective method of valuation in that he took into consideration the actual value of the amounts to the taxpayer at year end and did not apply an objective approach which would probably

have resulted in the taxation of the full value of the "amount" accrued. The addition of "in cash or otherwise" to the definition of gross income, although required in terms of the findings of the above case, has given rise to much dispute due to the complications which arise in assigning a value to non-cash items.

3.2.2 *Commissioner for Inland Revenue v Delfos* (1933) AD 242, 6 SATC 92

A few years after the *Lategan* case was decided, the case of *Commissioner for Inland Revenue v Delfos* (1933) AD 242, 6 SATC 92 (hereinafter referred to as *"Delfos"*) was heard. The main issue addressed in this case was the meaning of the term "accrued to" which concerns the timing of the valuation. The facts of the case and conclusions reached as to the meaning of this term will be explained in detail later.

Of relevance to the present chapter dealing with valuation is that the judges in this case differed on their interpretation of the word "accrual". There was debate as to whether an amount payable in the future had a taxable value in the current year of assessment. In terms of the inclusion of a "right to future payment" in gross income, a statement of support was made by Wessels AJ who appears to have agreed with the idea previously put forward by Watermeyer in *Lategan* regarding the characteristics of "gross income" and the need to interpret the definition widely so as to fulfil the intention of the legislator:

> We therefore start by ascertaining the "gross income" of the taxpayer. Section 7(1) tells us how to arrive at this. We must find what the total amount is in cash or otherwise which was received by or accrued to or in favour of the taxpayer in the year of assessment, not being receipts or accruals of a capital nature, from any source within the Union. . .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.

Williams (1995: 106) is of the opinion that a statement made in the *Lategan* ruling referred to above is obviously correct. "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."

3.2.3 *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* (1933) AD 242, 6 SATC 92

The case of *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* (1933) AD 242, 6 SATC 92 (hereinafter referred to as *"People's Stores")* confirmed the *Lategan* principle that the word "amount" in the definition of "gross income" is not restricted to cash amounts, but includes every form of property which is capable of being converted into money and put to an end a period of much debate. This confirmation is relevant to the present research in that if every form of property, including non-cash items, can be included in gross income and it is vital that the taxpayer, the Commissioner and the courts are able to accurately value these "amounts" for inclusion in gross income.

The taxpayer in this case, a subsidiary in the Edgars group of companies, was a retailer of clothing and footwear and other goods. In the course of trade, the taxpayer sold goods on what was referred to as a "six month revolving credit scheme." Under this scheme, a customer who purchased goods on credit had to pay the amounts charged to his or her account in six equal monthly instalments. On the last day of the year of assessment in issue, instalments under this scheme which were not payable until the following year amounted to R341 281. The Commissioner included this sum in the taxpayer's gross income. The taxpayer objected to the assessment and contended that the instalments which were neither payable nor paid during the current year of assessment ought not be included in the gross income for that year; in the alternative, the taxpayer contended that the face value of such instalments should not be included in gross income but only the present value.

Having unsuccessfully objected to the assessment for normal tax for the year in question, appeal was made to the Special Court. Two questions were submitted to the Special Court for decision:

1. Ought the value of the instalments not yet payable or paid to have been included in the taxpayer's gross income?
2. If so, at what value ought those instalments to have been included in the gross income? Ought it to have been done at the face value, or at the value to the taxpayer, or at the market value, or at some other value?

This case is perhaps the first case in which the courts were required to be either subjective in their approach to considering the actual value to the taxpayer in terms of the facts of the case or to take an objective stance and instead interpret gross income literally by including the total face value of the amount in the "gross income" of the taxpayer.

The court held that:

(i) That income, although expressed as an "amount" in the definition of "gross income", need not be an actual amount of money but may be "every form of property earned by the taxpayer, whether corporeal or incorporeal, which has money value . . . including debts and rights of action".

(ii) That income in a form other than money must, in order to qualify for inclusion in "gross income", be of such a nature that a value can be attached to it in money.

(iii) That the fact that the valuation of the income may sometimes be a matter of considerable complexity does not detract from the principle that all income having a money value must be included.

(iv) That no more is required for an accrual in terms of the definition of "gross income" than that the person concerned has become entitled to the "amount" in question.

(v) That any right (of a non-capital nature) acquired by the taxpayer during the year of assessment and to which a money value can be attached, forms part of the "gross income" irrespective of whether it is immediately enforceable or not, but that its value is affected if it is not immediately enforceable.

(vi) That the decision in *Lategan v Commissioner for Inland Revenue* reflects the law correctly.

(vii) That the value of the instalments not yet payable nor paid at the tax year-end must be included in the taxpayer's gross income for that tax year.

(viii) That the outstanding instalments constituted rights to receive payment in the future and these rights had to be valued, such value being obviously affected by their lack of enforceability; they accordingly had to be valued at their market value.

It appears that the Special Court considered itself bound by the judgement of the full bench of the Cape Provisional Division in *Lategan.* The Court held that the value to be assigned to the "amount" was the present value of the outstanding debt and in doing so upheld the correctness of the decision in *Lategan* that the "present value" of a right to future payment is arrived at by deducting an amount from its face value to allow for the fact that it is not immediately payable.

The legal position regarding the discounting of an amount for inclusion in gross income was changed shortly after this decision by virtue of an amendment to the Income Tax Act, which introduced a proviso to the definition of "gross income" in section 1. The proviso states that when:

- a taxpayer becomes entitled to an amount during the year of assessment; and
- that amount is payable on a date falling after the last day of the year under assessment,

then it will be deemed that the face value of the amount (and not the present value) accrues to the taxpayer in the relevant year of assessment.

Williams (1990) posed an interesting question regarding the concept of accrual and whether it relates to timing or whether it concerns a quality distinctive of income. No South African case has recognised this underlying problem and thus it remains unresolved.

A further concern voiced by Williams (1995) is that this judgement perpetuates the long-standing problem and unfortunate habit whereby South African courts view income tax problems as an abstract exercise in statutory interpretation. In other words, tax cases are interpreted differently to other legal matters. A concern which directly relates to the research topic at hand is the court's complete lack of reliance in this case upon the concept of business and the generally accepted principles and practices of commercial accountancy in placing a value on amounts for inclusion in gross income. It is submitted that the decision in *Lategan,* in which the present value method was utilised, results in a logical result.

According to Williams (2005), in *Lategan's* case and in the *People's Stores* case, the court held that when a taxpayer becomes entitled to anything, in cash or otherwise, of a revenue nature, that property accrued to the taxpayer in the year of entitlement, but if it did not consist of cash, it required valuation. As was stated by Hefer JA in the *People's Stores* case, when a right to payment in the future accrues to a taxpayer, it has to be valued and its value is obviously affected by its lack of immediate enforceability. The accrual of the right and its value are inseparably linked. Williams (2005: 92) submits that the proviso severs this link. In his opinion, "[t]he severance is hopeless in concept, since it departs completely from commercial and economic reality. It equates in value for tax purposes a cash payment and a

debt payable at some future date . . . It throws the whole credit system into disarray for tax purposes."

3.2.4 *Cactus Investments (Pty) Ltd v Commissioner for Inland Revenu*e (1999) (1) SA 315 (SCA)

The judicial formula established in the case of *Lategan* and its progeny, *People's Stores*, had effectively hardened into a rule of law by the time *Cactus Investments (Pty) Ltd v Commissioner for Inland Revenu*e (1999) (1) SA 315 (SCA) (hereinafter referred to as *"Cactus Investments"*) came before the court. The taxpayer in this case, in terms of a scheme enabling investments into interest-bearing loans without attracting liability for tax, exchanged taxable interest income for non-taxable dividend income by way of cession and counter cession. The court confirmed the formulation that the expression "accrued to" must be interpreted to mean "become entitled to" and that this includes *rights* of a non-capital nature. The decision in the *Brummeria* case involved the valuation of the *right* to utilise an interest-free loan.

Hefer JA effectively summed up the law in *Cactus Investments* by saying that the definition of "gross income":

> . . . includes, as explained in *Commissioner for Inland Revenue v People's Stores* not only income actually received, but also rights of a non-capital nature which accrued during the relevant year and are capable of being valued in money.

The exchange of interest income for dividend income has since effectively been brought to a halt by section 103(5) which is an anti-avoidance provision aimed at transactions, operations and schemes where a taxpayer has ceded his right to receive any amount in exchange for dividends. The effect of this section is that taxpayers are taxed as though the cession had not been effected (Huxham & Haupt: 2011).

3.2.5 *Mooi v Commissioner for Inland Revenue* (1972) (1) SA 675 (A), 34 SATC 1

The decision in *Mooi v Commissioner for Inland Revenue* (1972) (1) SA 675 (A), 34 SATC 1 (hereinafter referred to as *"Mooi"*) illustrated that for there to be an accrual, the "amount" in question must have a monetary value. Williams (2005) explains the implications of this case that where a taxpayer acquires a right which is conditional, (which depends on the occurrence of a future uncertain event) no valuable right accrues until the fulfilment of these conditions. Due to the case being more relevant to the issue of the timing of a valuation, the specific facts of the case will be discussed in a later chapter.

What is relevant to the present topic of valuation is that the decision in this case applied the idea suggested by Watermeyer J in the case of *Lategan* that the "gross income" definition be interpreted widely to include "rights of action," in this case, the right to acquire shares. Furthermore this case supports the inclusion of non-cash "amounts" in gross income and the need to establish a means of valuation for these items in line with the goals and objectives of the Income Tax Act.

In this case, although the main issue involved the timing of the valuation, it is important to note that on the fulfilment of the conditions, the court assigned a value to the "amount" based on the objective market value of the non-cash item, in this case, the shares. Although it appears as though this decision was unfair, since the shares in question appreciated in value over the years from 1963 to 1967 when they were included by the Commissioner, resulting in a larger taxation burden, it is submitted that this decision in fact protects taxpayers from having an amount included in gross income, based on the "accrual" principle, which the taxpayer may not receive should the conditions to which the amount is subject fail to be fulfilled. Further, non-cash items, such as shares, do not always appreciate in value, as in *Mooi,* and thus it appears as though this method of valuation results in an acceptable degree of fairness for both parties.

Placing a value on a non-cash amount based on relevant market prices is, however, not always as simple as it may initially seem. The problems relating to this "objective" means of valuation will be discussed in detail later.

3.2.6 *Ochberg v Commissioner for Inland Revenue* (1931) AD 215, 5 SATC 93

A particularly controversial case concerning non-monetary receipts and accruals and the valuation thereof is the case of *Ochberg v Commissioner for Inland Revenue* (1931) AD 215, 5 SATC 93 (hereinafter referred to as *"Ochberg"*). This case illustrates how, by applying a strict and objective approach, patently unfair results can occur. This case involved a taxpayer who was considered by the court for the purposes of the judgement to be the sole beneficial shareholder of a certain company. He rendered services to the company in consideration for which the company allotted him additional shares. After the allocation of the additional shares, he remained the sole shareholder of the company. Looking at the transaction from a purely objective accounting, economic and business point of view, the additional shares that he received had a value, but, due to the company having to allot additional shares, the total value of the shares, including the shares allotted to him, remained the same. That is, the value of his original shares decreased correspondingly with the value of the additional shares issued to him. His economic wealth had not increased at all. The taxpayer, it is submitted, correctly argued that he had received no financial benefit for the services for which he had been "paid" in the form of shares and should not be liable for taxation thereon.

The majority of the Court, however, were unmoved by the taxpayer's argument and held that the value of the shares received must be determined objectively, in other words, what a willing buyer would pay for the shares in an open market, and taxed accordingly.

De Villers CJ, with whom majority of the Court agreed, argued as follows:

> Here the shares were issued for services rendered, just as presumably they would have been issued to any outsider for the same services rendered. What connection can there be between such a transaction and the fact that the person who rendered the services and to whom consequently the shares were issued happened to be not only a shareholder, but virtually the sole shareholder. How could, what is after all a purely fortuitous circumstance affect the legal position so as to convert what is received by an outsider as income into capital when received by him.

Stratford JA and Wessels JA, in their separate minority judgements, explained the illogical result arising from applying the reasoning of the Chief Justice. Stratford JA said:

> To assess the appellant in respect of this issue which clearly brought no added wealth to him, would be to work a manifest injustice upon him, and unless forced to do so by express words of the legislature, we should avoid doing so. I can find nothing in the Income Tax Act which compels us to designate as income something which every principle of reason and common sense tells us is nothing of the kind.

In similar vein, Wessels JA argued that:

> The principle which underlies the Income Tax Act is that the State takes a percentage of the money or moneys value which has accrued to the taxpayer during the year of assessment. In other words that he pays his tax not out of his capital but out of his incomings. If therefore, we assume that Ochberg possessed nothing beside the interest in the company, then if he is liable to pay income tax and super tax on the face value of the 4 938 shares, he will not be able to pay the tax out of moneys or the value of money which has increased his estate but he will be obliged to realise capital in order to pay his income tax. This seems to me contrary to the whole tenor of the Act. (own emphasis)

In effect, both minority judgements used a subjective test for valuing something received in a form other than cash, namely, what the value was to that individual taxpayer, in his particular circumstances. In taking this stance, the Judges effectively applied a purposive approach in that they considered both the intention of the legislature and the context of the case. The majority of the court however followed the strict and literal interpretation of the words "received by in cash or otherwise" for the purposes of the definition of "gross income" and valued the receipt accordingly using an objective approach.

It is submitted that should a more subjective approach have been taken, the result of the case would have been far more equitable. According to Newman (1982) the receipt of assets should not constitute income in the hands of an individual unless the asset is useful to him or her. In this case, the receipt of the shares cannot be said to have increased the utility of the taxpayer. Williams (1997) states that the decision in this case is clearly regrettable due to the fact that the basic principles of accountancy and good business practice were treated as being irrelevant and as a result, the decision is at odds with both established economic principles and commercial reality.

A person may sell property or render services to a company but is, in terms of the agreement, obliged to use the purchase price or the remuneration to acquire the equivalent amount in shares in the company. According to De Koker (2010), the question which then

arises is whether the purchase price or remuneration agreed upon constitutes "income" for tax purposes or whether the amount to be included in gross income is the value of the shares acquired?

A case which illustrates the court's inclusion of non-monetary benefits in the form of shares in gross income is the case of *Lace Proprietary Mines v Commissioner for Inland Revenue* (1938) AD 267, 9 SATC 349.

3.2.7 *Lace Proprietary Mines v Commissioner of Inland Revenue* 1938 AD 267, 9 SATC 349

Lace Proprietary Mines v Commissioner of Inland Revenue 1938 AD 267, 9 SATC 349 (hereinafter referred as *"Lace Proprietary Mines"*) is an important case in the discussion relating to the inclusion of non-monetary amounts in gross income and the valuation thereof in that it illustrates that the ascertainment of the "value" of the shares is a question of fact. The judgement in this case confirmed the *Ochberg* decision that the strict, literal approach to interpreting the word "amount" is the best suited in cases of non-monetary assets. This interpretation, it is submitted, will result in an objective valuation method being applied as in both *Ochberg* and the present case.

In *Lace Proprietory Mines*, the taxpayer company acquired certain mineral rights over the farm Spaarwater for the purpose of disposing of those rights to a company to be formed to mine the property. The contract of sale stated that the purchase price was the sum of £250 000 to be paid and was satisfied by the allotment to the taxpayer of 1 000 000 fully-paid up five shilling shares in the purchasing company. The issue which had to be decided upon in this case was whether the "amount" received by the taxpayer in terms of the contract was the cash price or the "value" of the shares.

Stratford CJ expressed the opinion that the intention of the parties was that the consideration due to the taxpayer under the contract was one million shares in the purchasing company and that this consideration therefore had to be valued. The determination of the value of the shares, according to Stratford CJ:

> . . .[w]as a question of fact; . . . The market price was admittedly relevant but it might have been fictitious and momentary. The stability of the market quotation and its approximation to value is

> properly tested to some extent by reference to the market quotation before and after that date . . . The value of the shares must, of course, be ascertained by enquiring what price could have been obtained for them on an open market by adopting some reasonable method of sale on that date.

This statement is explicit confirmation that the objective test applied in the *Ochberg* case is best suited for valuing assets received, and not the subjective one, despite the inequities which may arise by adopting such an approach.

3.2.8 *Income Tax Case 391* (1937) SATC 477

Previously, before the *Lace Proprietary Mines* case was heard, in *Income Tax Case 391* (1937) SATC 477 (hereinafter referred to as *"ITC 391"*), the consideration for the sale of certain properties was stated to be the payment in cash of £150 000 subject to the obligation of the company simultaneously with such payment to subscribe for at par and to pay for in cash 300 000 shares with a nominal value of 10s each in the new company. The court considered that under the terms of the contract the consideration received by the seller of the properties was the cash fixed by the agreement, namely, £150 000, the further terms relating to the purchase of shares being a supplementary agreement that did not affect the nature of the consideration actually passing.

De Koker (2010) submits that the decision in this case was possibly incorrect, since the true intention was that the consideration should be the 300 000 shares, which should have been valued for tax purposes and not the cash consideration. It is submitted that this case is one of many cases where an objective approach, which ignores the actual value to the recipient of the non-cash amount received, has resulted in a somewhat obscure valuation, not in accordance with the intention of either party. Should a more subjective approach have been applied to the case, a fairer value could have resulted. If the shares have been held to be the true consideration, the court would have had to establish a value based on the relevant market value. This, as mentioned previously, is not always simple, especially where the shares represent private interests. This is because a valuation of private shares cannot simply be done by referring to the market as the shares are not listed on a stock exchange and thus essentially do not have a market value. It is submitted that the court may have been hesitant to adopt such an approach based on the complexity of the valuation they

would have had to perform. Despite this difficulty, it is nonetheless submitted by De Koker (2010) that valuing the shares would have been the correct route.

3.2.9 *Stander v Commissioner for Inland Revenue* (1997) (3) 617 (C), 59 SATC 212

Although not necessarily relevant to the issue of valuation, the legal relationship between parties also has an effect on the incidence of taxation. This aspect is well illustrated in *Stander v Commissioner for Inland Revenue* (1997) (3) 617 (C), 59 SATC 212 (hereinafter referred to as "*Stander"*)*,* where the legal relationship between the parties was thoroughly analysed in deciding whether the "amount" in question was subject to taxation or not. Before discussing the facts of the case in detail, it is important to note that there are two aspects to the *Stander* decision. The first relates to the legal relationship described above and effectively means that if a taxpayer receives a benefit from an employer, it will be included in gross income in terms of paragraph (c), being a reward for services rendered. Of relevance to the present research is the second aspect of the decision, which involved the valuation of the benefit which the taxpayer received. In this case, a subjective valuation was applied by the court in valuing the non-cash amount.

The facts of this case involved *Stander,* a taxpayer who was employed by a motor vehicle dealer, Frank Vos Motors (Pty) Ltd as a secretary. Frank Vos Motors had originally entered into an agreement with Delta Motors Corporation (Pty) Ltd, a manufacturer and distributer of motor vehicles which were marketed through franchise dealers, in terms of which it held a franchise for the Worcester district. In terms of the franchise agreement, Frank Vos Motors was required to furnish monthly financial reports to Delta and these reports were drawn up by the appellant and forwarded by Frank Vos Motors.

Towards the end of 1988, the appellant received an invitation from Delta to attend a convention in Johannesburg where it was announced that he had been adjudged one of the top five bookkeepers of the franchise dealers of South Africa. The franchiser had, unbeknown to the appellant, instituted a competition for the employees of the franchise dealers to recognise excellent standards of performance in financial management. The taxpayer concerned won a prize consisting of a non-convertible overseas holiday for himself

and his wife. The Commissioner assessed to tax the value of the prize awarded to the taxpayer, as an amount of R14 000.

The decision in this case is relevant to the discussion relating to the valuation by the Courts of non-cash "amounts" for the purposes of their inclusion in "gross income." The main issue raised in this case was whether the non-convertible holiday constituted an "amount" for the purposes of taxation and if so, how this "amount" was to be valued. The Court was required to investigate whether the overseas trip awarded to the taxpayer represented "property" which has a money value or whether it constituted a right that could be "turned into money" (had an ascertainable money value.)

The Court concluded that the promise by the franchiser to award the taxpayer an overseas trip amounted to an executory donation but since the terms of the donation were not embodied in a written document as required by section 5 of the General Laws Amendment Act, 50 of 1956, the franchiser's offer did not give rise to a valid contract of donation which was enforceable by the taxpayer and therefore the taxpayer had not received a "right", even if a monetary value could be placed on the trip he received.

In response to the question whether a value could be placed on what the taxpayer received by going on the trip, Friedman JP said:

> The answer to this question is, in my view, in the negative. Having gone on the trip he had not received any "property" on which a monetary value could be placed in his hands. He was no more able to turn it into money or money's worth after accepting the award, than he was at the time when the donation was still at the executory stage.

In his judgment, Friedman JP referred to the judgment of Conradie J in *Income Tax Case 701* (1950) 17 SATC 108:

> Conradie J, in delivering the judgment of the Special Court, accepted the principle that in order to fall within the tax net, receipts or accruals other than money had to have a money's worth. However, Conradie J rejected the argument that only benefits which a taxpayer can turn into money can be said to have a money's worth. He stated that there was no warrant for such a restricted form of valuation and held that a service which is available in the market place has a value attached to it by the market. That, he stated, was the value of the benefit which anyone who availed himself of the service enjoys.

> In other words, one simply looks at what the consumer of the service would have had to pay for it if he had not been given it for nothing.

Friedman JP did not accept this view as correct and concluded:

> Having regard to the conditions applicable to the enjoyment of the award, the overseas trip had no "value" in Stander's hands . . .

It appears that the Court in this case accepted that a subjective valuation was necessary in order to produce a desirable and fair tax value. Instead of objectively establishing an amount, the approach taken by the Court in the case of *Stander*, it is submitted, was wholly subjective. This is because, according to Goldswain and Engelbrecht (2008), it was decided that due to the individual taxpayer not being able to sell or alienate his right to the holiday for cash, he had not received a benefit capable of being valued in money. In other words, the court looked at the actual subjective value to the taxpayer himself, which was established to be nil, and applied this value instead of valuing the holiday in terms of the market and establishing what would be considered an objective value, as in previous cases. This case also implied that notional amounts did not have an ascertainable value and thus resulted, for a number of years, in a general acceptance that these amounts were not taxable.

3.2.10 *Commissioner for Inland Revenue v Butcher Brothers (Pty) Ltd* (1945) AD 301, 13 SATC 21

In calculating taxable income, if an amount is capital in nature then, by virtue of the general definition of "gross income", the enquiry must not stop there. The special inclusion paragraphs (a) to (n) must also be investigated to ensure that the capital payment amount is not inadvertently caught in the tax net under one of those provisions. In terms of section 82 of the Income Tax Act, the burden of proof that any amount is not subject to tax rests on the taxpayer. De Swardt, Jordaan and Silke (2007) submit, however, that the onus of proving that an ascertainable money value exists falls on the Commissioner and not on the taxpayer.

Authority for the proposition that the Commissioner has the onus of proving a money value exists can be found in *Commissioner for Inland Revenue v Butcher Brothers (Pty) Ltd* (1945)

AD 301, 13 SATC 21 (hereinafter referred to as *"Butcher Brothers"*). The taxpayer company in this case acquired land, which was subject to a fifty year lease. The terms of the lease obliged the lessee to erect and maintain buildings on the leased premises to the value of at least £55 000. At the end of the lease, the buildings would become the property of the taxpayer, who was not obliged to pay any compensation to the lessee. During the lease contract, the lessee demolished the existing building on the leased premises and erected new buildings, which were completed in 1955.

The issue before the court was whether the Commissioner was correct to include the amount of £55 000 in the taxpayer's gross income for the 1935 tax year on the basis that, when completed, the buildings were a "premium or like consideration" in terms of the Income Tax Act, 1925.

It was held that the advantages accruing to the taxpayer were not capable of being accurately valued in 1935 as they were only completed in 1955, twenty years later. Therefore, these advantages were not an "amount" in terms of the "gross income" definition and thus, because no "amount" had been received by or had accrued to the taxpayer, there was no basis for taxation.

Williams (1997) notes that, when *Butcher Brothers* was decided, the Income Tax Act did not contain a provision such as the current paragraph (h) of the definition of "gross income." The case was therefore argued purely on the basis of whether the lessor's right to have improvements effected on the leased premises was a "lease premium" and therefore an "amount." In judging the case, the court refused to uphold the assessment because no "amount" had accrued to the taxpayer during the year in issue. In arriving at this outcome, the court considered the length of the lease and the uncertainty as to what the value of the improvements would be at the end of the lease and, due to the fact that it was impossible to place a "value" on the improvements, no "amount" had been received or accrued for the purposes of gross income. Although it could be argued that the objective value of the improvements was £55 000, the right to enjoy the improvements only accrued twenty years later. Therefore, subjectively, it was impossible to place a value on the improvements in 1935, twenty years before the date on which they were completed. It is submitted that the decision in this case is correct as it would be unfair to tax a taxpayer on a "value"

established purely by estimate and lacking in accuracy. Further, a taxpayer should only be liable for tax on amounts which the Commissioner can correctly establish and justify.

In cases where the courts are faced with valuing non-cash items, it appears that the utilisation of "fair market value" has been accepted as the norm. However, in circumstances where a market does not exist, the courts are faced with the difficulty of establishing a value using an alternate valuation means. An example which illustrates this problem is the valuation of private equity. Private interests are not listed on a stock exchange and therefore do not have a readily ascertainable market value. Thus, they require valuation in terms of *numerous* variables. The difficulties in valuing private shares based on appropriate variables will be discussed in further detail in a later chapter.

It is submitted that logic such as that applied in the *Butcher Brothers* case should perhaps be adopted in cases where the court or the Commissioner cannot value a benefit accurately. Following decisions, like *Butcher Brothers,* where a taxpayer escapes the tax net, the South African Revenue Service often adjusts the law so as to prevent future loss to the *fiscus*. Following this decision, paragraph (h) was inserted into the definition of gross income and subsection 11(h) into section 11. Paragraph (h) includes in the gross income of the lessor the value of the improvements affected on his or her land or to his or her buildings. The inclusion only applies if the lessor has a right to have improvements effected to his or her property. In addition, there must be an agreement obliging the lessee to effect improvements on the land or to the buildings (De Swardt *et al*: 2010). The inclusion in gross income should, according to a strict interpretation of the Income Tax Act, be made in the tax year in which the improvements or the right to have them effected accrues to the lessor. The owner of a building will effectively be taxed on improvements on his or her land or to his or her buildings in terms of the lease agreement. The amount which will be included in gross income is the amount stipulated in the agreement as the face value of the improvements or as the amount to be expended on them, or if no amount is stipulated, an amount representing the fair and reasonable value of the improvements (De Swardt *et al*: 2010). It is interesting to note that the term "fair value" is introduced in a situation where no readily available value exists. Section 11(h) allows the Commissioner to grant an allowance to the lessor in special circumstances so that he or she may spread the benefit of a lease premium or leasehold improvements over a period of time. Since lease premiums

are generally received in cash, section 11(h) is rarely applied and thus lease premiums are generally included in gross income in the year in which the premium is received or accrued. The section 11(h) benefit is therefore mainly enjoyed by lessors on whose property improvements have been effected.

3.2.11 *Land Dealing Company v Commissioner of Taxes* (1959) (3) SA 485 (SR), 22 SATC 310

The case of *Land Dealing Company v Commissioner of Taxes* (1959) (3) SA 485 (SR), 22 SATC 310 (hereinafter referred to as "*Land Dealing Company")* was an important case in relation to the taxation of notional receipts and accruals and the timing of the valuation thereof. The taxpayer in this case acquired certain land in 1940 as a capital asset at a price of £1 300. In 1947, its shares were taken over and it became a land-dealing company. At that time the value of the land in question was £6 500. In 1957 the property was sold for £9 000 pursuant to a scheme of profit-making. The Commissioner assessed the company to taxation on the difference between the selling price and the cost price. The taxpayer objected on the grounds that, since the property became stock-in-trade in 1947, it should be assessed to tax on the difference between its value at that date and the eventual selling price.

The issue which the court had to decide upon was whether, when property held by the taxpayer changes from capital to trading stock, the increase in value between its acquisition and the change to trading stock is a "receipt" or "accrual" of capital nature. The court held, in the negative, that the increase in the value was merely notional, and the Income Tax Act is concerned only with actual receipts and accruals. The only actual receipt was the £9 000 which accordingly was "gross income" within the meaning of Act.

This case implies that "notional" receipts and accruals are incapable of having a taxable value and should not be included in "gross income". A similar view was expressed in the *Stander* decision, as previously discussed.

Section 22 of the Income Tax Act now deals with the valuation of trading stock. Of relevance to the above case discussion is section 22(2) of the Income Tax Act which provides for the valuation of opening stock. Section 22(2)(b) deals with assets which are on hand at the beginning of the year but were not included in the closing stock at the end of the previous

year because they were originally held as capital assets. If, in the current year, a taxpayer changes his intention and the assets in question become trading stock, the market value of such assets as at the date of the change is included in the opening stock as a deemed cost. In terms of section 22(3) the cost of such stock is the market value on the date on which the goods change from being capital in nature to revenue.

3.2.12 *Income Tax Case 1791* 67 SATC 230

In *Income Tax Case 1791* 67 SATC 230 (hereinafter referred to as "ITC 1791"), the taxpayers were developers of retirement villages and had conducted the business of development and marketing of retirement villages since 1988. During the period in issue, the taxpayers disposed of the right to occupy units in retirement villages (these rights were referred to as "life rights") in exchange for the receipt of interest-free loans.

The Commissioner assessed the taxpayers on the basis that the benefit received by the taxpayer, the right to utilise the loan capital interest-free, constituted a benefit other than in cash which was taxable in terms of the definition of gross income in section 1 of the Income Tax Act. The Commissioner calculated the value of the accrual of this alleged benefit by applying the average prime overdraft rate of interest to the average amount of the loans in the possession of the taxpayer in the particular year. The taxpayers objected to these assessments on the basis that they had not received a receipt constituting gross income.

The Court held, in favour of the taxpayer companies, that the "right" to the use of the loan capital interest-free did not fall into gross income as the monies in issue were not used by the companies for income producing purposes and that the Commissioner had assessed them on the basis of notional income received from the use of the money, which in the court's opinion, was not permissible. Further, the "rights" could not be ceded or transferred and thus the only right which arose was the right to retain the money lent until the happening of certain predetermined events and this "right" had no cash value.

On appeal to the Supreme Court of Appeal in *Commissioner South African Revenue Services v Brummeria,* however, the decision in *ITC 1791* was reversed and a precedent was set that

an objective approach to valuation must be adopted when valuing non-cash receipts and that accordingly, the right to the interest-free loans must be valued objectively, in terms of the market, on the basis that, in the modern commercial world, a right to retain and use loan capital interest-free for a period of time, is a valuable right.

Before concluding the chapter and discussing the *Brummeria* decision in detail in the next chapter, it is important to briefly explain the concepts behind the subjective and objective schools of thought with reference to some of the cases discussed above. It is submitted that the literal approach to interpretation cannot be directly equated to the objective approach and similarly, the purposive approach is not equivalent to the subjective methodology. This present research merely suggests that the literal approach tends to result in objective valuations whereas the application of a purposive approach tends to yield more subjective valuations.

3.3 Concepts underlying the subjective and objective methods of valuation

For the subjective school of thought, the motivating argument is that an individual should be taxed upon what the value of the property received as income is actually worth to him or her. This principle was briefly touched upon in the *Ochberg* case, where it was argued by the minority that taxing an individual who has not received any actual increase in economic wealth is an injustice. The minority judges in this case, in their dissenting judgement, considered the intention of the legislator and it was suggested that the purpose of the Income Tax Act is to tax a percentage of "money earned" and that the increase in shares had no effect upon the financial position of the taxpayer and thus it had to be considered whether any "amount" was received for the purposes of taxation. They expressed the view that it seems unacceptable that the SARS should be able to reach into the pockets of individual taxpayers when they have not received any increase in wealth. This clearly fails to meet the fairness and equity requirements of the Constitution of the Republic of South Africa, Act 108 of 1996.

In the subjective viewpoint, it appears that the rights of the individual are the primary concern and thus arguments based on this approach are aimed at protecting the rights of the individual concerned to be taxed fairly by considering the context in which the case

occurs and whether or not there has been an actual financial gain to the taxpayer. This approach, it appears, better meets Constitutional requirements. The problem with this approach to interpreting the Income Tax Act, however, is that it is very difficult for the Commissioner to value amounts based on the personal circumstances of the individual taxpayers in each tax case and thus consistency is compromised which ultimately results in a taxpayer's right to readily predict their tax burden being threatened.

In analysing the cases which took an objective approach, it is submitted that the main idea is that all income received should be taxed as if it were received by a third party in an arm's length transaction – a transaction between willing parties in an open and unrestricted market. By taking this stance, it is thought that equity for all parties concerned results due to the fact that the "value" of a benefit does not change based on the personal circumstances of different individual taxpayers. The majority judgement in *Ochberg* was based on this idea.

Although the subjective argument is suited to the taxation of a particular individual, the objective argument is possibly more effective for taxing taxpayers in general as it provides consistency and predictability which is desired by taxpayers and essential in order for a taxation system to be effective. In fact, there is a trade-off between the desires of taxpayers to have their cases treated individually and their need to be able to reasonably predict the actions of the South African Revenue Services and the courts.

Due to the *Brummeria* case (which will be discussed in detail in chapter 4) being a Supreme Court of Appeal case, it creates a binding precedent. The application of this precedent is evidenced in the case of *Vacation Exchanges International v Commissioner for Inland Revenue (*2009) JDR 0743 (WCC) (hereinafter referred to as *"Vacation Exchanges International"*), which applied an objective approach to valuation in a manner similar to the *Brummeria* decision. This will also be discussed in chapter 4. As a result of the decision in *Brummeria*, it is submitted that each taxpayer's own fair assessment based upon what the value of a benefit received or accrued is to him or her is now considered irrelevant. As a result of the subjective approach being abandoned, the provisions of the Income Tax Act can be applied consistently and in so doing, create an environment of more certain tax planning. By applying an objective approach, one is effectively taxed upon what the value of

the “amount” received by him or her is worth to any third party and not to the taxpayer as an individual, as is the case with the subjective approach. However, an individual’s right to be taxed fairly upon what an amount is actually worth to him or her is foregone by adopting an objective approach which creates more consistency and predictability in the tax system. This method could possibly be challenged based on its lack of constitutionality. Both methods appear to have advantages and disadvantages in the light of both the Constitution and administrative feasibility. Again, the inevitable trade-off between the fairness resulting from a subjective approach, and the consistency offered by a more objective approach must be highlighted.

3.4 Conclusion

When explaining the objective approach, it was submitted that the main result of this approach is that it creates more consistency than the subjective approach as individuals are taxed upon what the value of the amount would be to any third party. This clearly creates a higher level of predictability. The subjective method of valuation is concerned more with individual fairness as it values amounts in terms of their actual value to the individual taxpayer concerned.

With regard to the South African cases dealing with the valuation of “amounts” in the form other than cash, leaving aside the subjective *versus* objective debate, it appears that before the *Brummeria* case was decided, the court had already settled many other issues relating to valuation. Firstly, in the case of *Lategan,* it was established that the “gross income” definition requires wide interpretation so as to include non-cash amounts. The problem then encountered was whether discounting amounts to their present value for taxation purposes would be allowed. Despite the findings in *Lategan* and *People’s Stores* that this would be allowed, a proviso was added to the “gross income” definition which now prohibits the discounting of an amount for taxation purposes and states that the full face value must be included. The first valuation problem was thus solved.

A second problem was the timing of the inclusion of the amount in gross income. In the *Mooi* case it was established that valuation and inclusion of amounts in “gross income”

should only occur once any conditional requirements pertaining to the receipt of the "amount" had been fulfilled.

Another problem addressed in the case of *Butcher Brothers* was whether or not an amount can be included in taxation when it cannot readily be valued. This problem was resolved when the court decided that in cases where an accurate valuation cannot be established, no "amount" accrues. In the case of *Land Dealing Companies,* it appears that the court solved the valuation issue of notional accruals and receipts when it was ruled that these do not constitute gross income and thus do not require valuation. It is submitted that this case followed a similar logic to that of *Stander* where a holiday that could not be converted into cash was not valued and included in the recipient's gross income.

In each case discussed above, certain valuation problems were addressed and resolved. The one valuation issue, however, which remained unresolved was whether an objective or subjective valuation should be applied to non-cash amounts. Cases such as *Stander* and *Ochberg,* for example, adopted a completely different approach in terms of how an amount should be valued.

In 2007, in the Supreme Court of Appeal case *Commissioner for Inland Revenue Services v Brummeria,* the topic of "notional" income and whether it falls within the ambit of "gross income" as defined in section 1 was again raised. The point in contention was whether or not the use of an interest-free loan constituted an "amount" which had "accrued" to the taxpayer for the purposes of the definition of "gross income" in section 1 of the Income Tax Act and if so, what valuation method should be used to value such a benefit.

The decision in this case would have a far-reaching impact as it resolved the objective *versus* subjective debate which had been ongoing for years. Despite this seeming resolution, the decision in this case has stirred much controversy and the judgement has been criticised for its lack of economic logic in that it does not take into consideration the commercial reality of the transaction which the taxpayer companies entered into.

Due to the impact and importance of this Supreme Court decision, a detailed analysis of the case is essential to the topic of this research, and will be dealt with in chapter 4.

CHAPTER 4: ANALYSIS OF THE DECISION IN *BRUMMERIA*

4.1 Introduction

In chapter 2 a discussion of the interpretation methods used by the courts was presented. It was found that there are two main interpretative models, the strict literal approach and the purposive approach, which appears to have become more prominent in modern legislative interpretation. In chapter 3 the application of these approaches in terms of South African tax law was analysed, focussing on the interpretation of the definition of "gross income" and in particular, the interpretation of the term an "amount in cash or otherwise". The analysis of South African cases dealing with valuations which was presented in chapter 3 illustrated that the courts have, in the past, encountered a considerable number of problems when interpreting the term "amount in cash or otherwise" and attributing to it a consistent meaning. The courts have established an accepted meaning of the term "amount" in terms of justice Watermeyer's judgement in the *Lategan* case that an amount constitutes "any form of property", notwithstanding whether it is cash or non-cash. Once it has been determined that an "amount" does exist, other problems needed to be addressed. This is because non- cash amounts then require valuation in order to establish a monetary value upon which income tax can be levied. Particular attention was paid, in this discussion, to the subjective versus objective valuation debate and the concepts underlying these approaches to valuation were briefly explained in relation to the valuation cases discussed throughout the chapter.

Chapter 3 concluded that, in terms of the Supreme Court of Appeal's decision in *Commissioner for Inland Revenue Services v Brummeria Renaissance (Pty) Ltd and Others* (2007) SCA 99 (RSA); 69 SATC 205, an objective approach with reference to current market values, must be applied in all tax cases requiring a valuation of an amount. Despite the growing prominence of the purposive approach in general legislative interpretation, this decision appears to indicate the court's adherence to a stricter interpretative approach in taxation matters. *Brummeria*, which has been described as being "a cat amongst the pigeons" by tax writers such as Cameron (2008), has been widely criticised on the basis that

the valuation technique applied was not only harsh and unfair, but at odds with accepted economic and accounting principles and did not reflect commercial reality.

The present chapter will analyse the *Brummeria* decision in detail. This continues the exploration of the third goal of the research to analyse South African case law relating to the interpretation by the courts of "an amount in cash or otherwise" and the valuation of non-cash benefits. The facts of the case, as well as the arguments advanced by the taxpayers will be presented. After a thorough discussion of the method used to value the right to the interest-free loan capital in the case, the shortcomings of decision will be addressed. In addition, alternative valuation means, which may have been applied in order to yield a more equitable result, will be illustrated. The effect of the precedent set in the *Brummeria* decision, that an objective means of valuation must be applied in cases of the receipt of a non-cash amount, will be explained by analysing the decision in the case of *Vacation Exchanges International* which followed shortly after the precedent was set. The chapter will conclude by briefly discussing the possibility of the Commissioner for the South African Revenue Services taxing other non-cash benefits (other than employee benefits) such frequent flyer miles, in terms of the *Brummeria* decision and the difficulties involved with the valuation thereof.

4.2 An analysis of the *Brummeria* decision

According to Jansen van Rensburg (2008), the decision by the Supreme Court of Appeal in *Brummeria* is one of the most important tax cases decided in the past thirty years. The ruling by the Supreme Court of Appeal in *Brummeria* added to and amended South African case law regarding the critical definition of "gross income" in the Income Tax Act. In this case, the court departed from the existing precedent set in cases such as *Stander* that receipts that "could not be converted into cash and could not be transferred to anyone else" are not taxable. In *Brummeria* the court ruled that the key principle to be established is whether the benefit has an ascertainable monetary value.

Prior to examining the impact of the ruling and the decision in this case, it is essential that the factual details and arguments upon which this case was based are explained. The case has often been criticised in that the argument put forward by the retirement companies' counsel was weak and this contributed to the seemingly unfair and illogical decision by the court (Cameron: 2008).

The facts of the *Brummeria* case involved a group of taxpayer companies which operated retirement villages. The retirement village operated in terms of a scheme where each resident of the village would provide the taxpayer with an interest-free loan in return for which the resident would be afforded the right to occupy housing in the retirement village free of rental. When the resident vacated the housing, the company was then obliged to repay the loan, but without any interest. The funds required for the repayment of the loan would be financed by the granting of a new loan and the intention of the companies was to ultimately sell the units at a profit.

The exact facts presented to the court in *Brummeria* were that:

- The respondents in the case were companies in the business of developing retirement villages;
- Agreements were entered into between the property developers and the potential occupants of property units;
- The significant features of the agreements were that:
    - the potential property occupant provided a loan that is interest-free to the property developer;
    - the interest-free loan was advanced to provide funding for the construction of a property unit in the retirement village;
    - the title deed of the property was registered as security in favour of the potential property occupant;
    - a right of lifelong occupation of the property unit was conferred on the potential property occupant;
    - the ownership of the property unit remained with the property developer;
    - the interest-free loan was advanced in return for the lifelong property occupation right; and

- the loan would be repaid on cancellation of the agreement or upon the occupant's death (whichever is the earliest event.)

To further explain the concept of the "life right" discussed in the case, as set out in the facts of the case, an agreement was concluded whereby the property occupant received a right to occupy the retirement village unit rent-free in exchange for a loan that was secured by a debenture for as long as the companies had a right to utilise the loan capital. It is also important to note that the developers applied the interest-free loan exclusively for the development of the property unit and that no part of the borrowed amounts was used for income-earning investments.

It was reported (at 206) that the Commissioner for SARS contended that the *quid pro quo* which the respondents received in return for the units was the selling price obtained from the purchasers of units under sectional title or the benefits 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 rationale for the subjection of the right to the interest-free loans to tax appears to be that there were two ways of turning the property into gains, by selling them or receiving the right to the interest-free loans. Therefore the benefit received from the right to use the interest-free loans had an ascertainable money value in the hands of the respondents, which fell within the definition of "gross income". The Commissioner valued the rights to use the funds advanced to the companies as interest-free loans by applying the weighted prime overdraft rate for banks to the average amount of the interest-free loans in the possession of the particular company in the relevant year of assessment.

The respondents contended that the interest-free loans did not result in any "amounts" being "received by" them as contemplated in the definition of gross income. They also contended that the rights valued by the Commissioner could not be turned into money and therefore did not fall within the ambit of the decision in the *People's Stores* case, relying for this proposition on the *Stander* case and the decision in the English case *Tennant v Smith (Surveyor of Taxes)* [1982] AC 150 (HL). Counsel for the companies also argued that the right was of a capital nature. As this matter was not an issue before the tax court and the companies did not raise this as an issue in their statement of grounds of appeal, the

Supreme Court of Appeal could not pursue the matter. In addition, at no stage was the manner in which the right was valued by the Commissioner challenged by the respondents.

The *Brummeria* case was heard on appeal from *Income Tax Case 1791* 67 SATC 230, where it was held that the companies had not used the monies (the interest-free loans) to produce any income and that the Commissioner had assessed the companies on notional income, which was not taxable. The tax court also held that the benefit had no existence independent from the liability to repay the loans, it could not be transferred or ceded and that it clearly had no money value.

With regard to whether the rights to use the loans interest-free constituted "amounts" which "accrued" to the respondents, it was held (at 207) that:

- "the word "amount" and the phrase "accrued to" had been summed up in *Cactus Investments* by stating that the definition of gross income included not only income actually received, but also rights of a non-capital nature which accrued during the relevant year and were capable of being valued in money and that no more was required for an accrual than that the person concerned had become entitled to the right in question." This decision referred to a "right" that had accrued and was valued in money. In the case of the companies in the present case, the "right" that accrued was the right to the interest-free loan. The Commissioner did not value the right when it accrued, but valued the benefits flowing from the right on an annual basis;

- "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 respondents' gross incomes for the years in which such rights accrued to them". Cloete JA went on to refer to *Commissioner for Inland Revenue v Berold* 24 SATC 279 where it was held that the making of an interest-free loan constituted an ongoing donation to the borrower which conferred a benefit upon the borrower. This was presumably in support of the method of valuation used by the Commissioner to value the benefit arising from the right to use the loan capital interest-free on an annual basis. Cloete JA also stated that in the modern commercial world this right is a valuable right and that the basis on which the Commissioner valued the right had not been challenged on appeal;

- it was clear from the authorities [citing the decisions in the *People's Stores* case and the *Cactus Investments* case] that "the question whether a receipt or accrual in a form other than money has a money value is the primary question and the question whether such receipt or accrual can be turned into money [as was held by Friedman JP in the *Stander* case as the reason why the prize awarded to *Stander* did not constitute an "amount" which could be included in gross income] is but one of the ways in which it can be determined whether or not this is the case"; and

- "in other words, it did not follow that if a receipt or accrual cannot be turned into money then it has no money value as the test is objective and not subjective". On this basis Cloete J concluded that the passages quoted in the *Stander* case incorrectly reflected the law and he affirmed the reasoning of Conradie J in *ITC 701* 17 SATC 108. He also rejected the decision in *Tennant v Smith (Surveyor of Taxes*) (1892) AC 150 as authority as the provisions of income tax legislation in England at the time were very different from the meaning that the Supreme Court of Appeal in South Africa had held must be given to the definition of gross income in South Africa.

It was also held (at 208) that the benefit, as taxed by the Commissioner, remained whatever the respondents did or did not do with the loans. There could be no question of double taxation if the amounts had been invested to produce interest (as counsel for the respondents had alleged) as there would be two separate and distinct receipts or accruals to be included in gross income (the accrual relating to the interest-free loan and the accrual of the interest on the investment.) Although Cloete JA did not specifically refer to the inclusion of notional amounts in gross income, he referred to the decision (at 215) by the tax court in *ITC 1791* that the Commissioner had assessed the companies on notional income, but rejected this stating that "[i]t is true that had the companies invested the amounts lent, the income so derived would also have formed part of their gross incomes [b]ut this is beside the point." His argument was that the Commissioner had taxed them on the value of the benefit and not on the basis of notional investment income.

To interpret the term "received by or accrued to", the court related the facts presented in *Brummeria* to past rulings of the courts. It was necessary to do this in order to contextualise the existing case law interpretations against the background of the facts presented. In the

interpretations put forward by the court in *Brummeria*, neither additions nor amendments were made to the existing case law interpretations of the phrase. The case therefore did not provide any additional insight into the already existing case law interpretations of this aspect of the "gross income" definition.

The court emphasised that it is the benefit of having a right to retain and use loan capital interest-free that it sought to include in gross income, not the loan capital itself. It appears that the decision to value the right to the interest-free loans as an "amount" for the purposes of inclusion in "gross income" is correct if the principles established in the cases of *WH Lategan v Commissioner for Inland Revenue* (1926) CPD 203, 2 SATC 16 and *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* (1933) AD 242, 6 SATC 92 are applied.

In summary, the court in *Lategan* held that:

- the word "income" does not always consist of a sum in monetary terms; and
- "income" is produced through the employment of capital and intellect. The incentive that is subsequently earned may be cash or may be in a form of "some other kind of corporeal property or in the form of rights."

Cloete JA further endorsed this principle and restated in the *People's Stores* case that:

> The first and basic proposition is that income, although expressed as an *amount* in the definition, need not be an actual amount of money but may be every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value … including debts and rights of action.(own emphasis)

The learned Judge of Appeal did not agree with the earlier decision of the Tax Court (ITC 1791) against which appeal was granted that the benefit included by the Commissioner in the companies' gross income had no existence independent from the liability to repay the monies borrowed; that it could not be transferred or ceded; and that it "clearly has no money value." The learned Judge stated that:

> This reasoning loses sight of the fact that if a right has money value – as the right in question did . . . the fact that it cannot be alienated does not negate such value. The contrary view articulated in *Stander's* case is thus wrong.

In summary, the Supreme Court of Appeal decided that the right is received on the basis of a *quid pro quo* that is given by the taxpayer and that the right must be objectively valued and included in the taxpayer's gross income.

The *Brummeria* decision has confirmed that:

- the objective method and not the subjective method is to be used to value amounts received or accrued in a form other than cash. This thesis has discussed cases where the objective value of an amount has given rise to a result that is unfair and does not reflect the economic reality of the transaction. The *Brummeria* decision can be criticised on the same basis; and

- the fact that the benefit cannot be turned into money is not decisive in determining whether or not an amount has an ascertainable value. This is but one of the considerations to be taken into account in valuing a benefit.

There are a number of issues that the decision did not address. Although the taxation of "notional" income was raised, no decision was made regarding the possible taxation of notional income.

The method of valuing the benefit arising from the right to use the loans interest-free (using the weighted average prime overdraft rate) was not addressed as counsel for the companies did not include this in the ground for appeal. The method used to value the benefit has been criticised (refer to the discussion below.)

The fact that no account was taken, in valuing the benefit, of the loss of rental income on the units that were occupied rent-free has been criticised in an editorial in The Taxpayer (2008: 161) as an "economic disaster" imposing "double taxation". Again, this was not raised by the counsel for the companies, who relied for their defence on the argument, based on the decision in *Stander* that, as the benefits could not be turned into money, they consequently had no value. In Interpretation Note 58 (South African Revenue Services: 2010), which illustrates the method that SARS will used in valuing the benefit of an interest-free loan and the *quid pro quo* of the right to occupy retirement units rent-free in similar cases in the future, addresses this concern. This is discussed in detail later in the thesis.

Finally the time of accrual of the value of the right to use the loan interest-free was not addressed by the Court. In Interpretation Note 58 (South African Revenue Services: 2010) both the value of the right to use the loan interest-free and the value of the right to occupy the units rent-free are included in gross income when the rights accrue. This is discussed later in the thesis.

4.3 An analysis of the *Brummeria* decision in terms of United States Tax Law

In an article by Cohen (2010), a comparison of the *Brummeria* judgement with United States Income Tax Law leads to interesting observations. The first observation is that, as a matter of tax policy, the result in *Brummeria* is essential to the fundamental concept of income taxation. Cohen (2010: 489) states that "[a]s a practical matter, income is calculated primarily with reference to cash transactions, that is, the actual receipt of cash or the accrual of the right to receive cash." Notwithstanding this fact, taxable income cannot be restricted to cash and must include significant non-cash economic benefits, including the value of below-market interest loans. In Cohen's (2010: 489) opinion, "to ignore non-cash income is to undermine the fundamental objective of the income tax, which is not simply to raise revenues, but to apportion the tax burden according to the overall economic capacity as measured by income so that those with larger income pay more tax."

Cohen (2010) explains that other significant benefits or in-kind compensation (referred to as fringe benefits in South Africa) such as housing, cars, vacation trips and alike should be accounted for in order to apportion income tax fairly according to economic well-being. According to Cohen (2010: 490), "no difference in principle exists between these familiar non-cash benefits and below-market interest loans." In analysing these opening statements of Cohen, it initially appears that he is in support of the *Brummeria* decision to assign a value to the interest-free loans received by the taxpayer company on the basis that the company had a right to receive cash which would then reflect a zero percent interest rate (clearly well below the market rate.)

The second observation which Cohen (2010) makes is, however, vital to understanding the controversy which the *Brummeria* decision aroused. According to Cohen (2010: 490), the

Brummeria judgement, although partly correct, is incomplete. The court correctly stated that that the right to receive and utilise the loan capital interest-free produces an economic benefit for the borrower but neither fully, nor properly characterised the economic benefits of the loan. Cohen recognises in his article that the court failed to disaggregate the loan into its constituent parts and in so doing, treated the loan incorrectly.

Cohen (2010) further explains that a below-market interest loan is economically equivalent to a loan bearing interest at a market related rate coupled with a non-loan payment of cash from the lender to the borrower that funds the borrower's payment of the market-rate interest on the loan. In accordance with this equivalence, United States tax law re-characterizes a below-market interest loan as an implicit non-loan payment from the lender to the borrower of an amount equal to the foregone interest, defined as the excess of market-rate interest over the interest nominally charged. This payment represents the economic benefit to the borrower, correctly identified by the court in the case of *Brummeria.* There is however, a reciprocal implicit payment of interest at the market rate by the borrower to the lender. In the *Brummeria* case, this can be equated to the rental foregone by the taxpayer companies as a *quid pro quo* for the right to the interest-free use of the loan capital. It is this additional payment which the court failed to consider in their judgement resulting in what Cohen (2010: 490) describes as "double taxation."

Cohen (2010) discusses the types of loans recognised in the United States and compares the tax treatment to that in South Africa in order to establish the differences between the two tax systems and illustrate how it is relevant to compare the treatment of the interest-free loan in *Brummeria* to the treatment it would have received should the case have been heard in the United States.

The first loan which Cohen discusses is an employer-employee demand loan. Under United States tax law, as previously discussed, should an employer make an interest-free loan to an employee, repayable at its demand, the below-market interest loan is re-characterized, according to section 7872 of the United States Internal Revenue Code, as implicitly involving two separate reciprocal payments for each year that the loan is outstanding. There is a non-loan payment of interest at the market rate to the employee by the employer and an equivalent interest payment at market rate by the employee to the employer. This provision

does not specify the character of the first payment made by the borrower to the lender which thus depends on the relationship between the two parties. If it is an employer-employee relationship, the first payment would be characterised as compensation for the employee's services (this would be treated as taxable income.) The tax treatment of the payment made by the employee depends on the circumstances of the transaction. If the interest payment is fully deductible, the income generated by the receipt of compensation is fully offset for tax purposes by a deduction for paying interest. Consequently, there is no net effect on the employee.

If the loan is considered from the employer's point of view, then the payment by the employee would be treated as interest income. The tax treatment of the payment made by the employer to the employee also depends on the circumstances. Provided that the compensation is fully deductible, the income generated by the receipt of interest is fully offset for tax purposes by a deduction for paying compensation and thus, there is also no net effect on the employer.

In terms of South African income tax, an employee who receives a below-market interest loan from an employer is treated as having additional income equal to the difference between the interest rate charged by the employer and the market rate. In other words, the portion of interest the employer forgoes by offering a lower rate of interest is included in the income of the employee, except to the extent that the interest would have been deductible by the employee as being incurred in the production of income in terms of paragraph 11 of the Seventh Schedule to the Income Tax Act. However, South African law does not treat the employer as paying additional compensation to the employee in the amount of the foregone interest and as receiving from the employee interest at the market rate. To disregard the tax treatment of the employer providing the low interest loan, is to treat the implicit payment of the additional compensation as being immediately deductible in full.

The terms of the loan described above imply that the economic benefit to the borrower arises over time from the use of the funds loaned without having to pay interest at the market rate. The United States tax law accounts for this economic benefit arising over time on an annual basis. Each year, the lender is treated as transferring the amount of foregone

interest to the borrower, and each year, the borrower is treated as retransferring the same amount as interest to the lender, according to section 7872(a)(2) of the United States Internal Revenue Tax Code. In South Africa, the employee is taxed annually on the benefit of the interest-free (or low interest) loan, but the employer is not regarded as having received the same amount from the employee. According to Cohen (2010), in the case of a loan that is repayable only after a specified term, the borrower receives an economic benefit instantly as soon as the loan itself is provided. Because the borrower is charged a below-market interest rate, the nominal amount loaned to the borrower will exceed the present value of the future repayment obligations, discounted using the market rate. The excess amount effectively constitutes an immediate economic benefit to the borrower. In other words, the economic benefit occurs instantaneously rather than arising over time as in the case with a demand loan. To further explain, the demand loan borrower does not have income at the time the loan is first provided, since the borrower is under an obligation to repay the full principal amount loaned at any time, on demand.

In the case of a term loan, the United States tax law still re-characterizes the loan as involving reciprocal transfers but treats the payments as occurring at different points in time. Thus, the payment of compensation occurs as soon as the loan is extended, but, the market rate of interest on the loan accrues continuously over the term of the loan. Due to the differences in timing, the amounts do not offset each other as in the case of a demand loan.

South African income tax does not treat employer-employee low interest loans differently to demand loans. According to Cohen (2010), the consequences of this are that in present value terms, the employee's income is understated because the income item should be reported earlier than the deduction item. Similarly, the employer's income is overstated because the deduction item should be reported earlier than the income item. If the marginal tax rates of both parties are of the same, the over- and understatement of tax will offset each other, making no difference to the overall collection of tax. Cohen (2010) highlights a weakness in our tax system in that each party is subject to a different marginal rate, which is likely to be the case, and therefore the over and understatement will not offset each other and, should the employee be subject to a higher rate, there will be a revenue loss to the *Fiscus.*

If the United States concepts and tax treatment of loans were applied to the case of *Brummeria,* Cohen (2010) submits that the outcome of the case would have been significantly different due to the differences in the treatment of loans explained above. Cohen (2010) illustrates this by providing an example as follows. Assume that the initial loan to the company was an amount of one million rand, that the nominal interest rate was zero, and that the market interest rate was ten per cent. The loan is effectively a demand loan, since it must be repaid, not at the end of a specified term, but whenever the lender vacates the housing. Thus, each year, the lender is treated as transferring one hundred thousand rand to the company, and each year the company is treated as transferring one hundred thousand rand in market-related interest on the loan back to the lender.

Whilst the second imputed payment is described as interest by the United States taxation statute, the categorization of the first payment depends on the relationship of the parties. In *Brummeria,* the relationship is not that of an employer-employee. Assuming that the borrower and the lender are tenant and landlord, the implicit transfer from lender to company will be considered a payment of rent for housing in the retirement village. If the below market interest rate rules apply, the transaction is re-characterized as involving the payment of one hundred thousand in rent by the lender to the company followed by the company's payment of one hundred thousand in interest to the lender.

Focussing on the company, the taxpayer companies in the *Brummeria* case, Cohen (2010) questions whether these amounts are offsetting each other for income-tax purposes. The hundred thousand in rent received by the company clearly constitutes income. If the interest expense paid by the company is currently deductible in full, then the income and deduction items are fully offsetting, and the company has no additional net income to report. It is on this basis that Cohen (2010) criticises the *Brummeria* judgement for imposing "double taxation."

According to the contract in *Brummeria* between the taxpayer companies and the retirees, each loan granted to the taxpayer was to be utilised to finance the construction of housing units in the retirement village that the lenders would occupy. Under both United States tax law and South African tax law, should such a loan bear interest, the interest is subject to capitalisation and may not be deducted as an expense during the construction period.

United States law refers to such interest as construction period interest in terms of section 263A(f) of United States Internal Revenue Code. South African law refers to it as pre-production interest in terms of section 11(bA) of the Income Tax Act.

In both countries, this concept of capitalisation means that the company's interest expense is treated as a construction cost of the housing unit being financed and is not immediately deductible (the interest expense may not be deducted as it is incurred but may only be treated as an expense once the construction is complete.) As a result, during the construction period, the company has rental income without an offsetting interest expense due to the interest deduction effectively being postponed until the completion of the housing units under construction. Therefore, it is submitted that the taxpayer company has additional net income to report.

In the *Brummeria* case*,* it is submitted, the position of the lenders of the loan capital was not sufficiently considered by the court. With the characterization of the loan as involving reciprocal transfers, the lender receives market-rate interest of one hundred thousand which, under United States law, is always taxable. Moreover, the payment of the rent is not deductible under United States law since rent is a personal consumption expense in terms of Section 262 of United States Internal Revenue Code. Therefore, the imputed amounts in terms of rental expense and interest income are never offset against each other under United States law.

Cohen (2010) explains that under South African law, the treatment of the lender may differ due to the fact that there is an income tax exemption for interest income up to a ceiling amount in terms of section 10(1)(i)(xv) of the Income Tax Act. To the extent that the interest is exempt from tax, the lender would have no additional income to report.

In the *Brummeria* judgement, the court correctly treats the lender as implicitly making a payment to the borrower of an amount equal to the market related rate of interest. The court, however, failed to recognise the corresponding implicit payment of interest from the company to the lender (the amount of rent foregone by the taxpayer companies.) Consequently, according to Cohen (2010), the court did not consider whether the payment of interest by the company was or was not deductible and therefore whether the payment

would or would not offset the income arising from the economic benefit to the company of the interest-free loan.

The only issue that was addressed by the Supreme Court in South Africa was whether or not the companies were liable for tax on the economic benefit they received from the use of the loan capital interest-free. The court did not have before it the specific question of whether the company, if treated as receiving rental income equal to the market-rate interest, should also be treated as paying a market-rate interest. Nevertheless, it is Cohen's (2010) opinion that this additional element is a necessary part of the analysis which should have been contemplated by the court. By taxing the retirement companies and not allowing them a deduction of imputed rent as a result of disregarding the lenders of the loan capital, the *Brummeria* decision fails to reflect economic reality. The decision effectively imposes an unjustified tax burden upon the taxpayer and confers a tax-free benefit on the lender.

4.4 An analysis of the valuation method applied in the *Brummeria* case

In returning to the topic of research of the present thesis, valuation, the principles applied in the *Brummeria* case can be further explained. It is submitted that although the interpretation of the word "amount" in the *Brummeria* case appears to have been correct, the valuation method used to establish a monetary figure in order for the amount to be included in gross income, is questionable. The value assigned to the taxpayers' right was determined by applying the weighted average prime overdraft rate to the weighted average amount of the interest-free loans in a given year. Unfortunately, it appears that the taxpayers' argument was based solely on the argument that the benefit received by virtue of the interest-free loan was not the "receipt" of an "amount" and the valuation of the "amount" was not challenged.

To explain the "weighted prime overdraft" valuation method further:

- the court used the banks' prime overdraft rate in order to value the right; and
- considered the variability of the banks' prime overdraft rate by determining the applicable weighted average rate for the period.

Counsel for the taxpayers should have contested this method of valuation in that, firstly, it is highly unlikely that the taxpayers would have received the prime overdraft rate of interest. Realistically, had they invested the funds, they would have received a percentage or two lower. Secondly, the valuation method did not account for the rental income forgone by the taxpayer companies in exchange for their right to the use of the loan capital interest-free.

4.5 Alternate valuation methods

There are a number of alternate methods which could be utilised in a situation such as that which arose in the *Brummeria* case.

An alternative method suggested by Phasha (2009) is the general anti-avoidance method. General anti-avoidance provisions were originally included in section 103(1) of the Income Tax Act. This section has since been repealed by the Amendment Act 20 of 2008 and sections 80A to 80L are now included in the Income Tax Act, the provisions of which are only slightly different to the provisions of section 103(1).

The Income Tax Act stipulates that once it has been established that the requirements of section 80A are met, the provisions of section 80B will be applied to the transaction. In terms of section 80B, the Commissioner may determine the tax consequences of any avoidance arrangement for any party by:

- disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;
- reallocating any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
- re-characterising any gross income, receipt or accrual of a capital nature, expenditure; or

- treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such a manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

Phasha (2009) suggests that had SARS applied the anti-avoidance rules to the facts presented in the *Brummeria* case, the property occupants would have been taxed on the deemed interest value of the loans and the developers would have been taxed on the deemed attributable rental value.

SARS could have interpreted the case differently by considering the true substance of the agreement rather than its legal form. In legal form, the agreement was made up of an interest-free loan and the right to occupy property. Due to the fact that the property developers in *Brummeria* granted the right to occupy the property units to the potential property occupants, the true substance of the agreement is therefore similar to that of a lease or rental agreement. In this type of agreement, the lessor grants the right of occupation of the property to the lessee in return for a right to receive proceeds in the form of monthly rentals agreed upon by the two parties. In the case of *Brummeria,* the receipt of monthly rentals was in the form of the right to the use of interest-free loan capital granted to the developers by the property occupants.

In terms of section 80B of the Income Tax Act, SARS would set aside the legal arrangement of the agreement and tax the property developers as if they had received monthly rentals, assumedly at a market related rate. The problem, however, is that the company would still be in an adverse position as it could not deduct the "notional" interest on the loan. It is therefore submitted that this method is not appropriate as it does not solve the issue of "double taxation" which was levied on the developers in the method applied in *Brummeria.*

The "donations tax usufruct" valuation method has also been suggested by Phasha (2009) as a possible alternative method to value the right to the interest-free loans. South African donations tax is levied in terms of sections 54 to 65 of the Income Tax Act. Section 55 contains the definition of property, which is defined to be inclusive of "any right in or to

property whether moveable or immoveable, corporeal or incorporeal." The right to the use of loan capital and the right to occupation are thus included in the definition of property. The values to be placed on property and property rights are set out in section 62 of the Income Tax Act. The explanation of how property rights are to be valued includes the valuation of rights such as fiduciary interests (usufruct interests, bare dominium interests and annuity income interests.) A fiduciary interest is an award of partial rights to property where the holder thereof does not have complete ownership rights to the property. A usufruct interest is an entitlement to a right of unlimited use of the property without the right of disposing the property and a bare dominium interest grants its holder the right to ownership of the property without the right of use of the property.

If these definitions are applied to the interests exchanged in the *Brummeria* case, the property developers essentially relinquished their rights to rental income in respect of the occupation of the property and the following can be inferred from this scenario:

- the property occupants and the developer companies enjoyed limited interests to the properties;
- the property developer companies had a bare dominium interest in the property as they possessed the right to ownership and title to the properties; and
- the property occupants had usufruct interests because they were entitled to the lifelong right of occupation and usage of the properties.

The value of a usufruct is calculated according to a formula which is stated in section 62 of the Income Tax Act as follows:

Property usufruct value	=	Annual value x present value factor
Annual value	=	Market value of the property x 12%

According to Phasha (2009), it is important to note that where the donor of the property has full ownership rights, the value attached to the property for donations tax purposes is the "fair market value" of the property.

The present value factor is calculated using the Estate Duty Act 45 of 1955 Tables A and B. Table A is a life expectancy table and Table B is an annuity table. According to the tables, the life expectancy of a company is set at fifty years.

If these principles are applied to the *Brummeria* case, the following would result:

- the signature date of the agreements between the unit occupants and the property developers would decide the date to be used when determining the market value of the property;
- the "fair market value" of the property units would be used in the calculation because the developers have full ownership of the property units;
- in calculating the present value factor, the length of the period of the usufruct would be determined with reference to life expectancy, which is calculated based on the age of the potential occupant of the unit at the signature date of the agreement;
- using the Estate Duty Tax Table (Table B), for a life expectancy of five years the present value factor to be applied is 3,6048;
- assuming that the market value of the property was R1 000 000 and the unit occupier had a life expectancy of 5 years, the usufruct value would be R432 576 [(R1 000 000*12%) * 3,6048)];
- the annualised usufruct value would then be R86 515 [432 576/5]; and
- the monthly rental charge would thus be R7 209,60 [R86 515/12.]

If this valuation was applied by the court in the *Brummeria* case, the monthly value attached to the benefit of the interest-free loan capital would be R7 209,60. An advantage of such a method of valuation is that the value derived cannot easily be manipulated by the taxpayer because it is determined using a set formula and the market values are determined by the market and not the taxpayer. It is submitted that this method would lie towards the objective end of the objective-subjective continuum.

The above methods proposed as alternatives to value the benefit of the right to interest-free loan capital accruing to the companies fail to address the question of the rental income

foregone. It appears that no matter which method is applied, the company is still in an adverse tax position.

4.6 Interpretation Note 58

The valuation methods discussed above are simply examples of other valuation techniques which are recognised in the Income Tax Act and applied to benefits similar to that dealt with in the *Brummeria* case. Interpretation Note 58, (South African Revenue Services: 2010), which was issued following the *Brummeria* case, sets out the way in which any benefits of this type will be valued in future by SARS and appears to use the "donations usufruct method" suggested by Phasha (2009) to value the rental income forgone by the taxpayer developers. By placing a value on the rental income forgone and allowing foe a deduction thereof from the total value of the right to the interest-free loan capital received by the property developers, the Interpretation Note appears to have addressed the issue of double taxation.

Interpretation Note 58 was issued by the Commissioner for SARS on 30 June 2010 and is aimed at clarifying the income tax treatment that the Commissioner will apply in future where interest-free (or low interest) loans are advanced in exchange for the receipt of goods or services. Unlike the judgement in the *Brummeria* case*,* it appears that SARS has taken into account the commercial reality of the transaction, as well as the matching concept applied in accountancy. It is submitted that the guidelines proposed by Interpretation Note 58 result in a much more equitable method of valuation.

The Interpretation Note provides an example which deals with the retirement village scenario and, unlike the valuation applied in *Brummeria,* allows a deduction of the "imputed rental" (the taxpayers' obligation to provide free rental.) The example sets out a barter transaction that consists of two elements that need to be valued. In the first element, the developer receives an interest-free loan for the remainder of the occupant's life span, and in the second, the developer's right of use of the property is sterilised as long as the interest-free loan is in place. The value of the accrual in the hands of the developer will accordingly

be the net "profit", or the difference between the value of the interest-free loan enjoyed and the right of use of the property granted to the occupants.

For the retirement village scenario, SARS calculates the present value of the potential interest (market related) on the interest-free loan, discounted at the average prime interest rate in that year. This amount is then reduced by the value of the usufruct in the underlying property (using the valuation rules applicable to estate duty.) It is submitted that by allowing for the deduction of the usufruct, the Interpretation Note has addressed the equity concerns of the valuation method used by the court in the *Brummeria* case, as previously discussed.

What is interesting to note is that the method used in the Interpretation Note values the right to the interest-free loan capital when it accrues, unlike the *Brummeria* judgement, which valued the benefits flowing from the right on an annual basis when these benefits accrued. The fact that SARS values the right on the date of accrual of the interest-free loan and not on the date of the accrual of the benefits flowing from the right indicates that a timing problem also existed in the *Brummeria* decision. The timing of an inclusion in gross income can have a significant effect on the ultimate valuation and this, as well as other valuation difficulties, will be discussed in Chapter 5.

By issuing the Interpretation Note, SARS has indicated that it will not seek to apply the *Brummeria* decision in the manner applied by the court (with regard to both the valuation method and date of accrual.) This provides a great deal of certainty for taxpayers in South Africa. It is important to note, however, that the Interpretation Note is not in itself law. The method set out in the interpretation note merely provides guidance as to how interest-free loans may be valued and taxed as a benefit by SARS in the future and does not overturn the precedent established in *Brummeria.*

In cases where valuation rules do not exist, the *Brummeria* precedent may pose a significant challenge in identifying and valuing the various elements of a barter transaction. In this regard SARS has merely indicated that each case must be evaluated on its own facts and merits. In practice, this may result in disputes with SARS.

One such dispute gave rise to a very recent case, *Vacation Exchanges International v Commissioner for Inland Revenue* (2009) (A253/2008). The appellant taxpayer in this case conducted business as a holiday timeshare exchange company. The taxpayer company employees would visit various resorts and provide advice as to the facilities and services offered by the timeshare developers and thereafter these resorts utilised the branding of the taxpayer company to attract clients. The developers sold timeshare in their resorts to purchasers who thereby became members of the appellant taxpayer for a period of three years. The timeshare resorts were set up as share block companies. Each purchaser's shareholding entitled him or her to occupy a timeshare resort for a particular week of each year. The taxpayer's timeshare scheme business allowed members to "space-bank" their occupation rights in return for which they were credited with "points" on the taxpayer's internal computer system. The number of points awarded was based on the exchange value of the member's occupation rights as rated by taxpayer. The members were then able to accumulate "points" each time they "space-banked" further occupation rights and use the "points" to "trade-up" for higher grade holidays. Once a right of occupation was "space-banked" with the company, the member ceased to have any interest in the right of occupation, which became the property of the taxpayer. The rights of occupation were held by the taxpayer for the purposes of exchange with other members. The appellant taxpayer earned revenue by charging an exchange fee for each exchange made by the members utilising points in order to reserve accommodation in the taxpayer's bank of rights of occupation.

The issue which arose in the case was that the appellant provided its permanent staff members with the opportunity to visit various resorts by allocating 17 000 points to each employee annually for "resort education". The appellant taxpayer argued that the allocation of points to staff enabled them to visit several resorts in any given year to further their expertise regarding the exchange system and to gain firsthand knowledge of all affiliated resorts which would assist them to provide a better service to their customer members, resulting in successful exchanges and a growing business.

The Commissioner was of the opinion that the allocation of free points to employees was a benefit to staff and was thus subject to taxation in terms of the Seventh Schedule (amounts

forming part of the employee's gross income in terms of paragraph (i) of the gross income definition in section 1 of the Income Tax Act.) To explain further, it was submitted that the employees had been provided with free residential accommodation (as envisaged in paragraph 2(d) of the Seventh Schedule) or alternatively, that their employee company had settled amounts owing by the employees to a third party (as envisaged in paragraph 2(h).) SARS assessed the taxpayer company for failure to withhold employees' tax of approximately ten million rand.

The taxpayer's principal ground of appeal was that it did not provide its employees with accommodation. Rather, it simply allocated points to its employees and that these points constituted an asset received by the employee from his employer (as envisaged in paragraph 2(a)), the cash equivalent of which was nil (a similar logic to that applied in the *Stander* decision). In the taxpayer's opinion, this system afforded employees a conditional right to exchange points for an occupation right acquired by the appellant taxpayer from its members. These conditional rights were assets "otherwise than in cash" and thus, according to previous case law, an objective monetary value should be placed on them. The taxpayer argued that the value of the asset acquired by the employees was the market value of the asset at the time they received the points in terms of paragraph 5(2) of the Seventh Schedule. However, by virtue of the conditions attached to the rights in question, it was argued that the rights had a market value of nil. It was further submitted by the taxpayer that the conditional rights constituted "moveable property" which was acquired by the taxpayer either in order to dispose of them to the employees or could be considered "trading stock" as defined in section 1 of the Income Tax Act. In either case, the contingent rights had to be dealt with in terms of paragraphs 2(a), 5(1) and (2) of the Seventh Schedule as they constituted assets acquired by the employees from the appellant taxpayer. The taxpayer contended that contingent rights have no ascertainable monetary value in the hands of employees in that the points were not readily convertible into cash and that cash equivalent of the deemed taxable benefit was thus nil.

The Commissioner challenged the submission made by the taxpayer that the allocation of points was purely for the purpose of "education." In the Commissioner's opinion, should

this have been the case, it would not have been necessary to award the employees with points which itself implied a "privilege."

Counsel for the respondent submitted that:

> . . . the awarding of points is not only a management tool, but also a privilege given to staff in order to retain their services, to award them for services rendered and further their morale . . . the allocation of points to employees is not used as a tool in their training process, but as a benefit in the nature of a free holiday which is causally linked to their employment. The appellant thereby provides its employees with a fringe benefit . . .

In the grounds of the appeal, the taxpayer relied on the finding in the *Stander* case for the contention that the cash equivalent of a deemed taxable benefit in the form of the acquisition of a non-cash asset by an employee which cannot be converted to cash, is nil. The Court, however, applied the principle in the *Brummeria* case and advanced a strong argument that the right to accommodation was a benefit for which the employee would have to pay if he or she had not been given it for nothing. This right had a money value and the fact that it could not be alienated did not negate the value.

The Commissioner cited the decision in the *Brummeria* case in response to the taxpayer's appeal. The taxpayer appellant submitted that it was not possible to attribute a value to the accommodation in question (being timeshare accommodation acquired by the appellant at no cost and available only to members and employees.) The Commissioner, however, referred to paragraph 9(4) of the Seventh Schedule to the Income Tax Act which sets out methods by which the rental value of accommodation provided free of charge to employees can be determined. Paragraph 9(4)(a) applies where the accommodation is hired by the employer and was thus not relevant in the present case. Paragraph 9(4)(b) applies "in any other case"; that is, including cases where the accommodation in question is not hired by the employer.

In such cases, the rental value is:

> . . . calculated at the prevailing rate per day at which such accommodation <u>could normally be let to any person who is not an employee of the employer</u> (own emphasis).

The taxpayer company had not raised as part of their appeal an argument relating to the method of valuation provided for in paragraph 9(4) of the Seventh Schedule as submitted by the Commissioner and therefore at the conclusion of the case, in favour of the Commissioner, a notional value, based on current market values, was placed on the rental value of the accommodation and the taxpayer's employees were liable for tax thereon.

The Court, in *Brummeria,* went to great lengths to emphasise that an objective approach must be applied to determine the value of a receipt in a form other than money. Accordingly, the taxpayer company's argument in the *Vacation Exchanges International* case that the value of the asset acquired was nil due to the restrictions attached to the points, was dismissed. It is interesting to note, however, that when it came to determining the final employees' taxation to be assigned to the alleged benefit, it appears that SARS assessed the company with reference only to the actual holidays taken, as opposed to an assessment based on all of the points allocated to the employees.

Le Grange (2008) states that this indicates that SARS focused on the substance of the transactions rather than the form. In other words, the approach applied by the court was not fully objective in nature. The intention of the taxpayer company was to give the employees a holiday and the "mechanical" way of achieving this was ignored by the court. Le Grange questions why a value was not assigned to the points themselves. In her opinion, it would surely be possible to determine the value of the points at the time of the allocation (for example in connection with the average daily rate of a resort visit.) It is therefore submitted that, despite the *Brummeria* precedent requiring the application of an objective method of valuation, an element of subjectivity is still evident in cases following *Brummeria.* This illustrates the practical difficulty in applying fully objective valuations.

An important issue, relevant to the present research, which was raised in *Vacation Exchanges International,* was the section 82 burden of proof which is stated in the Income Tax Act as follows:

> The burden of proof that any amount is:
>
> - exempt from or not liable to any tax chargeable under this Act;

- subject to any deduction, abatement or set-off in terms of this Act; or
- to be disregarded or excluded in terms of the Eighth Schedule,

shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.

The appellant company challenged this section as it imposes the burden of proving the existence of an "amount" on the Commissioner after which the burden rests on the taxpayer to prove that such "amount" is "exempt from or not liable to any tax chargeable under the Act."

In *Commissioner for Inland Revenue v Dakator Engineering (Pty) Ltd* 1998 (4) SA 1050 (SCA) the Supreme Court of Appeal was called upon to address the issue raised in the Special Court whether the Commissioner bore the onus to prove on a balance of probabilities that an ascertainable money value can be ascribed to a benefit. In his judgement, Harms JA referred to a statement made by Roos JA in the case of *Ochberg v Commissioner for Inland Revenue* 1931 AD 215, 5 SATC 93:

> . . . that the section means that an amount received by the taxpayer, on which assessment has been made by the Commissioner, is taxable unless the taxpayer shows that it is not income.

As the law currently stands, it appears that once the Commissioner has established that an "amount" exists which is taxable, the Commissioner ascertains the value of the amount for the purposes of assessment and it is then up to the taxpayer to prove that either an "amount" does not exist, that if an "amount" exists, the "amount" does not have ascertainable value, or, that the value ascribed to the "amount" is incorrect.

It appears that in cases such as *Ochberg* (as previously discussed) and *Brummeria,* the objective approach does not always result in a fair outcome for the taxpayer. Another element of injustice also rests on the fact that taxpayers are burdened with the onus to prove the Commissioner wrong once an "amount" has been valued for tax. A weakness which existed in the arguments advanced by counsel for the taxpayers in the *Brummeria* case, was that only the existence of an "amount" was contested and no argument was

raised that the valuation of the amount, should the Commissioner prove its existence, was incorrect.

The application of the *Brummeria* precedent may possibly result in a number of other benefits, previously regarded as being non-taxable, being included in gross income by virtue of the fact that they are capable of objective valuation. An example of such a benefit is frequent flyer miles. Since the decision in *Brummeria* and subsequently in *Vacation Exchanges International,* there has been much discussion about the possible taxability of such a benefit, especially in the case of an employee being awarded frequent flyer miles which result from flights paid for by employers (Cunningham: 1999). There are a number of questions relating to the valuation of such a benefit, such as upon which basis the value of the benefit should be included in income and when the "amount" actually accrues to the taxpayer in terms of the gross income definition (when the miles are issued, when they are redeemed or when they are utilised.)

4.7 The taxability of frequent flyer miles

The principle that, should a non-cash benefit have an ascertainable value, it should be included in gross income for the purposes of taxation was established in a number of cases and was ultimately confirmed in the case of *Brummeria.* This judgement, being a binding Supreme Court judgement, may bring into the realm of taxation a number of benefits which have, in the past, not been seen as being taxable. An example of a benefit of this type is frequent flyer miles earned by persons who travel frequently and regularly, including employees who travel for the purposes of their employment.

An example of a South African frequent flyer programme is "Voyager." In simple terms, Voyager is a South African Airways programme of rewards for travellers, designed to thank them for choosing to travel with the airline (South African Airways Voyager Member Guide: 2010). Frequent flyer programmes such as "Voyager" allow passengers to earn "air miles" or "frequent flyer points" each time they fly. These can then be redeemed in exchange for free flights and other benefits. Certain programmes, such as the Voyager Programme, are associated with credit card companies; in the case of Voyager, Diners Club members get

additional points when purchasing on credit, the hiring of vehicles from associated companies, booking of associated hotels, flights actually taken or a myriad of other purchases linked to the loyalty programme.

Bearing in mind that an "amount" as referred to in the "gross income" definition as confirmed in the case of *Lategan* includes not only money, but also the value of any property (whether corporeal or incorporeal) for which a monetary value can ascertained, tax writers such as Jones (2009) have questioned whether or not "frequent flyer" miles should be taxed. Cunningham (1999), in discussing frequent flyer benefits, states that a distinction must be made between benefits earned through personal travel and those earned through business travel. Frequent flyer mileage earned through personal travel is generally viewed by tax academics as a "rebate of part of the cost in consideration of flying on a particular airline or a purchase price adjustment" and is therefore considered to be non-taxable. It is submitted that in deeming these benefits to be non-taxable, the rationale applied is that the cost of the ticket for private flights is not a deductible expense and therefore the "rebate" cannot be taxable.

According to Cunningham (1999), tax experts generally view frequent flyer miles earned by employees in the course of business travel not as tax-free commercial bargain purchases but as taxable income. Cunningham identifies that the key to this differentiation is that, in the case of business miles earned, the original flights earning the points are purchased by the employer. Therefore, experts have argued that the mileage subsequently awarded to employees represents disguised compensation from the employer for services and that the benefits should be classified as "employee fringe benefits." Despite these arguments, tax authorities have been slow to officially hold that frequent flyer benefits are taxable, much less to enforce any taxability.

Assuming that frequent flyer bonus awards awarded to employees by employers do constitute income, the tax authorities must establish proper valuation rules. It is submitted that this could be complicated. Garsson (1987) explains that a few valuation techniques have been suggested by tax experts, the first of which is valuing the benefits in terms of resale value. In America, when a prize winner is unable to resell the prize for the amount that the contest sponsor paid for it, the Tax Court has held that the resale value, not original

cost, determines the amount of the taxable income. In *McCoy v Commissioner* (1962) 38 T.C. 841 a salesman won an automobile which cost the employer approximately $4 500. After driving the vehicle for ten days, the taxpayer decided to trade the car in for another car costing $2 600 and $1 000 in cash. The Tax Court held that on receipt the car was worth less than $4 500, but more than $3 600 which the taxpayer effectively received when he traded in the car. The Court ultimately held that tax was to be based on the "fair market value" of the car which they determined to be $3 900. Garsson (1987) argues that in the context of air travel, it would be difficult to determine a value based on this technique due to the fact that flight values themselves change daily and are based on different classes, seats, time of day, etc.

Although no longer acceptable in a South African context due to the *Brummeria* precedent, there is evidence that the Tax Court has considered the actual value to the individual taxpayer of a benefit where fair market value may overstate the taxpayer's "accession to wealth." In *Turner v Commissioner* (1954) 13 T.C.M. (CCH) 462*,* an American case, but of relevance to the topic of the present research, the taxpayer successfully argued that his prize of two non-transferable round-trip first-class steamship tickets from New York to Buenos Aires was not worth the retail price (market value) to him. The Court recognised that should the taxpayer sell these non-transferable tickets, he would receive substantially less than the current market price of the tickets. Similarly, in the case of *Stander,* the taxpayer managed to satisfy the court that the prize which he was awarded did not increase his wealth, was not worth the retail price to him, and thus had a taxable value of zero. Unlike the *Stander* decision, however, the American Court, did not take a fully subjective approach to the valuation and instead, used their discretion by arbitrarily setting an amount of $1 400 as the value of the prize. There was no explanation as to how this value was achieved. It is put forward that such arbitrary valuation allocations are unacceptable in that they create undesirable levels of inconsistency and threaten a taxpayer's ability to predict the taxation consequences of their transactions.

Although the concept of "value to the taxpayer" may contradict the "fair market value" basis usually applied to valuation cases, Garsson (1987) submits that the former appears to result in a fairer value. The courts may be hesitant, however, to apply a subjective taxpayer-by-taxpayer approach to valuation as it threatens the consistency required in order for the

tax system to function effectively so that taxpayers to be able to readily determine their tax burdens in terms with the rights afforded to individuals in terms of the Constitution (as previously discussed.) This concern has been discussed previously in the present research. In the case of *Charley v Commissioner* (9th Cir. 1996) 91 F3d72*,* the Ninth Circuit Court of Appeals confirmed a Tax Court decision holding that a corporate president was required to include in his gross income the value of frequent flyer miles which the taxpayer had sold to his employer for cash. The Court emphasised in its reasoning that the frequent flyer benefits in this particular case represented an increase in wealth over which the taxpayer had sole control and were therefore taxable, but failed to create a common law solution applicable to all frequent flyer cases.

According to the *South African Airways Voyager Membership Programme Guide* (2010), in South Africa, frequent flyer bonus miles, in addition to being used to acquire an air ticket free of charge, can be exchanged for a number of benefits including accommodation, rental cars, game reserve holidays and even the purchase of wine, all of which can be valued in money terms and therefore included in gross income. In considering the inclusion of frequent flyer miles in gross income, a number of cases may be relevant. The *Lategan* case held that the meaning of gross income must be considered widely and includes not only amounts in cash but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value. In *Butcher Brothers,* Carlisle J referred to the word "amount" as meaning an amount having an ascertainable money value. It is submitted that since the miles can be converted into any of the benefits referred to above and therefore all have a monetary value.

In programmes such as "Voyager", it is also possible for frequent flyers to buy additional bonus miles in order to qualify for a flights or any other type of benefit offered by the loyalty programme. This illustrates that there is clearly a money value which can be established by airline companies and allocated to the miles earned by taxpayer-employees. No matter what benefit a taxpayer exchanges his or her frequent flyer miles for, quantifying the value, whether an airline ticket is chosen, or a holiday, or a car rental, is quite straight forward as quotations can easily be sought from travel agents, car rental companies, or the airline themselves. The valuation itself therefore does not appear to be a problem. Once an amount has been ascertained, the next part of the definition of gross income which requires

discussion is whether such an "amount" has been actually "received by" or has "accrued to" the taxpayer. The general rule is that if no receipt or accrual can be established, then no normal tax consequences can arise.

The term received by was clearly explained in the case of *Geldenhuys v Commissioner for Inland Revenue* 1947 3 SA 256 (C) 266 to mean an amount "received by the taxpayer on his own behalf for his own benefit". If an employer pays for an employee's flight ticket, the air miles awarded would originally be received by the employer who then has the choice of whether to utilise the miles or transfer them to the employee. The miles are therefore not received by the employee on his or her own behalf for his or her own benefit. Because the receipt of the air miles falls directly into the hands of the employer, the employer would ultimately be liable for tax. The value of the air miles awarded to the employees by the employer would not be included in the employee's gross income by virtue of the *Geldenhuys* principle. Instead, the award will be included in gross income in terms of paragraph (c) or paragraph (i) of the gross income definition as the awarding of the air miles can be connected to services rendered by the employee to the employer.

Paragraph (c) of the "gross income" definition in section 1 of the Act brings into gross income all amounts received for services rendered. In terms of this paragraph, the following are included in the taxpayer's gross income (Huxham & Haupt: 2011):

- any amount;
- including <u>voluntary awards</u>;
- received or accrued in respect of services rendered or to be rendered; or
- any amount (other than an amount referred to in section 8(1)) received or accrued in respect of or <u>by virtue of any employment</u> or the holding of any office. (own emphasis)

According to Huxham and Haupt (2011: 553), the important points to note are:

- there must be an amount received or accrued
  (in this respect, *Lategan* applies in that the term amount must again be interpreted widely to include cash and non-cash amounts. The opinion expressed in *Butcher*

Brothers that an amount must have an ascertainable money value must also be noted); and

- voluntary awards are included

  (as a result of an Appellate Division case, *Commissioner for Inland Revenue v Lunnon* (1924 AD), paragraph (c) was introduced into the definition. In that case the court decided that a voluntary payment made to an employee some months after the termination of services did not fall into gross income because it was of a capital nature. As a result of the introduction of paragraph (c) the capital or revenue nature of the payment is now irrelevant if it is respect of services. As long as it is paid for services rendered or to be rendered it falls into gross income.)

If the company is paying for the air tickets, being awarded air miles and then transferring these to the employee to utilise as they see fit, surely this can be regarded as a voluntary award in terms of paragraph (c).

If paragraph (c) is not applicable, paragraph (i) of the gross income definition can be considered. Paragraph (i) applies only to employees and office holders. It is a departure from normal gross income principle of "total amount," which implies an ascertainable money value, in that it refers to the value of any benefit. Fringe benefits generally do not represent an "amount" received by or accrued to an employee because a fringe benefit usually cannot be turned into money, or cannot be valued in money terms, or is difficult to value. This is why it became necessary to specifically include fringe benefits in gross income and introduce a schedule (the Seventh Schedule) which sets out how benefits are to be valued.

Paragraph (i) states that the cash equivalent, as determined in terms of the provisions of the Seventh Schedule, of the value during the year of assessment of any benefit or advantage granted in respect of employment or to any holder of office, is a taxable fringe benefit as defined in the Seventh Schedule. The timing of the valuation of frequent flyer miles may also be problematic. If the "gross income" definition in South African taxation law is considered, an amount must be included in gross income at the earlier of the date of receipt or accrual. In terms of voyager miles however, a participant may have received "taxable property" at five different points in time:

- each time the airline credited the taxpayer's account with mileage points;
- the date the taxpayer filed an award form with the airlines in order to claim a benefit;
- the date the taxpayer received the certificates indicating his or her free tickets;
- the date the taxpayer redeemed the certificates for the airline tickets; or
- the date the taxpayer utilised the free ticket.

It appears that in South Africa currently, SARS has not yet sought to tax frequent flyer miles as a taxable fringe benefit and thus, the problem surrounding the valuation of such a benefit remains unresolved.

Canada has recently adopted the "fair market value" approach for valuing frequent flyer awards. The Tax Court of Canada, in a November 1995 case, *Giffen v the Queen* (1995) C.T.C 53, 57, held that personal flights received from mileage accumulated on employer-paid flights are taxable to the employees when the mileage is redeemed. While the Canadian Tax Court agrees with most United States tax experts that the mileage is taxable because the employer paid for the flights on which the mileage was earned, there was minimal debate as to how the mileage should be valued; the court simply determined that the correct value to be included was the "price the employee would have paid for a ticket on the same flight in the same class service and subject to the same restrictions as the ticket obtained with the mileage."

If South Africa, in order to be consistent with international tax decisions such as those made in Canada and the United States, recognises such a benefit as being taxable, it will be interesting to speculate how and when the South African courts will undertake the valuation thereof, in the view of the decision in *Brummeria* that an objective valuation means must be applied and the subsequent decision in *Vacation Exchanges International* where the courts placed a value on timeshare units based on the *Brummeria* precedent.

4.8 Conclusion

The present chapter has discussed the *Brummeria* decision in detail. This case, it appears, has put an end to the objective *versus* subjective valuation debate. The decision reached in the case ultimately means that a precedent now exists that in future valuation cases, an objective method must be utilised. In terms of the continuum previously referred to, the *Brummeria* decision lies far towards the objective end of the continuum. The *Brummeria* precedent was recently applied in the case of *Vacation Exchanges International,* where time-share points were taxed based on what the court referred to as their "fair market value". As the court only placed a value on the points utilised by the employees and not the total number of points allocated, it is suggested that this decision, although it applies an objective valuation method, does not lie as far toward the objective end of the continuum as its predecessor in that the actual benefit to the employees, being the total number of points allocated to them, was not valued and included in taxable income in full.

The *Brummeria* decision, as discussed, stirred much debate in that there were a number of issues that the court did not address. An example of such an issue was that although the taxation of notional income was raised, no clear decision was made by the court as to whether or not this kind of income should be included in taxable income. Based on the decision in *Brummeria* and *Vacation Exchanges International,* the possibility that notional amounts could be taxed in the future exists. The possibility that the value of frequent flyer miles could be included in taxable income was discussed and the problems associated with valuing such a benefit were highlighted.

The Brummeria decision was discussed in detail and the problems with the decision were noted and explained. The fact that the counsel for the retirement development companies did not address the method for valuing the benefit arising from the right to use the loan capital interest-free (the utilization of the weighted prime overdraft rate) was cited as being a significant problem. The counsel for the companies relied solely on the principle in the *Stander* decision that, as benefits are not capable of being converted into money, they consequently had no value and thus were not taxable. The method used to value the benefits in *Brummeria* was therefore not challenged resulting in a "double taxation" due to the fact that the right to utilize the loan capital is valued in terms of the market and included

in taxable income without allowing for a deduction for the rental income forgone by the companies as a *quid pro quo*. Another problem that was referred to was the fact that the valuation method used in *Brummeria* did not value the right to the interest-free loan capital when the right itself accrued to the taxpayer companies but instead valued the benefits flowing from the right on an annual basis. The timing of the inclusion in gross income seems to be in conflict with the decision in earlier cases such as *Lategan* and *Delfos* where the timing of the inclusion in gross income was established.

It was submitted that the main weakness of the *Brummeria* decision and resulting precedent is that the counsel for the taxpayer failed to address the inequity of the valuation method and instead focussed on the existence of an "amount." Alternative valuation methods were discussed but it was concluded that these methods failed to address the main concern surrounding the *Brummeria* valuation, the "double taxation" levied on the developers. The Interpretation Note issued by SARS in this respect appears to have provided guidance and clarity as to how SARS will value similar benefits in the future. It was however noted that the Interpretation note does not overturn the precedent set in the *Brummeria* case that an objective method, which reference to the market, must be used to value non-cash benefits in the future.

In analysing the valuation method applied in the *Brummeria* case*,* the taxable benefit ("amount") of the interest-free loan was calculated using a market-related prime overdraft rate. In the case of *Vacation Exchanges International,* again, the timeshare accommodation was valued in terms of current market rates. Thus, it seems that SARS is consistent in its taxation of assets at a so called "fair market value". If SARS consistently taxes amounts for the inclusion in gross income at "fair market value", a further question arises as to how a "fair value" is calculated when no market exists for the asset in question?

The following chapter will discuss the implications of applying an objective "fair-market value" approach to assets such as private equity for which a market does not exist. As evidenced by the decision in *Vacation Exchanges International,* due to the *Brummeria* precedent, there now exists a possibly that an "objective fair-market value" will be assigned to benefits previously regarded as being non-taxable. In further addressing the sixth goal of

the research, the problems which arise when attempting to ascertain a “fair market value” will be analysed and explained.

Because many problems exist when trying to establish a market value for certain benefits, alternative methods of valuation such as the Keller Principle (Keller: 1983) and the Economic Utility method (Newman: 1982) will be discussed. Despite being more subjective in nature than the “fair market value” method, these methods may possibly address both the difficulties inherent in applying the “fair market value” method as well as the unfairness of the *Brummeria* valuation.

CHAPTER 5: OTHER VALUATION ISSUES AND METHODS

5.1 Introduction

In the previous chapter the case of *Commissioner for Inland Revenue Services v Brummeria Renaissance (Pty) Ltd and Others* (2007) SCA 99 (RSA); 69 SATC 205 was discussed and it was concluded that the debate as to whether a subjective or an objective approach should be adopted when valuing an amount was finally resolved when the Supreme Court of Appeal held (at 10) that "the test is objective, not subjective" and the interest-free loan in question was thus valued objectively in terms of the prime overdraft market rate of interest.

The decision rejected the principle applied in *Stander v Commissioner for Inland Revenue* (1997) (3) 617 (C), 59 SATC 212 that if a taxpayer is unable to convert his or her non-cash benefit into cash, it has a value of nil for tax purposes. In addition, it can be inferred from the decision in *Brummeria* that contrary to popular belief, notional amounts are in fact taxable. The law now stands that should a benefit be capable of a valuation in monetary terms, it should be valued objectively and included in the gross income of the taxpayer.

As previously explained Interpretation Note 58 (South African Revenue Services: 2010) describes the way in which the SARS intends to apply the *Brummeria* decision and it is important to note that it differs in terms of the timing of the valuation as the *Brummeria* decision appears to contradict the usual interpretation of the phrase "received by or accrued to" that an amount (the value of the right to an interest-free loan) must be included in gross income when the taxpayer is unconditionally entitled to it.

Issues relating to the timing of the inclusion of an "amount" in gross income were also highlighted in the discussion regarding frequent flyer miles where it was illustrated that there a number of points in time where the benefit may be regarded as having being "received" or "accrued". Due to the effect that the timing of the inclusion in gross income of an accrual may have on its valuation, this chapter will discuss South African tax case law relating to the time of receipt or accrual and will illustrate how the court has had difficulty in arriving at a consistent method of establishing the time of an accrual.

In addition, this chapter will discuss other valuation problems relating to the application of purely objective valuation method based on "fair market value", where no market exists for

an amount. The precedent established by the *Brummeria* decision has already been applied in the case of *Vacation Exchanges International* and the question has been raised as to whether, since timeshare holiday points have been allocated a value, a value could be assigned to other previously non-taxable benefits such as frequent flyer miles, for example. This possibility was investigated in chapter 4.

If the law now requires that amounts are to be valued objectively in terms of their "fair market value", the question arises as to how the courts will value amounts where a market does not exist. This chapter will analyse the term "fair market value" in terms of whether or not it is truly objective and will attempt to explain that such an ideal method of valuation is not always possible in practice. Private equity is a prime example of an asset for which a market does not exist. The courts have often been called upon to determine the value private shareholdings and have experienced much difficulty in this regard. Problems experienced in this area will be further explained in order to illustrate the weaknesses of the "market value" approach.

In the light of the fact that applying a "fair market value" approach is sometimes problematic, alternate means of valuing non-cash assets which could possibly address the weaknesses of this approach as well as the unfairness of the precedent set in the *Brummeria* decision require discussion. Two alternatives to the "fair market value" method of valuing an amount for the purposes of gross income are discussed in chapter 5: the Keller principle (Keller: 1983) and the economic utility method (Newman: 1984). These methods must be investigated to determine whether they could be applied successfully in practice, despite being more subjective than their market valuation counterpart.

5.2 The timing of receipt or accrual and its relationship with the valuation of the amount.

The timing of the inclusion in gross income of a receipt or an accrual is very important in that values change over time. To explain this concept, the valuation of shares can be considered. Should a taxpayer receive a right to obtain shares on a particular date in the future, the shares will have a different value on the date on which the right to acquire the shares accrues and the date on which the taxpayer exercises the right. Valuation must therefore take place on the correct date to ensure an accurate basis for taxation.

When discussing the *Brummeria* case, it was submitted that the valuation method could be criticised in that the court valued the annual benefit of the interest-free loan capital flowing from the right when it accrued (i.e. at the end of each financial period when the interest, should the loans have been invested, would have accrued to the taxpayer company), rather than when the right to the interest-free loan actually accrued. According to Interpretation Note 58 (South African Revenue Services: 2010), however, SARS valued the right at the time the right to the interest-free loan capital accrued and not when the benefits flowing from that right accrued. This implied that in terms of the established principles of receipt and accrual, the timing of the valuation in *Brummeria* was incorrect.

The courts have, in the past, debated as to when exactly an "amount" should be included in gross income. A case discussion follows to illustrate some of the timing issues which have been addressed by the courts.

5.2.1 The *Lategan* case

In *WH Lategan v Commissioner for Inland Revenue* (1926) CPD 203, 2 SATC 16, as previously discussed, it was argued by the appellant that no amount had accrued for the purposes of gross income. In the opinion of Watermeyer J, however, "accrued to" meant "entitled to". Although the taxpayer in this case had not become entitled to the right to claim payment of the debt in the year of assessment, he had acquired a right to claim payment of the debt in the future. This right had vested in him and thus it had "accrued to" him for the purposes of inclusion in gross income.

In addition, in *Lategan*, it was implied that the value of an amount which has accrued to the taxpayer must be determined as at the last day of the year of assessment, in that Watermeyer J stated the following:

> Assuming that the right to receive the instalments was not converted into money by sale or otherwise during the year of assessment, the value to be fixed (apart from any question whether the debt was good or bad) would be the present worth of the instalments at the end of the year, i.e. 30th June 1920 (own emphasis).

For many years the "entitlement" principle, namely that an amount accrues to a taxpayer when he becomes entitled to claim payment, even if only at a future date, caused much controversy.

5.2.2 The *Delfos* case

As previously mentioned, the decision in *Commissioner for Inland Revenue v Delfos* (1933) AD 242, 6 SATC 92 is very important in relation to the timing of valuations and thus, since the facts of the case were not previously explained in the present research, the details of the case require further elaboration.

In this case, the managing director of a company, under his terms of appointment, was entitled, with his director's fees, to a sum of £3 200 per annum. Owing, however, to the financial position of the company, the full amount of the salary and fees was not paid to him for the years 1924 to 1929. In respect of each of these years, the balance of the amount was credited to him in the books of the company, with the result that at 30 June 1929, he was in credit in respect of arrear director's fees to the amount of £9 900. During the year ended 30 June 1930, this accumulated amount was paid to the director in full. The Commissioner for Inland Revenue included the full £9 900 that was received by him during the year ended 30 June 1930 in the director's taxable income in that year of assessment.

The managing director appealed against this assessment on the grounds that the arrears for each year had accrued to him in respect of that year and should be assessed for that particular year. Thus, the Commissioner should re-open the assessments of the previous years and tax him in each year on the outstanding amount which had fallen due in that year. In essence, the director believed that actual value of his earnings in each of the years in

which they became due should be included in his gross income as this would be the correct interpretation of the principle of "accrued to" in relation to the facts of the case. It is submitted that the contention of the director is reasonable in that, should the company have been in a sound financial position, the amounts in question would have been received by the director as soon as they accrued to him. Instead, by no fault of the taxpayer, the amounts accrued to him and were reflected as a credit in the books of the company in each year, but were not actually received by him. If the definition of gross income is applied logically, the taxpayer is to be taxed when amounts are received by, accrued to, or applied in his favour, whichever occurs first. On this basis, the taxpayer's ultimate goal was to be taxed on the accrual of the each amount, instead of on the receipt of the sum thereof.

The Special Court held that the assessing officer had effectively allowed the deduction of the arrears each year as debts which were irrecoverable by permitting the taxpayer to exclude the amounts not yet received, but held that as the debts had originally accrued to the taxpayer in those years, they could be assessed only as income of those years and that the Commissioner was to remedy the situation by re-opening the applicable assessments.

Being dissatisfied with this decision, the Commissioner appealed to the Transvaal Provisional Division against the finding of the Special Court and the argument of the taxpayer on the grounds that by including in his gross income only the amounts actually paid to him by the company, the arrears owing to the director had effectively been treated as bad debts and thus no accrual had taken place as they amounts had not been considered as "due and payable" by the taxpayer. Therefore, only on recovery of the amounts of such debts did an accrual take place. The sum of accruals thus only constituted income of the year in which it was received, 1930.

The ultimate question at issue in *Delfos* was whether bad debts, when recovered in later years, should be regarded as income of that year due to only having "accrued to" the taxpayer then or whether debt amounts can be considered to have "accrued to" the taxpayer concerned in each of the years in which the unpaid debts arose.

As previously stated, an important point to note from this case is the differing interpretation of the term "accrual" by the judges before whom the case was stated. There was dissention due to two of the judges, Wessels AJ and Curlewis AJ supporting the *Lategan* doctrine (the

entitlement principle) whilst the other two judges, Stratford AJ and de Villiers J, concluded that "accrued to" implies that an amount should be "due and payable", notwithstanding vested rights. These conflicting pronouncements gave rise to a debate as to the correct meaning of the words "accrued to" on which the timing of valuation ultimately hinges.

It was ultimately held that because the taxpayer had only accounted for amounts actually paid to him in each of the years in question, effectively treating the amounts owing to him as unpaid debts, this had the effect of excluding the amounts from the taxable income of the taxpayer in those years and thus the amounts were not considered to be "due and payable" by the taxpayer and were thus not taxable in each of those years. The accumulated sum of arrears was thus taxed in full in the year in which it was received, 1930.

The "due and payable" part of the *Delfos* decision was finally overturned in *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* (1933) AD 242, 6 SATC 92.

The *People's Stores* case, as previously discussed, involved a six-month revolving credit scheme which resulted in the taxpayer company being owed a certain sum of money at the end of the financial year. The court was called upon to decide whether or not amounts owing to the company had "accrued to" the company in terms of the gross income definition. It was decided by the court that "accrued to" meant "entitled to" and thus, because the company was entitled to the amount outstanding, it constituted gross income and was thus taxable despite having not yet been received.

5.2.3 The *Mooi* case

After the *Lategan* case, an important further requirement was introduced by the court in the *Mooi* case, which must be met before an amount can be said to have "accrued to" a taxpayer for the purposes of taxation. As explained in the discussion of the valuation problems, this principle established that, in order to be included in gross income, the taxpayer is required to be "unconditionally entitled" to an amount. This additional requirement has a significant impact on the timing of valuation. The details of this judgement require further explanation.

In the *Mooi* case*,* the taxpayer was an employee of a copper-mining company, Palabora Mining Co Ltd. The employer company wrote a letter to the taxpayer dated 25 July 1963 granting him an option to subscribe, at R1,25 per share, for 500 of the company's R1 ordinary shares, subject to various conditions. The conditions stipulated firstly that the option was not exercisable until six months had expired after the completion of the company's mine at Palabora and secondly that the option could be exercised only if the taxpayer was still employed by the company. It was common cause that the option was in respect of services rendered and to induce him to render future services to the company. In October 1966 the taxpayer exercised the option and acquired 500 shares for R1,25 each. Their market value at the time was R6,40 each. The total market value of the shares acquired by the taxpayer thus exceeded the option price paid to him by an "amount" of R2 575.

The Commissioner included the sum of R2 575 in the taxpayer's gross income for the tax year ending 28 February 1967, as an amount which had accrued to him in respect of services rendered or to be rendered when the option became exercisable, that is, 1 September 1966. The taxpayer objected on the grounds that all that had accrued to him in respect of the services rendered or to be rendered was the right he acquired on 27 July 1963 to exercise an option at a later date when certain conditions had been fulfilled. The taxpayer argued that, when he exercised the option, the accrual was not in respect of services rendered.

It is important to note that this case was decided in terms of the "gross income" definition and not section 8A of the Income Tax Act which only came into force later.

It was held by the court that what accrued to the taxpayer was the right, on the fulfilment of certain conditions, to obtain shares at a price of R1,25. This accrual took place when the option to acquire the shares became exercisable, that is on 1 September 1966. At that date, the taxpayer was in the service of the company and there was a causal relationship between the benefit he acquired and his services to the company; hence the benefit fell within the statutory definition of "gross income."

After a brief analysis of the cases above, it is submitted that an amount is to be included in gross income on the date of accrual, which is the date upon which the taxpayer becomes "unconditionally entitled" to the amount in question. Despite the resolution of the timing

problem that these cases have provided, it appears that the point in time when the amounts were valued and included in gross income in the *Brummeria* case is at odds with the tests established in these cases. Interpretation Note 58 (South African Revenue Services: 2010), which illustrates how and when SARS intends to value interest-free loans in the future, appears to support this submission as it proposes that the benefit of an interest-free loan in circumstances similar to those in the *Brummeria* case will be valued by SARS when the right to the interest-free use of the loan accrues to the taxpayer and not in each year of assessment when the actual benefit flowing from the right to use the funds accrues as was done in the *Brummeria* case. The discounting which is applied in the Interpretation Note clearly indicates the different values that the right assumes in terms of the *Brummeria* decision and the Interpretation Note, if the timing of the accrual is taken into account

5.3 The Concept of "Fair Market Value"

There are no set methods or guidelines provided in the Income Tax Act as to how the valuations are to be conducted by the Commissioner in cases where an immediate value is unavailable. However, throughout the Income Tax Act, there are various references to "market value". Numerous references are also made to "fair market value", especially in relation to Donations Tax and in the Estate Duty Act 45 of 1955. Donations tax is levied on the "fair market value" of assets, as is the case with Estate Duty. This implies that assets should be valued in terms of the market when no immediate value is available. The criticism of cases such as *Brummeria*, where a so-called "fair market value" was applied, rests heavily upon the lack of fairness in the valuation method utilised.

The South African Income Tax Act, as well as the Estate Duty Act, use the term "fair market value" in various sections which describe how assets should be valued. Like South African tax law, the American Internal Revenue Code and Regulations also uses the concept of "fair market value" to place a monetary value on economic benefits received or paid in a form other than cash. Fair market value, according to Goldberg (1982), is both a measure of income for the receipt of property and the measure of deductions for losses or payments in the form of property.

According to Gordon (1953), most people would assume that there is no need for an in depth discussion about the phrase "fair market value" which, in legal contemplation, has been used in income, estate and gift or donations tax laws for a very considerable period of time, and has been applied in hundreds of cases as a formally accepted legal definition. Gordon explains that in terms of the International Financial Reporting standards, succinctly worded, the definition of "fair market value" is the "price at which a sale would take place between a willing seller and a willing buyer, neither being under compulsion to trade and both having reasonable knowledge of the material facts". While never stated as part of the definition it has always been recognised that the sale must be at arm's length in the free market. The wording of the definition has wide acceptance, but it is submitted that its application and meaning is not yet clear.

Madigan discusses real estate projects in terms of objective and subjective value. According to Madigan, objective value is a fact. It is an arithmetical computation of the total costs of an undertaking which may include, for example, the cost of the acquisition of the land, construction of the buildings, improvements to the land and legal and consulting fees. Madigan illustrates that subjective value is very different in that it is merely a perception or opinion about what the actual costs of the project are. He explains subjective value as being a view of what the property is worth in the minds of the particular buyer and seller. Where an actual value is not readily ascertainable, it is up to the buyer and seller to come to an agreement as to what the value is, and depending on the buyer and seller, the same undertaking may be allocated a range of values. This "subjective" value established by the parties to the transaction is essentially the so called objective "fair market value."

The above example illustrates the uncertainty surrounding the objectivity of "fair market value" which clearly requires further analysis in terms of the present research. The definition of "fair market value" can be broken down into separate components which include the knowledge requirement, the market requirement and the existence of willing buyers and sellers.

There have been a number of tax cases such as *Premier Packing Co*. v Commissioner (1928) 12 B.T.A 637 and *C.A. Bryan v Commissioner* (1930) 19 B.T.A 111 which have enforced the

information condition of the definition literally. The decisions in these cases were based on the idea that "a sale made without knowledge of the material facts relating to value cannot be said to produce a "fair" price, except by coincidence." Gordon (1953) is of the opinion that this correct.

Gordon (1953) further explains that "fair market value" basically means "sound value." It is the price for which the owner would hold out if he could. This knowledge requirement is designed to preclude the use of fair values established in the absence of a readily accessible market and at prices which vary greatly from intrinsic value. These excluded sales, if used, would cause taxation to be based upon accidental, erratic events having only coincidental relation to the taxpayer's income or property upon which taxation is based.

According to Gordon (1953), in terms of the market requirement, it appears that judges have disagreed on what a willing buyer is, or on how the absence of a willing buyer may be proved. An example of such a disagreement occurred in the case of *French Dry Cleaning v Commissioner* (1934) 72 F.2d 167 where the taxpayer's claim that no fair market value existed was finally rejected by the court in a seminal decision. He cites an example of a case where the taxpayer's claim that no fair market value existed was accepted, is *Old Colony Trust Company v Commissioner* (1928) 12 B.T.A 1334.

It appears that "fair market value" does not require the existence of an actual market but many decisions seem to be in conflict with this and this, according to Gordon (1953), is because judges have differing interpretations regarding the application of the "fair market value." This is an interesting argument relevant to the present research as the reason why a "fair market value" is assigned to property is so that the taxation of an amount may be based on an objective value. If courts do not agree on what "fair value" actually means and whether a "fair value" exists or not, how then can a "fair market valuation" be objective?

Gordon (1953: 45) questions as follows: "[W]hen we talk of willing buyers and sellers in the definition of 'fair market value,' are we referring to actual buyers and sellers, whose existence is a prerequisite to finding of 'fair market value,' or are we merely referring to their putative substitutes, whose decisions we are constructing?" He also asks the following questions: "If buyers and sellers exist, are they required to meet any qualifications before

prices set by them may be used as evidence?" and "Is there any further requirement indicated by the word 'willing'?"

Another question posed by Gordon (1953) is whether in establishing a "fair market value", a fair market price is required. Since the definition of "fair market value" requires the price at which a trade would occur between willing buyers and sellers, it may be supposed that no other qualifications exist for an acceptable price. Surely, if a market price is substantially lower than the notion of a "fair" price for an item of property, it could not be referred at as a "fair market value"? In the case of *Champlin v Commissioner* (1934) 71 F.2d 23, the court accepted the intrinsic value as the "fair value" which the market price must approach if it too, is deemed to be "fair." This creates the proposition that if a substantial variance exists between the market price and the intrinsic price, the former must be rejected as the "fair market value."

According to Gordon (1953), when the receipt of property constitutes a gain, the ability to sell the asset and realise the market value is not the only basis on which tax can be imposed. Another justification is that the taxpayer can exploit the valuable right of holding it as an investment producing income. Should the taxpayer then be taxed on the intrinsic price of the asset? In the case of *Guggenheim v Rasquin* (1941) 312 U.S. 254, the Supreme Court sustained a finding that cost, rather than the cash surrender value of a premium life insurance policy, was the proper measure of valuation. Referring to the definition of fair market value, the Court stated that it "did not establish market price as the sole criterion of value." Fair market value covers not only the value of parting with the property but "the right to retain it as well" because, for example, of its "investment virtues".

Based on Gordon's research, it is submitted that despite the wide use and acceptance of the definition of "fair market value," tax courts continue to experience problems in placing a value on property based on the "superficial" market value to which the definition must be applied.

According to Goldberg (1982), the problem with the definition of "fair market value" is that it fails to take into account the identities of the buyer and seller as well as what their intentions are regarding the property being valued. Goldberg (1982) is also of the opinion that the same piece of property may change hands at different prices, depending on the

market in which it is being sold. Goldberg (1982: 834) provides the following useful example in explanation of his argument:

> An article of tangible personal property that costs $5.00 to make may be sold by the manufacturer to a wholesaler for $10.00. The wholesaler may in turn sell it to a retailer for $15.00, who may sell it to a retail customer for $20.00. The same property could be sold back to the retailer for $14.00 and resold to another retail customer for $20.00.

Goldberg (1982) explains that even though all of the above transactions were at arm's length and involved willing buyers and willing sellers, they involved several sales prices. The price differential can be attributed to the market in which each sale took place. Therefore, the determination of fair market value under the "willing buyer and seller" test cannot be applied without first determining in which market the transaction takes place.

Although separate and distinct markets exist for certain kinds of property, most taxpayers only have access to one kind of market. Most individual customers who wish to purchase personal property only have access to the retail market and the typical customer, when purchasing property, receives a normal retail mark up. Basically, the retail mark up of the dealer represents the spread between the retail and the wholesale prices. Goldberg (1982) emphasises that the spread is not all profit to the dealer as the dealer may have substantial carrying, rent, sales, advertising, and other costs. The mark-up charged by the dealer is usually proportional to these expenses. In turn, sellers of personal property usually only have access to the wholesale market.

According to Goldberg (1982), the "fair market value" issue arises in the context of valuing property in the hands of a particular taxpayer. In establishing a "fair market value", two distinct queries need to be made. Firstly, one must enquire as to whether "fair market value" is the amount it would cost a similarly situated taxpayer to purchase the property, the "replacement value," the amount that the taxpayer would realise on the sale of such property, or the "liquidation value?" Secondly, what value should be chosen among the range of prices available, whether liquidation or replacement value?

Goldberg (1982) argues that the standard for determining "fair market value", whether replacement or liquidation value, should further the purpose of the particular statutory provision that requires valuation. In other words, Goldberg (1982) supports a more

purposive approach to valuation in which the standard applied allows for an element of subjectivity and flexibility according to the purpose underlying the provision under consideration. Goldberg's approach is based upon two general principles that consider the ownership of the property at the time of valuation to determine whether replacement value or liquidation value is appropriate. The property approach implies the following:

- Replacement value is generally the proper method of valuation when the taxpayer *retains* the property after the transaction that gives rise to the need for valuation.
- Liquidation value is the proper measure of valuation when the taxpayer does not retain the property.

This approach results in the application of a variable standard to define the single concept of "fair market value". A trade-off is however evident in that in order to apply the approach and establish, in Goldberg's opinion, a "fair" value, consistency may be compromised.

Goldberg (1982) argues that, in general, the court has used the replacement value as the proper measure of "fair market value" but at times they have departed from this valuation method and have instead adopted the liquidation value as the appropriate measure of "fair market value". The courts have not, however, articulated a consistent theory for justifying this departure and thus there is very little guidance for determining the "fair market value" in taxation law.

In applying the "fair market value" definition, Bosland (1964) submits that one of the most difficult problems in tax administration and faced regularly by tax courts worldwide is the determination of the value of ownership interests where there is no ascertainable market quotation, as in the case of unlisted shares. In the valuation of unmarketable securities for the purposes of imposing estate duty or donations tax, courts generally consider criteria such as the nature and history of the business and its prospects, the economic outlook in general, the book value of the stock, the earning capacity and dividend-paying capacity of the company, intangible and goodwill value as well as the market price of shares of companies engaged in a similar line of business, financial conditions and capital structure. According to Bosland (1964), courts consistently insist that valuations be made in the light of "all relevant factors" in the context of hypothetical transactions between the "willing buyers" and "willing sellers" discussed previously. In practice, the courts have constantly

refrained from setting any definite rules or formulae for determining how these factors should be weighted, or how much or how little importance should be attributed to each of them. These criteria, depending on how much weight has been ascribed to each of them, result in a value which, it is submitted, is fully dependant on the subjective opinion of the court as to the importance of each of the criteria in relation to the shares being valued. How then can the established value be classified as an "objective market value?"

In the case of *Commissioner v Marshall* (1942) 125 F.2d 943*,* Judge Frank described the uncertain nature of "value:"

> The truth is that it has different meanings in different contexts, even in the restricted field of "tax law." And there, as almost always, "value" involves conjecture, a guess, a prediction, a prophecy.

In most cases, the courts have failed to provide an informative explanation as to how they established a value, based on the criteria mentioned above. The result, according to Bosland (1964: 77) is "an apparent lack of any consistently applicable standards" which "breeds a feeling of uncertainty and apprehension among taxpayers and leads to frequent charges that in this regard, at least, taxation is likely to be more or less arbitrary, if not, an outright gamble."

Rice (1950) argues that the importance of the problem of valuation in taxation has been exceeded only by neglect. In the estate tax field, volumes of literature have been published about the items which are included in the net estate, but relatively little attention has been paid to the problem of translating those items into monetary figures for the purposes of computing the tax thereon. Rice (1950) explains further that the amount of estate and gift taxes should be fixed by what is transferred, the amount of the tax increasing with the dollar equivalent of the property. Accordingly, if a descendent leaves cash, a partnership interest, shares or fixed property, it is necessary to establish a cash figure for these non-cash items. Similarly, where a taxpayer exchanges one property for another property, it may be necessary to establish a cash equivalent for the property received to ascertain whether the recipient taxpayer realized a gain on the transaction for income tax purposes.

Rice (1950) suggests that ". . . it is not necessarily a problem related to 'what is value?'. . . It is a practical problem of what standard will relieve the complexities of tax administration . . .

to the maximum extent compatible with fair treatment for the taxpayer." In his opinion, the income, gift and estate tax statutes reflect only the disposition to ignore the problem. Instead of meeting the problem head-on and attempting a solution, tax administrators have evaded the problem.

In America, the estate tax statutes provide that the tax shall be measured by the "value" of the net estate. A similar provision is made in the gift tax statute. Under the income tax provisions the measurement of taxable gains is made on the basis of the "fair market value" of the property sold or received. As previously mentioned, in terms of South African tax law, the Estate Duty Act, donations tax provisions, as well as income tax provisions are all based on the concept of "fair market value."

As discussed, shares are also valued with reference to the market for tax purposes. It appears that taxation law has consistently reiterated a reliance on the general concept of "fair market value" and the price which "willing buyer would pay to a willing seller." The definition of "fair market value" has been criticised as the root of the current "valuation" dilemma by many writers including Rice. Rice (1950: 370) criticises the idea of "fair market value" as follows:

> The clarity of the current standards of value is not increased by the frequent use of the phrase that "value" is what a willing buyer would pay to a willing seller for the property, each having a reasonable familiarity with all the facts. The courts in practice have frequently rejected this theory. If there are actual sellers and buyers, the prices set obviously do control. If there are none, a substitute standard must be established. If no "value" referable to a market actually exists, we do not promote analysis of the issue – selection of a substitute standard – by developing the fiction that we are looking for a "market value" where it is clear that none exists. What we are looking for is a substitute for "market value." In practice, the substitute is established by a review of "all relevant factors." . . . Thus, the search for a standard for transmuting property into dollar equivalents for tax purposes proceeds from generality to generality without enlightenment; from "value" to "fair market value" to "what a willing buyer would pay a willing seller" to "all relevant factors." . . . In the absence of information as to what is "relevant" there are in fact no standards . . . to control the establishment of dollar equivalents for tax purposes.

According to Rice (1950), it requires little citation of authority to support the conclusion that "value" is a "question of fact". In most cases, the ultimate conclusion as to value is prefaced by a statement that the valuation is based on all the evidence and a consideration of "all

relevant factors." What is troubling is that the Commissioner, the taxpayer and the Tax Court or the appellant courts have not yet established a consistent standard for determining either the relevance of these "factors" or the weight which should be accorded to any of them.

Rice (1950: 376) argues further that "[i]t is not only that the taxpayer must introduce evidence concerning every potentially relevant factor; but also that the Tax Court must set out in each case a result for that case alone: a ticket 'good for this day and train only'. Thus to an extraordinary degree, not only does the Tax Court make the law, but it makes a separate rule for each case as it is presented."

It is therefore submitted that in applying what is meant to be an objective "fair market value", the valuation process results in a subjective value based on the opinions of the parties involved concerning the so called "relevant factors".

The difficulties of ascertaining "value" in the absence of any standard are obvious from a number of court decisions which have stressed that a result was only reached because the issue of "value" had to be resolved somehow. An example of such a case is *Commissioner v Amy H. DuPuy* (1946) 9 T.C. 276, 284*,* where it was said that:

> The evidence does not lead irresistibly to any amount as the obviously correct value, but, since a finding of a precise amount must be made, the Court has concluded, after considering all of the evidence in the case, that the value of the stock on the valuation dates was $1300 per share.

In other cases such as *Commissioner v. Marshall* (1942) 125 F.2d 493, appellant courts have reiterated that a finding of "value" simply represents a conjecture.

According to Rice (1950: 377), "[i]f giving the appearance of justice is an important adjunct to the rendering of justice itself, the present valuation process leaves much to be desired."

The effect of the present valuation problem was aptly described in *Patterson v Commissioner* (2d Cir 1930) 42 F.2d 148, 149 where it was stated:

> Probably it is true that the holder of such shares must usually be content with the guess of the Commissioner, because when property is not sold on an open market where a number of buyers can establish its value, it will seldom be possible to contradict the first honest judgement formed.

Bosland (1964) suggests that the problem currently being experienced in most countries is that the tax administrators, whose determinations of value have the presumption of correctness under the law, are frequently being accused of choosing the factor or combination of factors that will yield the highest valuation and subsequently, the highest tax burden. Taxpayers, however, emphasise measures which result in lower valuations so as to increase tax efficiency. As a result, valuations are based on a compromise between the subjective arguments put forward by each party. In assigning an objective "fair market value," courts consistently settle on subjective compromises. This, according to Bosland (1964: 77) "leads to the impression among the legal profession, accountants, estate managers, and others that valuation is essentially a process of 'horse-trading' in which each party takes an extreme position in the hope that the final compromise will be to his or her advantage."

Despite the criticism of "tax valuation by compromise," it appears that this subjective method of obtaining a value provides a sense of justice in that both parties achieve something. Again, it appears that a trade-off is required between consistency and fairness. It is submitted, however, that based on the vagueness of the definition of "fair market value" and the subjective interpretations of the courts, it is not possible always to place an objective value on non-cash items, especially where no active market for those items exists.

In essence, Rice (1950) explains that the term "value" means whatever the Commissioner and the courts choose it to mean. The process of determination basically works as follows: the Commissioner imposes a tax in view of the nature of the property transmitted; but this must not be unreasonable; that the Tax Court may say that the determination is unreasonable; and that the appellant courts may review that decision. In practice, the Commissioner does not state the reasons for his determination; the Tax Court in review does not state its reasons, but expresses a monetary figure after consideration of "all relevant factors"; the appellant courts usually rely on the Tax Court decisions but occasionally reverse them on the ground that weight should or should not be given to a specified factor. According to Rice (1950: 383), "it is under law, a conspiracy of silence".

Rice (1950: 383) proposes two solutions which would improve the problems currently being experienced in valuing private stocks:

1. All reference in regulations to "all relevant factors" should be stricken.
2. A specific formula for the valuation of closely held stock should be adopted, based on the asset value of the issuing corporation.

The consideration of all "relevant factors," according to Rice (1950), has been interpreted to mean that the decision shall not be based on a specific group of factors but that depending on the shares in question different factors may be relevant. It thus becomes an instrument for concealing, rather than expressing thought. As a result, the Commissioner and the Tax Courts consistently avoid explaining exactly how they reached their respective decisions. The construction of case law on the subject of valuation has thus not progressed and will remain as it is until the courts fully express their reasons for decision to decision to the extent that they can be articulated. In other words, in order to build up a "case bank" which could be used from case to case to create a measure of consistency in valuation decisions, the courts should have a duty to disclose their methods of valuation, instead of simply stating that they have considered various "relevant factors."

The second solution submitted by Rice (1950), is that a specific standard for the valuation of stock needs to be imposed. Rice suggests that the value of closely held stock should be established by computing the net cash equivalent of the net assets of the corporation including goodwill as well as "going concern" value. The total sum should then be divided by the total number of shares outstanding to reach a cash equivalent of each share for taxation purposes. The method which Rice refers to is known universally as the "net asset value" method.

Rice (1950) argues that the use of net asset value is superior to the capitalisation of earnings method, which has in the past been accepted as the proper means of valuing closely held stock, as it seems fairer due to the fact that there is less opportunity for variation in results.

According to Rice (1950), in utilising the capitalisation of earnings method, the Commissioner must select a period of time which would reasonably reflect average annual earnings and apply a capitalisation rate to these earnings. Depending on the stability of the

business, the rate would be high or low. The selection of a reasonable period of earnings and a suitable capitalisation rate is extremely subjective, and no general rules respecting proper rates for various industries have been adopted. While the use of net asset value is also subjective in part, Rice (1950) submits that it unquestionably has more certitude for the administrators, the taxpayers and the courts.

Although the application of "net asset value" appears to provide a possible solution for the problems currently being experienced in the valuation of private equity by the courts, it is submitted that despite the market value method as well as the net asset value method of valuation providing a high level of objectivity, neither of these methods can be categorised as being completely objective as every valuation methodology has an implicit subjective basis.

Due to the fact that the application of the "fair market value" method is often problematic, as evidenced by the difficulties experienced when attempting to value private equity in this manner, alternate means of valuing non-cash assets which may possibly address these problems and result in a fairer value than that established in the *Brummeria* case can be discussed.

5.4 The taxation of barter transactions: The Keller principle

It is submitted that the transaction in the case of *Brummeria* between the taxpayer property companies and the retiree residents can be described as a barter transaction which is an exchange of goods or services for other goods or services such that no money changes hand. Although in the *Brummeria* case, money did change hands in the form of the original loan, it is submitted that the exchange of the right to utilise loan capital interest-free for a life-right to rent free occupation is akin to a barter transaction. As discussed previously, the courts concluded that the right to an interest-free loan is a taxable benefit which should be valued objectively and included in gross income.

In the light of the controversial *Brummeria* decision, Keller's (1983) research dealing with the taxation of barter transactions is very interesting. Of relevance to the present research are Keller's (1983) findings about direct barter transactions in which one taxpayer

exchanges goods or services for the goods or services of a second previously unrelated taxpayer. According to Keller (1983: 443), "[a]ll taxpayers who engage in barter transactions are in the same economic position they would have been had they received cash for their goods or services in an amount equal to the value of the goods or services actually received and used that cash to purchase goods or services from the other party to the exchange."

To illustrate this principle, Keller (1983) uses the example of a swop of services between a doctor and an accountant. The doctor performs a physical examination on the accountant, in exchange for which, the accountant prepares the doctor's individual tax return. Assuming each party to the transaction would have charged $500 in a cash transaction for his or her services, the doctor would have gross income of $500 and a $500 itemized deduction whilst the accountant would have $500 gross income and would account for a medical deduction of $500.

Keller (1983) then explains the taxation consequences should the exchange have taken place between the doctor and a painter, who paints the personal residence of the doctor in exchange for a physical examination. In this case, the doctor would still have $500 gross income, but would not be able to claim any deduction for the painter's personal services. Similarly, Keller (1983) explains that if the doctor swapped services for those of an architect, who drew up plans for the doctor's new residence, the doctor would again have $500 gross income, but the $500 payment to the architect would simply be included in the basis of the doctor's new home.

Keller (1983) believes that a rational taxation system would treat every barter exchange in the same manner as an economically equivalent two-payment cash transaction. To reach this result, Keller (1983: 444) submits five basic tax principles:

- principle I: all economic benefits, regardless of form, are includable in income; the amount of the income is the fair market value of the benefit received;
- principle II: if the value of the benefit received cannot be determined with reasonable accuracy but the value of the benefit given up can be, the value of the former is presumed to equal the value of the latter;

- principle III: the “cost” basis of property received in a taxable barter exchange is the property’s ”fair market value” at the time of the receipt;
- principle IV: the term “paid or accrued” or “paid or incurred” includes the “fair market value” of an in-kind benefit received in a taxable transaction by the taxpayer; and
- principle V: Even if the reporting of an item of gross income under Principle I would permit the taxpayer to claim an equal tax deduction under Principle IV, both income and the deduction items must be reported on the taxpayer’s income tax return.

In the accountant-doctor example, in which $500 worth of services were exchanged, the principles governing the tax treatment of both the taxpayers are Principles I, IV and V. The doctor reports the value of the accountant’s services as income under Principle I and also claims their value as a deduction for the tax return preparation under Principle IV. Similarly, the accountant has received $500 of gross income and has paid $500 of medical expenses. According to Principle V, all income and expenses are reported notwithstanding their offsetting effects.

If Keller’s (1983) principles are applied to the barter transaction which occurred in the *Brummeria* case, it is submitted that a more equitable valuation would have resulted in that the income, in the form of notional rental income, would have been offset against the notional interest expense. Instead, the taxpayer companies were taxed solely in terms of the benefit of the interest-free loan and were afforded no deduction for the “life-right” which they granted to the retiree in exchange for the benefit. In the previous discussion about the *Brummeria* decision in terms of United States tax law, Cohen’s (2010) main criticism of the case was that the decision was incomplete. In applying Keller’s Principle, this problem is further emphasised.

Keller (1983) explains, however, that the only type of economic benefit that most American courts have yet to include in gross income is that derived from the receipt of an interest-free loan and this implies that he is uncertain as to how such a barter exchange is to be valued for the purposes of inclusion in income tax. It is therefore submitted that the five

principle approach may not be suitable to a notional receipt such as that dealt with in the *Brummeria* case.

Other writers such as Newman (1984) criticise Keller's use of "hypothetical cash purchase price" to determine "fair market value." Newman (1984) argues that participants enter into barter transactions precisely because they are unable to sell their goods and services for cash. Consequently, the use of hypothetical cash purchase price inflates the actual value of goods and services. When discussing the valuation of the interest-free loan in the *Brummeria* case, it was suggested that by valuing the interest in terms of the prime-overdraft rate applicable at the time the loan was in use, the benefit of the use of the interest-free loan was overstated as the property companies, should they have invested the loans, would be unlikely have received such favourable interest rates. This idea supports Newman's criticism. It is submitted that by allowing the taxpayer companies a deduction for the notional rental income which would be calculated in a similar manner, such a problem may be resolved resulting an acceptable net income.

5.5 The economic utility as a value for taxation

According to Newman (1982), both from the perspective of economics and the law of taxation, the receipt of assets should not constitute income in the hands of an individual unless the asset is useful to him or her.

The concept of economic utility was recognised by the court in case of *Bloch v Secretary for Inland Revenue* (1980) 42 SATC 7, where Vos J, in his discussion about the elements of a capital receipt stated the following:

> In *Sekretaris van Binnelandse Inkomste v Aveling* (1978) (1) SA 862 (A) fixed capital is described as something held with an element of permanency and which will produce income for the holder. What about a house, or a motor car? If these are used by the owner to live in or to drive in they do not produce income, but only economic utilities. Yet they are normally capital goods. Other examples are paintings and antique furniture. Hence, with respect, I would prefer to say that capital is that which is held with an element of permanency and with the object that it should produce an economic utility for the holder.

It is generally assumed that money is useful to everyone; it is only in the case of non-monetary assets that the question of utility should be raised. An individual may receive a non-monetary asset which is useless to him or her in its present form but has the potential to be traded for an alternative asset which is useful. In terms of the economic theory of utility, as long as an asset is transferable, it can be treated as income in the hands of the recipient, even if it is not useful to him or her. In valuing an asset which is not immediately useful to an individual but can be traded and used by someone else, Newman (1982) argues that the taxable income generated by such an asset should not be measured by the asset's fair market value, but rather by the value of the useful assets that can be acquired in trade, reduced by any transaction costs.

If transferability can render an otherwise useless asset useful, then it can be assumed that transferability can make a useful asset potentially more useful, and non-transferability would then obviously make a useful asset less useful. Based on these assumptions, if an individual is offered the choice of a useful, non-transferable asset, or the market price of that asset in cash, the individual is likely to choose the cash, unless that asset represented the individual's optimum value of the asset. According to Newman (1982), if this is the case, then surely the taxable income generated by a useful, non-transferable asset ought to be less than its market price and should be measured by its subjective value to the individual recipient.

Newman's (1982) analysis suggests four working assumptions with respect to the relationship of transferability and utility to taxable income:

- the receipt of useless non-transferable assets generates no taxable income;
- the receipt of useful, transferable assets generates taxable income in the amount of the objective fair market value of the assets;
- the receipt of useful, non-transferable assets generates taxable income in the amount of the subjective value of those assets to the recipient; and
- the receipt of useless but transferable assets generates taxable income only in the amount of the useful assets for which they can be traded, or their "transfer value."

In the case of a useless, non-transferable asset, the objective fair market value is clearly zero due to the fact that the asset is not useful to the recipient and is not wanted by anyone else.

If, for some reason, the asset is non-transferable in the hands of the recipient, it would not increase the material well-being of the recipient if the asset itself is useless to him or her and he or she would be unable to trade it for anything else. Newman (1982) suggests further that a rational person, when offered something that was neither useful to him nor transferable, would simply refuse to accept it.

It is equally clear that a useful, transferable asset generates taxable income in the hands of the recipient of at least the amount of the transfer value of the asset. This is because, if the recipient chooses to use the asset rather than to sell or trade it, he or she foregoes the sales proceeds and thus the asset is taxable to the individual in that amount. In addition, if the individual chooses to utilise the asset, it is probable that the asset is useful to him in the same way as it would be useful to any other person and therefore it is submitted that the individual would have been willing to pay the objective fair market value for the asset.

The remaining assumptions are not as clear and require a more detailed discussion. According to Newman (1982), a rational person, when offered the choice between a useless transferable asset or the cash amount of its transfer value, would certainly choose the cash. The reasons are that the individual would be required to put in an effort in order to convert or trade the asset and secondly that there is always a risk that the individual will overestimate the value of the asset and then not be able to receive his or desired "price." Therefore, it is highly unlikely that useless, transferable assets would be valued on the basis of an arm's length exchange, assuming comparable bargaining power on the part of the two parties to the transaction. Newman (1982: 33) therefore suggests that the asset can only represent income of amount equal to the transfer value of the asset "as demanded by common sense and good economics."

Newman (1982) explains that the case of an asset which is useful but not transferable has caused much unrest in tax courts worldwide. Newman (1982: 33) explains that the reason for this is that an asset of this type contemplates a subjective, rather than objective valuation and tax administrators are hesitant to apply subjective valuations due to the fact that they require "laborious, unpredictable, case-by-case determinations."

An example of a South African taxation case involving a useful, non-transferable asset is *Stander*, in which the court subjectively valued the prize given to the taxpayer. The case

involved a taxpayer, Stander, who was awarded a prize in recognition of his employment performance. The court had to consider whether the value of the prize should be included in the taxpayer's gross income in terms of paragraph (c), paragraph (i) or any other paragraph of the definition of gross income. Once the court had established that paragraph (i) was not applicable due to the absence of a direct employer-employee relationship, it was held that the taxation of the prize could therefore only included in gross income on the basis that the trip fell within the ambit of paragraph (c) (an "amount" in respect of services rendered.) Of relevance to the present topic is the test which was used to determine whether there was an "amount." The courts questioned whether the advantage obtained can be turned into money or money's worth (in other words, cash or convertible to cash.) If not, it was concluded that there can be no amount to include in gross income.

The cost to the franchiser of the trip amounted to R14 000. The Commissioner assessed the value of the prize to tax, based on this amount. The question which arose in the court was whether the trip constituted "property" which has a money value or whether it constituted a right that could be "turned into money." The court held that the trip amounted to an executor donation but because the terms were not embodied in a written and signed document, no "right" had been acquired. Further, that having gone on the trip, the taxpayer had not received any "property" on which a monetary value could be placed in his hands. Ultimately, because of the lack of transferability of the prize in this particular taxpayer's circumstances, the value placed on the "amount" was zero.

The second part of the decision in this case that, because the holiday awarded to the taxpayer was not convertible into cash, no "amount" had accrued for the purposes of gross income, has been overruled by the Supreme Court in the *Brummeria* case where it was decided by the court that an objective approach to valuation should consistently be taken whereby any benefit with a monetary value must be included in gross income, irrespective of whether or not it could be converted into cash.

It is submitted that the *Stander* decision that an asset that cannot be converted into money cannot be included in "gross income" is more in line with the economic theory of utility which could be used as an alternate basis to challenge the results of the *Brummeria* decision, which it was argued are illogical and unfair.

5.6 Measurement of taxable consumption: an argument against the economic utility as a means of establishing value

An interesting valuation problem which was brought to light in the case of *Zarin v Commissioner* (1989) 92 T.C. 1084 (hereinafter referred to as *"Zarin")* was how to measure and account for the value of consumption in applying an income tax. The facts of the case involved David Zarin, a gambler whose principal game of choice was craps, a dice game that involves no significant skill and has unfavourable odds for all bets and under all betting strategies. After gambling at a number of resorts, Zarin quickly became a popular and valued gambling patron. According to Shaviro (1990), by the late summer of 1978, he was receiving the complimentary use of a luxury three bedroom suite. In addition, he was granted free meals, entertainment, and twenty-four hour access to a free limousine for himself and his guests. The resort motivated their generosity based on the large crowds that Zarin drew to his table and the increased amount of betting and consequently profits which resulted.

By November 1979, Zarin's permanent line of credit extended by the casino had been increased from an initial $10 000 to $200 000. Furthermore, he was being permitted to exceed this limit by signing counter cheques, or "markers", provided by the casino in exchange for gambling chips. By December 1979, Zarin had incurred gambling debts of approximately $2.5 million, which he paid in full. Meanwhile, the resort where Zarin gambled most frequently was being investigated by the New Jersey Casino Control Commission for a number of gambling violations including one hundred which related directly to Zarin. As a result of the investigation, the resort was forbidden to issue credit in excess of properly approved limits to any gambling patron. The resort however, effectively ignored this order by treating Zarin's uncleared personal cheques as "considered cleared" and by granting him excess credit increases referred to as "this trip only" credits.

Zarin continued to gamble up to $15 000 per throw of the dice and eventually, in April 1980, he was asked to settle debts in the amount of $3 435 000 for which he wrote a personal cheque. The cheque bounced resulting in the suspension of credit facilities at the resort. Despite Zarin's promise to repay his debts, the Resort filed a complaint against him in the New Jersey State Court, seeking payment of the amount owed. Using the casino's violations

of the State Law as an affirmative defence Zarin managed to negotiate a lesser amount of $500 000 in settlement of the $3 435 000 which he actually owed.

The Internal Revenue Service, upon an audit of Zarin's affairs, determined that, as a result of settling the Resort's lawsuit, Zarin had income arising from the cancellation of indebtedness in the amount of $2 935 000, the difference between his gambling debts and the settlement amount of $500 000.

The issue upon which the court had to decide was whether the cancellation of indebtedness constituted income or a purchase price adjustment, excluded from taxation. Underlying the analysis however was a deeper concern: Did the settlement with the Resort merely spare Zarin an enormous economic loss? Or, did it instead grant him an enormous taxable benefit in that he continued to gamble at a fraction of the actual cost?

In deciding the case, the court referred to an earlier judgement, *United States v Kirby Lumber Co.* (1931) 284 U.S. 1, where it was decided that a settlement of a debt for less than its face value generally gave rise to taxable income. The Tax Court noted that Zarin had received gambling chips worth $3 435 000, in exchange for a promise to repay, and that only this promise prevented the chips from being income upon receipt. Further, that the chips provided Zarin with something that he, at least, considered valuable, the opportunity to gamble and that upon failing to fulfil his promise to repay the total amount owing, the cancelled debt constituted a benefit which required valuation and inclusion in taxable income. It is submitted that the court considered the subjective value of the chips to the individual taxpayer as they valued the gambling chips according to the amount of entertainment Zarin gained from gambling chips. Although the court addressed the subjective value to Zarin, this valuation is also objective because in this case, the market value of the chips equates the value of the chips to the taxpayer. Should the courts consistently place a value upon an amount in terms of the subjective value to the individual taxpayer, this will certainly not always be the result.

In response to this decision, Zarin advanced an alternative argument against the taxation of the settlement discount based on the exclusion of purchase price adjustments from taxation. Zarin suggested that the settlement discount constituted an agreement that the proper purchase price of the chips received was only $500 000. Furthermore, that by losing

the chips at the craps table, he had transferred them back to the resort. This argument was rejected by the court.

An interesting dissenting opinion was expressed by Judge Tannenwald who argued that there was no cancellation of indebtedness income in the absence of legal enforceability because Zarin received nothing of value upon incurring the debt. In his view, the opportunity to gamble did not constitute an "amount" capable of valuation because:

> [t]he concept that Zarin received his money's worth from the enjoyment of using the chips (thus equating the pleasure of gambling with increase in wealth) produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth.

Further, Judge Tannenwald expressed the view that had Zarin attempted to redeem the chips for cash instead of gambling with them, the Resort would have strongly resisted this.

Shaviro (1990: 222) suggests that due to the Zarin case being both perplexing and theoretically difficult under the current tax law, the decision has an "undeniable Alice in Wonderland quality." The dissenting arguments, including the one referred to above, questioned whether a gambler can possibly have more pleasure from gambling the more he loses. If so, was this gambling pleasure measurable? Was Zarin truly $2 935 000 better off after gambling his chips?

Sharivo (1990) discusses the Haig-Simons notion which equates income with the market value of the taxpayer's consumption and change in net worth during the relevant accounting period. According to Shaviro, the issues raised in Zarin relate to consumption and the valuation thereof. In analysing the possibility of taxing consumption, Shaviro considers income informally as the sum of one's cash receipts, other than loans and untaxable gifts, plus a few in-kind benefits (such as a prize) less business but not personal expenses. This colloquial definition, much like the actual gross income definition, fails to address the issue of consumption.

If one considers the concept of income in economic terms, spending money results in a decrease in one's wealth, and saving money means retaining wealth. If this is the case, then all cash receipts must either be spent or saved as these are the only two options regarding the current use of cash and as such, if a taxpayer's income equals cash receipts less business

expenditure, but not personal expenditure, than the latter is effectively a part of taxable income. If private consumption is a part of taxable income, and cash merely a means to consume, then how can consumption be accurately measured? Is the value of consumption simply the amount spent on it?

Shaviro (1990) explains the Haig-Simons "income" concept which was originally expressed as follows:

> Modern economic analysis recognises that fundamentally income is a flow of satisfactions, of intangible psychological experiences. If one receives a dollar he receives something which he ordinarily can and does spend - perhaps for a dinner. Is his income the dollar, or is it the dinner which he buys with the dollar, or is it, at bottom, the satisfaction of his wants which he derives from eating the dinner - the comfort and the sustenance it yields to him? If one spends his dollar for something more durable than a dinner - say a book or a pipe - is his true income the book or the pipe, or the series of satisfactions or "usances" arising from reading the book or smoking the pipe? There is no doubt as to the answer to these questions. A man strives for the satisfaction of his wants and desires and not for their own sake.

Shaviro (1990) submits that this basically suggests that income can exist in the absence of any material object and that the mental state of satisfaction or psychic income is enough to warrant taxation. Although this idea has some merit, the administration thereof would be impossible as non-material psychic income is not precisely measurable.

According to Shaviro (1990), under most taxation systems currently, a taxpayer's subjective psychological experiences are taken into account early in the process of determining gross income. This occurs when establishing whether an item constitutes consumption, and thus potentially in-kind income, or a non-deductible personal expense. After this primary determination however, the process of determining taxable income becomes purely objective as taxation systems generally assume that in disallowing personal expenditures, the subjective value of consumption is equal in value to the cash amount paid for it.

It is submitted that this approach to taxation can be criticised as it would be exceptionally difficult to place a subjective value on consumption income based on each individual's personal preferences. Although the utilisation of economic utility as a basis of taxation would be ideal in terms of fairness, it is submitted that this cannot be measured directly or with any correctness or consistency.

In explanation of this valuation dilemma, Shaviro (1990: 225) submits the following:

> Consider first the difficulty of determining on a uniform scale (such as dollars) the value of one's own consumption, for example, the pleasure derived from a movie, as opposed to a dinner. Then consider the difficulties both of verifying a person's claimed valuations (given the incentive to minimize tax liability) and measuring different people's utilities on the same scale. The only practical way to get subjective value of consumption is through objectively observable proxies for it, such as cost of a taxpayer's consumption purchases or the fair market value of an in-kind benefit from one's employer . . . the tax system's choice of objective factors should be guided by the goal of approaching as closely as possible what we believe are the underlying subjective realities.

As always, when discussing valuation difficulties in terms of taxation, the idea of "fair market value" is introduced as a means of solving the problem. It is submitted that the only plausible defence for use of "fair market value" is that of administrative necessity.

If "fair market value" is used to value consumption, this means that at any time, an item of consumption has uniform tax value for all taxpayers to whom the same market applies. According to Shaviro (1990), this uniformity is not the sole basis for the market value standard.

Of relevance to the current research is the alternative defence which Shaviro (1990) submits for the use of "fair market value" - that a possible reason for the use of fair market value could be that the market price ultimately expresses a collective social judgement about an item's subjective value. Fair market value has largely been viewed as the most objective means of valuation in most taxation cases, yet Shaviro (1990: 227) suggests that the strongest ground for the fair market value standard is subjectively based:

> If a taxpayer either pays the market price for an item or consumes the item instead of selling it for that price, we know that she expected the subjective value of the consumption to be at least as great as the amount paid or foregone.

It is submitted that this view can be criticised, however. For example, a chocolate bar which is relatively cheap in terms of objective monetary value can provide a taxpayer with great satisfaction and thus the subjective value is far in excess of the amount paid. In turn, a taxpayer may pay a large amount of money for a meal at a restaurant which turns out to be very disappointing and provides limited satisfaction of much lower subjective value than the price paid.

It appears that, as in the case of non-marketable goods, in attempting to create a fair and consistent valuation standard for intangibles, such as "consumption," neither "fair market value" nor economic utility can fulfil both the fairness and consistency requirement so widely desired. In addition, despite the fact that the *Brummeria* precedent demands an objective method of valuation, neither method is fully objective because, as discussed, there is always an inherent level of subjectivity. The methods, as submitted, lie on a continuum depending of the level of subjectivity associated with the valuation method. The method applied in *Brummeria*, the "fair market value" method is the most objective valuation means as the value attributed to the taxable benefit is effectively the value any taxpayer on an open market would be expected to pay for such a benefit. Even market value, however, is inherently subjective as it is the value attributed to goods and services based on supply and demand and ultimately the individual perceptions of consumers. The Keller Principle (Keller: 1983) is less objective in that individuals exchange goods with others for other goods which they perceive to have equal value. Different individuals will thus accept different goods in exchange for their items based on their own value judgements. This valuation means would lie closer to the subjective end of a continuum. The economic utility method would lie even closer to the subjective end of the continuum as the method of valuation is fully dependent on each individual's utility and thus each individual would value the same benefit differently resulting in numerous values being applied to the same benefit.

5.7 Conclusion

This chapter has addressed the seventh goal of the research by focussing, *inter alia*, on the timing issues and other problems associated with valuation of amounts. It was concluded that although the meaning of the term "accrued to" in the definition of gross income has been clarified, the *Brummeria* case seems to be at odds with generally accepted timing principles.

The decision in the *Brummeria* case that an objective method of valuation is to be adopted was shown to introduce problems in connection with the requirement that amounts should be valued at their "fair market value" where a market does not exist for every type of benefit a taxpayer may receive. The term "fair market value" was critically analysed and it

was shown that in cases involving private equity, for example, this method of valuation is not suitable and a certain measure of subjectivity is involved in valuing such an asset. Although the term is universally accepted and applied, on further analysis, doubt was cast as to whether "fair market value" is, in reality, always objective.

Chapter 5 continued to address the seventh goal of the research by discussing alternatives to the "fair market value" method of valuing an amount for the purposes of gross income. These included the Keller Principle (Keller: 1983) as well as the Economic Utility method (Newman: 1982). The chapter investigated whether these alternative valuation approaches could be successfully applied in practice despite being more subjective than their market valuation counterpart.

The Keller Principle (Keller: 1983) is based on the rationale that a taxation system should treat every barter exchange in the same manner as an economically equivalent two-payment cash transaction. According to Keller (1983) taxpayers who engage in barter transactions are in the same economic position they would have been had they received cash for their goods or services in an amount equal to the value of the goods or services received in lieu of cash and had used that cash to purchase goods or services from the other party to the exchange. Newman's (1982) argument that participants enter into barter transactions precisely because they are unable to sell their goods and services for cash was then discussed and it was found that the use of hypothetical cash purchase price tends to inflate the actual value of goods and services in some cases and may therefore result in inaccurate valuations.

After analysing the five principles put forward by Keller (1983), it was submitted that should Keller's principles be applied to the barter transaction which occurred in the *Brummeria* case, a more equitable valuation would have resulted in that the income, in the form of notional rental income, would have been offset against the notional interest expense. The fact that, based on valuation concerns, American courts have yet to include in gross income the receipt of an interest-free loan however, casts doubt on whether the Keller Principles (Keller: 1983) could be successfully applied to such notional receipts.

The concept behind the economic utility method (Newman: 1982) of valuing amounts was then explained and it became obvious that this method was very subjective. This valuation

method is clearly the most subjective in that value is based on the perceptions of the taxpayer to whom the "amount" accrues. It was submitted that in terms of South African case law, this method of valuation is most evident in the case of *Stander.* It was submitted that this method would possibly result in a much fairer basis for taxation.

The *Zarin* case was discussed, which effectively involved the valuation of gambling chips. According to Shaviro (1990), the valuation issue which required addressing was whether a value could be attributed to "consumption income." In the discussion it became clear that utilising economic utility as a valuation means is problematic as it is not administratively feasible as it would be exceptionally time consuming to consider the circumstances of each taxpayer. An "amount" may have several different values depending on the taxpayer being investigated. In addition, taxpayers may not reflect their true utility when submitting their tax returns. As previously submitted, it is very important that a tax system be consistent and thus the inconsistency introduced by using economic utility as a valuation method is not acceptable. Again, the trade-off between fairness and consistency is evident. It appears that no valuation method can fully meet the prerequisites of an effective taxation system or the requirements demanded by the Constitution. Each method has its flaws and no valuation can be classified as being fully objective. It is thus doubtful whether judicial consistency will ever be achieved.

The following chapter will briefly review the valuation problems discussed throughout this thesis and conclude the discussion.

CHAPTER 6: CONCLUSION

6.1 Introduction

The present research has focussed on the problems associated with and the parameters for the valuation of amounts received or accrued in a form other than cash, for the purposes of inclusion in gross income. For an amount to be subject to taxation in South Africa, it has been explained that it must first satisfy the requirements of the definition of "gross income" in section 1 of the Income Tax Act. The definition provides as follows:

> In relation to any year or period of assessment, in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, or, 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 (own emphasis).

The need for and importance of the court's interpretation of statutes and in particular the gross income definition was illustrated throughout the research. The courts have, in the past, often been called upon to give meaning to the terms of the gross income definition which are not expressly defined in the Income Tax Act. It was therefore submitted that the courts' interpretation ultimately forms the basis upon which South Africans are taxed as they ultimately give meaning to fiscal law. Due to the responsibility that the courts are faced with, it is vitally important that they adopt a not only a consistent method of interpretation but one which is defensible in terms of the Constitution which dictates the rights of all South African individuals. On analysing the case law relating to the interpretation of tax statutes, it appears that the courts have had difficulty in agreeing upon one acceptable means of interpretation. Whilst some judges have applied the literal wording of the Income Tax Act, others have looked to the intention of the legislator and applied a broader, more subjective approach based on the purpose of the statute in relation to the specific facts of each the case presented to the court. Because of the inconsistency in case decisions, much uncertainty remains as to how fiscal law should be interpreted and applied. Especially in the area of valuations for tax purposes, which forms the central issue of the present research, a debate has persisted as to whether an objective or subjective approach should be adopted,

which appears to have been settled by the decision in *Commissioner for Inland Revenue v Brummeria Renaissance (Pty) Ltd*.

Internationally, in terms of general law, it appears that early decisions have been made in terms of the strict and literal approach. Many reasons were given for this. The primary reason reflected in the *dicta* of judges in cases such as *Partington v. Attorney General (1869) LR HL 100* is that tax law has no purpose other than the levying of taxation and that allowing judges to interpret the wording of legislation more broadly, based on a further purpose, would result in an unacceptable level of subjectivity being introduced into the process of legislative interpretation. This subjectivity, it was suggested, would threaten the separation of powers, which forms the foundation upon which our legal system operates, as Judges would effectively be making law case-by-case instead of applying what is already in legislation. In recent more times, a movement towards a more purposive approach is evident. In a South African context, this movement could possibly be attributed to the enactment of the Constitution which demands fairness and equity for all South African citizens. It appears that the purposive approach tends to result in decisions more in line with these constitutional requirements. In taxation law, the same developments as those taking place in general law are not as clearly observable and therefore some uncertainty in this area of interpretation remains due to the inconsistency observable in fiscal case law. Some cases have been interpreted objectively whereas others have been approached in terms of a more subjective methodology. The present research suggested that in deciding which valuation method is most appropriate, a trade-off exists between the goal of the objective literal approach to promote consistency in judicial decisions and the goal of the purposive approach to apply the law more fairly in terms of its purpose in relation to the facts of each case. The present research focussed mainly on the interpretation by the courts of the phrase “total amount in cash or otherwise” in the gross income definition. Case law regarding this area of the gross income definition was discussed and it was found that the because both cash and non-cash amounts are included in gross income by virtue of the early *Lategan* decision, valuations are required for tax purposes as non-cash amounts must be given a monetary value upon which taxation can be levied.

Case law discussed in the present research indicated a lack of consistency in the application of either a strict objective approach or a more flexible subjective approach when valuing an

amount in a form other than cash. The strict objective interpretation approach is based on the idea that if an amount can be valued in money terms, it should be included in gross income. This method of valuation is advantageous in that it affords taxpayers reasonable certainty as to whether or not they will be taxed, due to the fact that it results in relatively consistent outcomes. The strict approach has, however, also resulted in a number of decisions, such as *Ochberg,* which can be questioned in terms of fairness, economic logic and constitutionality. Simply because an amount can be valued in terms of money does not mean that it is actually valuable in the hands of the taxpayer. As in the case of *Ochberg,* where the receipt of shares by the taxpayer did not result in an increase in the economic value of his shareholding in the company, all amounts received by taxpayers may not necessarily increase their wealth. Should an objective approach be applied consistently to the valuation of all non-cash amounts, taxpayers may be forced to meet their tax burden on non-cash amounts out of other income or out of capital. The subjective approach, as applied in the *Stander* case, where a taxpayer was not taxed on the value of a holiday awarded to him based on the fact that he was not able to transfer or exchange the holiday for a cash amount, appears to result in fairer decisions as taxpayers are not taxed on an amount unless it is actually valuable to him or her and results in an increase in his or her personal wealth. This approach to valuation is, however, significantly more difficult to administer as decisions may differ from case to case depending on individual facts and circumstances. The objective *versus* subjective debate was finally settled by the Supreme Court in the *Brummeria* case, where it was decided that non-cash amounts should be valued objectively. The present research provided a critique of the *Brummeria* decision and illustrated the harsh inequity of the decision arising from the fact that the taxpayer companies were taxed on the notional benefit of the right to interest-free loan capital but were not granted a deduction for the notional rental foregone in exchange for this benefit. In effect, a "double taxation" occurred. In fairness to the judges in the case, counsel for the companies did not challenge the method of valuation and the judges were only called upon to decide whether the benefit of the use of an interest-free loan was a taxable benefit in the hands of the companies. The value of the right to interest-free loan capital was valued in terms of the market-related interest rate, implying that objective value can be equated to "market value." Should an objective approach be applied consistently in the future to all non-cash benefits in terms of the *Brummeria* decision, the value assigned to non-cash

amounts for the purposes of inclusion in gross income will effectively be the "fair market value" of the non-cash item. The present research analysed the concept of "fair market value" and demonstrated that this term has given rise to substantial debate as to whether it is, in fact, "fair" or "objective". Despite the seeming resolution to the ongoing valuation debate, it appears that the application of a purely objective approach is likely to give rise to further problems as not all benefits can be valued in terms of the market.

Due to the problems associated with the application of a purely objective approach, alternative valuation methods were considered in the research. It was ultimately concluded that each method of valuation has flaws. No method of valuation can be classified as being purely objective and no method appears to comply fully with the requirements of the Constitution. Much uncertainty therefore remains.

6.2 Review of findings of the research

Chapter 2 addressed the first goal of the research by briefly discussing the most important methods of legislative interpretation applied by the courts, with the central focus being to distinguish the interpretation approaches that are used to interpret fiscal legislation. Due to the inherent complexities of taxation law and lack of definitions provided in the Income Tax Act, the courts have often been required to give meaning to many of the terms in the legislation. Interpretation by the courts of South African taxation legislation therefore ultimately forms the cornerstone upon which a taxpayer's rights are built. As a result, it is crucially important that the courts interpret the Income Tax Act in a manner that is fair and consistent. This, it was submitted, has proved difficult in the past as it appears that when deciding on an appropriate interpretation method to apply, there is a trade-off between consistency and fairness which can seldom, it appears, both be achieved. The inconsistency of valuation methods applied in the past was illustrated by discussing relevant International and South African case law.

Two main approaches to interpretation were discussed in detail and analysed in terms of the subjective *versus* objective debate. The literal approach, which seeks to apply the actual wording of legislation, was shown to give rise to valuations based on an objective

methodology. The purposive approach, which considers the intention of the legislator, was shown to result in decisions which, it was submitted, are more subjective in nature as they tend to apply tax legislation based on the particular facts and circumstances of each case. The chapter introduced the idea that case decisions and valuations applied in taxation cases lie somewhere on a subjective-objective continuum.

It appears that the literal approach was, historically, the primary approach to interpretation, with the purposive approach initially only being applied occasionally in circumstances where the court has had difficulty in applying the direct wording of the Income Tax Act. What was first introduced as the "golden rule" has gained a growing acceptance as courts have begun to place emphasis on the purpose of the legislation when interpreting the wording of statutes. This has resulted in wider interpretations and fairer decisions which are more in line with the requirements of the Constitution of the Republic.

In addition to analysing the two main interpretation approaches, this chapter also addressed the second goal of the research by considering whether each approach satisfies the requirements of the Constitution and the Bill of Rights. It was found that neither of the approaches fully meets the requirements. The literal approach improves a taxpayer's ability to reasonably predict whether or not he or she will be liable for tax or to what extent, as the method results in relatively consistent outcomes. The approach has resulted in certain decisions that are at odds with economic reality, such as that of *Ochberg*, which was discussed in detail. The purposive approach recognises an individual taxpayer's right to fairness and equity but is difficult to administer in practice as it threatens the consistency required in order for a tax system to function effectively. It was submitted that there appears to be a trade-off between the fairness and equity requirements of the Constitution and the consistency.

The chapter had, as a central theme, the interpretation of the term "amount in cash or otherwise" in the gross income definition. It was explained that non-cash amounts require valuation in order to establish a money value in order to be included in gross income. The subjective approach to valuation, it was discussed, has as its primary concern, the maintenance of equity and the rights of individuals. In terms of this approach individuals should be taxed upon what the value of property received as income is actually worth to

them (the actual increase in personal wealth of an individual.) Individuals have different perceptions of worth and it was concluded that administering a tax system based on this approach would be very problematic as valuations of the same "amount" may differ from case-to-case depending on the subjective value to the individual of the "amount". The principle underlying the objective approach to valuation is that individuals should be taxed on income based on a transaction with an independent third party in an arm's length relationship. The value ascribed to property received as income is therefore not influenced by the circumstances and facts of individual cases. This method leads to consistency in valuations but does not take into account fairness or equity and was thus questioned in terms of its constitutionality. Chapter 2 concluded by emphasising the trade-off which exists between the goals of the objective approach to maintain consistency in the law and the subjective approach which has fairness as its main concern.

Chapter 3 addressed the third goal of the research and went on to discuss fiscal interpretation in a South African context. Case law relating to the development of the phrase "an amount in cash or otherwise" and the valuation of non-cash benefits by the courts was analysed. Because an "amount in cash or otherwise" is included in the definition of gross income, assets which do not have an immediately ascertainable cash value require some means of valuation in order to establish a monetary figure upon which to levy tax and, although the need for certainty in taxation was articulated as early as 1776 by Adam Smith in his Wealth of Nations, it was submitted that the basis upon which persons are taxed in South Africa is not always certain as the courts have appeared to vary in their approach to the valuation of amounts in a form other than cash. It appears that there has been an ongoing debate as to whether an objective or subjective approach should be applied when valuing an "amount" for the purposes of inclusion in gross income.

In addition to the objective versus subjective valuation debate, the courts have also in the past been faced with other valuation problems. In *WH Lategan v Commissioner for Inland Revenue,* where it was decided that the "gross income" definition requires a wide interpretation, the court had to decide whether the discounting of amounts to their present value for taxation purposes was acceptable. This problem was again faced in *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* and was finally resolved by the legislature with the addition of a proviso to the "gross income" definition prohibiting the

use of the present value of an amount which has accrued but has not been paid at the end of a year of assessment. Another problem faced by the courts was the timing of the inclusion of an amount in "gross income". This problem arose due the differing interpretations of the words "received by" and "accrued to" in the "gross income" definition and it was ultimately decided by the court in *Mooi v Commissioner for Inland Revenue* that in order to be included in gross income, a taxpayer must be unconditionally entitled to the amount. In *Butcher Brothers* the court did not include the amount in question, based on the fact that a value was not readily ascertainable. This implied that should an amount not have an ascertainable value for taxation purposes, that it could not be included in gross income.

Although certain issues relating to valuation (as referred to above) were effectively resolved by the courts, the subjective-objective debate appears to have remained until *Commissioner for Inland Revenue Services v Brummeria,* which was discussed in detail in Chapter 4. The decisions in certain cases were shown to be completely contradictory in terms of their approach to the valuation of the non-cash amounts in question. The cases of *Stander v Commissioner for Inland Revenue* and *Ochberg v Commissioner of Inland Revenue* are apposite examples in this regard. In 2007, after many years of ongoing debate, the subjective versus objective argument was laid to rest by the Supreme Court of Appeal in the *Brummeria* case. The point in contention was whether or not the use of an interest-free loan constituted an "amount" which had "accrued" to the taxpayer for the purposes of the definition of "gross income" and, if so, what method should be used to value such a benefit in money terms. In effect, the notional interest that could have been earned had the amount been invested, was subject to tax.

Chapter 4 set out the facts of *Brummeria* and described the arguments put forward by the Commissioner and the taxpayer companies. The discussion emphasised the fact that the counsel for the taxpayer failed to address the inequity of the valuation method and instead focussed solely on the actual existence of an "amount" for tax purposes resulting in a decision which has been criticised by authors such as Cohen (2010) for being incomplete. The question relating to the method of valuation to be applied by the Commissioner for SARS to interest-free loans in situations similar to that of the *Brummeria* case was later clarified by the issue by SARS of Interpretation Note 58 (South African Revenue Services: 2010), which sets out how valuations will be performed in similar cases in the future.

Although this interpretation note addressed the inequity of the outcome of the valuation method applied in *Brummeria,* it was noted that the Interpretation Note is not binding law. It merely provides guidelines as to how a similar benefit will be valued by SARS in the future.

The decision in the *Brummeria* case means that a precedent now exists that in future valuation cases an objective method of valuation must be utilised. Although the objective *versus* subjective debate appears to have been settled, the application of the precedent in future cases, where non-cash benefits will require an objective valuation, may be problematic. Interpretation Note 58 requires that a market-related interest rate be utilised to value interest-free loans in transactions similar to that of *Brummeria*. This implies that objective value can be equated to "market value."

The effect of the *Brummeria* precedent was illustrated in the case of *Vacation Exchanges International* where time share points awarded to employees by employers were included in taxable income as a fringe benefit and valued in terms of current market rates. It was submitted that the valuation in this case, unlike the *Brummeria* decision, was not purely objective as the Commissioner only valued the points which had been utilised by the employees concerned and not the total number of points which they were allocated.

The possible taxation of frequent flyer miles was also discussed as they are an example of an employee non-cash benefit which may require valuation should SARS wish to recognise these benefits as being taxable in the future. The main issue with valuing such a benefit was found to be at what point in time the benefit should be valued and included in gross income. It was ultimately established that the application of an objective approach, in terms of the market value, is not always possible or plausible.

In analysing the *Brummeria* valuation and the value assigned to the time-share points in *Vacation Exchanges International* thereafter, it appears that SARS is consistently applying "fair market value" to non-cash assets. The question then raised was: How can a "fair market value" be established for a non-cash amount for which no market exists? If no market exists for a non-cash benefit and the value of the benefit is established based on a superficial market, this value can surely not be classified as being objective.

In addressing the fourth goal of the research, the term “fair market value” was critically analysed in chapter 5 and it was concluded that the application of “fair market value” is very difficult where a market does not exist for the “amount” in question. In cases involving private equity, for example, this method of valuation is not possible. In fact, the valuation of private equity shares cannot be classified as being objective at all, as required by the *Brummeria* precedent, as many subjective factors require consideration in establishing a value and the weighting attributed to each of these factors appears to differ case-by-case.

Because the application of “fair market value” as an objective means of valuation is not always possible, chapter 5 went on to address the fifth goal of the research by introducing alternative methods of valuation and assessed whether these valuation methods could possibly be applied in cases where a market price is not available. The Keller Principle (Keller: 1983) deals specifically with barter transactions and it was submitted that this valuation approach was relevant as the *Brummeria* transaction ultimately constituted a barter transaction in which the right to utilise loan capital interest- -free was exchanged for the right to rent-free occupation of units in a retirement village. Although this method appeared to be logical, it fails to account for the fact that the two parties to a transaction are possibly bartering as a result of their inability to exchange their items directly for cash. This tends to result in an overvaluation in some cases as the taxpayers, had they sold the goods for cash, would possibly not have received the full cash value. In addition, this method of valuation introduces a level of subjectivity into valuations which would be unacceptable in terms of the precedent set in *Brummeria* that an objective approach to valuation must be applied. If the objective-subjective continuum is considered, this method would lie significantly close to the subjective extreme.

The economic utility method was also discussed as a means of alternative valuation and it was concluded that this method results in the fairest valuation in that it considers each individual taxpayer and the utility that an “amount” actually provides them with. Taxpayers are essentially taxed on the actual benefit they receive from amounts and not on the market value which reflects the value to taxpayers generally. Despite being very equitable, this method is very subjective and would lie closest to the subjective end of the continuum, as each case is effectively considered in isolation based on the facts and circumstances relating

to each individual taxpayer. In addition to having an exceptionally high level of subjectivity, the method can also be criticised on the basis that it is not administratively feasible.

6.3 Concluding remarks

The *Brummeria* case has laid to rest the objective-subjective debate in relation to valuations. Precedent now exists that an objective approach must be taken when valuing non-cash amounts for inclusion in gross income. Although the case was widely criticised based on the inequity of the method utilised to value the interest-free loans, Interpretation Note 58 (South African Revenue Services: 2010), issued after the decision, clarifies how SARS will value such a benefit in the future and will alleviate the harshness of the outcome of the case.

Although the controversy surrounding the actual valuation method used in *Brummeria* appears to have been settled by the Interpretation Note, it is not clear how far-reaching the impact of the *Brummeria* decision will be as the Interpretation Note itself is not binding law. An objective valuation, in terms of the precedent set in *Brummeria,* was applied to timeshare points awarded to employees in the case of *Vacation Exchanges International* and it remains to be seen what other benefits will be valued for the purposes of inclusion in gross income based on the decision that if an amount has an objective money value (can be converted into cash), it is taxable. The present research therefore investigated the possible consequences of applying the decision to an employee benefit such as frequent flyer miles, which are currently not taxed in South Africa.

Alternatives to applying the "fair market value" such as the Keller Principle (1983) which focussed on barter transactions and the Economic Utility method (Newman: 1982) which values benefits based on the subjective utility to each individual taxpayer, were discussed. After analysing these methods, it was concluded that despite addressing the inequity of the *Brummeria* decision, these alternatives have high levels of subjectivity. Although they meet the fairness requirements of the Constitution, they would be very difficult to apply in practice.

It is submitted that the *Brummeria* decision is correct in that benefits capable of valuation should be valued and included in gross income. However, the present research found that purely objective valuations do not always result in a fair outcome for taxpayers, such as in the case of *Ochberg.* The *Butcher Brothers* case should be noted in that it established that if an accurate value cannot be ascertained, the benefit should not be taxed. It is submitted that this provides a more equitable result. In the case of *Vacation Exchanges International*, the Commissioner only sought to tax points which had been utilised by the employees and not the total number of points awarded to them. This could imply that the courts have recognised that a purely objective approach to valuation is not always fair or possible.

From the analysis of the decision in the *Brummeria* case and the application in the *Vacation Exchanges International* case*,* it was concluded that objective value has effectively been equated to "fair market value" by the courts. It was concluded however that using the "fair market value" is not always objective, as a market does not exist for every non-cash asset requiring valuation.

The present research has ultimately concluded that no valuation technique can be classified as being wholly objective as subjectivity is inherent in any valuation. In deciding whether an objective or more subjective approach is more appropriate, based on the effect of each approach on individual taxpayers, the trade-off between fairness and consistency must be carefully considered and the valuation method which best meets the constitutional requirements in this regard and is possible to administer effectively, should be consistently adopted and applied.

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