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Title: The Brummeria judgment: A comprehensive discourse on this case and its application to interest free loans granted to trusts

This paper examines the recently decided Supreme Court of Appeal case between the Commissioner for South African Revenue Service and Brummeria Renaissance (Pty) Ltd and others. Focusing particularly on its application to interest-free loans made to trusts by the founder of the trust.

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Research dissertation presented for the approval of Senate in fulfillment of part of the requirements for the Post Graduate Diploma in Income Tax Law in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Post Graduate Diploma in Income Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Signed:

Signed by candidate

On:

15/02/2010

Contents

"Imagine a bank being taxed on the accrual of its right to use the customer's funds and also on the income it earns on using the customer's funds! Economic chaos!"

D Meyerowitz- The Taxpayer[1]

[1] Meyerowitz D, 'Brummeria: The road to economic chaos', *The Taxpayer*, editorial Volume 56 Number 12, December 2007

Introduction

In September 2007, the world of South African tax planning received an unexpected judgment in the income tax case of the *Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others*[2]. The reason why the decision in this case caused much controversy was because it ran counter to the long-held belief that interest-free loans are not taxable in the hands of the borrower. Rather, it may now be possible for the Commissioner for South African Revenue Services to impute a notional income on the borrower. This paper seeks to examine whether or not this is appropriate and in which circumstances this is applicable. The *raison d'être* why the judgment was unexpected was due to the fact that taxing notional income is contrary to what was held by Feetham JA in the Butcher Brothers case[3] where in the context of lease premiums, the consideration had to have an "ascertainable money value, and not merely a conjectural value".

There has been much debate and concern from a wide range of persons some of which include tax specialists, trustees and donors. The main cause for concern is the question of how this judgment will be applied *in futuro* and how far-reaching its effects will be.

This judgment has caused some concern in the South African tax circles, with several persons and entities considering changing the terms of their interest-free loans in order to incorporate an interest element. The reasoning behind this is to attempt to circumvent the possibility of the Commissioner for South African Revenue Services imputing an interest charge into their "gross

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[2] 2007 (6) SA 601 (SCA), 69 SATC 205

[3] *CIR v Butcher Bros (Pty) Ltd*, 1945 AD 301, 13 SATC 21

incomes" in terms of the definition of "gross income" as contained in the Income Tax Act[4], which may not be a market related one.

For this reason, this paper seeks to examine whether or not the concern is legitimate, in what context it may be applicable and the safeguards one can put in place in order to ensure that the judgment in Brummeria is not applicable to one's own circumstance.

[4] 58 of 1962

Intention and scope

The intention of this paper is to examine the recently decided Supreme Court of Appeal case between the *Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others*[5]. Focusing particularly on its application to interest-free loans made to trusts by the founder of the trust.

Accordingly, this paper aims to:

1. examine the facts and findings of this judgment,
2. ascertain whether or not the Brummeria judgment can be applied to interest-free loans made to trusts,
3. identify an approach to quantify the amount to be included in a taxpayer's "gross income",
4. consider the impact if the council for Brummeria had put forth an argument that the right was capital in nature,
5. consider the implications if an adequate *quid pro quo* had been given that was not interest in nature,
6. consider what the implications could be for the lender of the loan capital, and
7. examine how the decision has filtered through the courts in other judgments.

[5] 69 SATC 205

1. What the courts have found to be Gross Income

The Commissioner of the South African Revenue Services (C:SARS) sought to tax the companies in the Brummeria case as it was believed that there was a benefit obtained by these companies when they received interest free loans in exchange for providing life rights for the occupation of a unit in a retirement village.

In order for C:SARS to seek to tax the parties in this case, the "gross income" definition as contained in section 1 of the Income tax Act No. 58 of 1962 must be met. The definition of "gross income" is as follows: In relation to any year or period of assessment, it means:

i) in the case of a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident... excluding receipts or accruals of a capital nature.

(Emphasis added)

Paragraph c of the "gross income" definition goes on to include "any amount, including any voluntary award, 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 by virtue of any employment or the holding of office". In addition, there are two provisos to this paragraph that are not applicable in the context of this paper.

As the legislation is broad and the above terms have not been defined in the Income Tax Act, the courts are required to interpret what the legislature means with respect to the "gross income" definition.

The courts have found as follows:

TOTAL AMOUNT

Before any "gross income" can arise, there must be an "amount" that has been received or accrued. In terms of section 82 of the Act[6], the burden of proof is on the taxpayer to prove the non-taxability of an amount; however, the onus is on C:SARS to establish the existence of an amount (*CIR v Butcher Bros (Pty) Ltd 1945 AD 301, 13 SATC 21*). In the case of Butcher Bros, the Commissioner could not prove that 'any specified "amount" ... accrued to or was received by the company'[7] and therefore the Commissioner was not entitled to include the amount in dispute in the taxpayers "gross income" for that year of assessment.

It was held in People Stores[8] that the word "amount" did not only refer to an "actual amount of money", but that it could be the value of "every form of property earned by the taxpayer, whether corporeal or incorporeal, which had a money value... including debts and rights of action" (per Watermeyer J in *CIR v Lategan 1926 CPD 203 at 219*).

However, it was held in Stander's case[9] that in the case of a benefit received that is not in the form of cash, there could only be an amount if the right could be turned into money and therefore have a 'money value'.

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[6] Income Tax Act No. 58 of 1962
[7] *CIR v Butcher Bros (Pty) Ltd*, at 330
[8] *CIR v People's Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A), 52 SATC 9
[9] *Stander v CIR*, 1997 (3) SA 617 (C), 59 SATC 212

Due to this rationale, there must be an amount that can be turned into money in order for "gross income" to arise. If there is no actual amount, there can be no tax as tax may not be levied on notional amounts. An illustration of a notional amount would be the interest income that a taxpayer could have earned had he invested his income rather than kept it safe under his mattress where no interest was earned[10]. Cohen also illustrates this concept with the following example. An attorney in law could earn fees of one million rand per year but prefers to work as a lifeguard for 50,000 rand. The attorney's potential income, the income he could have earned but chose not to, is one million rand. His actual income is 50,000 rand. It is the attorney's right to choose a profession that he wants to build a career in. The principles of respect for individual autonomy and choice would be violated if the attorney is taxed on income that he could have earned but chose not to [11].

The Brummeria decision criticises the judgment held in Stander's case[12] and a discussion of this can be found in chapter 3.

RECEIPT

For an amount to be included in a taxpayer's "gross income" there must be a receipt or accrual. This criterion relates mainly to the timing of the inclusion in "gross income". In practice "gross income" arises at the earlier of the date of receipt or accrual[13].

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[10] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007

[11] Cohen S, 'Brummeria Renaissance Revisited: The real cat and the real pigeon', *The Taxpayer*, Volume 57 Number 9, September 2008

[12] *Stander v CIR*, 1997 (3) SA 617 (C), 59 SATC 212

[13] Huxham K and Haupt P 2007, *Notes on South African Income Tax*, 26th edition, Hedron Tax Consulting and Publishing CC, Republic of South Africa

The Geldenhuys case[14] found that an amount is also only taxable if it is received for one's own benefit. An example of when an amount is not received for one's own benefit would be when one is acting as agent for another and thereby receiving amounts in order to pass these on to the principle.

ACCRUAL

The leading case on the meaning of what constitutes an accrual is People Stores[15]; in which Hefer JA held that all that is required for an accrual is that the taxpayer has become "entitled to an amount". In *Mooi v SIR*[16], this entitlement principle was further extended so that the taxpayer must become "unconditionally" entitled to an amount before an accrual has taken place.

IN CASH OR OTHERWISE

In order for an amount to be included in "gross income", it must be received in cash or otherwise. Therefore, it is not only cash that is received that can be included in a taxpayer's "gross income", but rather any amount, including corporeal and incorporeal assets that have an ascertainable money value and can be converted into money (*CIR v Delfos*[17]).

If the income is received by means of something other than cash, Stratford CJ in Lace Proprietary Mines[18] held that the test for the value of the income is what the amount is that can be demanded by the seller. In other words, what he can sue for.

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[14] *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419
[15] *CIR v People's Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A), 52 SATC 9
[16] *Mooi v SIR*, 1972 (1) SA 675 (A), 34 SATC 1
[17] *CIR v Delfos*, 1933 AD 242, 6 SATC 92
[18] *Lace Proprietary Mines Ltd V CIR*, 1938 AD 267, 9 SATC 349

RESIDENCE

South Africa applies the residence basis of tax. This means that residents are taxed on their world wide income and non residents are only taxed on the income that is earned from a South African source. The important fact to establish is whether or not one is a resident as defined.

The term resident is defined in the Income Tax Act[19] in section 1 and specifically includes in paragraph b "a person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic".

The exact meaning of the phrase "place of effective management" has been subject to some uncertainty within the realms of South African income tax due to the fact that the Organisation for Economic Co-operation and Development (OECD) defines this on an international level as the place where the highest level of management and strategic decision making takes place; whereas the South African Revenue Service, in its Interpretation Note 6[20] defines it as the place where the day to day management takes place. This discrepancy is beyond the scope of this paper.

NOT OF A CAPITAL NATURE

For an amount to be included in a taxpayer's "gross income", it must be a receipt or accrual that is not of a capital nature. In other words, the receipt or accrual must be revenue in nature for it to be included in "gross income".

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[19] 58 of 1962

[20] South African Revenue Services, Interpretation Note: No.6, Resident: Place of effective management (persons other than natural persons), 26 March 2002

One of the most important factors to ascertain in determining whether the taxpayer's income is of a capital or revenue nature is the intention of the taxpayer (Pick 'n Pay Employee Share Purchase Trust[21]). If a taxpayer has the intention of selling an asset in the pursuance of a profit making scheme, it constitutes a revenue intention and is therefore taxable under the "gross income" definition[22] (Elandsheuwel case[23]). The pursuance of profit making was found to mean that the revenue earned is not fortuitous, but designedly sought and worked for (Pick 'n Pay Employee Share Purchase Trust[21]).

The applicable areas of the "gross income" definition that will be focused on in this paper in keeping with the intention of the paper are as follows:

- The total amount
- In cash or otherwise
- Accrual
- Excluding receipts or accruals of a capital nature

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[21] *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (a), 54 SATC 271

[22] As contained in the Income Tax Act No 58 of 1962

[23] *Elandsheuwel Farming (Edms) Bpk v SBI*, 1987 (1) SA 101, 39 SATC 163

2. Facts of the Brummeria Case

In the case of *C:SARS versus Brummeria Renaissance (Pty) Ltd and others*[24], the taxpayers being the respondents in this case were three private companies that developed retirement villages. The three companies were Brummeria Renaissance (Pty) Ltd, Palms Renaissance (Pty) Ltd and Rand Poort Renaissance (Pty) Ltd[25].

These companies received interest-free loans from the prospective retired occupants and in exchange granted the right for the lender of the loan to occupy the retirement unit for the remaining duration of his life. These loans were used by the companies as finance for the construction of the retirement villages.

In terms of the agreements between the respondents and the potential occupant, it was simply a right to occupy the unit that was received, not the ownership. The ownership remained with the respondent. On the cancellation by or death of the occupant, the life right would revert to the respondents and the respondents would have to repay the loan, which would then subsequently be replaced by a new loan[26].

The judgment by Cloete JA[27] set out the main features of these agreements as follows:

a) Each company obtained an interest-free loan from a potential occupant in order to finance the construction of a unit in a particular retirement village by the company in question.

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[24] 2007 (6) SA 601 (SCA), 69 SATC 205
[25] SAICA, *Integritax* 1591 'The Brummeria Judgment' Issue 101, January 2008, www.saica.co.za accessed 30 June 2008
[26] Ger B, 'Interest-free loans and tax', http://butterworths.uct.ac.za accessed 14 July 2008
[27] In the Brummeria judgment at paragraph 3 on page 209 of 69 SATC 205

b) A debenture was issued to the lender acknowledging the loan; the title deeds of the property forming the subject matter were registered as further security in favour of the lenders.
c) The lender was granted the lifelong occupation of the unit, whilst ownership remained with the company.
d) The company was obliged to repay the loan to the occupant upon cancellation of the agreement, or upon the occupant's death.

The standard contract with each occupant provided that the interest-free loans constituted the consideration for the life rights. The term "life rights" was defined as the right of the occupant, as a result of the fact that he granted a loan to the company, to occupy the unit and to use the facilities subject to payment of monthly levies and special fees, as of the date of completion of the property.

As a result of these arrangements, the respondents initially paid very little tax. SARS then decided to reopen the respondents' assessments and to reassess them based on the argument that interest-free loans received when issuing occupation rights constituted "gross income"[28]. The three respondents objected to this assessment on the basis that loans could not be included as "gross income" as no amount had been received by or accrued to them as the loans would have to be repaid on cancellation by or death of the occupant.

C:SARS reluctantly accepted this reasoning[29], but subsequently issued further revised assessments arguing that the right to utilise interest-free loans was a benefit in and of itself and this benefit could be taxed as "gross income". C:SARS sought to tax this benefit calculating it on the basis of the weighted average prime interest rate.

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[28] As defined in section 1 of the Income Tax Act No 58 of 1962
[29] Ger B, 'Interest-free loans and tax', http://butterworths.uct.ac.za accessed 14 July 2008

Once again, the taxpayers did not agree and decided to object, but in this instance C:SARS did not concede and the matter went to the Special Tax Court.

The Special Tax Court decision

In this court, Goldblatt J held on the authority of Standers case[30], that SARS could not tax notional income as it was attempting to do and that the right to an interest-free loan that could not be transferred or ceded could not constitute income in the hands of Brummeria and the other companies.

C:SARS did not however accept this judgment and appealed directly to the Supreme Court of Appeal (SCA) with a bench of five judges.

[30] *Stander v CIR*, 1997 (3) SA 617 (C), 59 SATC 212

3. Findings of C:SARS v Brummeria in the Supreme Court of Appeal

This chapter seeks to outline the arguments of both the appellant and the respondents as well as the judgment of Cloete JA with Scott JA, Van Heerden JA, Kgomo JA and Mhlantla AJA concurring.

Appellant: Commissioner for South African Revenue Services[31]

The appellant's argument revolved around the fact that they believed that the respondents' right to hold and utilise the interest-free loan capital for a number of years was a right which had a money value that could be ascertained and that this right accrued to the respondents.

C:SARS argued that the *quid pro quo* that the respondents received in return for the houses was the "selling price obtained from the purchaser in respect of the disposal of the units under sectional title; or the benefit of the rights to interest-free loans obtained from the occupants, in respect of the disposal of the life rights to occupy the units and that the benefits received in exchange for the provision of occupation rights had an ascertainable money value which accrued to the respondents and accordingly fell within the definition of gross income"[32].

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[31] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd,* 2007 (6) SA 601 (SCA), 69 SATC 205
[32] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd,* at page 206 of 69 SATC 205

Respondents: Brummeria Renaissance (Pty) Ltd, Palms Renaissance (Pty) Ltd and Rand Poort Renaissance[33]

The respondents argued that the interest-free loans did not result in any "amounts" being "received by" them as contemplated in the definition of "gross income" and, as a result, the amounts had been incorrectly included in their "gross income".

The respondents relied on the findings in Stander's case[34], a judgment from the courts of the Cape Provincial Division, to argue that the rights valued by C:SARS could not be turned into money by the companies and therefore did not meet the criteria as set out in the Peoples Store's case[35] for the loans to be included in "gross income" for the respondents.

Unfortunately for the respondents, they had not included as a basis for their arguments the question of whether or not the right to an interest-free loan is of a capital nature, as well as, an argument of the quantification of the imputed notional income against the weighted average prime interest rate. As such, the court could not consider these grounds as it was not an issue before the tax court as a result of these issues not being included in the statement of grounds of appeal (per tax rule 11). Neither of the parties followed the procedures as set out in tax rule 13[36], being:

1. The Commissioner and the appellant may agree in writing to the amendment of the statement of the grounds of assessment or the statement of grounds of appeal, or both.
2. The court, consisting of the President sitting alone may, on application of notice grant leave to amend the statement of the grounds of assessment

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[33] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (6) SA 601 (SCA), 69 SATC 205
[34] *Stander v CIR*, 1997 (3) SA 617, 59 SATC 212
[35] *CIR v People's Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A), 52 SATC 9
[36] As contained in the Income Tax Act No 58 of 1962

or the statement of grounds of appeal, subject to such orders as to postponement and costs as the court deems appropriate.

Held by Cloete JA (Scott JA, Van Heerden JA, Kgomo JA and Mhlantla AJA concurring)

It was not the loan capital amount that was being included in "gross income" by the Commissioner as it had been correctly held in Genn[37] and Felix's[38] case that such a receipt did not constitute a receipt for the purposes of the "gross income" definition.

It was rather the right to "retain and use the loan capital, *interest-free* which constituted the right which had an ascertainable money value and which accrued to the companies" that C:SARS sought to tax[39].

In Lategan's case[40] in the Cape Provincial Division Court, Watermeyer J determined what the word "amount" and the phrase "accrued to" means and both of these meanings were upheld in the SCA in the Peoples Store's case[41]. The meanings were then restated by Hefer JA in Cactus Investments[42] in the SCA, where he found the meaning of "gross income" "includes, as explained in *CIR 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"[43] and that "the judgment in the People's Stores case tells us

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[37] *CIR v Genn and Co (Pty) Ltd* 1955 (3) SA 293 (A) at 301 B-G, 20 SATC 113 at 122
[38] *CIR v Felix Schuh (SA) (Pty) Ltd* 1994 (2) SA 801 (A) at 812 D-G, 56 SATC 57 at 69
[39] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd,* At page 211 of 69 SATC 205, paragraph 9
[40] *Lategan v CIR* 1926 CPD 203, 2 SATC 16 at 209
[41] *CIR v People's Stores (Walvis Bay) (Pty) Ltd,* 1990 (2) SA 353 (A), 52 SATC 9
[42] *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA), 61 SATC 43
[43] At 319 G-H; 61 SATC at 45

that no more is required for an accrual than that the person concerned has become entitled to the right in question"[44].

Cloete JA held that the right to retain and use interest-free loans had a money value. He further held that the making available of funds without charging interest constitutes a "continuing donation" to the borrower which bestows a benefit on him (Berold[45], Woulidge[46]). In addition Cloete JA found that it was a valuable right to have access to an interest-free loan in the current business world.

The respondents' relied on Stander's case[47] and the decision of *Tennant v Smith*[48], which held that if the right could not be turned into money, it did not fall within the definition of "gross income" as it was not an "amount".

Cloete JA rejected this argument based on what Hefer JA held in the People's Stores case[49] in terms of what the test is when determining whether a receipt or accrual in a form other than money can be included in "gross income". Hefer JA said that the enquiry is whether the receipt or accrual has a money value and not whether it can be turned into money. The latter of these tests is only one of the possible methods of determining whether the former test is met or not and as such, this makes the test an objective one. Cloete JA went on further to state that it is based on this reasoning that Stander's case[47] is incorrect. It follows that if the law was based on whether an individual could turn a receipt into money, then the right to live in a house or drive a motor vehicle

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[44] At 320 H; 61 SATC at 46
[45] *CIR v Berold* 1962 (3) SA 748 (A) at 753 F-G, 24 SATC 729 at 735-6
[46] *Commissioner, South African Revenue Service v Woulidge* 2002 (1) SA 68 (SCA) paragraph 10, 63 SATC 483
[47] *Stander v CIR*, 1997 (3) SA 617, 59 SATC 212
[48] *Tennant v Smith (Surveyor of Taxes)* 1892 AC 150 (HL)
[49] *CIR v People's Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A), 52 SATC 9

rent-free would not be taxable as the individual is not in the position to turn that right into money. This would seem absurd and out of line with the intention of the legislature.

The question is whether there is any difference between these two enquiries. In the case of Stander[50], the taxpayer received a prize as an award which consisted of a seven day overseas holiday for himself and his wife. He was not able to cash in this prize or transfer it to another person. As such, there is a monetary value attributed to it, being the cost of the holiday, however, the taxpayer is unable to turn it into money. This illustrates that there is a difference between the two enquiries. A further question is whether this should make a difference when determining whether a receipt or accrual in a form other than money can be included in "gross income". It would appear that there should not be a distinction between the two accruals as in both situations the taxpayer has received a benefit, which falls within the gross income definition, the only uncertainty being how to value this accrual.

Income need not be an actual amount, but can include "every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value... including debts and rights of action" (Watermeyer JA, Lategan[51]).

Cloete JA accordingly held that the benefit to use the loans without paying interest was a receipt that could be turned into money and consequently must be included in "gross income". The amounts were included in the taxpayers' "gross income" at the weighted average prime interest rate for the year, as this method of calculating the amount had not been under appeal.

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[50] *Stander v CIR*, 1997 (3) SA 617, 59 SATC 212
[51] *Lategan v CIR* 1926 CPD 203, 2 SATC 16 at 209

4. Application of Brummeria to interest free loans to trusts

The purpose of this paper is to establish whether or not the Brummeria judgment applies to the situation in which an interest-free loan is granted to a trust by the founder of the trust. This chapter seeks to negate or concur with Brummeria's application in this circumstance.

It is important to bear in mind that every case is distinguishable on its specific facts and that "precedents can seldom be decisive and each case must be decided on its own facts and circumstances" [52].

It is correct that the courts have held that the receipt of the loan itself was not an amount that should be included in these taxpayers' "gross income". Schreiner JA in Genn's case held the following:

> "It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent or trustee for another, the former has not received it as his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for the present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed"[53].

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[52] ITC 1267, 39 SATC 149 at 150

[53] *CIR v Genn and Co (Pty) Ltd* 1955 (3) SA 293 (A) at 300

In the Brummeria case, there was an exchange of services between the company and the occupant of the retirement unit. The occupant paid the company a loan that bore interest at zero per cent and in exchange the company provided the use of the retirement unit for the remaining life of the occupant. In other words, the right to occupy the retirement units was "inseparably linked to the continued making of the interest-free loan[54]". In order to distinguish Brummeria from other interest free loans, it is helpful to apply to this situation the definition of a barter transaction which, according to the Oxford Dictionary means "to trade by exchanging goods etc for other goods, not for money"[55]. Therefore, this is a barter transaction as there is an exchange of services that is not for money. A barter transaction is defined broadly and is not specific to interest-free loans; therefore the arrangement could have concerned any asset or right and does not necessitate special tax treatment merely because it was an interest-free loan. The court gave no indication that the use of every loan that bears interest at zero per cent or at a rate below that of market value will, as a result, be included as a benefit in the taxpayer's "gross income"[56]. This is due to the fact that most interest-free loans, such as loans to trusts and family members, are made with no consideration being payable by the borrower of the funds for the use of the loan capital[57].

However, if one is able to borrow at a rate that is significantly below that of the prime rate of interest, there is a potential argument that one then receives a benefit that could also fall within the realms of the principles found in the Brummeria judgment. On the other hand, the counter argument may be that

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[54] Brincker E, 'To which extent is an interest-free loan taxable'?, *Tax Ensight*, www.problemsolved.co.za/newsletter/briefs/tax/Oct07IntFree.html, accessed 14 July 2008

[55] *The Oxford Paperback Dictionary*, compiled by Joyce M. Hawkins, 2nd edition, Oxford University Press, Oxford, 1987

[56] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007

[57] Temkin S, 'Ruling proves interest-free loans still a taxing issue', www.businessday.co.za/articles/article.aspx?ID=BD4A582496, accessed 18 July 2008

paying a minimal amount in interest would take a person out of the ambit of the Brummeria judgment as consideration is paid for the use of the capital.[58] However, it is SARS's opinion that this will not change the impact of the Brummeria case. It will simply reduce the rate per 'D' in the calculation at the end of chapter 5 by the percentage of interest actually paid[59].

In terms of Roman Dutch law, there is no obligation to pay interest on a loan, therefore it is implied that nothing has been waived. As such, there does not appear to be an inherent obligation to charge interest on a loan. In modern society, interest is charged on loans on order to compensate the lender for the opportunity cost of not having those funds at his disposal.[60]

Consider the common situation in which the founder of a discretionary family trust makes available to the trust, funds that carry interest at a rate of zero per cent for the trust to use and to generate income in order to benefit the beneficiaries. In this circumstance, the founder receives no benefit or right for making the funds available to the trust, likewise, he does not receive any right to the income that is generated by the trust as a result of the use of the funds. This would be the case even if the founder is a beneficiary, due to the fact that the trust is a discretionary trust and therefore it is at the discretion of the trustee whether distributions from the trust income are made or not. In other words, the founder, being the lender of the funds, does not obtain a *quid pro quo* for providing the funds to the trust. The Brummeria judgment[61] is based on the principle that if one receives a benefit for the provision of a loan, then that

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[58] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007

[59] SARS legal and policy division, Draft Interpretation Note- SUBJECT: Commissioner, SARS v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) - The right to use loan capital interest free, October 2008

[60] Meyerowitz D, 'Is an interest free loan a donation?', *The Taxpayer*, Volume 57 Number 6, June 2008

[61] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (6) SA 601 (SCA), 69 SATC 205

benefit could be taxable. There must be a causal link between the provision of the capital and the receipt of services or goods provided[62]. As illustrated above, the founder does not receive a *quid pro quo* for the provision of the funds and therefore, no amount should be included in his "gross income" as there is no benefit that could be taxable in his hands. Likewise, the trust that received the loan has not provided any goods or services to the founder and therefore this transaction is not a barter transaction, which implies that there is no valuable benefit or right in the trust's hands that could be taxed.

Extending this situation further, the typical interest-free loan made to a trust is made upon the sale of property from the founder to the trust. As consideration for the property, the trust owes the founder the purchase price of the property. Generally, this remains as an interest-free loan in the trust and is paid to the founder as and when the founder deems it necessary. The loan arose as a result of the sale of the property, in which ownership transferred from the founder to the trust. The founder no longer has any right to the use of the asset, or any additional benefit receivable due to the fact that the loan is still outstanding. The founder is not entitled to occupy the property or receive any services from the trust as a result of the interest-free loan, therefore, he does not receive any benefit for providing the use of the funds and, for the same reasons as in the above illustration, there is no amount to be taxable in the hands of the founder. Similarly, the trust has not provided any goods or services in exchange for the interest-free loan as this illustration involved the sale of a property, not an exchange of services or goods. Therefore, once again, there is no valuable benefit or right that could be taxed in the trusts hands.

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[62] SAICA, *Integritax* 1591 'The Brummeria Judgment' Issue 101, January 2008, www.saica.co.za accessed 30 June 2008

This principle is further enforced in the Interpretation Note on Brummeria issued by SARS, where the situation of interest free loans to companies within a group is provided as an example. This Interpretation Note indicates that where a shareholder or group company grants the right of use of an interest-free loan, the intention is not necessarily to be in exchange for goods sold, services rendered or some other benefit granted by the borrowing company. Therefore, interest free loans between shareholders and their companies and between companies within the same group of companies would not necessarily automatically be subject to Brummeria, as these loans would have been granted as being capital in nature.[63] Similarly, this example provided by SARS could be applied to trusts and their founders.

If one examines the opposing principles laid out by Wunsch J in the case of *CIR v Cactus Investments*[64], where the example provided was of a tailor selling a suit in exchange for the right to receive dividends, it was indicated that despite the fact that dividends are exempt, the right to receive dividends was a valuable consideration and would therefore be taxable[65]. Applying this to the situation in which one provides an interest-free loan to a trust and, as a result, obtains the right to receive the goods or services that the trust offers as its normal trading operations, then a benefit is received as *quid pro quo* for providing the use of the capital and could therefore be taxable.

As indicated by the South African Revenue Services (SARS), it would seem that the court did not intend for its decision to be applicable to interest-

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[63] SARS legal and policy division, Draft Interpretation Note- SUBJECT: Commissioner, SARS v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) - The right to use loan capital interest free, October 2008

[64] *CIR v Cactus Investments (Pty) Ltd*, 59 SATC 1

[65] Brincker E, 'To which extent is an interest-free loan taxable'?, *Tax Ensight*, www.problemsolved.co.za/newsletter/briefs/tax/Oct07IntFree.html, accessed 14 July 2008

free loans in general[66], and SARS also indicated that it would issue an Interpretation Note on interest-free loans, which will be dealt with in the various chapters as is applicable.[67] SARS has indicated in this Interpretation Note that based on the Brummeria judgment, the principles laid down in this judgment may be applied in all cases where a benefit in a form other than money is granted in exchange for goods, services or any other benefit given. This reinforces the principle that a *quid pro quo* must be granted in order for Brummeria to apply to the given situation[68].

Nowadays, it is rare that a person is able to obtain a loan without incurring interest on it. For this reason, if one is able to access such funds, it leads to a benefit being received. In other words, it is the *status quo* that loans bear some form of interest and if one is able to receive an interest-free loan then one has obtained a benefit one would otherwise not have received had the lender of the funds charged interest[69].

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[66] Forster H, 'Net sekere rentevrye lenings belasbaar', *Die Burger*, 18 September 2007

[67] Green C, 'Few surprises in Budget '08', http://www.fin24.com/articles/default/display_article.aspx?Nav=ns&ArticleID=1518-1818-2340_2266310, accessed 18 July 2008

[68] SARS legal and policy division, Draft Interpretation Note- SUBJECT: Commissioner, SARS v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) - The right to use loan capital interest free, October 2008

[69] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007

5. Quantification of the amount

It is, with respect, unfortunate that all that Cloete JA has to say on the matter of the quantification of the amount was that "the basis upon which the Commissioner valued that right on each particular year of assessment in the further revised assessments, was not challenged on appeal[70]". This is anomalous considering that one of the taxpayer's grounds of appeal was that the "rights so valued by the Commissioner could not be turned into money by the companies[71]", and hence the argument was that no amount had been received by or accrued to the companies.

This chapter deals with the fact that the judgment of Cloete JA in the Brummeria case reinforces the requirement that barter transactions have need of an assessment of the value of the assets in order to determine the *quantum* that should be included in the taxpayer's "gross income"[72].

In the case of *Ochberg v CIR*[73], the taxpayer was the sole shareholder of a company and received additional shares as a result of services that he rendered to the company. The court held that even though the taxpayer had not benefited from the transaction due to the fact that his percentage shareholding had remained the same, being 100 per cent, in substance the shares received constituted an amount in a form other than cash. This was held as constituting consideration for the services that the taxpayer rendered, because the shares would be taxable had they accrued to a third party. For this reason, the test for valuing a right is an objective one.

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[70] At page 212 of 69 SATC 205, paragraph 12
[71] At page 212 of 69 SATC 205, paragraph 13
[72] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007
[73] *Ochberg v CIR*, 1931 AD 215, 5 SATC 93

The value included in Brummeria's "gross income" was computed with reference to the weighted average prime rate of interest, which is an indirect determination of how much interest the taxpayer's could save through borrowing money interest-free as opposed to incurring the rate of interest that would normally have been paid. The concerns with this method is that the amount imputed in the taxpayers income has not been adjusted for inflation and the method used would result in different approaches being followed for different taxpayers depending on whether they were in a net borrowing or net investment position.[74] A net borrowing position is where a taxpayer has more loans than cash in the bank resulting in the interest rate used for this investor being one of a lending rate, whereas, a net investment position means that the taxpayer has more cash than loans, and as such, the interest rate used for this investor is a deposit rate, which is lower than the lending rate. This is contrary to the principles of neutrality and certainty, which are the canons of taxation as laid out in the Margo Commission Report[75].

The Income Tax Act[76] has a number of provisions that deal with interest-free loans; particularly applicable to the focus of this paper is sections 7(3) and 7(5) dealing with interest-free loans to trusts. In certain circumstances these sections provide for a deemed accrual that will revert to the founder of the trust who has lent capital on an interest-free basis, if the income of the trust accrues to his minor child or is retained in the trust[77].

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[74] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007

[75] Honourable Mr Justice Margo, 'Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa', Chapter 4 Part III, 198

[76] 58 of 1962

[77] SAICA, *Integritax* 1597, 'The Brummeria Judgment', Issue 102, February 2008, www.saica.co.za accessed 30 June 2008

In terms of Joss[78] and Ovenstone[79], being the cases that dealt with the "or other disposition made" as contained in section 7(3) of the Income Tax Act[80], the courts imputed interest on the loans to trusts and treated the non-charging of interest as a donation. This is because the benefit received is the difference in the interest one should have paid and what was actually paid. In practice, SARS has generally accepted the prime rate of interest as a fair rate of interest. However, a detailed analysis of these two sections is beyond the scope of this paper.

This SARS practice is further confirmed in its Interpretation Note issued on the Brummeria case where it is stated that in order to determine the value of the receipt or accrual that is in a form other than money, an objective test should be applied. An objective test would be with reference to an arm's length amount, with due regard to the facts and circumstances of each case as well as the intention of the parties involved. It is further noted by SARS that the weighted average prime rate of interest will not always be appropriate and each case should be evaluated on its own facts and circumstances. [81].

It may be helpful to draw on financial accounting principles in order to establish how to quantify the amount that should have been included in Brummeria's "gross income". In terms of the International Financial Reporting Standards' SIC 31 (*Revenue- Barter Transactions involving Advertising Services*) there have been some discrepancies as to how exactly to measure revenue in a barter transaction. Although this standard deals with advertising, its principles can be applied equally to the Brummeria case with regards to the exchange of an interest-free loan for the right to life occupation of the retirement unit. The

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[78] *Joss v SIR*, 1980 (1) SA 664 (T), 41 SATC 206

[79] *Ovenstone v SIR*, 1980 (2) SA 721 (T), 42 SATC 55

[80] As contained in the Income Tax Act No 58 of 1962

[81] SARS legal and policy division, Draft Interpretation Note- SUBJECT: Commissioner, SARS v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) - The right to use loan capital interest free, October 2008

consensus reached in this standard is that revenue cannot be reliably measured at the fair value[82] of the services received, but rather at the fair value of the services rendered[83]. This standard goes on further to state how to quantify the amount with reference only to non-barter transactions. Factors to take into consideration include similar transactions with the following characteristics:

a) services rendered similar to those in the barter transaction,
b) services that occur frequently, and
c) represent a predominant number of transactions and amount when compared to all transactions that are similar,
d) involve cash and/or another form of consideration, for example marketable securities, and
e) do not involve the same counterparty as in the barter transaction.

Based on these principles, it is the value of the service that Brummeria offers that should have been included in their "gross income". Drawing on this, it is the life right to occupation of a retirement unit that should be valued in order to ascertain an amount to be included in Brummeria's "gross income". Therefore, the source of income for Brummeria is really rental income and not interest income. Some of these criteria cannot be applied in this case as Brummeria uses this form of barter transaction for all its commercial dealings and therefore to compare the transactions to one that is for cash is not feasible.

It would seem that the basis that C:SARS adopted when using the weighted average prime rate of interest, was perhaps due to the estimated conjecture as to how long the occupants would reside in the retirement units

[82] Note: Fair value is similar in concept to market value
[83] International Accounting Standards Board, 2006, International Financial Reporting Standards, SIC 31 (Revenue- Barter Transactions involving Advertising Services) paragraph 5

and the uncertainty pertaining to this[84]. However, with respect, this method is rather subjective and creates much uncertainty. A potentially more objective solution to this is valuing the amount with reference to the rate of return that a taxpayer could earn should he have invested the funds until such time as the loan became due to the lender. This rate could possibly be the government bond rate, which is a neutral rate as far as risk is concerned. In this case, the same answer should be arrived at irrespective of the taxpayer's state of affairs and his credit rating.[85]

Alternatively, one could possibly have, with respect, valued the life rights based on a market value of providing the right to occupy a unit for the period of the occupant's life. Another potential basis that one could employ is a discounted cash flow analysis which would compute the market value based on projected cash inflows and outflows. Examples of cash inflows would be a market related rental received by Brummeria and cash outflows would be rates, taxes, water and electricity and any repairs that may be required[86].

Even if this approach is not followed, it is unclear what the justification was for deciding that the amount that was to be included in Brummeria's "gross income" would be the weighted average prime rate of interest. Brummeria should be able to obtain loans from the bank at less than the prime rate of interest. Even individuals with good credit records can borrow at less than the prime interest rate. Further, one cannot automatically presume that the value of the amount would be the weighted average prime rate of interest, as no person making a deposit would receive the prime rate of interest on that investment,

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[84] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007
[85] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007
[86] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007

but rather an interest rate somewhat lower[87]. Consideration of the life expectancy of the retired person would need to be made, as this loan would be for the remainder of the retired person's life, therefore, an actuarial calculation would have to be computed in order to ascertain what each person's life expectancy is. In terms of the Butcher Brothers case[88], it was held by Feetham JA that where one cannot be precise in valuing an accrual; the accrual should not be included in the taxpayers gross income. As there would be a fair amount of estimation involved in computing the accrual, life expectancy and rate of interest, it should be considered whether this amount would be precise enough to be included in a taxpayer's gross income according to Feetham JA.

In addition, this basis of valuing the right results in some taxpayers being prejudiced. A case in point is that the interest rate that one can borrow at is partly dependant on one's credit rating. Therefore, if one person has a good credit rating, he would be able to borrow at a rate below that of the prime rate of interest, conversely, if someone has a particularly poor credit rating, he would possibly only be able to borrow at a rate above that of the prime rate of interest. As a result, in the first instance the taxpayer is prejudiced as he is taxed based on a standard rate, being the weighted average prime rate of interest, which implies that he can only borrow at that rate when in fact he can borrow at a lower rate and in the second instance, the taxpayer benefits by only being taxed on the prime rate of interest while it is only possible for him to obtain finance at a higher rate of interest.[89]

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[87] Brincker E, 'To which extent is an interest-free loan taxable'?, *Tax Ensight*, www.problemsolved.co.za/newsletter/briefs/tax/Oct07IntFree.html, accessed 14 July 2008

[88] CIR v Butcher Bothers (Pty) Ltd, 1945 AD 301, 13 SATC 21

[89] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007

Another factor to consider is what would happen should the loan be repaid immediately after it was granted. In this instance, the right to use the loan has a negligible value, as the benefit obtained from not having to incur interest is minimal due to the fact that the interest-free funds are only used for a short period of time[90].

The Interpretation Note issued by SARS concerning the Brummeria case provides a formula and examples of how to calculate the benefit to include in a taxpayers gross income. This is illustrated as follows[91]:

Formula:

$$A = (B \times C \times D) - E (B \times C \times D)$$

Where,

A = The monetary value of the right to the use of the interest free loan which must be included in gross income

B = The amount of the interest free loan

C = The present value of R1 per annum over the life expectancy of the occupier

D = The weighted average prime overdraft rate for banks in respect of the relevant year of assessment

E = 93,1%, which is the percentage to be allocated to the monetary value of the life right of a unit, as opposed to the value of the complete ownership of the unit. This percentage is an average of amounts determined which is based on actuarial calculations done and is acceptable to SARS for all life rights granted.

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[90] Ger B, 'Interest-free loans and tax', http://butterworths.uct.ac.za accessed 14 July 2008

[91] SARS legal and policy division, Draft Interpretation Note- SUBJECT: Commissioner, SARS v Brummeria Renaissance (Pty) Ltd (2007) SCA 99 (RSA) - The right to use loan capital interest free, October 2008

To illustrate this formula the following facts will be used:

1. The owner of a retirement village enters into an agreement in terms of which the owner grants a life right of occupation in respect of a sectional title village to a retired person on 1 June 2008.
2. In terms of the agreement, the retired person and his/her spouse will be entitled to occupy the particular unit in exchange for the grant of the use of an interest free loan to the value of R400,000 to the owner. The retired person paid the loan of 1 July 2008.
3. The retired person turned 75 years of age on 16 February 2008.
4. According to the life expectancy table, the present value of R1 per annum for the life of the retired person is 4.59354.
5. The interest free loan is to be repaid by the owner of the village to:
    a. The retired person, when the retired person's agreement is cancelled for various reasons
    b. His/her estate when he/she dies
6. The weighted average prime overdraft rate for banks during the relevant year of assessment is 13,44%.
7. The financial year of the owner of the retirement village ends on 28 February 2009.

Calculation:

The amount to be included in the owner's gross income can be calculated as follows:

A = (B X C X D) - E (B X C X D)

= (400,000 x 4.59354 x 13,44%) - 93,1% (400,000 x 4.59354 x 13,44%)

= R246,948.71 - R229,909.24

= R17,039.47

6. Consideration of the argument that the right in the Brummeria case was capital in nature

A receipt or accrual is only included in a taxpayer's "gross income" if it is "not of a capital nature"[92]. In the law of taxation, an amount is either capital or revenue in nature, there is no middle ground[93]. It is possible to apportion[94] a receipt or accrual between capital and revenue, but then one portion is revenue and the other portion is capital in character.

For an amount to be revenue in nature, it must be made in the "pursuance of a profit-making scheme"[95]. Smalberger JA in Pick 'n Pay Employee Share Purchase Trust restated the test and held that this phrase essentially means that receipts and accruals are revenue in nature if they are "not fortuitous, but designedly sought for and worked for"[96].

It was held in the case of Cactus Investments[97] that the definition of "gross income" includes rights of a non-capital nature which accrue during the relevant year of assessment and are capable of being valued in money.

The facts of the Brummeria judgment indicate that the loans were obtained in the ordinary course of the companies' trading operations. The response from SARS implies that as a result of this fact, the loans were not of a capital nature and should therefore have been included in the taxpayers' "gross

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[92]Definition of gross income, Section 1 of the Income Tax Act No 58 of 1962
[93] Emslie T.S, Davis D.M, Hutton S.J & Olivier L 2001, *Income Tax Cases & Materials*, 3rd edition, The Taxpayer, Republic of South Africa, page 180
[94] *Tuck v CIR* 1988 (3) SA 819 (A), 49 SATC 28
[95] *Elandsheuwel Farming (Edms) Bpk v SBI*, 1978 (1) SA 101 (A), 39 SATC 163
[96] *CIR v Pick 'n Pay Employee Share Purchase Trust*, 1992 (4) SA 39 (A), 54 SATC 271, at 57
[97] *Cactus Investments (Pty) Ltd v CIR*, 1999 (1) SA 315 (SCA), 61 SATC 43

income". One of the reasons behind SARS's inclusion of the amount in "gross income" seems to be that it is of a revenue nature. This leaves a wide scope for interest-free loans that could potentially not be of a capital nature, but that were obtained for reasons other than the taxpayer's ordinary business ventures. Consider the case in which a father provides an interest-free loan to his son in order to assist his son's company that is experiencing financial difficulty. This qualification made by SARS creates a grey area for distinguishing whether the use of the interest-free loan is taxable or not.[98]

Advocate Peter Solomons, the advocate who acted on behalf of C:SARS in the Brummeria case, believes that in certain circumstances it is not necessary to ascertain whether or not an accrual is of a capital nature, this is due to the fact that there are specific inclusions in the "gross income" definition[99] which apply irrespective of the nature of the amount[100].

Advocate Solomons provided a few examples of when an accrual is not of a capital nature. These instances are as follows:[101]

1) In the case where a taxpayer provides the use of a building and does not receive rent as compensation, but rather receives an interest-free loan.

2) If the taxpayer provides services and as compensation receives an interest-free loan.

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[98] Cilliers C, 'Brummeria Renaissance: The interest free cat among the borrower pigeons', *The Taxpayer*, Volume 56 Number 10, October 2007
[99] As contained in Section 1 of the Income Tax Act No. 58 of 1962
[100] Consultation note: Advocate Peter Solomon SC and Mr. Peter Dachs of Edward Nathan Sonnenbergs [email] 17 January 2008
[101] Consultation note: Advocate Peter Solomon SC and Mr. Peter Dachs of Edward Nathan Sonnenbergs [email] 17 January 2008

3) In essence, whenever the borrower of the loan could have made productive use of the asset that it made available, then the accrual is of a revenue nature.

However, if there is no asset given as consideration in exchange for the loan, for example where a parent company makes available funds interest-free to one of its subsidiaries, then the accrual is probably capital in nature as there is no scheme of profit making being undertaken[102]. In essence, if there is a *quid pro quo* given for the use of the interest-fee loan, then it is revenue in nature because it is earned in the scheme of profit making. For this reason, the use of the interest-free loan in the Brummeria case was revenue in nature since the *quid pro quo* given for the use of the loan without paying interest was the life right to occupy the retirement unit by the lender of the funds. This was essentially the taxpayer's trade that it was carrying on and the loan was obtained in the confinement of the taxpayer's trade or profit-making scheme[103]. It was not a loan made available for no consideration and there was an expectation which was set out in the contract between the company and the occupant that should the occupant wish to rescind the contract or upon his death, the life right of occupation would come to an end and the loan would have to be repaid in full. Meyerowitz argues that although the *ratio* of the Brummeria case did not specifically say that the judgment was confined to the taxpayer carrying on a trade, it is implied from the milieu of the case and that the absence of a *quid pro quo* will result in the right to use the loan interest free being of a capital nature[104]. He argues further that the '*quid pro quo* test' is deficient and creates uncertainty and that the test should rather be that the *quid pro quo* given must be

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[102] Consultation note: Advocate Peter Solomon SC and Mr. Peter Dachs of Edward Nathan Sonnenbergs [email] 17 January 2008

[103] SAICA, *Integritax* 1591 'The Brummeria Judgment' Issue 101, January 2008, www.saica.co.za accessed 30 June 2008

[104] Meyerowitz D, 'Laying Brummeria to rest? Hardly!', *The Taxpayer*, Volume 57 Number 10, October 2008

of the kind that would be supplied in the ordinary course of the borrower's trade. If this was not the case, then a favour between two friends (A and B) where A gives B a loan in exchange for the use of B's lawnmower would be taxable in the hands of B.[105]

Contrast this with the illustration provided in Chapter 4, where the founder of a discretionary trust makes available to the trust, funds that carry interest at a rate of zero per cent for the trust to use and to generate income in order to benefit the beneficiaries. In this circumstance, the founder receives no benefit or right for making the funds available to the trust; he does not receive any right to the income that is generated by the trust due to the use of the funds. This would be the case even if the founder is a beneficiary, due to the fact that the trust is a discretionary trust and therefore it is at the discretion of the trustee as to whether they make distributions from the trust income or not.

The illustration in Chapter 4 was extended further to incorporate the typical interest-free loan that is made to a trust upon the sale of property from the founder to the trust. As consideration for the property, the trust owes the founder the purchase price of the property, where this remains as an interest-free loan in the trust and is paid to the founder as and when the founder deems it necessary. The loan arose as a result of the sale of the property, where ownership transferred from the founder to the trust. The founder no longer has any right to the use of the asset, or any additional benefit receivable due to the fact that the loan is still outstanding. In all three of the examples, provided by Advocate Solomons and cited in this chapter, where the use of the interest-free loan is indicated as being revenue in nature, there is the use of an asset or the provision of ongoing services that are provided in exchange for the interest-free

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[105] Meyerowitz D, 'Laying Brummeria to rest? Hardly!', *The Taxpayer*, Volume 57 Number 10, October 2008

loan. It is not the sale and transfer of ownership of the asset *per se* and it is also not the making available of funds in order to assist a company or person in financial difficulty. These are of a capital nature and should not be included in a taxpayer's "gross income".

In conclusion, in the majority of instances in which interest-free loans are granted, the loan is analogous to equity and the person who provided the funds does not acquire any rights over the assets of the entity it provided the funding to, as was the situation in the Brummeria case[106].

[106] SAICA, *Integritax*, Stop Press 'Interest free loans and the Brummeria decision', Issue 97, September 2007, www.saica.co.za accessed 30 June 2008

7. Adequate *quid pro quo* of a non-interest nature

This paper has, thus far, focused on interest-free loans where there is no consideration in the form of interest that is given for the use of the loan capital. This chapter seeks to examine the implications if the borrower provides adequate *quid pro quo*, which is, however, not in the form of interest paid.

An illustration of how this situation could arise is when an interest-free loan is provided to the borrower, but in exchange the borrower pledges to cede to the lender its rights to, for example, dividends. In this case, where the consideration is in a form other than interest, there is a possibility that one can argue that on the basis that some form of payment is made, there is then no "valuable right"[107] for the borrower and therefore no accrual to be included in the borrower's "gross income" in respect of the value of the right.[108]

The distinction between the example above and those provided by Advocate Solomons in Chapter 6 is subtle and essentially relates to the fact that the examples in Chapter 6 concern assets or services provided to the lender who in return, instead of making payment, for example, in the form of interest or rent, rather grants an interest-free loan to the borrower. This differs from the illustration provided above, as in this example some form of payment is made as a *quid pro quo* for the use of the loan capital, and therefore there is no valuable right due to the fact that the borrower does actually make payment.[108]

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[107] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (6) SA 601 (SCA), 69 SATC 205
[108] Consultation note: Advocate Peter Solomon SC and Mr. Peter Dachs of Edward Nathan Sonnenbergs [email] 17 January 2008

There would seem to be no reason to include a notional amount of interest in the borrower's "gross income" merely due to the fact that the consideration is in the form of something other than interest[109]. The raison d'être for this is due to the fact that an adequate *quid pro quo* has already been provided. The *dictum* of Watermeyer CJ in the Lever Brother's case[110] provides precedence for this reasoning,

> "Although, colloquially, one speaks of a debt carrying interest, or interest on a debt, as though interest were a sort of growth sprouting from the debt, the language used means no more than that the borrower pays interest, if that is the agreement between borrower and lender, as consideration for the benefits allowed to him by the lender."

It would seem to be inherent in the above quote that there is no evidence that the consideration must take the form of interest payable by the borrower to the lender.[111]

Further, where an adequate, arm's length *quid pro quo* is given for the use of the funds by the borrower, there is no "valuable right"[112] because the borrower is paying an amount in the form of something other than interest for the right to use the loan capital.

Consider the situation in which a company (company A) provides an interest-free loan to a trust (trust B) and in exchange, B agrees to cede its right to dividends on one of its investments to A as payment for the use of the loan. The

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[109] Cohen S, 'Brummeria Renaissance Revisited: The real cat and the real pigeon', *The Taxpayer*, Volume 57 Number 9, September 2008
[110] *CIR v Lever Brothers and Unilever Ltd*, 1946 AD 441, 14 SATC 441 at 451
[111] Emslie T.S, 'Tax implications of interest-free loans', 4 June 2008
[112] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (6) SA 601 (SCA), 69 SATC 205

dividend rights represent amounts considered to be arm's length and appropriate. In this example, the interest-free loan is similar to a more standard interest-bearing loan, rather than the loan in issue in the Brummeria case. The reason for this is that it is a standard loan with the only exception being that the payment for the use of the funds takes the form of dividends instead of the usual interest, which as indicated, results in there being no "valuable right"[113] that could be taxable.[114]

Based on this, it does not seem that there is any notional income that can be found to be taxable in the hands of the borrower due to the fact that although the loan is agreed upon *inter partes* as being free of interest, it is not without consideration.[114]

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[113] *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*, 2007 (6) SA 601 (SCA), 69 SATC 205
[114] Emslie T.S, 'Tax implications of interest-free loans', 4 June 2008

8. Implications for the lender

This chapter seeks to apply the principles as laid out in the Brummeria judgment to the lenders of the loan capital, applied specifically to the founder of a family trust who grants an interest-free loan to the trust. While this aspect was not specifically addressed in the above judgment, as there was a barter transaction, there are two contracting parties to the interest-free loan agreement. Thus, there should also be some tax implications for the lender of the funds.

Inclusion in gross income

In the Brummeria case, the occupants had also received a *quid pro quo* for the use of the loan capital, being the life right to occupy the units. On this basis there is a potential argument for an amount to be included in their "gross incomes" representing the interest income that they would have received had they charged interest on the loan[115].

Johan Troskie of Deneys Reitz Attorneys[116] formulated several questions that should be asked in order to establish whether or not a particular interest-free loan arrangement falls within the realm of this judgment. These are quoted below:

1. What is the commercial rationale for the loan being interest-free?
2. What is the commercial substance of the transactions, looked at holistically?

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[115] Meyerowitz D, 'Laying Brummeria to rest? Hardly!', *The Taxpayer*, Volume 57 Number 10, October 2008

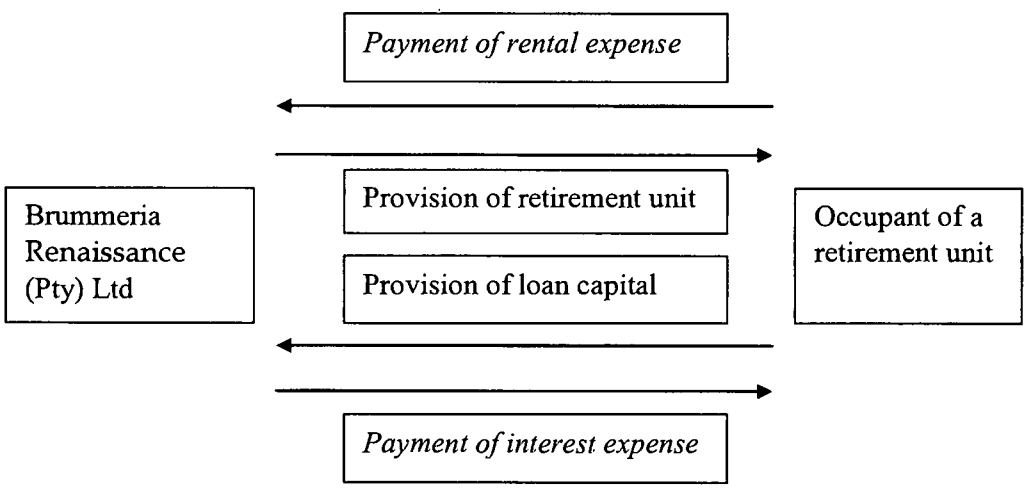
[116] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007

3. What does the lender receive in return for granting a loan on an interest-free basis?
4. What is the borrower required to do as a *quid pro quo* for the interest-free arrangement?
5. Does that *quid pro quo* involve the borrower providing a service or goods to the lender?
6. Had the borrower, instead of receiving the commercial benefit of an interest-free loan, received cash, would the receipt have constituted income of a revenue nature or capital nature?

On applying these questions to the common example where the founder of a discretionary family trust grants an interest-free loan to the trust for it to use and generate income in order to benefit the beneficiaries the following can be ascertained. The commercial rationale for the loan being interest-free would be to aid the trust financially in order for it to maximize its income and cash flow. The holistic substance is that the founder has provided funding to the trust in a similar manner that shareholders would provide capital to a company. The lender, being the founder of the trust, receives no consideration or benefit for granting the loan interest-free. The borrower, being the trust, is not required to do anything as *quid pro quo* for the loan and hence there are no goods or services that are provided as consideration for the use of the loan capital. The receipt of cash as opposed to the use of an interest-free loan would equate to equity funding provided by shareholders of a company and hence would be regarded as being of a capital nature. Based on the answers to these enquiries, it would seem that in the case of a founder providing a loan to a trust, the founder would not be required to include a notional amount of interest income in his "gross income".

9. Deductions for the borrower

It would seem, with respect that *in casu* the judgment in the Brummeria case only focused on one side of the transaction for the borrower. The focus was on the accrual of an amount, however, in substance there was an expense, being the interest expense, which should have been incurred but was not due to the fact that the parties entered into a barter transaction.[117] In essence there are two transactions between these parties. Scrutinizing it from the company's perspective, the first transaction was the provision of a retirement unit for occupation by the retirees and the consequent receipt of rental income. The second transaction was the receipt of an interest-free loan from the occupant and the resultant incurrence of interest expense being payable to the occupant. In effect, the parties, by entering into a barter transaction, were bypassing the middle part of the substance of the transactions, as illustrated in italics below.



[117] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007

Should the parties have contracted as illustrated above, then Brummeria would have received rental income and incurred interest. Providing the two amounts were the same, Brummeria would have been in a neutral tax position, but in the same financial position as the original agreement.[118] However, as a result of the manner in which the two parties contracted with one another, a deduction for the notional interest incurred would not be allowed, due to the fact that Corbett JA in the Edgars Stores case[119] held that for an expense to be deductible it must be "actually incurred"[120] which he found to mean that "only expenditure in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s11(a) from income returned for that year"[121].

(Emphasis added)

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[118] Troskie J, *Tax Update*, Deneys Reitz Attorneys, No. 26 2007

[119] *Edgars Stores Ltd v CIR*, 1988 (3) SA 876 (A), 50 SATC 81

[120] Section 11 (a) of the Income tax Act No 58 of 1962

[121] SAICA, *Integritax* 1597, 'The Brummeria Judgment', Issue 102, February 2008, www.saica.co.za accessed 30 June 2008

10. How Brummeria has been applied in recent tax cases

In a recent Tax Court decision[122], delivered in January 2008, concerning time-share points that were issued to the employees of a time-share company, the judge held that the points awarded to the employees were a taxable fringe benefit in terms of the Seventh Schedule of the Act[123]. The taxpayer, being the time-share company, attempted to rely on the judgment of *Stander v CIR*[124], which held that the benefit obtained must have an ascertainable money value. The basis of relying on this case was the taxpayer's argument that the time-share points did not have a monetary value.[125]

The tax court relied on the judgment of the Brummeria case, which had overturned certain aspects of Stander's case. On this basis, the tax court held that the principles found in Brummeria were applicable to this case, and that the right to the accommodation provided by the company is a benefit that the employees would have had to pay for had they not received the time-share points. As a result, the court held that the benefit which the employees received, being the time-share points, had a monetary value and should therefore be included in the company's taxable income.

As this case was presented in tax court, the judge was obliged to follow the principles enunciated in the highest court of the land, being the Supreme

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[122] Case number 12244
[123] Income Tax Act No. 58 of 1962
[124] *Stander v CIR*, 1997 (3) SA 617, 59 SATC 212
[125] SAICA, *Integritax*, 1627 'Fringe benefit: The receipt of timeshare points' Issue 105, May 2008, www.saica.co.za accessed 30 June 2008

Court of Appeal. Therefore, it is important to note that the principles established in the Brummeria judgment were upheld in this case.

Subsequent to the judgment in the tax court, the taxpayer concerned, Vacations Exchanges International (Pty) Ltd appealed the decision in the Western Cape High court on the argument that the revision of the value of the fringe benefit should be made in the employees' assessments and not on the company itself. It was held by Davis J that the reassessments should be raised on the employee and not the employer in terms of paragraph 12 and 2 of the Fourth Schedule of the Income Tax Act[126]. A further discussion of this judgment is outside of the scope of this paper.[127]

[126] Income Tax Act No. 58 of 1962

[127] *Vacation Exchanges International (Pty) Ltd v CSARS*, 2009, Case number A253/2008

Conclusion

Irrespective of one's views on the correctness of the Brummeria judgment, it is a decision that was made in the highest court of the land and is therefore one that must be followed by all courts below it.

As set out in this paper, the facts in the Brummeria case were fairly specific and it is my opinion that this judgment cannot without due consideration be applied to all interest-free loans. The essential component that must be present in the context of interest-free loans in order for a notional amount to be included in a taxpayer's "gross income" is the fact that a benefit must be received by the taxpayer as *quid pro quo* for the use of the loan capital.

Based on this, the concern in South African tax circles surrounding this judgment and its possible far-reaching effects seem to be unfounded. Pertaining particularly to trusts, and the typical interest-free loans that are granted to trusts by their founders, it does not seem that the Brummeria judgment can be applied and therefore these loans should not result in any notional income being imputed and taxed.

In conclusion, it still remains to be seen just how far-reaching the Brummeria judgment will be as well as how SARS intends to apply this judgment *in futuro*. In this regard, the Interpretation Note issued by SARS is an indication of how this judgment will be applied. However, there are a number of deficiencies in the note issued by SARS, which can only be dealt with appropriately if Brummeria or a case with similar facts comes before the court.

Areas for future study

The implications of the Brummeria judgment give rise to numerous potential areas that still require examination. A few of these areas are listed below.

- How this decision will impact on other taxes such as donations tax, capital gains tax and fringe benefits.
- The application of the Brummeria judgment principles on whether air miles and other loyalty benefits are taxable.
- Whether an interest-free loan constitutes a donation subject to donations tax.
- Whether or not the taxation of the notional amount in the Brummeria case does in fact give rise to double taxation.

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