

Loan deemed to count as gross income

THE Supreme Court of Appeal delivered its judgment in the long-awaited *Brummeria Renaissance* case last month.

It was held that the right to use an interest-free loan constituted an "amount", which "accrued to" the relevant taxpayers in terms of the gross income definition contained in the Income Tax Act.

Pursuant to this judgment, commentators have indicated that the effect is that all inter-company interest-free loans and funding loans to trusts would be taxable. In this context the same type of issue would, for instance, apply to low interest rate loans as opposed to interest-free loans.

The matter dealt with interest-free loans made by occupants of units in retirement villages. In particular:

- The taxpayers obtained interest-free loans from a potential occupant to finance the construction of a unit in a particular retirement village;
- A debenture was issued to the potential occupant acknowledging the loan;
- The lender was granted a lifelong right to occupy the unit on the basis

that ownership remained with the taxpayer; and

- The taxpayers were obliged to repay the loan to the lender upon cancellation of the agreement, or upon the lender's death.

The taxpayers in fact used the financing so acquired to develop the units, and the funds were not invested in income-earning investments.

It is important to appreciate that the loan was given in return for acquiring the lifelong right to occupation. In other words, the right to occupy the units was inseparably linked to the continued making of the interest-free loan.

The question was whether the right to use the interest-free loan constituted a reward in a form other than cash which is taxable in terms of the definition of gross income.

The definition of gross income is defined as, inter alia, the total amount, in cash or otherwise, received by or accrued to or in favour of a resident.

In the statement of the grounds of assessment it was argued that the developer or taxpayer received a quid pro quo and that "the benefit received in exchange for the provi-



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sion of occupation rights has an ascertainable money value and accordingly falls within the definition of 'gross income' of the act".

It was not argued that the actual receipt of the loan resulted in the receipt of amounts for the purposes of the gross income definition.

The argument for the South African Revenue Service (SARS) was that the right to retain and use the loan capital on an interest-free basis constituted a right which had an ascertainable money value and which accrued to the taxpayers.

The appeal court held that:

- Rights of a noncapital nature and which are capable of being valued in money are included under gross income;
- Making an interest-free loan constitutes a continuing donation,

which confers a benefit on the borrower (*CIR v Berold*);

■ Even though the rights could not be turned into money, the question is whether a receipt or accrual in a form other than money has a money value. The question whether the receipt or accrual can be turned into money is one of the ways in which one can determine the value. The test is objective and not subjective. The judgment in *Stander v CIR* is thus wrong.

■ Paragraph (i) of the gross income definition dealing with fringe benefits was inserted not because those benefits are not otherwise taxable, but to put it beyond doubt which benefits are taxable and how to determine their value;

■ The fact that a right cannot be alienated does not negate a value;

■ The taxpayers would also have been taxed on amounts received should those amounts have been invested (in the form of interest). No question of double taxation would arise as the amounts lent "were to have been invested so as to produce interest" and there would then have been two separate and distinct receipts or accruals, each of which would fall to be included in the gross income of a taxpayer;

■ The taxpayers did not put into dispute the valuation of the rights with reference to the application of the weighted prime overdraft rate for banks;

■ The taxpayers only belatedly argued that, if there was an amount, it was of a capital nature and thus did not form part of gross income; and

■ The link between the right of occupation and the interest-free loans was always acknowledged.

The initial argument was that the interest-free loan as such constituted gross income, as it was received in exchange for granting the occupation right. Subsequently it was said that the value of the benefit of the right to use the amounts constituted gross income. However, in both instances it was always linked to the granting of occupation rights.

It is correct to say that the receipt of a loan would never fall within gross income. It is for this reason that the grounds of assessment were amended.

The importance of a right to receive an asset was also illustrated by Judge Basil Wunsch in the judgment of *CIR v Cactus Investments*, where the example was used of a tailor selling a suit in exchange for the right to receive dividends. Even though dividends themselves are exempt, Judge Wunsch indicated that the re-

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Loan seen as gross income

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ceipt of the right constituted valuable consideration and would have been taxable (similar to the approach in the *Brummeria* case).

In both instances, whether in the *Brummeria* case or in the case of the tailor, a right is received on the basis of a *quid pro quo* that is given by the taxpayer.

The valuation of the right and that it has to be determined objectively, was confirmed previously by our courts.

IN *Ochberg v CIR* the taxpayer previously held most of the share capital of the company and received further shares pursuant to services that he rendered. Even though the relative shareholding of the taxpayer remained the same, the court said that one should consider the substance of the transaction and that the test was not whether or not the taxpayer was benefited.

The shares constituted an amount other than in cash and they were given for services rendered. The fact is that, if the shares had been received by a third party, they would have had value. On this basis an objective test is thus followed.

However, the issue is still how to value the right. One cannot automatically assume that the weighted prime overdraft rates would be the consideration, as no individual taxpayer would be able to obtain a prime rate on a deposit.

The judgment is also correct in the sense that there may be two accruals, ie the first for the right to receive the loan and that a tax could arise to the extent that the funds may be deposited subsequently. In other words, there are two tax events.

In the circumstances, it therefore follows that the judgment does not have such a far-reaching effect as some commentators might think. It is quite fact-specific because it was clearly indicated that the right to the loan was granted in return for the right to occupy the relevant units. In the case of an interest-free loan to a company, the causal connection is not present and there is not a *quid pro quo* for granting the loan. It is in this context that one would not be able to apply the judgment in the case of all interest-free or low interest rate loans.