IN THE HIGH COURT OF SOUTH AFRICA
WESTERN CAPE HIGH COURT, CAPE TOWN

Reportable
Case No.: A 253/2008

In the matter between:

VACATION EXCHANGES INTERNATIONAL (PTY) LTD Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICES Respondent

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JUDGMENT: DELIVERED ON 7 AUGUST 2009

DAVIS J:

Introduction

[1] The appellant appealed to the court a quo against an estimated assessment in respect of employees tax raised by respondent in terms of paragraph 12 of the Fourth Schedule to the Income Tax Act 58 of 1962 ('the Act') for the period of assessment 2002 – 2006.

[2] The court *a quo* dismissed its appeal and accordingly respondent has proceeded on appeal to this court.

Factual Background

[3] Appellant trades under the name RCI. Its business is primarily that of 'timeshare exchange'. As at 31 December 2002 appellant had approximately two hundred and twenty five thousand active members. Its subscription income from members in that year was almost R 37 million and further income generated from exchange fees amounted to more than R 65 million. It employs some three hundred and eighty persons of whom about two hundred and seventy are employed in the call centre environment.

[4] Every year permanent employees of the appellant with more than six months service are granted seventeen thousand exchange points free of charge which they can use to take up occupation rights in timeshare resorts affiliated to RCI. The extent to which employees individually have taken up such rights in each of the tax years in question has not been placed in dispute. Appellant contends that the essence of its case is that the occupation rights acquired by the employees cost the appellant nothing, a contention hotly disputed by the respondent.

[5] The evidence of appellant's witnesses describes the member exchange arrangement thus:

1. The member first acquires (at cost to him/herself) a right to occupy a particular unit in the RCI accredited resort for a particular period, that is a right exercisable against the owner of the resort in question, usually a share block company;

2. The member becomes, and may after three years choose to remain, a member of RCI. Subscription fees are payable by the member;

3. The member may 'space-bank' a right of occupation for a particular period by agreeing to transfer that right to the appellant;

4. Prior to space-banking the right of occupation, no member can make a time share exchange;

5. Once the right is transferred to the appellant by 'space-banking' it is regarded as forming part of the appellant's 'inventory'. The member who transferred the right has no further say over it;

6. From this the respondent contends that the appellant does not acquire the occupation right from the member without cost. It argues that appellant effectively pays for that right by giving the member in exchange a right to acquire from it a different right or rights to occupation of timeshare property under the control of appellant, subject of course to the terms of the exchange scheme;

7. The right accruing to the members is expressed in the form of 'points' which was described as the currency of the scheme. The appellant thus pays for the right in points rather than money;

8. The number of points which the appellant must allocate to the member reflects the relative value of the rights so transferred. The space-banking creates a credit for the contributing member, the value of which is linked to the resort grading, the season, and the quality and size of the unit and thus the points allocated reflect 'trading power'.

9. Respondent contends that the appellant has no need to attach rand value to the points used as its own currency for the scheme. This currency nevertheless is real value to members as they are entitled to use it to purchase other rights of occupation from the appellant to an equivalent value to which they have banked. The appellant's witnesses referred to members who employ their points to acquire an accommodation right as 'buyers of that piece of inventory';

10. A member who space-banks an accommodation right has no contractual nexus with the member who occupies the relevant unit. In general the former will typically not know whether the unit was even occupied, or if so, by whom precisely.

[6] Mr Petersen, who appeared together with Mr Janisch on behalf of the respondent, submitted that an exchange of property thus construed involved two independent transactions each between a member and the appellant. In the first, a member sells his accommodation rights to the appellant in exchange for currency of the scheme, that is points reflecting

the market or trading value of the rights so transferred. In the second another member purchases an accommodation right from the appellant and pays for this by using the currency of the scheme. According to Mr Petersen, appellant could not contend that the occupation rights in its inventory cost it nothing. These rights were certainly not donated to it but were received in exchange for real value. Thus, in the years of assessment in question, appellant had granted to its employees, by virtue of their employment, the right to occupy certain timeshare units which rights were under its control as a result of holding 'space-banked' units of its members. This benefit stood to be classified as a holiday accommodation fringe benefit which had cost appellant an amount which could be valued. Accordingly, this amount fell to be included in the employees' gross income as contemplated by paragraph (i) of the definition of gross income and the Seventh Schedule to the Act.

[7] Before dealing with the question of the evaluation of the so called fringe benefit, appellant, by agreement, was permitted at the hearing before the court *a quo* to raise a new ground of appeal. It appears that this was not recorded in any formal amendment to the statement of the grounds of appeal but was expressed in the judgment as follows:

> *"The assessment, including the imposition of interest and penalties, falls to be set aside on the ground that, in terms of paragraph 3 (2) of the Seventh Schedule, the respondent's remedy – if he is*

dissatisfied with the determination with the cash equivalent made by the appellant – lies against the appellant's employees upon assessment of their liability for normal tax, not against the appellant by way of an assessment for employees tax."

If this argument, although dismissed by the court *a quo*, is successful, it would resolve the appeal in favour of the appellant. I proceed thus to deal with this argument. However, it becomes necessary firstly to examine the nature of the taxation of fringe benefits.

The Taxation of Fringe Benefits

[8] The starting point for the analysis of the taxation of fringe benefits in terms of the Act must be the Fourth Schedule and in particular paragraph 2 thereof which obliges an employer who pays or becomes liable to pay any amount by way of remuneration to any employee to deduct or withhold from that amount in respect of the liability for normal tax of that employee.

[9] Remuneration is defined in the Fourth Schedule to include *inter alia*;

(b) any amount required to be included in such person's gross income under paragraph (i) of that definition;

The manner in which remuneration is defined appears to support the conclusion that, in order to include a fringe benefit which falls ultimately to be taxed within paragraph (i) of the definition of gross income in terms of section 1 of the Act, there is a need to calculate the 'amount' which must

be included in the remuneration as defined. The prior task is then to quantify the 'amount' of the benefit which forms part of the remuneration. In my view clearly, this 'amount' must be quantified in terms of the Seventh Schedule to the Act, which provides the mechanisms for the quantification. In broad terms, the Schedule defines the taxable benefits, quantifies their value (the cash equivalent) and imposes obligations upon the employer in regard to withholding of employees' tax and notification of the benefits to the revenue authorities.

[10] The relationship between the Seventh Schedule and the taxation of fringe benefits may be considered in terms of the purpose of the Seventh Schedule, that is to provide certainty in the calculation of fringe benefits. When the Seventh Schedule was introduced, Meyerowitz wrote the following:

> *"Sometimes in the minds of employers and employees a rose by another name smelt differently. An entertainment or traveling allowance could be well in excess of actual entertainment or traveling expenses incurred on behalf of the employer but because it was given that name, it was not treated by the employer as remuneration nor returned by the employee. A business trip undertaken on behalf of an employer gave the opportunity to take a holiday with one's wife, the first class airfare paid for by the employer being converted into two economy class or excursion*

tickets. An executive at the employer's "instance" might occupy an expensive prestige house provided and maintained at the employer's cost, but because the executive paid a nominal rental therefor he could cheerfully not disclose the fact in his return that he was enjoying the benefit of residence and board. Similarly in the case of cars, where by paying a relatively low consideration for the use of the car to the employer, the employee could in good conscience avoid disclosing the advantage from employment. Having the education of his children paid for by his employer was also considered not within the realm of a taxable advantage or benefit and therefore not disclosed. These are but samples of "fringe benefits" which went untaxed. Their importance in determining the "all in" remuneration package grew over the years. The higher the income level, the bigger the role played by fringe benefits. Those engaged in salary surveys have put the value of untaxed fringe benefits at the managerial and executive level as ranging up to 30% of the total pay package.

Untaxed fringe benefits created an inequality in taxation and thereby brought the whole tax system into disrepute. Benefits of equal value – whether received in cash or kind – should receive the same tax treatment. The new legislation does not achieve this, in that in the major instances of fringe benefits dealt with, the value

determined by the Act falls short of the real value of the benefit, but what it does do is to bring some order into the taxation of the benefits. Firstly, it spells out the various benefits which are taxable. Secondly, it lays down the measures by which they are to be valued. Finally, it casts the onus upon the employer to include their values in the calculation of employees tax." **1984 Taxpayer 105-106**

[11] The question thus arises as to how this calculation is to be done.

[12] The relevant provisions of the Seventh Schedule read thus:

"3(1) The cash equivalent of the value of a taxable benefit shall, for the purposes of paragraph (1) of the definition of "gross income" in section 1 of this Act, be determined in accordance with the provisions of this Schedule by the employer by whom the taxable benefit has been granted.

3(2) The Commissioner may, if such determination appears to him to be incorrect, re-determine such cash equivalent upon the assessment of the liability for normal tax of the employee to whom such taxable benefit has been granted.

3(3) If the employee concerned is dissatisfied with any determination or proposed determination by the employer of the value of any taxable benefit included in the remuneration

of the employee for employees tax purpose, the employee or the employer may refer the matter to the Commissioner and the Commissioner may, if it appears to him that the determination or proposed determination should be adjusted, issue a directive to the employer as to the manner in which such determination should be made and the employer shall be obliged to act upon such directive: Provided that nothing in this subparagraph contained shall be construed as preventing the Commissioner from making a redeterrmination of such cash equivalent under the provisions of subparagraph (2)."

[13] In summary, the method of calculation is as follows:

Paragraph 3 of the Seventh Schedule provides for the employer to make the estimate of the taxable benefit for the purposes of paragraph (i) of the definition of gross income in accordance with the provisions of the Seventh Schedule. If the respondent disagrees with this estimate, it is duly empowered to recalculate the estimate which has been made by the employer in terms of paragraph 3 (2) of the Seventh Schedule.

[14] A sanction is provided, namely in the event that an employer fails to issue a certificate to its employer reflecting the fringe benefits enjoyed and its

cash equivalent, respondent is entitled to levy a penalty in terms of paragraph 17 (4) thereof, that is a penalty of 10% of the cash equivalent of the value of the tax benefit.

The essence of the decision of the Special Court

[15] The court *a quo* held that paragraph 3 (2) is not an exclusive remedy but an alternative available to the respondent when it disagrees with the determination made by the employer pursuant to paragraph 3 (1) of the Seventh Schedule. As Mr Petersen correctly submitted, the implication of this finding is that respondent is empowered to correct the valuation directly when assessing the employee and is not compelled to do so by way of the mechanism of employees tax collected through the employer.

Respondent's submission

[16] In support of the finding of the court *a quo,* Mr Petersen submitted that, were respondent compelled to leave the employer out of the assessment process, this would potentially paralyze the mechanism of collection which the Act had created by way of employees' tax collected through the employer. In his view, it would leave the door wide open for employers to evade the imposition of tax through unsatisfactory determinations.

[17] Turning to the use of the words 'the Commissioner may' in paragraph 3 (2), Mr Petersen submitted that permissive statutory language such as the word 'may' is usually only empowering and does not give rise to a

mandatory obligation. Furthermore, he contended there were no compelling policy reasons, based on the wording or purpose of paragraph 3 (2) or the scope and objects of the Act which would favour an interpretation of the paragraph as contended for by appellant, and which would oblige respondent to pursue employees directly for outstanding tax and preclude it from pursuing, as a first resort, the employer for the collection of the outstanding tax.

[18] Mr Petersen sought to buttress this argument with a reference to policy, namely that were appellant's argument to be accepted, it would hamper the respondent in the efficient enforcement of the employees tax system by effectively removing a defaulting employer from the equation and thus reducing the employers risk of having to pay penalties or interest. There would be little recourse for the respondent against an employer which had made an incorrect determination. In turn this would create a climate for tax abuse on the part of employers.

[19] Mr Petersen contended further that, to give a construction to the remedy under paragraph 3(2) which would make it an exclusive remedy, would be unduly restrictive. Why, the question might be asked, should the respondent possess power under paragraph 12 of the Fourth Schedule in terms of non- fringe benefits which could not be similarly employed in regard to fringe benefits. This would allow employers to award fringe

benefits but levy no tax thereon deliberately with a view to favouring itself/or the employee thereby depriving the fiscus of tax due to it. In these circumstances would the employer escape unscathed (apart arguably, from the penalty provisions for in paragraph 17(4) of the Seventh Schedule)? In such circumstances, the respondent would be limited to the potentially very cumbersome remedy of having to make individual assessments upon all employees before he could collect the tax due. There would be little, if any, deterrent upon an employer who may well have deliberately circumvented its obligations in terms of the Act.

[20] The argument thus is that the primary obligation of the employer to deduct and pay such taxes to the respondent is set out in paragraph 2 of Part II of the Fourth Schedule. In terms of paragraph 6(2)(A), failure to comply with this obligation attracts a penalty 'not exceeding twice the amount of employees tax'. This appears to be potentially a much heavier penalty than that provided for in paragraph 17(4) of the Seventh Schedule. The latter penalty is limited to 10% of the cash equivalent of the value of the taxable benefit equivalent (presuming it was not certified at all). This comparatively modest penalty also contrasts sharply with the full initial liability for the entire undeclared tax which the employer must bear following receipt of an estimated assessment in terms of paragraph 12 of the Fourth Schedule. Thus, it is argued that, upon a purposive interpretation of the two Schedules read within the context of the Act as a

whole, the respondent may employ either of the two remedies available to him. They are therefore concomitant and not exclusive.

Assessment

[21] In my view, the key question in resolving this dispute turns on the precise role of the scheme as set out in the Seventh Schedule and in particular whether this Schedule provides an exclusive or an alternative remedy to the Commissioner to enforce what he considers to be the correct estimate of the employees' remuneration.

[22] In this connection, the use of the word 'may' in paragraph 3 (2) of the Seventh Schedule which was the subject of such considerable emphasis by respondent can only be assessed by an examination of the language of the statute, its general scope, purpose and objects. South African Railways v New Silverton Estate Ltd 1946 AD 830 at 842. In my view, the word 'may' does not advance the case of respondent that the Commissioner has a choice of remedy. The wording of paragraph 3 (2) which includes the word 'may' supports the existence of an obligation on the Commissioner, if he sees fit, to use the permissive power granted to him if the employer's determination appears to him to be incorrect. This is because all else flows from such a determination. In this context, such a redetermination can be seen as a pre-existing requirement to any further action which the respondent may wish to take to recover taxes he

considers are due. In other words, paragraph 3(2) does not confer a discretion on the Commissioner in the sense that he can elect to collect the tax he considers to be outstanding otherwise than by way of making a re-determination in terms of paragraph 3(2) of the Seventh Schedule of an assessment of the employee.

[23] The answer to this interpretative dispute therefore depends, in my view, on an examination of the purpose of the Seventh Schedule. It was introduced to bring certainty to the calculation of fringe benefits. Prior to the introduction of the Seventh Schedule fringe benefits were taxable but until the Schedule introduced, there was considerable uncertainty as to the manner of the calculation of the cash equivalent of the benefit. The Seventh Schedule was therefore introduced to provide a clear means by which respondent could tax each of the various fringe benefits set out in the Schedule, whether it be a car scheme, the provision of housing, meals or holiday accommodation for an employee, as provided for by its employer.

[24] When a fringe benefit is provided by an employer, the amount stands to be quantified in terms of the Seventh Schedule. That was the purpose for its introduction into the Act and that remains its object. Paragraph 3(1) makes it clear that the cash equivalent of the value of a taxable benefit shall be determined in accordance with the provisions of the Schedule. Once this calculation is done, that is the cash equivalent is determined,

the amount is added to 'remuneration' as defined in the Fourth Schedule. The employer, in terms of paragraph 2 of the Fourth Schedule, must now deduct or withhold the necessary tax from the remuneration as determined. Until the fringe benefit is given a 'cash equivalent' it is not possible to so determine the total remuneration and withhold tax as provided for in paragraph 2 of the Fourth Schedule.

[25] Even the way the penalty which can be imposed upon a recalcitrant employer, as formulated in terms of paragraph 17 (4) of the Seventh Schedule, is instructive in this regard. Paragraph 17(4):

> *"Any employer who fails to comply with the requirements of this paragraph shall pay to the Commissioner a penalty equal to 10 per cent of the cash equivalent of the value of the taxable benefit in question or where the said cash equivalent has been understated, of the amount by which the cash equivalent was understated: Provided that the Commissioner may, if he is satisfied that such failure was not due to any intention on the part of the employer to evade his obligations under this Act and was not designed to enable the employee concerned to evade such employee's obligations under this Act, remit the whole or any part of the penalty imposed under this subparagraph."*

The wording emphasizes the "cash equivalent" which means the cash equivalent of the benefit. In other words, the determination of the 'cash

equivalent' of the fringe benefit is a separate and prior question to the application of the provisions of the Fourth Schedule.

[26] Expressed differently, the estimate in terms of the Seventh Schedule constitutes the first step in the process of withholding tax. This calculation must take place prior to the estimate of the total remuneration on which amount the employer is obliged to deduct or withhold tax. If the employer fails to fulfill this obligation, a penalty may be imposed by respondent in terms of paragraph 17 (4). Viewed accordingly, the Act has a logical and coherent structure: firstly there is a requirement to determine the cash amount of the fringe benefit. Once the amount is calculated, this calculated amount of the fringe benefit is then added to any other remuneration as defined and from this total amount received by the employee, tax is deducted by the employer.

[27] There appears to be no coherent reason as to why the legislature, having so introduced the Seventh Schedule for the purposes as outlined, would then adopt a parallel system of remedies, that is to allow the respondent to employ either the Seventh or Fourth Schedule at its own discretion to deduct tax from fringe benefits particularly as the structure, as I have outlined it, gives effect to the very wording of the Fourth and the Seventh Schedules and fits the overall scheme. The very purpose of the Seventh Schedule was to quantify fringe benefits which were then brought within

paragraph (i) of the definition of gross income. Other than references to policy, there was but one substantive argument raised to gainsay this interpretation of the relevant provisions of the Act.

[28] That argument was based upon the provision of paragraph 12 (1) of the Fourth Schedule:

> "*(1) Where any employer who is required to deduct or withhold employees' tax in terms of paragraph 2 –*
>
> *(a) has failed to furnish a return as required in terms of paragraph 14 (1);*
>
> *(b) has furnished a return as required in terms of paragraph 14(3) but the Commissioner is not satisfied with the return;*
>
> *(c) has failed to deduct or withhold employees' tax; or*
>
> *(d) has failed to pay over any amount of employees' tax deducted or withheld,*
>
> *and such employer has not been absolved from his or her liabilities in terms of the provisions of this Schedule, the Commissioner may make a reasonable estimate of the amount of employees' tax which is required to be deducted or withheld and issue to the employer a notice of assessment for the unpaid amount.*"

While this paragraph provides the Commissioner with a clear remedy, it is triggered by a failure on the part of the employer to furnish either a return, an unsatisfactory return or a failure to deduct tax. Here, the employer

furnished a return and deducted tax from its employees. In terms of the one provision, which on its face appears to be of application, para 12 (1)(b), if the Commissioner is dissatisfied with the return because of the tax deducted on the amount of remuneration so reflected, he can impose liability upon the employer. But in this case, until the quantification of the fringe benefit is determined, remuneration, as defined, has not been determined. In short, paragraph 12(1) provides a remedy after the prior question of the valuation of fringe benefit to be included in remuneration has been determined; hence its inapplicability to the present case.

[29] In summary, the dispute turns on the prior question: the amount of the cash equivalent of the fringe benefit to be added to remuneration for the purposes of triggering the provisions of the Fourth Schedule. Accordingly, paragraph 12 (1) is not relevant to this specific dispute.

[30] For the sake of clarity, let me recapitulate:

The structure of the Fourth and Seventh Schedule is an obstacle in the way of respondent's submissions which must be assessed in terms of the structure of the Act. Paragraph (b) of the definition of remuneration of the definition of gross income expressly refers to "amounts" required to be included under paragraph (i).

[31] Paragraph (i) of the definition of gross income reads:

"the cash equivalent, as determined under 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 the holder of any office, being a taxable benefit as defined in the said Schedule, and any amount required to be included in the taxpayer's income under section 8A."

To be part of remuneration as defined, a fringe benefit is initially quantified in terms of the Seventh Schedule. This duly calculated amount forms part of paragraph (i) and as such is included as remuneration under the Fourth Schedule.

[32] The remedy under paragraph 12 of the Fourth Schedule refers to paragraph 2 of the Fourth Schedule and is thus a clear reference to "remuneration". The under-estimation of fringe benefits is dealt with in terms of a specific remedy. If respondent considers the remedy under paragraph 3(2) of the Seventh Schedule to be inadequate to deal with the problems raised in this case, it has the option of crafting a legislative remedy It is not, however, for this Court to cure anomalies by way of judicial law making when the text can only be read in the manner set out in this judgment.

[33] Once this analysis is adopted, there is no need to canvas any of the remaining issues raised by appellant for respondent would have followed

an incorrect procedure in its assessments, which in terms of this judgment could not have been levied against appellant.

[34] For these reasons the appeal is upheld and the following order is made:

1. The appeal succeeds with costs.
2. The order of the Special Tax Court is altered to read: "the appeal is allowed and the assessments are set aside".

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DAVIS J

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BOZALEK J

I agree

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ALLIE J

I agree