CAPE INCOME TAX SPECIAL COURT

Before

The Honorable Mr Justice Davis — President

Mr RTJ de Beer — Accountant Member

Mr S Montsi — Commercial Member

CASE OF

APPELLANT

NO: 10918

(Heard in Cape Town on 12 August 2002)

Judgment given 13 August 2002

JUDGMENT

DAVIS J:

On 13 May 1994, appellant was offered 10 000 share options in the "C" at a price of 50 cents a share. This right was then ceded to the "A" ("the Trust")on 16 May 1994, for a consideration of R47 000.

On 4 May 1995 appellant was offered a further 3000 share options in "C" at a price of 3000 cents a share. This right was ceded to the Trust on

12 May 1995 for a consideration of R15 000,00. On 4 June 1997 the Trust acquired 3333 “C” shares in terms of the first option for R68 326,00. On 5 September 1997 the Trust disposed of the 3000 shares, acquired in terms of first option for the sum of R486 550,00.

The appellant’s employer, being “C”, calculated the amount which was required to be included in the appellant’s tax return for the 1998 year of assessments in the amount of R438 289,00 and on 29 June 1998 a further 1000 shares were acquired for R30 000,00 in terms of the further option which the appellant had ceded to the Trust. Again the “C”, being the appellants’ employer, calculated the value to be included in the appellants’ tax return for 1999 year of assessment in the amount of R690 360,00.

For the years of assessment ending 28 February 1998 and 28 February 1999, appellant submitted a return of income supported by accounts made up to that date. The respondent took the view that the amounts of R438 289,00 and R690 360,00, should be subject to tax in the applicable tax year of assessment, and accordingly included them in the appellant’s income for the relevant years.

Against these assessments the appellant lodged an objection. The objection was disallowed by respondent and an appeal was therefore brought before this Court. Initially it appeared that the basis of the assessment was predicated on the provisions of section 8A(6)(b)(i) of the Income Tax Act, 58 of (1962) ("the Act"), together with an application of section 103(1) of the Act, and further paragraph (C) of the definition of "gross income" in section 1 of the Act. The latter two arguments were not proceeded with by respondent. The entire dispute thus turned upon the application of section 8A(6)(b)(i) of the Act.

Section 8A(6)(b)(i) of the Act provides as follows:

> **"For the purposes of this section, a gain made by any person other than the taxpayer by the exercise, cession or release of a right to acquire any marketable security shall be deemed to be made by the taxpayer and shall be included in the taxpayer's income as though it were a gain referred to in subsection (1) -**

(b) if that right was originally obtained by the taxpayer as a director or former director of any company or in respect of services or to be rendered by him as an employee to an employer, and –

(i) the right was ceded by the taxpayer to any person otherwise than by or under a cession made by way of a bargain at arm's length"

(my emphasis).

APPELLANTS CASE:

Appellant called two witnesses, being the taxpayer and "B", an asset manager being in the employ of "C" for some eleven years.

The appellant testified how he acquired the options to which I have made reference. On 13 May 1994 he received a letter from his employer in which he was offered 10 000 share options from "C" at a price of 2050 cents a share. He decided for estate planning and asset protection purposes to cede this right to the Trust for a consideration of R47 000. On 4 May 1995 he was offered a further 3000 share options in "C" at a price of 3000 cents per share.

Again for the estate planning and asset protection reasons to which I have made reference, he ceded this right to the Trust for a consideration of R15 000. On 6 June 1996 he was offered a further 5 000 share options in "C" at a price of 5900 cents per share, a right which was then ceded to the Trust on 4 May 1996, at a consideration of R15 000.

The Trust had been set up in 1987 by appellants' mother. The trustees included appellant, his mother and her attorney, "D". The beneficiaries of the Trust included appellant, his wife and their children. The Trust paid for the options by the way of an interest free loan from appellant, payment of which could be demanded by appellant at will. Appellant testified that he was anxious to ensure that the price which was paid by the Trust for the options was a market related price. For this reason he decided to consult a colleague, "B", who, according to appellant, had considerable expertise in this field. On the basis of the advice given by "B" and the calculations of which were annexed to the correspondence which appellant sent to respondent, the prices which were paid were, in view of the appellant, were market related prices for the options.

"B" was the second witness to be called on behalf of the appellant. He testified that he had been in the employ of "C" for some eleven years, had expertise in the area of valuations and worked in the area of private clients Appellant had consulted him about the market value of the options which had been offered to appellant so that appellant would be able to sell these options to a family trust. In short, according to "B" he was aware of the mechanics which appellant sought to employ insofar as the sale of the options were concerned; "B"'s attitude was that this constituted a standard estate planning and asset protection mechanism of which he was well aware given his own experience.

"B" then described at some length how he came to arrive at the valuation which formed the basis of the sale. The following steps were employed:

1. He began with the prevailing "C" share price. In 1994, when the options was acquired the share price was R20,50.
2. He then doubled the price, which equaled R41,00.

3. He then deducted the option price to be paid by the acquirer, which led to a profit of R20,50.

4. Given that there were 10000 options the entire amount which would then be received or credited would be R205 000.

5. He then divided the R205 000 by 3 tranches of options to arrive at a figure of R68 327.

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He then employed the following depreciation process to take account of fluctuations in the share price, the possibility of appellant leaving "C"'s employ and therefore losing the options and further the debt which the Trust was irrevocably committed to pay whatever the future might have held for the options.

The following document which was handed in
20 and of which I merely cite an extract reflects the manner in which, "B" sought to deal with the depreciation question for the first tranch in 1995. The figure with which he worked was R30 000.

"On the day on which the option issued a depreciation of 25% was taken into account, therefore leaving a balance of R22 500.

The following year a further figure of 25% for depreciation was taken into account amounting to R5625 leaving the balance of R16 875. The following year a further 25% was taken into account in the amount of R4 219 leaving a balance of R12 656, and then in the year prior to the actual right to exercise a 40% depreciation was taken into account in the amount of R5 862 leaving a balance of R7 594. It was on this basis that "B" suggested to appellant this would be a market related price for the options on the day they were acquired.

"B", who was closely questioned about the depreciation allowances and in particular why it was necessary to have a larger allowance in the final year, explained that in the final year there was no escape to the option holder in that having paid for the option, if the share had depreciated, the option holder would have been locked into a price from which only a loss could result

THE RESPONDENT CONTENTIONS

Mr Chetty, who appeared on behalf of the respondent, submitted that the options had been ceded for a value which was much lower than the value placed upon them by the employer. Accordingly he contended that the appellant did not obtain the maximum outmost possible advantage out of the transaction which would be required in order for there to have been a bargain at arms' length. For this reason the cession of the three options by an appellant to a Trust of which he was the trustee and beneficiary for such a price would not meet the requirements of the arms' length transaction.

This submission illicit some debate in the Court about the issue of what constituted an arms' length transaction Respondent relies in particular on the case of **Hicklin v SIR 41 SATC 179(A)**, where the Court adopted the approach that a bargain at arms' length (the words used were slightly different in that **Hicklin's** dispute dealt with section 103 of the Act), contemplated that each party independent to each other each would seek to strike a bargain which would gain for each party the maximum possible

advantage from the transaction. In Mr Chetty's view this had not taken place in the present case.

The difficulty with this argument is that the value which the employer placed upon "shares" was the market value of the shares when the option was exercised, not the value of the options which were ceded to the Trust. In other words, Mr Chetty placed considerable emphasis on a document prepared by "E" of "C" which reflected the price of the shares at the date of the year of assessment in 1998. What "E" presumably had done was simply to have taken the prevailing market value of "C" shares held pursuant to the option, deducted the price paid therefore in terms of the option and provided the appellant with the net price.

The present dispute does not deal with the question of the market value of the shares at the date of the year of assessment, but rather with whether the value which was paid for options acquired by the Trust when such options were ceded by the appellant to the Trust represented a consideration which reflected market value; hence the transaction could fairly be classified as representing a bargain struck at arms' length.

As Mr Chetty properly conceded, there was no reason to disbelieve "B"'s evidence. The justification for the price, which "B" offered the Court, was based on rational grounds. No evidence was advanced by respondent to suggest that "B"'s valuation was a sham or a phony or computations so manifestedly incorrect that it could justify a conclusion that the parties had not struck a bargain at arm's length.

In a case such as the present, a word about the quality of evidence would not be misplaced. The question was raised by Mr Chetty as to whether, an expert notice should have been provided by appellants prior to calling "B". "B" was not an expert in this sense; he was the person who had been consulted by appellant to provide a value for the transaction which ultimately gave rise to this dispute. Had the respondent called an independent expert who would have had given credible testimony, it might well have been that the value placed on "B"'s evidence would have had to take account of his somewhat dependant relationship to "C" and his personal relationship (to the extent that there was one) with appellant.

Absent such an independent expert the Court is faced with an examination of the veracity and coherence of ”B”’s evidence. That there may be other methods of calculating an option is clear. “B” conceded as much. But the Court can only examine the plausibility and rationality of evidence by evaluating that which was presented to this Court. No alternative basis was offered by respondent, no evidence was proffered by respondent to justify another conclusion than that the price upon which the options were ceded was a market related price. That being the case, it follows that, in terms of section 8 (A)(6)(b)(i) of the Act, the right was ceded by the appellant to the Trust by way of a bargain at arms’ length.

For these reasons the appeal succeeds. The assessments for the years 28 February 1998 and 28 February 1999 are remitted to respondent for a proper assessment so that the amounts of R438 289.00 for the 1998 tax year and the R690 360.00 for the 1999 tax year maybe excluded from such assessment.

PRESIDENT

Mr N. Chetty represented the Commissioner for Inland Revenue.

Mr T.S. Emslie instructed by Deneys Reitz Inc. appeared on behalf of the Appellant.