INTERPRETATION NOTE: NO. 58 (Issue 2)

DATE: 4 October 2012

ACT	**:**	**INCOME TAX ACT NO. 58 OF 1962 (the Act)**
SECTION	**:**	**SECTION 1(1), DEFINITION OF "GROSS INCOME"**
SUBJECT	**:**	**THE *BRUMMERIA* CASE AND THE RIGHT TO USE LOAN CAPITAL INTEREST FREE**

Preamble

In this Note unless the context indicates otherwise –

- **"BGR"** means a binding general ruling issued under section 89 of the Tax Administration Act, 2011;
- **"SCA"** means the Supreme Court of Appeal of South Africa;
- **"section"** means a section of the Act;
- **"Tax Administration Act, 2011"** means the Tax Administration Act No. 28 of 2011;
- **"the *Brummeria* case"** means the judgment handed down by the SCA in *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd* 2007 (6) SA 601 (SCA), 69 SATC 205; and
- any word or expression in this Note bears the meaning ascribed to it in the Act.

1. Purpose

This Note has been published as a result of the judgment of the SCA in the *Brummeria* case. For the purposes of interpreting the definition of the term "gross income" in section 1(1), this Note –

- outlines the treatment of receipts or accruals in a form other than money; and
- serves as a BGR issued under section 89 of the Tax Administration Act, 2011 on the meaning of the term "amount" as used in that definition (see **7**).

2. Background

The *Brummeria* case concerned a group of companies (the taxpayers) that granted life rights over units in a sectional title scheme operating as a retirement village to the occupiers (life-right holders). As a *quid pro quo* (in exchange) the life-right holders granted interest-free loans to the taxpayers for as long as they occupied the units.

The SCA had to adjudicate the appeal on the issues as defined in the statement of the grounds of assessment read with the statement of the grounds of appeal. Issues that were not raised in the statement of grounds of appeal could not be pursued before the court. The court had to consider the taxpayers' contention that the interest-free loans did not result in any "amount" being "received by" them which could be, and was, wrongly included in their gross income.

The complete facts of the case and the arguments of the Commissioner and the taxpayers may be found in the reported judgment and are therefore not repeated in this Note.

The SCA held that the right to use the loan capital interest free has an ascertainable money value that should be included in the gross income of the taxpayers.

The SCA did not, in the context of the appeal, consider the position of the life-right holders. This Note therefore focuses on the borrowers of the money in the context of trade and not on the position of the life-right holders.

3. The law

Extract from the definition of the term "gross income" in section 1(1)

> **"gross income"**, in relation to any year or period of assessment, means—
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely—

4. Principles enunciated by the SCA in the *Brummeria* case

The judgment of the SCA in the *Brummeria* case may be referred to as authority for the following principles:

- The word "amount" in the definition of the term "gross income" is to be interpreted widely.
- The right to use the loan capital interest free (the right) has a monetary value.
- Even though the receipt or accrual of the right is in a form other than money (*in casu,*[1] the benefit of the use of an interest-free loan), which cannot be alienated or turned into money, it does not mean that the receipt of the right has no money value. The test to be applied in order to determine whether the receipt or accrual has a monetary value is an objective one and not subjective.[2]
- The value of the receipt or accrual in a form other than money (*in casu,* the right to use an interest-free loan) constitutes an "amount" that "accrues" to the

[1] In the case under consideration.
[2] On this point, *Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 21 was found to incorrectly reflect the law.

taxpayer and should be included in the gross income of the taxpayer for the year of assessment in which the right is received by or accrued to the taxpayer.[3]

- For a benefit of this nature to be taxable the amount does not need to fall within paragraph (*i*) of the definition of the term "gross income" in section 1(1) (that is, a "taxable benefit" as defined in the Seventh Schedule to the Act).

5. Issues not decided by the SCA

The SCA merely accepted, without deciding –

- the nature of the rights under the transaction – that is, whether they were of a capital or revenue nature (this was not an issue before the court);
- the timing of the accrual; and
- the valuation method.

The court merely accepted the approach taken by the Commissioner in his submission on these matters, since the taxpayers had not contested them in their grounds of objection and appeal.

6. Application of the principles enunciated by the *Brummeria* case

6.1 Receipts and accruals in a form other than money in exchange for goods supplied, services rendered or any other benefit given

It is evident from the facts of the *Brummeria* case, that the rights to use the interest-free loans were intended by the lenders (the life-right holders) to be in exchange for the life rights granted by the borrower.

As a result the principles from the judgment may be applied in all cases in which benefits in a form other than money (such as the right to use an interest-free loan) are granted in exchange for goods supplied, services rendered or any other benefit given.

The receipt or accrual in a form other than money could constitute an amount. Unless this amount is of a capital nature which is not specifically included in the definition of the term "gross income", it should be valued and included in the gross income of the taxpayer in the year of assessment in which it is received or accrued.

6.1.1 Determination of the value of receipts and accruals in a form other than money

(a) General principles of valuation enunciated by the SCA in the *Brummeria* case

The SCA made it clear in the *Brummeria* case that the question whether a receipt or accrual in a form other than money has a money value is the primary question. The ability to turn such a receipt or accrual into money is but one of the ways in which it can be determined whether it has a money value. It does not follow that a receipt or

[3] The principles in *Lategan v CIR* 1926 CPD 203, 2 SATC 16, *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 and *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA), 61 SATC 43 were confirmed.

accrual which cannot be turned into money has no value. The test is objective and not subjective.[4]

Arm's length principles of valuation must be applied in each case, having regard to the facts and circumstances and the intention of the parties.

(b) Value of the right to use an interest-free loan

The basis upon which the right to use an interest-free loan was valued by SARS was never challenged on appeal by the taxpayers and therefore was not under dispute before the court. The SCA therefore did not rule on the basis used in valuing the right.

In the *Brummeria* case SARS applied the weighted-average prime overdraft rate of banks to the average amount of interest-free loans in possession of the taxpayer in the relevant year of assessment as a method in order to place a value on the right to use an interest-free loan. The SCA neither accepted nor rejected this approach. It does not necessarily follow that this method will always be the most appropriate for valuing a right to use an interest-free loan. Each case must be evaluated on its own merits and all facts and circumstances pertaining to the right to use the interest-free loan must be taken into account in the valuation. A person adopting a different method of valuation will bear the burden of proving its appropriateness in the specific case.

6.1.2 Time of accrual of an amount in a form other than money

The timing of an accrual of an amount in a form other than money must be determined in accordance with general legal principles. In this regard, the courts have determined that an accrual can only take place when the taxpayer has become unconditionally *entitled* to the *amount* in question.[5]

The timing of an accrual of an amount in a form other than money must therefore be determined in each individual case having regard to the law and the facts and circumstances of each case.

The borrower in the retirement village industry is assessed on the right to use the interest-free loan in exchange for granting a right of occupation only in the year in which the borrower becomes entitled to the right to use the loan.

Note: The borrower is not assessed on the right to use the same loan in subsequent years irrespective of the term of the loan.

6.2 The right to retain and use an interest-free loan in the context of a group of companies and between shareholders and their companies

The right to use an interest-free loan given by a shareholder to a company or by a company to another company in the same group of companies may be made with the intention of providing long-term working capital to the company or to meet capital expenditure requirements within the group of companies.

[4] The *Stander* case was found to incorrectly reflect the law on this point.
[5] In *Lategan v CIR 1926 CPD 203,* 2 SATC 16, *CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A),* 52 SATC 9 and *Cactus Investments (Pty) Ltd v CIR* 1999 (1) SA 315 (SCA), 61 SATC 43.

The shareholder or group company that grants the right to use an interest-free loan may not necessarily intend the right to be in exchange for goods sold, services rendered or some other benefit granted by the borrowing company. Interest-free loans between shareholders and their companies and between companies within the same group of companies would therefore not necessarily be affected by the *Brummeria* case since these interest-free loans may be granted in a capital context.

However, a borrower that has provided any goods, services or other benefits to the lender in exchange for the use of an interest-free loan, must value the right to use that loan and include the amount in that borrower's gross income.

Each right to the use of an interest-free loan granted in this context must therefore be considered and evaluated against the background of its own facts and circumstances and intention of the parties to the interest-free loan to determine whether the amount is of a capital nature or not and whether its value must be included in the borrower's gross income.

6.3 Receipts or accruals in a form other than money in any other context

The value of a receipt or accrual in a form other than money would usually not have to be included in gross income if the receipt or accrual did not take place in exchange for goods supplied or services rendered. The reason for this is that such a receipt or accrual would probably be of a capital nature. However, each and every transaction will have to be evaluated on its own merits and against the background of its own facts and the intention of the parties.

7. Granting of life rights over units in a retirement village – Binding General Ruling (BGR)

The contents of this paragraph constitute a BGR under section 89 of the Tax Administration Act, 2011 and relate to the definition of the term "gross income" in section 1(1). This BGR applies with effect from the commencement of years of assessment ending on or after 31 December 2008 and will apply for an indefinite period.

Agreements in the retirement industry are frequently structured in such a way that one person (the owner of a unit) grants a lifelong right of occupation over that unit to another person (the life-right holder). As compensation the life-right holder advances the owner an interest-free loan for the duration of the period of occupation.

Only amounts received by or accrued to a taxpayer during a particular year of assessment must be included in that taxpayer's gross income for that year of assessment.[6] The value of a right that accrues to a taxpayer in a particular year of assessment must be determined in that year.[7]

In calculating the monetary value of the right to use an interest-free loan in the year in which it is granted, it should be taken into account that the owner of the unit has given something in exchange to the life-right holders. The *quid pro quo* is the granting of the lifelong right of occupation of the unit. The owner is therefore left only with the bare *dominium* of the unit for the full period of the loan. Only when the loan is repaid and the life right is re-united with the bare *dominium,* will the owner be in a position to deal freely with the complete ownership of the unit.

[6] Definition of "gross income" in section 1.
[7] *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.

The value of this *quid pro quo* given by the owner of the unit to the life-right holder should therefore be determined and taken into account in the valuation of the right to use the interest-free loan.

The right to use an interest-free loan granted by an occupant in a retirement village to the owner of that unit in exchange for the granting of a life right of occupation in respect of that unit usually does not relate to a fixed period. Instead, the period over which the right to the use of the loan is to be enjoyed depends on the life expectancy of the life-right holder and certain other contractually agreed contingencies (such as the possibility that the life-right holder may cancel the loan before his or her death).

In view of the above, it may be accepted that the value of the right to use the interest-free loan should be calculated in the year that the loan is granted with reference to the following factors:

A = The monetary value of the right of 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 a year over the life expectancy of the life-right holder*, or in the case of more than one life-right holder, the youngest of them

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

E = 93,1% (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 average percentage has been determined actuarially and is acceptable to SARS for all life rights granted.) SARS has accepted this method as a basis for calculating the amount to be included in gross income. This deduction accommodates the owner of the unit who gives a right to occupy the unit as a *quid pro quo* for the right to use an interest-free loan.

Formula:

A = (B x C x D) – E x (B x C x D)

* The life expectancy of the life-right holder and the present value of R1 a year for the life of the life-right holder may be determined by using the life-expectancy table issued under Government Notice No. R1942 of 23 September 1977 under section 29 of the Estate Duty Act No. 45 of 1955 (see **Annexure**).

The monetary value of the right to use the interest-free loan in the year in which it is granted and paid must be determined by multiplying the amount of the loan by the present value of R1 a year for the lifetime of the life-right holder and the weighted-average prime overdraft rate determined for the relevant year of assessment. The amount so calculated is then reduced by 93,1%. **Note:** This is a once-off calculation of the amount to be included in the gross income of the borrower in the year of assessment in which the borrower becomes entitled to the right to use the loan. The amount is therefore not re-calculated and included in the borrower's gross income in each subsequent year until the loan is repaid (see **6.1.2**).

Example 1 – Calculation of the monetary value to be included in gross income

Facts:

A retirement village is held under sectional title by the owner. The scheme is governed by the Housing Development Schemes for Retired Persons Act No. 65 of 1988. On 1 June 2011 the owner enters into an agreement, under which the owner grants a life right of occupation over a sectional title unit in the village to a person aged 75.

Under the agreement, the 75-year-old person and that person's spouse will be entitled to occupy the unit in exchange for the grant to the owner of the use of an interest-free loan of R400 000. The life-right holder advanced the loan on 1 July 2011.

The person turned 75 on 16 February 2011.

According to the life-expectancy table (see **Annexure**) the present value of R1 a year for the life of the 75-year-old male is 4,59354 (age next birthday = 76).

The interest-free loan is repayable by the owner of the village to –

- the life-right holder upon cancellation of the agreement under various circumstances, which include the life-right holder falling ill and requiring full-time medical care; or
- his or her estate when he or she dies.

The weighted-average prime overdraft rate for banks during the relevant year of assessment is 13,44%.

The financial year of the owner of the retirement village commences on 1 March 2011 and ends on 29 February 2012.

Result:

The monetary value of the right to the use of the interest-free loan is calculated as follows:

A = (B x C x D) – E x (B x C x D)

= (R400 000 x 4,59354 x 13,44%) – 93,1% x (R400 000 x 4,59354 x 13,44%)

= R246 948,71 – R229 909,24

= R17 039,47

An owner that is obligated to refund only a portion of the loan on death or cancellation of the agreement must include the amount not refundable in gross income in the year of assessment in which the loan is granted and paid by the person acquiring the life right.

Example 2 – Full loan amount not refundable

Facts:

The agreement between the owner and the life-right holder provides that only 80% of the interest-free loan of R900 000 is refundable on death.

Result:

The owner must include R180 000 (20% x R900 000) in gross income in the year of assessment in which the loan is granted and paid by the life-right holder.

In addition, an amount equal to the monetary value, calculated in respect of the right to use the interest-free loan, must be included in the owner's gross income in the year of assessment in which the loan is granted and paid.

Note: For purposes of calculating the monetary value, symbol "B" in the formula is 80% x R900 000 = R720 000.

In the case of an interest-free loan, the benefit to retain and use the interest-free loan will accrue to the owner on the date the loan has been granted and paid by the person acquiring the life right.

Example 3 – Date of accrual of an interest-free loan

Facts:

B retired on 30 March 2012 and entered into an agreement with a retirement village owner. Under the agreement, B will be entitled to occupy a particular unit in exchange for the grant of the use of an interest-free loan of R400 000. The agreement is concluded on 15 February 2012. B undertook to pay the R400 000 on receipt of his lump sum benefit from his pension fund. He paid over the R400 000 to the retirement village owner on 12 June 2012. The year of assessment of the owner ends on 31 December 2012.

Result:

The date of accrual for purposes of calculating the monetary value of the right to use the interest-free loan is 12 June 2012.

8. Loans at nominal interest rates

Some recent arrangements make provision for loans at nominal interest rates and a corresponding nominal rental to be paid. It is SARS's view that this will not change the impact of the *Brummeria* case. The value of the benefit received must be calculated in the same manner as above, but the weighted-average prime overdraft rate (symbol "D" in the formula) must be reduced by the interest rate payable.

9. Capital gains tax implications

A developer granting life rights over units in a retirement village to occupiers in exchange for the right to use loan capital granted interest-free by those occupiers to the developer for as long as they occupy the units, will not be subject to capital gains tax on these transactions.[8]

[8] See paragraphs 20(3)(*a*) and 35(3)(*a*) of the Eighth Schedule to the Act.

10. Conclusion

The *Brummeria* case is clearly not authority for the general conclusion that the value of the right to use an interest-free loan should in each and every case be included in the borrower's gross income. The value of a receipt or accrual in a form other than money would usually not have to be included in gross income if the receipt or accrual did not take place in exchange for goods supplied or services rendered. The reason for this is that such a receipt or accrual would probably be of a capital nature. However, each and every transaction will have to be evaluated on its own merits and against the background of its own facts and the intentions of the parties.

As a general rule all amounts received by or accrued to a taxpayer (in cash or otherwise) that are not of a capital nature and are capable of being valued, should be included in the taxpayer's gross income and are therefore subject to income tax. The principles from the judgment (see **4**) should, however, be applied with due regard to the specific facts and circumstances of each and every matter involving an accrual or receipt in a form other than money (including the right to retain and use an interest-free loan).

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

Date of first issue: 30 June 2010

Annexure

THE EXPECTATION OF LIFE AND THE PRESENT VALUE OF R1 PER ANNUM FOR LIFE CAPITALISED AT 12 PER CENT OVER THE EXPECTATION OF LIFE OF MALES AND FEMALES OF VARIOUS AGES

Age	Expectation of life		Present value of R1 per annum for life		Age
	Male	Female	Male	Female	
0	64,74	72,36	8,32791	8,33105	0
1	65,37	72,74	8,32828	8,33114	1
2	64,50	71,87	8,32776	8,33091	2
3	63,57	70,93	8,32714	8,33064	3
4	62,63	69,97	8,32644	8,33033	4
5	61,69	69,02	8,32567	8,32999	5
6	60,74	68,06	8,32480	8,32961	6
7	59,78	67,09	8,32381	8,32918	7
8	58,81	66,11	8,32271	8,32869	8
9	57,83	65,14	8,32146	8,32815	9
10	56,85	64,15	8,32007	8,32753	10
11	55,86	63,16	8,31849	8,32684	11
12	54,87	62,18	8,31673	8,32608	12
13	53,90	61,19	8,31480	8,32522	13
14	52,93	60,21	8,31265	8,32427	14
15	51,98	59,23	8,31029	8,32320	15
16	51,04	58,26	8,30770	8,32203	16
17	50,12	57,29	8,30489	8,32071	17
18	49,21	56,33	8,30180	8,31926	18
19	48,31	55,37	8,29841	8,31764	19
20	47,42	54,41	8,29471	8,31584	20
21	46,53	53,45	8,29061	8,31383	21
22	45,65	52,50	8,28613	8,31161	22
23	44,77	51,54	8,28117	8,30912	23
24	43,88	50,58	8,27564	8,30633	24
25	43,00	49,63	8,26959	8,30326	25
26	42,10	48,67	8,26274	8,29981	26
27	41,20	47,71	8,25516	8,29595	27
28	40,30	46,76	8,24677	8,29171	28
29	39,39	45,81	8,23737	8,28697	29
30	38,48	44,86	8,22694	8,28170	30
31	37,57	43,91	8,21538	8,27583	31
32	36,66	42,96	8,20257	8,26930	32
33	35,75	42,02	8,18836	8,26210	33
34	34,84	41,07	8,17262	8,25400	34
35	33,94	40,13	8,15536	8,24509	35
36	33,05	39,19	8,13647	8,23517	36
37	32,16	38,26	8,11558	8,22426	37
38	31,28	37,32	8,09274	8,21199	38
39	30,41	36,40	8,06781	8,19866	39
40	29,54	35,48	8,04030	8,18386	40
41	28,69	34,57	8,01067	8,16762	41
42	27,85	33,67	7,97844	8,14983	42
43	27,02	32,77	7,94344	8,13012	43
44	26,20	31,89	7,90547	8,10881	44
45	25,38	31,01	7,86380	8,08527	45
46	24,58	30,14	7,81924	8,05956	46

Age	Expectation of life		Present value of R1 per annum for life		Age
	Male	Female	Male	Female	
47	23,79	29,27	7,77109	8,03119	47
48	23,00	28,41	7,71843	8,00026	48
49	22,23	27,55	7,66236	7,96617	49
50	21,47	26,71	7,60201	7,92950	50
51	20,72	25,88	7,53713	7,88967	51
52	19,98	25,06	7,46748	7,84646	52
53	19,26	24,25	7,39387	7,79965	53
54	18,56	23,44	7,31631	7,74834	54
55	17,86	22,65	7,23234	7,69355	55
56	17,18	21,86	7,14414	7,63363	56
57	16,52	21,08	7,05178	7,56896	57
58	15,86	20,31	6,95225	7,49927	58
59	15,23	19,54	6,85004	7,42321	59
60	14,61	18,78	6,74206	7,34135	60
61	14,01	18,04	6,63010	7,25457	61
62	13,42	17,30	6,51232	7,16020	62
63	12,86	16,58	6,39301	7,06046	63
64	12,31	15,88	6,26822	6,95537	64
65	11,77	15,18	6,13789	6,84161	65
66	11,26	14,51	6,00726	6,72393	66
67	10,76	13,85	5,87165	6,59893	67
68	10,28	13,20	5,73403	6,46635	68
69	9,81	12,57	5,59182	6,32818	69
70	9,37	11,96	5,45165	6,18466	70
71	8,94	11,37	5,30775	6,03607	71
72	8,54	10,80	5,16744	5,88278	72
73	8,15	10,24	5,02437	5,72222	73
74	7,77	9,70	4,87876	5,55743	74
75	7,41	9,18	4,73490	5,38893	75
76	7,07	8,68	4,59354	5,21727	76
77	6,73	8,21	4,44663	5,04679	77
78	6,41	7,75	4,30309	4,87092	78
79	6,10	7,31	4,15898	4,69389	79
80	5,82	6,89	4,02440	4,51647	80
81	5,55	6,50	3,89051	4,34399	81
82	5,31	6,13	3,76802	4,17315	82
83	5,09	5,78	3,65276	4,00482	83
84	4,89	5,45	3,54546	3,83988	84
85	4,72	5,14	3,45232	3,67921	85
86	4,57	4,85	3,36864	3,52371	86
87	4,45	4,58	3,30066	3,37426	87
88	4,36	4,33	3,24907	3,23175	88
89	4,32	4,11	3,22597	3,10296	89
90	4,30	3,92	3,21438	2,98912	90