

'Received by' and 'accrued to'

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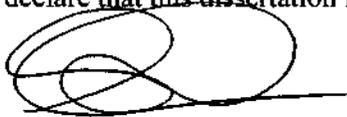
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DECLARATION

I hereby declare that this dissertation is entirely my own work.



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Abstract

Overall objective

The overall objective of this dissertation is to identify and analyse decisions in tax cases in which the concept of receipts and accruals has been applied over the years. As there is no definition in the Income Tax Act 58 of 1962 as amended (hereinafter referred to as 'the Act') as to the meaning of the terms 'received by' or 'accrued to', the other available option is to resort to case law as interpreted by the courts.

The research involves an analysis of reported cases, statutes and any research relevant to the topic with the hope of bringing a better understanding of the meaning of a receipt or an accrual, and to make appropriate recommendations. The dissertation includes the following chapters:

Aims of the topic

Introduction

The meaning of 'accrued to' the taxpayer

The meaning of 'received by' the taxpayer and beneficial receipt or accrual

Non-monetary receipts and accruals including barter transactions

Time of accrual and valuation of the accrued amount

Conclusion

Research question

The question to be answered by this dissertation will be an evaluation of the phrase 'received by' or 'accrued to' with emphasis on the valuation of non-monetary receipts for the purpose of the definition of 'gross income'.

Hypotheses

The point of departure is that case law has not yet resolved the issue around the meanings of 'received by' or 'accrued to' as is evident in the judgment from *People's Store's*. This perpetuates one of the great weaknesses of the South African law of income tax, namely, its almost total lack of 'analytical jurisprudence'. In *People's Stores* an important underlying question was whether the concept of 'accrual' relates to timing, or whether it concerns a quality distinctive of income. This case is analysed in detail in Chapter 2 of the dissertation.

Previous work

None

Methods used

- Research within and outside the Republic of South Africa. The research is done through the internet and with information from the library.
- Analysing various decisions made by South African courts.
- Analysis of the Income Tax Act and relevant Practice and Interpretation Notes.

Chapter Outline

Chapter 1

Introduction

(Income tax is levied on a taxpayer’s taxable income as defined in the Income Tax Act (the Act) for a particular year of assessment. First, before determining taxable income, a taxpayer’s gross income must be established. The definition of ‘gross income’ in the Act starts as follows:¹

‘ “gross income” in relation to any year or period of assessment means, in the case of any person, the total amount . . . received by or accrued to or in favour of such person during that year of assessment . . . excluding receipts and accruals of a capital nature . . . ’)

The terms ‘total amount’, ‘received by’ or ‘accrued to’ or ‘in favour of’ and ‘during that year of assessment’ mean that income tax is determined and levied on an annual basis excluding, except for special provisions, all activities preceding and following the current year of assessment.)

Further a ‘total amount’ that has been ‘received by’ or ‘accrued to’ means that the taxpayer must include not only the amounts received by him but also amounts that accrued to him during a year of assessment.

An amount will be included in gross income either when it accrues to or when it is received by the taxpayer without being taxed twice. It is an accepted general practice that the same amount cannot be taxed twice. When the accrual is disclosed in any tax return the practice of the Commissioner is to tax the accrual and not to wait for the subsequent receipt which could happen in a future year.

¹ Section 1 Income Tax Act 58 of 1962 as amended

The terms 'accrued to', 'received by' or 'in favour of' as they appear in the definition of 'gross income' are an indication that the definition applies to both of them.

It is submitted that, except for special provisions, if a person neither receives nor has anything accruing to him, there can be no amount to be included in his gross income. For example, notional income cannot be included in gross income because it is neither a receipt nor an accrual.

There are a few exceptions when the liability for tax arises even if there is neither a receipt nor an accrual:

- A gain arising on exercise, cession or release of a right to acquire shares can be subjected to taxation in certain circumstances under section 8A or section 8C even though the gain does not constitute a receipt or accrual.
- The value of trading stock applied by the trader for his private or domestic use may be included in his gross income. This is neither a receipt nor an accrual.
- A foreign exchange gain is also included in gross income in terms of section 24I of the Act.
- Fringe benefits enjoyed by employees are taxed under the Seventh Schedule, some of which are not receipts or accruals.

It has been stated that as a general rule, if there is neither a receipt nor an accrual there cannot be a liability to pay tax. But the Act does subject a person to tax on amounts that have been neither 'received by' or 'accrued to'. In addition, for example, section 7 of the Act, deals with deemed accruals. Its provisions were introduced to curb the distribution of wealth and to reduce tax liabilities of those taxpayers in high tax brackets.

An accrual can also arise when a creditor for whatever reason does not recover his money, for example, because he cannot be traced. In ITC 1634², a taxpayer transferred the amount standing on credit in a creditor's account to income when it became clear that no amount would be payable to that creditor. The unpaid amount can be treated as an accrual in the hands of the taxpayer and subjected to tax.³

² (1997) 60 SATC 235.

³ *Silke Silke on South African Income Tax Volume 1 2007* para 2.1.

Chapter 2

Meaning of 'accrued to'

After years of debates and deliberations about the meaning of the word 'accrual', that is, as to whether it meant 'entitled to', or 'due and payable' it was decided in *CIR v People's Stores (Walvis Bay) (Pty) Ltd*⁴ that an amount accrued to the taxpayer when he becomes (unconditionally) entitled to it, but that something must be deducted from the face value of an accrual that is receivable in a future year of assessment. There are a number of cases that are analysed so as to come to a common understanding of the meaning of the terms 'accrued to' and 'received by'.

The Appellate Division of the Supreme Court judgment in *Hersov's Estate v CIR* gave an instructive meaning to the word 'accrued' for the purposes of the definition of 'gross income'. The taxpayer was one of the managing directors of a company. An agreement was concluded between the taxpayer and the company that in the event of his death the company would pay 21, 2% of its surplus of assets (or in current terms its net asset value) as determined at the date of his death. Hersov died on 15 January 1949. A large sum of money was paid to his estate in terms of the agreement concluded before his death. The Commissioner in the determination of his taxable income from July 1948 to the date of his death included the amount in his gross income. The representative of the late taxpayer finally appealed to the Appellate Division. The nature of the amount was not an issue because it was established that the amount bore the character of remuneration and was therefore not of a capital nature. The court held that in terms of the agreement no amount could be paid until after the death of the taxpayer. The amount paid could not have been received by or accrued to the taxpayer for his final period of assessment. The amount could not be included in taxpayer's gross income. The accrual was in favour of his estate. The court viewed that the accrual took place two months after the death of the taxpayer. It is evident from this decision that Centlivre CJ, who delivered the judgment, having referred to the *Lategan* and *Delfos* cases, that accrual could take place only when the amount became due and payable.

⁴ 1990 (2) SA 353 (A), 52 SATC 9.

Another view was adopted in *Lategan v CIR*.⁵ The issue in this case, was in addition to the amount received by the taxpayer, what amount accrued to him during the year of assessment in question. The taxpayer was a wine farmer who sold the wine he had produced. In May 1920 the taxpayer sold wine to the value of £5 924. Of this amount £3 500 was received by the taxpayer before 30 June 1920 (the end of year of assessment).

The taxpayer belonged to a wine farmers’ co-operative formed to control and regulate the sale of wine by its members. The articles of the co-operative had a clause allowing for certain retention and contribution moneys to be deducted from moneys due and payable to, or receivable by, borrowing an accounting term, its members. The ‘retention’ moneys were used for operational expenses and the ‘contribution’ moneys were used partly for administration cost and partly for creation of reserves in which the taxpayer became entitled to receive shares.

The Commissioner included the whole amount of £5 924 in the taxpayer’s gross income not allowing a deduction for both ‘retention’ and ‘contribution’ moneys. The matter ultimately was brought before the Cape Town Provincial Division of the Supreme Court for a decision.

Watermeyer J, in his judgment said the following:⁶

‘In my opinion the words in the Act has accrued to or in favour of any person merely mean to which he has become entitled. So far as a debt is concerned which is payable in the future and that in the year of assessment, it might be difficult to hold that the cash amount of the debt has accrued to the taxpayer in the year of assessment. . . but he has acquired a right to claim payment of debt in future.

‘According to what has been stated above, the value of this right must in my opinion be included in the taxpayer’s gross income for taxation purposes. . . . but something must be deducted from their face value to allow for the fact that they were not payable at the close of year of the assessment.’

⁵ 1926 CPD 203, 2 SATC 16.

⁶ At 2 SATC 16.

This judgment was supported by an analysis made in the *Margo Report*⁷. It read as follows:
*CIR v Hersov*⁸ and *CIR v Delfos*⁹

‘... the test of entitlement is clearly appropriate as it determines when the assets exist in the business. ... where a taxpayer has become entitled to a right in terms of which amount is payable in a future year of assessment, due allowance should be made in the valuation thereof for the futurity of that right beyond twelve months.’

The result in the *Lategan* case was held to correctly reflect the law by the Commission of Enquiry into Fiscal and Monetary Policy in South Africa (the Margo Commission). It therefore recommended that no legislative resolution of the problem of the meaning of the word ‘accrued’ was necessary.

The meaning of ‘accrual’ was scrutinised in ITC 521¹⁰ where a taxpayer made a claim to the insurer for the loss of trading stock through fire. The insurer compensated for the lost trading stock. The proceeds were included in gross income and subjected to tax.

Years later it was discovered that there were additional amounts awarded by the insurer in terms of the policy to the taxpayer. These amounts were included in gross income and subjected to tax. The taxpayer objected on the grounds that these amounts were already included in gross income as accruals in the previous years of assessments.

⁷ *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (The Margo Commission Report), 1987.

⁸ At 18 SATC 20.

⁹ At 6 SATC 92.

¹⁰ (1942), 12 SATC 408.

The appeal was dismissed. It was held that there could be no accrual of the claim before it was notified to the insurer and duly approved. The assessment was then confirmed and amounts were subjected to tax in that year of receipt. This is interesting because it not only brings the issue of timing to the meaning of the word 'accrued', but also dealt with the 'due and payable' meaning as highlighted in *Lategan's* case. The amounts were payable in terms of the policy but were not 'due' because for that to happen, the payments had to be authorised. But before authorisation the taxpayer had to be notified. It is easy to understand the position of the taxpayer in this situation, because if the terms of the policy are that in the event of fire or other natural disaster the insurer will compensate the taxpayer, there would seem to be an accrual to the taxpayer.

It is understandable for the taxpayer to assume that when the event happened the accrual took place at that time, even before notifying and obtaining approval from the insurer. This shows that the legislature needs to revisit the meaning of the term 'accrued to', otherwise the courts are likely to be inundated with cases dealing with gross income on the issue of accrual. If there is no accrual the taxpayer will be able to argue that there is no amount to be included in gross income and therefore subjected to tax.

In *People's Stores*, the taxpayer, a subsidiary in the Edgars group of companies, was a retailer of clothing. The taxpayer was in the trade of selling goods on a 'six-month revolving credit scheme'. The customer under the scheme had to pay the taxpayer in six equal instalments. On the last day of the year of assessment in issue the instalments outstanding in the books of the taxpayer amounted to R341 281. This amount was payable in the following year of assessment. The Commissioner included this amount in the taxpayer's gross income in that year of assessment. The taxpayer objected to the assessment raised by the Commissioner on the grounds that the outstanding instalments were neither payable nor paid during that current year of assessment. In the alternative the taxpayer argued that if the Commissioner had to include the instalments outstanding, he should include only the present value of the amount, not its face value.

The critical issue in this case was whether the amount accrues to the taxpayer when it is 'due' that is when he becomes entitled to it, or when it is only due and payable. It was held that an amount accrues to the taxpayer in the year that he becomes entitled to it. There was controversy around the correctness of the ruling that the terms 'accrued to' or in 'favour of' merely envisage that the person concerned has become entitled to the amount in question.

The Appellate Division upheld the accrual principle. It confirmed that it meant entitlement and further confirmed the present value concept in terms of which an amount may be deducted because it is not immediately payable.

This resulted in an amendment to the definition of 'gross income' with effect from 23 May 1990 with a proviso being added. This proviso states that if the accrual is reflected at its present value in the current year the discounted factor would be deemed to accrue in the subsequent year.

But it then provides that any tax returns submitted after that date would be taxable at their face values and not discounted to net present values. This amendment to the definition of 'gross income' did not bring any clarity to the meaning of the term 'accrued to'. Instead it distorted even further the little harmony between the income tax system and commercial and economic reality. It equates in value for tax purposes the cash payment and an amount receivable in a near future. It does not make any economic and business sense.

For example, consider a taxpayer who sells fashion clothes on credit. The amount owing is due, but is payable only over a period of twelve months, as is common these days. Assume that this sale occurred on the last day of year of assessment. The taxpayer will be taxed on the full amount of the credit sale without taking into account the time value of money. This highlights the problem in the interpretation of the term 'accrued to' as used in the definition of 'gross income'.

The decision in *People's Stores* has been widely criticised for lacking a scientific approach to the law. The question that was supposed to be answered by this case was whether there is a relationship between an accrual and timing, or whether the accrual means the quality of a particular amount. In simple terms, does accrual mean that the taxpayer has a vested right of income, or does it mean that there is a potential for income in the future? Alternatively, does an accrual include both issues? No South African court has identified this problem and none have responded to it. If the latter view is adopted, then a potential amount that is due and payable in future will not be classified as an amount for inclusion in gross income until it qualifies to be an amount for inclusion in gross income.

The decision in *People’s Stores* was also criticised for adopting an abstract approach, in that it considered the quality of an item as ‘non-income’ or ‘income’ rather than focusing on the circumstances around a particular taxpayer.

The correctness of the judgment was also criticised in that the terms ‘accrued to’ and ‘in favour of’ merely mean that the person has become entitled to the amount in question.

In *Ochberg v CIR*¹¹ Watermeyer J, made it clear that before an amount can accrue, the taxpayer’s right to claim payment must be unconditional. If the right to claim future instalments is conditional or dependent upon performance by the taxpayer of certain obligations or fulfilment of certain terms, for example, the obligation to deliver property or render services, or the approval by a third party, there can be no accrual in terms of the Act. Accrual can take place only after the obligations have been complied with, or the conditions fulfilled. Until these events take place the taxpayer is not entitled to claim payment. The meaning of the term ‘accrued to’ was extended to unconditionally ‘entitled to’ in *Mooi v SIR*¹² where it was submitted this represented the correct meaning of ‘accrued to’.

*Silke*¹³ provides examples illustrating the *Lategan’s* principle of the meaning of ‘accrued to’. An assumption was made that in each situation the year of assessment ends on the last day of February. These examples are as follows:

- A merchant sells goods for R100 on 17 February. In terms of the contract of sale the goods are to be delivered on 15 March. The R100 will accrue only on 15 March when the delivery takes place because, until that event takes place, the taxpayer is not unconditionally ‘entitled to’ the amount. He will be ‘unconditionally entitled’ to the amount only upon delivery of the goods.
- A speculative builder of machines completes a machine on 1 February. The machine cost R3 000. On 28 February the market value of this machine is R4 000. It is sold and delivered on 10 March for R4 100. There is no accrual until 10 March, when the seller for the first time became entitled to the income. On 28 February, although the machine is already worth R4 000, there was no accrual since at that date the seller was not entitled to anything. An unrealised appreciation in value of trading stock is not taxable.

¹¹1933 CPD 256, 6 SATC 1.

¹²1972 (1) SA 675 (A), 34 SATC 1.

¹³ *Silke Silke on South African Income Tax Vol 1 2007* para 2.8.

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- A company declares a dividend on 10 February payable to shareholders registered in its share register on that date. Payment of the dividend is to be made on 15 May. The accrual will be the date of declaration when the shareholders become entitled to it.
 - A company declares a dividend on 10 February payable on 15 May. The date of accrual is the date of declaration, namely, 10 February, when the shareholder becomes entitled to it.
 - A company declares a dividend on 10 February payable to shareholders registered in the share register on 1 March. The dividend is actually paid on 15 March. Here the date of accrual is 1 March when a shareholder is required to be registered so as to participate in the dividend. It is only on 1 March that it may be said that a shareholder is entitled to the dividend.

As this example shows, this date is not necessarily the date of declaration, or the date of payment of the dividend. A dividend declared payable to shareholders registered at the date of declaration accrues on that date. The position with an interim dividend may be different if in law the interim dividend may be recalled by the directors of the company at any time before it is paid. On this basis the interim dividend will be included in gross income only when it is paid.

- In terms of the building contract, 10% of the contract price is to be retained as 'retention moneys' until a final certificate is issued by the engineer. This will occur after a period of six months after the completion date of the building. The building was completed on 28 January. The engineer's final certificate was issued, and the builder received the retention moneys, only on 31 August. Here the date of accrual of the retention moneys is the date of the engineer's final certificate, 31 August, because prior to that date the builder was not entitled to the retention moneys.

Another area of interest is securities that contain an element of interest or dividend in their purchase price. Some shares, debentures or government stock come with dividends and interest. To whom does the dividend or interest accrue?

If the interest or dividend has already accrued to the seller before the sale it will be included in the seller's gross income. If the interest or dividend accrues to the buyer after the sale, it will be included in the buyer's gross income.

When securities are bought and sold cum or ex dividend or cum or ex interest, the dividend or interest must be included in the gross income of the person to whom it accrues in terms of the Act. The anomaly about this is that it is not necessarily the person who is entitled to the benefit of the amount in terms of the contract. A situation may arise when a person is called upon to pay tax on an amount received by another person.

Once an amount has accrued to a taxpayer it is taxable in his hands even if he thereafter disposes of it. The opposite is true when the taxpayer disposes of an amount before it accrues to him. In this situation the amount will not be taxable in his hands. This is termed cession of income.

There are a number of cases dealing with the cession of income under the circumstances as mentioned in the previous paragraph. In *Hidding v CIR*¹⁴ the taxpayer divested himself of the right to the income before it accrued to him. The late Dr Hidding bequeathed to the taxpayer certain immovable property subject to the fideicommissum in favour of certain persons for three generations. In terms of the will, income from that immovable property accrued to the taxpayer for the period of his life. The property was then sold by an order of the court. The proceeds were transferred to the executor of the late Dr Hidding to hold and invest.

The net income was to be awarded to the taxpayer during his lifetime. On his death, the executor was to deal with the income and capital as directed by the will. In 1943 the taxpayer assigned to certain relatives a portion of his income from the trust.

The Commissioner included the moneys paid over to the relatives in the taxpayer's gross income as amounts accruing to the taxpayer. The taxpayer objected on the grounds that the amounts in question did not form part of his gross income because they did not accrue to him.

¹⁴1941 AD 111, 11 SATC 205.

The issue was whether the amount in question had accrued to the taxpayer who then disposed of it, or whether the taxpayer disposed of it before it accrued to him. The question could be answered only through the terms of the written contract. The Appellate Division held that the taxpayer disposed of the income before it accrued to him. Accordingly it did not form part of his gross income. It was held that the effects of the cession entered into by the taxpayer were to divest him of the right to receive income before it accrued to him.

The question whether the taxpayer has antecedently divested himself of income depends on the terms of a contract. For example, if the cession takes effect after the amount has accrued to the taxpayer it will continue to form part of his gross income. This is the question that was put to the court in *Rishworth v CIR*.¹⁵ The issue, in summary, was whether the rentals that the taxpayer's wife had ceded, continued to form part of her gross income, that is, did the cession take effect only after the rental had accrued to her?

The taxpayer's wife had executed a cession agreement, granting the cessionary the sum of £50 a month out of the rental due to her under a certain lease. This sum of money was to be paid directly to the cessionary. The Commissioner included this amount in the taxpayer's gross income.

Holmes JA came to the conclusion and stated that on the proper construction of the cession agreement, the cession took effect only after the rental had accrued to the taxpayer. In his judgment he said,¹⁶

'I come now to the consideration of the agreement of cession. The preamble indicates that Leslie H Chancellor should be entitled to a share of the rental payable in terms of the lease. What was agreed and done in the paragraph which I have lettered (b). . . was that the appellant's wife ceded to him. ' . . . the right to receive, out of the shares of the rental payable to her under the said lease, the sum of £50 per month.'

¹⁵1964 (4) SA 493 (A), 26 SATC 275.

¹⁶At 26 SATC 275.

In other words she ceded the right to claim the rental as and when they became due and payable to her, since if she had divested of herself in advance it could never become payable to her. This indicated a monthly accrual to her upon which the cession would operate. He then stated the following:¹⁷

‘ [I]n my view the foregoing aspects of the agreement of cession in this case, considered in their cumulative effect, lead to the conclusion that the rent accrued to the appellant’s wife each month, and in respect of such accrual the cession applied *pari passu*’.

The appeal was dismissed with costs. The decision in this case illustrates that a taxpayer can divest himself of the right to an amount, with the result that it thereafter accrues to someone else. In this case, however, the taxpayer failed to achieve an antecedent cession because the particular words used in the contract had the result that the cession took effect only after each month’s rental had accrued to the taxpayer. It is implicit in the judgment that a different form of words could have achieved the taxpayer’s objective.

In ITC 1415¹⁸ a minister of a particular religion regularly renounced, in writing, part of his salary to increase the funds of the church. It was held that he had no right to claim payment before his regular payday, and that he had always made his renunciations before that date. There was no accrual to him of the amount he had renounced.

The critical difference between the decisions of the above two cases was the construction of the contract. In the latter case the cession was effective before, and in the former case the cession was effective after, the accrual date. It is important when constructing an agreement of cession to word it properly because bad wording could be detrimental to a party ceding an amount to another person.

In *CIR v Witwatersrand Association of Racing Clubs*¹⁹ it was held that the proceeds of a race meeting accrued to the taxpayer as income, notwithstanding that it had been handed over to charities.

¹⁷ At 26 SATC 275.

¹⁸(1936) (48) SATC 179.

¹⁹1960 (3) SA 291 (A), 23 SATC 380.

The facts in *Witwatersrand Association of the Racing Clubs* differed remarkably from those that confronted the court in *C:SARS v Cape Consumers (Pty) Ltd.*²⁰ In the former case, the taxpayer organised a race meeting and paid over the profits to two designated charities. There was no prior entitlement that the two charities enjoyed to the money. Rather, the association decided that whatever profits accrued to it, it would pay them to charities. In contrast, in the latter case, the company was obliged by its articles of association to credit the amount earned to its Buyers’ Reserve Fund. In terms of the legal relationships between the company and its buyers, the moneys were not for its own benefit, but for the benefit of the buyers. Accordingly there was no prior receipt or accrual within the defined meaning as was the position in the *Witwatersrand Association of Racing Clubs* case.

For a cession to be effective from the income tax point of view it must operate in such a way that the cedent has no right to claim income in future. The court will examine the content of the contract and ascertain that the cedent has divested himself of the right to claim income when it accrues in the future. The divestment is effective whether it involves the cession of a right to receive payments in the future, or of the income generated by an asset that is controlled by the cedent. The cession need not necessarily be in writing, it could be an oral agreement, and it is as effective as a written agreement.

This was illustrated in ITC 265²¹ when the taxpayer had taken transfer of a property previously owned by his mother. There was a verbal agreement between the taxpayer and his mother that she should continue to receive the rentals derived from the property for the duration of her lifetime, should she not occupy the property herself. Notwithstanding that the agreement or servitude was not registered against the title of ownership held by the taxpayer. It was held on appeal that although unenforceable as against third parties, the verbal agreement had the effect of creating servitude in her favour. It was binding between the taxpayer and his mother and had to be accepted for tax purposes. The rentals were accordingly held to have accrued to the taxpayer’s mother and not to him.

The practice adopted by the Commissioner is that cession of income accompanied by a complete cession of all rights to the assets producing income is valid for income tax purposes provided that the cession is valid in law.

²⁰1994 (4) SA 1213 (C), 61 SATC 91.

²¹7 SATC 149.

When it is a right of income that is disposed of, the income accrues to the recipient of the right, and not to the person who disposed of the right (*Rishworth v SIR*).²²

In ITC 1405²³ a taxpayer who, as a means of providing additional security for an overdraft facility, arranged for the income due to him from a trust to be paid to the bank. He was found not to have ceded his right to the income and was therefore liable for tax on it. The taxpayer lost because his arrangement was a not a complete cession of all rights to the income. It was a payment arrangement as some sort of security. Also this amount was transferred to the trust only after it had accrued to the taxpayer.

For a cession to be effective from the income tax point of view, it must operate in a way that the cedent has no right to claim the future income (*CIR, Transkei, and another v Moodie and another*).²⁴ This is supported by the decision taken in ITC 1405. There are a number of cases dealing with cession of income. The common denominator in them is that there must be a complete transfer of rights to the income.

The agreement must also be valid in law for it to be valid from an income tax point of view. The last issue to be emphasised is that the agreement does not have to be in writing.²⁵

If the legislature adopted the same approach adopted by the accounting profession with regards to definition of the term, ‘accrued to’ the position could be less complicated. Accounting for receipts and accruals in the accounting environment is strictly in terms of principles contained in Generally Accepted Accounting Principles (GAAP). GAAP has a number of individual statements dealing with individual line items as disclosed in the balance sheet and income statement.

AC 111 is a revenue statement dealing with the accounting treatment of revenue. Revenue can be equated to gross income for income tax purposes even though the contents of the latter are not properly defined in the Act.

²²1964 (4) SA 493 (A), 26 SATC 275.

²³(1985) 48 SATC 46

²⁴1993 (2) SA 501 (TkAD), 55 SATC 164.

²⁵(1985) 48 SATC 46

Without going into details of this statement, it is important to highlight the salient features of the statement. These are as follows:

- Sale of goods or rendering of services.
- The use by others of enterprise assets yielding interest, royalties and dividends. Under AC 111 revenue is defined as the gross inflows of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in an increase in equity.
- The statement groups transactions into services rendered, sale of goods and income-yielding assets. These groups are accounted for differently in the books of account. (This is dealt with in detail under timing of accrual.) But it is important to highlight another critical feature of this statement. If it is not probable that income will be received, it will not be accounted for in the books of account. Unfortunately this is not the situation for normal tax.

In terms of AC111, income is earned only once it is probable that the economic benefit associated with the transaction will flow to the entity. It could be argued that it is probable is anything between 50% and 100%. But at least there is some guideline as to when income is earned for purposes of inclusion in the gross revenue of the taxpayer. The Act does not have a clear definition or other provision similar to the definition as per AC 111. But Appellate Division decisions have included entitlement, due and payable and unconditional entitlement to try to define the accrual of income. In essence it is about probability that there must be some certainty to receive income. Unfortunately the Act does not provide clarity with regard to the accrual of income.

The last issue to be dealt with in this chapter is the concept of contingent rights.

A contingent right in literal terms is a right that is dependent on the occurrence of certain future events. The vesting of this right is dependent upon the fulfilment of certain conditions and therefore it can never be a vested right.

A vested right is a right of ownership coupled with the right of enjoyment. The opposite holds for a conditional or a contingent right. Its enforceability is delayed until the happening of an uncertain future event. It is sometimes regarded as a chance or a possibility right.

In accounting terms this right is called a contingent asset. In terms of AC 130, a statement of GAAP, a contingent asset is not recognised in the books of account, or specifically in financial statements. The statement provides a definition and guidelines that are not far from certain judicial decisions on the treatment of a contingent right or asset. These are as follows:

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits (income for tax purposes) to the entity. An entity for tax purposes means any taxpayer, because the legislation taxes all persons who trade. It could be trading services for a salary or trading goods for income. An example is a claim that an enterprise is pursuing through a legal process, when the outcome is uncertain.

Contingent assets are not recognised in the financial statements since this may result in the recognition of income that may never be realised. But, when the realisation of income is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.

A contingent asset is disclosed if an inflow of economic benefits is probable. A contingent right, when comparing accounting principles to judicial decisions, cannot be a vested right. This principle was illustrated in *Mooi v SIR*.²⁶ The details of this case appear in Chapter 5, and it suffices to focus only on the judgment of the case for now. In arriving at his decision Ogilvie Thompson CJ said the following:²⁷

‘I am of the opinion that no accrual within the meaning of the definition of “gross income” occurred in July 1963. . . but that the relevant accrual occurred when the option became exercisable on 1 September 1966. The real benefit conferred upon appellant which was at all material times in the contemplation of all concerned, was the right to apply for shares at R1,25 a share and that right arose when, upon fulfilment of the condition of the option, the latter became exercisable.’

²⁶1972 (1) SA 675 (A), 34 SATC1 at 10.

²⁷ At 34 SATC 1at 10.

In summary the judgment of this case confirmed that a contingent right is not a vested right and cannot be regarded as an amount 'received by' or 'accrued to' for the definition of 'gross income' even though a contingent right has a money value at the time of acquisition of the right. But it is important to differentiate between a contingent right and a delayed right. A delayed or postponed right that does not depend upon the occurrence of an uncertain future event is not contingent but a vested right in the legal sense of the term. For example, an employer undertakes to pay an employee double his salary on 24 December 2004 without any conditions attached, as a gesture of goodwill. The employee's right is not conditional. It is therefore a vested right whose enjoyment is delayed or postponed to a date that is certain to arrive. In *Mooi v SIR*,²⁸ it was suggested if a *spes* has accrued to taxpayer, it must be valued to determine the amount for inclusion in gross income. If the right has no value, or it is impossible to value it, then there could not be an amount to be included in the gross income of the taxpayer.

In ITC 521²⁹ it was held that amounts payable under an insurance policy did not accrue to the taxpayer until the claim was submitted to the insurer and approved.

In the construction industry it is common that a certain percentage of the purchase price is withheld by the buyer of the property. These moneys are called retention moneys and are paid subject to the certificate of approval by an engineer. In *Building Contractors v COT*³⁰ it was held that the retention moneys did not accrue to the taxpayer until the certificate was issued by an engineer.

Another example is when a taxpayer is offered a discount on its liability if it pays within a specified period of time. The right to a discount is dependant upon him paying before a specified date and it is not a vested right.

Unfortunately these arguments cannot be supported by any provision of the Act but could be argued in the court of law. The definition of 'gross income' in its present form leaves much to be desired. It is unlikely to be amended in the near future to cater for the realities of the business environment.

²⁸1972 (1) SA 675 (A), 34 SATC 1.

²⁹ (1942) 12 SATC 408.

Chapter 3

Meaning of 'received by' the taxpayer and 'beneficial receipt'

The amount 'received by' the taxpayer for services to be rendered is included in his gross income in the year of assessment when that receipt occurs. This principle applies even if services are to be rendered over a period of more than one year of assessment. The taxpayer is not allowed to apportion this receipt over the years of assessments. It is not uncommon that an amount is received before it is accrued.

For example, a rental deposit received before the rental is due, an amount received in advance for a construction of a building, salary or fees paid in advance are included in gross income when they are received because they are revenue receipts not capital receipts.

Amounts of a revenue nature received in advance must not be confused with capital amounts, for example, loans that are repayable in future even though these moneys are set off against revenue income. For example, staff loans paid out of the salary of an employee and a loan to a builder paid out of his contract price.

Amounts received in advance may result in an overstatement of income for that particular year of assessment and do not reflect a true position of the profits in accounting terms, but the Act is not based on accounting principles and it taxes receipts and accruals when they occur whichever comes first. This is other anomaly created by the definition of 'gross income' as contained in the Act. It does not take into account the economic aspect of the transaction.

³⁰1941 SR 233, 12 SATC 182.

Deposits and receipts in advance are included in gross income unless they are trust moneys not held by the taxpayer for his own benefit.

There are a number of cases dealing with amounts received in advance that shed some light on the term 'received by' as used in the definition of 'gross income'.

In ITC 525³¹ the issue that was put before the court was whether the taxpayer by contract could determine in which years of assessment an amount was to be included in his gross income. This was dismissed by the court citing the fact that the Act states that income is included in gross income in the year of receipt or accrual whichever comes first. This principle could not be overridden by any contractual agreement.

A payment received by the taxpayer as a consideration for services to be rendered in future years is included in his gross income in the year of receipt. In ITC 702³² the critical issue was to determine whether the whole or only part of the consideration of £12 500 should be included in the taxpayer's gross income for the year of assessment in question.

The taxpayer company was a technical consultant and adviser. During the year of assessment in question the taxpayer was paid £12 500 in the form of 12 500 fully paid up shares with a nominal value of £1 each in a company to which the taxpayer had rendered services in that year of assessment. The taxpayer was to render similar services to the company in future years of assessment. Instead of receiving the amount in cash the taxpayer received the amount in shares.

The Commissioner included the full £12 500 and subjected it to tax. The taxpayer objected on the grounds that the two agreements in terms of which the shares were received should be read together, and if this were done, the amount received was to be regarded as a payment in advance for services to be rendered over a period of ten years.

The representative of the company went further saying that the whole amount was not to be included in gross income in the year of receipt, but it should have been apportioned and be included in proportions over the ten-year period. The Act does not allow an apportionment of

³¹(1942) 12 SATC 424.

³²(1950) 17 SATC 206.

included in proportions over the ten-year period. The Act does not allow an apportionment of amounts received or accrued, the Commissioner does not have the authority to do that since he is governed by the Act. There is not a practice note on apportionment or a known definitive case dealing with apportionment.

The taxpayer lost the appeal because the amount was not of a capital nature and it had been received by the taxpayer in that year of assessment. If an amount received by or accrued to a taxpayer is not of capital nature, except for the special inclusions provided for in paragraphs (a) to (n), it will be included in gross income in terms of its definition in section 1 of the Act.

The amount was included in gross income because it met the requirement of being ‘received by’ the taxpayer and the amount was not in question. The taxpayer’s argument was based on accounting principles. In accounting terms amounts received in advance for services to be rendered will be treated as a liability. If services have not been rendered the amount in question has not been earned, and if it has not been earned, it is not income but accounted for as a liability in terms of AC 130 Statement of GAAP. But the Act is not based on accounting principle.

More than being received, the amount must be ‘received by’ the taxpayer on his own behalf and for his own benefit. ITC 702 met all these criteria and accordingly it was included in gross income. This is illustrated in *Geldenhys v CIR*³² where a decision had to be taken on whether a sum of money was received or accrued to the taxpayer on the sale of a flock of sheep.

The taxpayer, a widow, was a farmer. She and her late husband were married in community of property and had made a joint will on their estate. On the death of either one of them, the surviving spouse would enjoy the fruits and income of the estate for his or her lifetime. The children would be the heirs of the joint estate. The taxpayer’s husband died, and in terms of the will she was to enjoy the benefits conferred on her for the rest of her life. One of the assets of the estate was the flock of sheep which at the death of her husband was valued at £1 451. Unfortunately due to a severe drought a number of sheep died. Thereafter the flock of sheep never reached its former level because of the drought. The farm was then considered to

³²(1950) 17 SATC 206.

³³1974 (3) SA 256, 14 SATC 419.

be overstocked. In 1943 the taxpayer gave up farming. Her children agreed that the flock of sheep should be sold. The taxpayer received £4 941.

The £3 490 included in the taxpayer’s gross income was the difference between the value when the taxpayer acquired the right to income (£1 451) and the amount realised when the flock of sheep was sold (£4 941).

The taxpayer appealed on the grounds that the flock of sheep did not belong to her but was the property of her children. The court upheld the appeal on the grounds that the taxpayer was a usufructuary of the flock of sheep and at the time of realisation she had no entitlement to the flock of sheep, the whole proceeds belonged to the heirs and did not form part of her gross income.

The increase in the value of the flock of sheep between the inception of the usufruct and the sale of the flock of sheep did not accrue to the usufructuary because the usufruct was for the flock sheep not its monetary value. Therefore the differential amount of £3 490 was subject to the usufruct and accrued to the heirs and not to the taxpayer as usufructuary. It was irrelevant that the amount was received by the taxpayer and that she gave the receipt in her own name and the proceeds were deposited in her own bank account. The usufruct continued to exist over the proceeds of the sale and she was dealing with those proceeds as in terms of the will. In law, the ownership of the proceeds vested and accrued to the heirs.

The issue of ‘received by’ for the benefit of the taxpayer was also dealt with in the Zimbabwean case *COT v G*.³⁴ The taxpayer was a government employee over a period of four years. He was in a position of responsibility and as part of his responsibilities he was entrusted with government funds for secret operations. He misused his position of trust to obtain from the government from time to time more money than was legitimately required. The excess moneys were misappropriated by the taxpayer for his own benefit. The money was either put in his bank account or used to buy goods for his private consumption.

The taxpayer over the period of four years stole a total amount of \$58 000. He was convicted and sentenced to imprisonment, a part of which was suspended on condition that the amount owed by the taxpayer was repaid in full. The money was repaid by the taxpayer in full.

³⁴1981 (4) SA 167 (ZA), 43 SATC 159.

The Commissioner included the moneys fraudulently received by the taxpayer in his gross income and it became assessable to tax. The Commissioner went further by imposing penalties in terms of section 35 of the Act.

The argument of the Commissioner was based on the fact that gross income as defined by section 8(1) of the Act meant every amount received by or accrued to or in favour of a taxpayer in a year of assessment, and that what the taxpayer stole he received in terms of that definition.

The taxpayer relied on the same definition of 'gross income'. He argued that the moneys he stole never became his, despite his intention to treat them as his own, and they were therefore never 'received by' him within the meaning of that term as used in the definition of 'gross income'.

Fieldsend CJ in his judgment said the following:³⁵

'I can see no warrant on the face of the statute for construing the word 'received' in s8 in any but its ordinary meaning. To extend it to cover a unilateral taking such as theft, which in any event confers no right upon the taker to the things taken, would be to give the word a meaning that could not be justified on any rational construction of the Act as whole. In short a thief takes, he does not receive, and that is what the taxpayer in this case did. . . . in my view the taxpayer in the appeal before us did not receive the money, he stole. This I think is a sufficient basis upon which to decide the appeal, but I would not be doing justice to the argument if I were to leave the matter there. It was common cause the word 'received' was not to be given its ordinary wide meaning and that it had to be limited at least to meaning 'received as part of the recipient's patrimony.'

³⁵1981 (4) At 43 SATC 159.

The learned judge went further and dealt with the issue of intention of both parties to the transaction. The intention of both parties, that is not only that of the taker, but also that of a giver, was important for the meaning of the term 'received by' as defined in the definition of 'gross income'. A practical example to illustrate the importance of the intention of both parties was that of a person who borrows a lawnmower from his neighbour with the genuine intention of returning it. He does not receive the lawnmower on his own behalf, nor does a person who fraudulently induces his neighbour to lend him his mower with the intention of keeping it himself. The person will not receive the mower in his own right, because his intention alone does not confer to him this right. The intention of the giver is important, before the item is 'received by' the person in his own right. He can receive the mower in his own right only if the giver intends that the other person receives it, not a unilateral taking.

This principle was applied to the present case. It was found that the government never intended that the moneys taken by the taxpayer should be used by him for private purposes. It was to be used for secret operations on its behalf. It was paid to him for a specific purpose and therefore the moneys received by the taxpayer were not received on his own behalf and for his benefit. The moneys were not to be included in gross income, and assessable to tax, because it did not fall within his gross income and should not have been taxed.

This decision, even though not a South African decision, highlights another anomaly in the definition of 'gross income' in general for most countries. This case was decided by Appellate Division of the High Court in Zimbabwe.

In *CIR v Genn & Co (Pty) Ltd*³⁶ it was held that borrowed moneys or loans were not received nor did they accrue to the taxpayer within the meaning of the definition of 'gross income'. The moment the person receives a loan he is obliged to repay it. It was further held that the physical control over money or money's worth did not constitute a receipt or an accrual.

For example, an attorney or accountant could receive money in trust on behalf of a client. The money received will not be included in the gross income of that attorney or accountant because he has received the money not on his own behalf and not for his benefit.

³⁶1955 (3) SA 293, 20 SATC 113.

On the issue of the loan, if it is issued with the understanding that it will not be paid in future then the real transaction will be looked at. Again if the loan is not in fact a loan, but is for services rendered, then it will be income in the hands of the recipient.

In the Australian case of *Scott v FCT*³⁷ the taxpayer was a solicitor who received a gift of £10 000 from a client by the name of Mrs Freestone. The taxpayer had previously acted for her with regards to her late husband's estate. Mrs Freestone had paid him separately and in full for all services rendered. The critical issue to be decided upon in this case was whether the gift or money given to the taxpayer was income.

Windeyer J suggested that for a receipt to be income depends upon its quality in the hands of the recipient. It does not depend upon whether the provider or giver was lawfully obliged to make that payment. He went further and stated that exceptional gifts that are not incidental to a man's calling or occupation cannot be income.

The issue of gratuitous gifts is a 'question of mixed law and fact'. In this regard he stated the following:

'An unsolicited gift does not, in my opinion, become part of the income of the recipient merely because generosity was inspired by goodwill and the goodwill can be traced to gratitude engendered by some services rendered.'³⁸

This case illustrates an important principle with regards to gifts. Payments or gifts made out of generosity or goodwill without any legal obligation can sometimes be described as income and in other times not. The word gift can have more than one meaning, in Roman-Dutch Law out of goodwill, sheer liberality or out disinterested kindness on the part of the donor was called a *donatio propria* or a *donatio mera*. This type of gift would never be categorised as 'income' in the hands of the recipient. On the other hand, gifts that are regularly received and incidental to a particular employment would be income in the hands of the recipient.

A common example of the latter scenario is a tip to waiter in a restaurant after a meal has been served. A tip to a bell boy in a hotel for carrying luggage for hotel guests is another example.

³⁷(1966) 117 CLR 514 (High Court of Australia).

³⁸At 20 SATC 113.

It is submitted that although this case was decided in Australia, its principle holds true in South African tax law. Whether a particular receipt is income does not depend upon whether it was payment that the payer was legally obliged to make. This principle was unfortunately misinterpreted and used to arrive at the wrong decision in *CIR v Lunnon*.³⁹

Without going into the details of this case, it is important to state that the critical issue of the case was whether the gratuity paid to the taxpayer formed part of his gross income. It was held in the negative. The payment of the money was not the *solutio* of an obligation. The amount was then held to be a gift and therefore of a capital nature. The taxpayer in this case was a director, who had resigned six months earlier and the payment was for services rendered by him as a board member.

The decision in *Lunnon* led to the amendment in the definition of 'gross income' to include paragraph (c). It includes in gross income:

'any amount including any voluntary awards received or accrued in respect of services rendered or to be rendered or any amount (other than amounts referred to in section 8(1) received or accrued in respect of or by virtue of any employment or the holding of any office . . .'⁴⁰

In *Scott* the court decided that the fact that the taxpayer had in the past rendered services was not enough to conclude that the payment or gift was income in the hands of the taxpayer.

But the court agreed that the gratitude which inspired the gift was engendered by rendering of those services. This principle will hold true in South Africa, both at common law, and in terms of paragraph (c) of the definition of 'gross income'.

Applying paragraph (c) of the definition of 'gross income', it can be said that a birthday present, a casual present, or a Christmas gift from an employer to an employee is income in the hands of the recipient, because it is closely related to employment or because there is a causal link between the amount received and services rendered.

³⁹1942 AD 94, 1 SATC 7.

⁴⁰(1942) 1 SATC 7.

If a taxpayer receives an amount on his own behalf and for his own benefit in pursuance of a void transaction the amount is nevertheless 'received' within the literal meaning of the word. The legality of the transaction does not have an effect on the amounts received for inclusion in gross income. In fact the definition of 'gross income' is silent on the issue of the legality of transactions.

In ITC 1624⁴¹ a business involved in customs clearing and freight forwarding fraudulently claimed wharfage fees disbursed by it in excess of the actual expenditure. It therefore recovered more than it incurred.

It was held that where a taxpayer receives money in the course of carrying on of its trade through fraudulent claims or negligent misrepresentation to customers, it receives the money and has intended to receive it as part of the business income. The amount was included in gross income and subjected to taxation.

Again an illegal or fraudulent transaction does not change the nature of the receipt from income to capital. The amount is received and because it is received within the literal meaning of the word, it will be taxable.

The Income Tax Practice Manual provides the following guidelines:⁴²

- Advances received against the value of livestock, produce or other merchandise delivered to agents or co-operative societies for disposal or shipment are not income for tax purposes. Income in these situations accrues only when goods so delivered have actually been realised for and on account of the deliverer.
- If a taxpayer takes credit in his accounts for advances, there is no objection to their treatment as taxable income, but this action may not be taken without the consent of the taxpayer.
- An advance payment in view of a termination of a contract of service is an accrual on the date of its receipt.

⁴¹(1996) 59 SATC 373.

⁴²*Income Tax Practice Manual (2004) Issue14 page A-29*

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- In terms of section 8(1) (a) any allowance or advance paid by an employer to a director, employee or another person for the travelling expenses, or another service must, to the extent that it cannot be proved to have been actually expended by the recipient on travelling, be included in the recipient's taxable income. In addition with effect from 1 August 2002 these unexpended amounts are subject to PAYE.
 - Payments received for services to be rendered are gross income as defined in section 1, provided that the amounts have been received during the year of assessment and are not of a capital nature.

Thus a conclusion was arrived at by the Special Court in ITC 675⁴³ where the appellant company's business of poultry farming included the supply of day-old chicks to customers in terms of a contract embodied in a printed form. The contract provided for payment of the purchase price in advance. It was refundable if the company failed to deliver all, or part, of the order. The delivery date and the condition of goods on arrival were not guaranteed. Orders were not subject to cancellation by customers. The amounts received in advance were accounted for as liabilities in the books of account. These amounts were treated as deposits received for containers and against poultry to be supplied. Commissioner included these amounts received in advance in the gross income of the company, and subjected them to tax.

The matter was referred to the Special Court on appeal. The Special Court dismissed the appeal rejecting the argument advanced by the representative of the taxpayer that amounts received in advance represented trust moneys. It decided on the facts that the customers were just merely concurrent creditors. The case was therefore not one of income subject to a trust. It was accordingly held that, in terms of section 1 the amounts were properly included in the gross income of the company for the years when the deposits were received.

In conclusion the President said the following:⁴⁴

'There can be little doubt that, viewing the matter from the aspects of a correct computation of the profits made by the taxpayer, the conclusion arrived at must be regarded as repugnant to correct accounting principle. But as we observed by Davis, AJA, in *Pyott's* case (13 (A), SATC 126) that whilst there is no doubt it is in accordance with those principles to make this provision in the Balance Sheet, the answer is that an Income Tax Act has laid down what is to be taxed even if doing so it may be said to disregard those principles.'

⁴³(1949)16 SATC 238.

⁴⁴At 16 SATC 238.

In ITC 707⁴⁵ an undertaker who carried on a funeral insurance business conducted in addition to his normal business a prepaid funeral scheme for persons not accepted in the insurance fund.

The scheme, subject to certain condition resulted in the undertaker receiving payments in advance for funeral services to be rendered in future. These amounts were included in the gross income of the taxpayer and subjected to tax. The taxpayer appealed to the Special Court. It dismissed the appeal and held that the amounts received for future services constituted the ordinary revenue or income of the business.

The court went further and stated that the moneys so received were not put in a trust fund and that the taxpayer had at all material times dealt with the these moneys in the ordinary course of his business as his own property.

The last two mentioned cases illustrate the importance of separating moneys received for services to be rendered in future. If these amounts were deposited in a separate bank account, not as part of the taxpayers' funds the decisions arrived at by the Special Court could have been favourable to both taxpayers. Some tax planning on the side of the taxpayers may have saved them some tax.

In pure accounting terms these taxpayers were not entitled to these amounts until the rendering of the services. Unfortunately as mentioned by the President of the Special Court in one of the quoted cases that the Act is not based on accounting principles. Moneys received will be taxed in terms of the Act even if it violates those accounting principles. The definition of 'gross income' would be simplified if it adopted accounting principles that define terms and concepts with clarity. A good example is AC 112, a statement dealing with changes in foreign exchange rates. The corresponding provision in the Act is section 24I.

⁴⁵(1950) 17 SATC 224.

Without going into details in comparing the two, any foreign exchange movement is treated in exactly the same way. If the exchange movement results in a gain the amount is treated as income in terms of AC 112 and section 24I of the Act. The opposite is true when an exchange loss is suffered.

It will be a deductible expense in terms of the Act and treated as an expense in the books of accounts in terms of AC 112. Even the calculation of these exchange movements are performed in the same way.

Section 24J, a specific provision of the Act dealing with interest, is another provision that follows an accounting principle. Under this provision interest accrues or is incurred on a daily basis.

So far this chapter has dealt mainly with the meaning of 'received by'. But something more is required for an amount received to be included in gross income. An amount is not 'received by' a taxpayer nor does an amount 'accrues to' him unless it is received by the taxpayer on his own behalf and for his benefit. This beneficial receipt or accrual has been covered, but not in detail, in the previous paragraphs.

This principle was illustrated in *Geldenhuis v CIR*. When a person receives an amount as a usufructuary that amount does not form part of his gross income but is included in the gross income of the holder of the bare dominium.

Another example is moneys received by a parent as a guardian of a child. This amount is not included in the gross income of the parent, but included in the gross income of the child.

An amount received by the taxpayer as a refundable deposit for a sale on revenue account is included in his gross income unless he holds it as a trustee. This was a principle that was adopted in *Pyott Ltd v CIR*.⁴⁶ The critical issue in this case was whether the deposits paid on the tins accrued to the taxpayer on its behalf and for its benefit.

⁴⁶1945 AD 128, 13 SATC 121.

The taxpayer was in the business of manufacturing biscuits. In addition to biscuits the taxpayer had a factory that manufactured the tins in which the biscuits were sold. The tins were sold together with the biscuits. A sale was raised in one invoice. The tins were sold to customers at cost plus a marginal mark up.

The price of tins was refundable to customers if they returned the tins to the taxpayer in good condition. In the year of assessment ending June 1941 the taxpayer set aside £9 000 as a provision for refunds payable to customers who returned the tins in good condition.

This amount was not included in the income of the taxpayer but was shown as a liability in its books. The Commissioner refused to allow this treatment of the moneys received as refundable deposits. The matter was ultimately referred to the Appellate Division for a decision.

The fact that the taxpayer was contractually obliged to accept the tins and refund the customers if the tins were in good condition was not contested.

Davis AJA held that the deposits were not trust moneys. If they had been, they would not have been included in the accounts of the taxpayer. These moneys were not capital and therefore must be income for there is no halfway house between the two categories. In his judgment he stated that he understood that in terms of the relevant accounting principle, the taxpayer had to provide in its balance sheet for amounts refundable to customers should they return the tins. But he further emphasised that the Act is not based on accounting principles. The moneys remained income. They were beneficially received by the taxpayer even though he did not disclose them as income in his books.

The same principle was adopted in *Brookes Lemos Ltd v CIR*.⁴⁷ The taxpayer was in the same position when it received a deposit that was refundable subject to the return of bottles to the taxpayer. The issue to be decided by the court was whether the moneys received formed part of the taxpayers' gross income. It was held that the taxpayer did not hold the deposits as a trustee or pledge.

This case extended the principle adopted in *Pyott Ltd v CIR*. It was held that when the taxpayer receives a deposit, the amount is received on his own behalf and for his benefit unless he is a trustee in the strict legal sense of the word, in relation to the amount he has received. It is not enough that the money is set aside or it is not treated as income by the taxpayer. The test is not how the amount is treated, or how as a matter of business, or good accounting practice, it ought to be treated, but whether as a matter of law the amount was held in trust. The taxpayer had to create a trust account in which the amounts would be deposited and held until refunded to customers as and when the need arose.

The taxpayer would then be a trustee, not a recipient, and these amounts would not be accounted for in the taxpayer's books of account.

The issue of deposits received in advance was visited years later in *Greases (SA) Ltd v CIR*.⁴⁸ The same question was asked. Did the deposit form part of the taxpayer's income? It was held in the affirmative, because the facts of this case were no different from the facts in the *Brookes Lemos* case.

In summary, the taxpayer was in the business of selling grease in drums. Because of a limitation of drums the taxpayer took a decision not to supply drums to its customers. The customers were required to pay a deposit of £1 a drum. It was later increased to £2 a drum. The taxpayer argued that the refundable deposit was not part of the purchase price of the drum but was some form of assurance that the drums would be returned. The deposits were not treated as sales in the accounting records of the company. They were credited to a Drums Suspense Account. It was debited every time a refund was paid to a customer.

The deposits were included in the taxpayer's business account. They were used in the ordinary course of its business. These moneys received in advance were not deposited in a separate trust account.

⁴⁷1947 (2) SA 976 (A), 14 SATC 295.

⁴⁸1951 (3) SA 518 (A), 17 SATC 358.

The Commissioner included the amounts received in advance in the taxpayer’s gross income for all the years of assessment affected, but allowed as a deduction the cost of drums held by the customers at the end of each year of assessment. The taxpayer objected. The matter was ultimately referred to the court for a decision.

In arriving at his conclusion Centlivres CJ said,⁴⁹

‘... [t]he dominating fact in the present case is that the appellant, although it opened a Drums Suspense Account, received the deposits for its own benefit, in that it was entitled to use these deposits in its business and the moneys were not deposited to any trust account. . . . the deposits became and were intended both by the appellant and its customers to become the absolute property of the appellant and it could use them as it pleased; and the fact that it had undertaken to pay such of their customers as returned drums an amount equivalent to the amount which they had paid as deposits in respect of those drums did not constitute the appellant a trustee with regard to those deposits’.

Mr Ettling who appeared on behalf of the taxpayer relied on *Morley v Tattersall*.⁵⁰ He argued that the fact that the moneys were not paid into a trust account does not alter the fact that they were held ‘in trust’ for customers. He drew the attention of the courts to a comment made by Atkinson J. He then said.⁵¹

‘as a matter of law, these moneys when received by (by Tattersall) were not the taxpayer’s moneys at all; they belonged to their clients and if a client came in the next day and demanded his money they would have to pay it away.’

Responding to Mr Ettling, Centlivres CJ went further and said:

‘... [that] is not the position in the present case: here there was no obligation on the part of the appellant to pay a customer a sum equivalent to the deposit he had made when the customer tendered to it a usable drum. . . . I can see no essential difference between the case of *Brookes Lemos* and the present case and in my opinion the appeal must be dismissed with costs.’

The decision of this case confirmed the principle upheld in *Brookes Lemos* that for an amount to be excluded from a taxpayer’s ‘gross income’ it must be received and held ‘in trust in the *stricto sensu* of the word.

⁴⁹At 17 SATC 358.

⁵⁰108 LJ KB 11.

⁵¹At 17 SATC 358.

The critical issue is not how the money is accounted for in terms of accounting principles as it appears in the accounting records of the taxpayer. But if the taxpayer was entitled in terms of the law to deal with it as he pleased.

The only transaction that would have saved the taxpayer was nothing less than a trust in the legal sense of the word or a pledge that could convince the court that the moneys received did not form part of the taxpayer's 'gross income'.

There are also foreign cases dealing with an amount 'received by' or on behalf of the taxpayer and for his benefit. In *Jay's Jewellers Ltd v IRC*,⁵² the critical question was whether the surplus 'receipts' of the pawn broker's trade were profits assessable to tax. In summary it was held that the surpluses were trade receipts, not in the year when they arose, but in the year when they became the property of the taxpayer. This decision illustrates that the English income tax system attaches more weight to the proper accounting treatment of an amount received in advance. The opposite is true for the South African income tax system. That is why it was not important to delve into further details of this case because it would be less persuasive in South African courts. But none the less it is useful to compare different types of income tax systems. In South Africa the critical issue would be as follows:

- When did the proceeds or surpluses become beneficially received by the taxpayer?
- Did the change in the capacity in which the surpluses were held constitute a 'receipt' or an 'accrual' to him?

But using the judgments from the *Brookes* and *Greases* cases where it was held that the moneys received by the taxpayer will not be included in its 'gross income' provided it acted as a trustee and created a trust in *stricto sensu* or was not legally entitled to the moneys received, the taxpayer in *Jay's Jewellers Ltd* would not be taxed on moneys received until they became its property.

In ITC 1346⁵³ a controversial issue was raised that has not yet been resolved by the current income tax system. In fact it is one of many flaws of the South African income tax system. Unfortunately it affects a taxpayer more than it does the South African Revenue Service.

⁵²[1947] 2 All ER 762, 29 TC 274.

⁵³(1981) 44 SATC 31.

An advance salary paid to an employee is included in his gross income in the year of receipt in terms of the definition of 'gross income' even if the amount may be repayable by him in future. The taxpayer was a pathologist who took sabbatical leave to do research for the period 1 February 1977 to 31 January 1978. During this period he resigned from his post. In terms of his employment contract, the moneys received by him during this period in these circumstances had to be refunded. He was obliged to refund R6 930, being the six-month salary he had received while on leave.

The critical issue in this case was to determine whether the remuneration that the taxpayer was obliged to refund to his employer had been 'received by' him and therefore formed part of his gross income. The representative of the taxpayer argued that in these circumstances the amount did not form part of his gross income because it was neither 'received by' nor 'accrued to' him. It was held that the amounts received as an advance salary were 'received by' the taxpayer on his behalf and for his benefit to do with it as he pleased.

Schock J, in arriving at his decision said,⁵⁴

'... [i]n my judgment the appeal cannot succeed. During the year in question the taxpayer received the amount in question as his own and presumably used same for his own purpose. . . . The fact is that in the tax year in question he received the amount in question and retained it as his own. . . . the fact that in terms of the contract he may in certain circumstances, have to repay the same later, does not have the effect of excluding these amounts from his "gross income" for the year in which he received the same.

'The results may seem anomalous but the position would be equally anomalous if the taxpayer was not liable for tax on the salary in the tax year in question. . . .

'I see no escape from the conclusion that on the facts of this case the amount in question falls clearly within the taxpayer's "gross income" in the tax year in question.'

On the facts the amount received by the taxpayer was 'beneficially received' by him and therefore formed part of his gross income. But if the amount had been lent to the taxpayer it would not have formed part of his gross income. The issue whether the taxpayer would be allowed a deduction was raised in the judgment, but was not answered.

⁵⁴At 44 SATC 31.

In fact there is no provision in the Act that could allow the deduction of this expenditure. The anomaly is that the amount is included in the taxpayer's gross income in the year of receipt but when it is refunded back to the employer, it cannot be deductible under any provision of the Act.

Chapter 4

Timing and valuation of receipts or accrual

*Silke*⁵⁵ is of the view that proper time of accrual of a non - cash item for example, assets, payments in kind, goods exchanged for other goods and foreign exchange is the time of accrual. This view was supported by the decisions in *Mooi*⁵⁶ and *Lace Proprietary Mines*.⁵⁷

*Meyerowitz*⁵⁸ provides a list of examples of the time of accrual. These are as follows:

- Credit sales – there is an accrual when in terms of the contract the seller becomes entitled to payment, when the payment is to be made.
- Cash sales – under a contract of a sale requiring cash against delivery, the Act deems the accrual to have taken place on the date of the agreement.
- Hire purchase – when hire purchase contracts are entered into, the Act deems the accrual to take place on the date of the agreement.
- Rental – when the lease is for a fixed period and cannot be determined before the conclusion of the period, the rental for the full period accrues in the year the lease is entered into. Because the lessor has performed his obligation to the lessee by giving him possession, the lessor's entitlement to the rental is unconditional. In practice, in a year of assessment, the rental is taxed only to the extent that it became due and payable, in that year, or in the ratio that the period of the lease concluded during the year bears to the total period of the lease. This practice is justifiable if it is accepted that the rental accrues on a day- to- day basis.
- Dividends – a dividend accrues on the date of its declaration, or when the dividend is declared payable to shareholders registered on a particular date, then on that particular date.
- Partnerships and joint ventures – the receipts and accruals of a joint venture or a partnership accrue to the individual partners at the same time as they accrue to the partnership.

⁵⁵*Silke Silke on South African Tax Vol 1 2007* para 217.

⁵⁶1972 (1) SA 675 (A), 34 SATC 1.

⁵⁷1938 AD 267, 9 SATC 349.

⁵⁸David Meyerowitz, S.C. *Meyerowitz on Income Tax 2003-2004* para 6.19 to para 6.37

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- Commissions – if the commission is paid at the conclusion of the contract, then the date of conclusion will be the accrual date. If the commission is paid after the delivery of goods ordered or upon payment by the debtor, the date of accrual will be the date of delivery or payment.
 - Option contracts – premiums accruing for an option contract are deemed to accrue on a day- to-day basis during the term of the contract. When, however, the option contract is exercised, terminated or disposed of, the unaccrued balance is deemed to have accrued on the date of its exercise, termination or disposal.
 - Unpaid accruals – once there has been an accrual the fact that the debtor is not in a position to pay or has not paid the debt does not affect the position as far as gross income is concerned. If the debt is doubtful or bad there is a provision for doubtful debts or bad debts written off.
 - Sale of a business with retrospective effect – if the business is sold with retrospective effect, for example, a contract of sale is entered into on 30 September, the purchaser to have the benefit of profits or assume the losses as from 1 July, while between the parties the contract is valid and effect must be given to it, the incidence of tax cannot be altered. All amounts accrued for the business up to the date of the contract of sale accrued to the vendor, and he (and not the purchaser), is liable for tax on them and is entitled to claim the resulting permissible deductions.
 - Sale of a business subject to a suspensive sale condition – if a business is sold subject to a precedent condition or a suspensive condition, for example, when a business is sold subject to the sale only becoming effective when transfer of licence has been effected, the taxing of the profits or loss in the interim period depends upon the terms of the contract. If the purchaser is put in possession of the business and the profits or losses are for his account, unless and until the condition is fulfilled, then the accruals are those of the vendor, even though in terms of the agreement the purchaser becomes entitled to the profits on fulfilment of the condition.

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- Sale of a business subject to a resolutive condition for a example, – if a business is sold subject to a resolutive condition, for example, if payment of the purchase price is not made on due date then the sale will be cancelled, in this instance the sale is effective from the date the contract came into effect and the date of cancellation, if it is cancelled, will be, it is considered, those of the purchaser and not the vendor, even though as a result of the cancellation the purchaser must account for the receipts and accruals to the vendor. This is so because the purchaser cannot be regarded as a trustee or fiduciary for the receipts or accruals. The receipts and accruals are his absolute property. The fact that he may be obliged to account for them to the vendor upon the happening of a resolutive condition does not impress them with a trust.
 - Contract for the benefit of a third party – when there is a contract between two parties disposing of an asset or a business for the benefit of a third party (*a stipulatio alteri*) the tax position will be governed by the terms of the contract. If, for example, A contracts with B that the latter (B) sells his business to C, upon the condition that the sale becomes effective only when C accepts the benefits of the contract, the receipts and accruals, until C accepts, will be those of B. If, on the other hand, the sale is immediately effective, A being personally liable should C not accept, then the receipts and accruals are in the interim, it is considered, income subject to a trust, the taxation of which is governed by section 25B.

In terms of the definition of 'gross income', only amounts 'received by' or 'accrued to' the taxpayer during a particular year of assessment are subject to tax in that year. Years of assessment are not linked to one another but each stands on its own. This is critical because tax rates and rebates change every year. So it is important that a receipt or accrual is taxed in the correct year of assessment. If amounts accrued and are received in a year of assessment it does not cause a problem. But a problem arises when there is an accrual that is not received before the end of the year of assessment. It is common cause that the gross income includes both 'receipts' and 'accruals' and that accruals are dealt with in terms of the accrual rule.

The accrual rule provides that an amount to which a taxpayer is entitled, but that is payable only after the end of the year of assessment, accrues during the year of assessment when he became entitled to it, not the year of assessment when it is received. It therefore ends the long-standing debate about the meaning of the word 'accrued'. In terms of this rule accrual is about 'entitlement' not 'due and payable'.

The accrual rule is not only about timing but also deals with the amount of the accrual. Its objective is to include the full value of the accrual not payable at the last day of the year of assessment. In terms of the proviso to the definition of 'gross income',⁵⁹ the rule has done away with the discounting of the accrual outstanding at the last day of the year of assessment. Taxpayers were allowed to include discounted values and submit their returns of income on this discounted basis on or before 23 May 1990.

If the taxpayer after this date included in his gross income a discounted amount that was payable after last day of the year of assessment, and when in subsequent years the taxpayer finally received an amount, the untaxed difference or the discount of the accrual would be deemed to have accrued to the him during that subsequent year of assessment. The untaxed or discounted portion of the accrual is the difference between the original accrual to the taxpayer and the present value (or the discounted amount) that was included in his gross income in the year of accrual.

The accrual principle has some shortfalls that have been highlighted in a number of judicial decisions. The accrual principle is contained in a proviso to the definition of 'gross income'. It reads as follows:

'Provided that where during any year of assessment the taxpayer has become entitled to any amount which is payable on a date or dates falling after the last day of such year, there shall be deemed to have accrued to him during such year. . . such amount.'

The above proviso deals with the taxpayer's entitlement at the end of year of assessment to an amount payable after year end. It uses the Lategan principle. It states that to become entitled to an amount means 'to become entitled to claim payment' of that amount. An amount will always include both money and moneys' worth, but the proviso makes no reference to amounts expressed in money.

Silke⁶⁰, suggests that the proviso refers to two different 'amounts', one of these amounts in specific terms and the other by implications.

⁵⁹ Section 1 of the Income Tax Act 58 of 1962 as amended.

⁶⁰ Silke *Silke on South African Income Tax Vol1 2007* para 2.6.

The first is the 'amount' to which the taxpayer is entitled at the end of year of assessment. This amount cannot be valued otherwise the proviso will appear to be going against the *Lategan* principle. Since the proviso endorses or authorises the *Lategan* principle it means all outstanding amounts payable after the last day of year of assessment are valued at the end of year of assessment. This means that a settlement discount should be taken into account and that all amounts payable in the future must be discounted to their present values.

It is assumed that the second amount is the 'amount' payable at the future date that is not specifically referred to.

If this amount is expressed in money and is required to be valued at the date of payment, the value that will be included in gross income will be the face value of the 'amount' being the invoiced value. This interpretation would achieve the objective of the proviso in a normal income tax system. If the amount is moneys' worth, which is not uncommon, it means that the taxpayer must discount forward because he cannot discount backward to find a future value of the 'amount' to be included in gross income.

*Silke*⁶¹ suggests that the error of logic made in the proviso is that it assumes that the alternative outcomes (presented as paragraphs (a) and (b)), being mutually exclusive actually constitute the full range of possible outcomes. It is further suggested that the legal meaning of the word 'amount' has been overlooked and this is the error of law.

The proviso appears to allow recognition of outstanding settlement discounts when valuing outstanding accruals at the last day of the year of assessment. Even if the opposite was true it could be argued that an 'entitlement to claim payment' means an amount for which one can sue. If a supplier offers a settlement discount to a buyer at the last day of year of assessment, he can claim the full settlement of the full selling price. The agreement between the buyer and the seller is that on that day if the seller could claim his payment, it would be reduced by the settlement discount.

⁶¹*Silke Silke on South African Income Tax Vol1 2007 para2.7.*

The Act also lays down methods for the determination of the date of accrual in other circumstances. These have been covered in the preceding paragraphs. Other provisions of the Act dealing with date of accrual are

- section 8A,
- section 24I,
- The Fourth Schedule, and
- The Seventh Schedule.

A number of cases have dealt with the timing of accrual. In ITC 1488⁶² a taxpayer had resigned from both his employment and as a member of the pension fund. The critical issue in this case was the date of accrual of his resignation benefit from the pension fund. The fund provided for resignation benefits and other benefits. The fund used its discretionary powers to increase the benefits to the member.

The taxpayer was awarded his resignation benefits from the fund. Because he was dissatisfied with those benefits he turned them down and applied for larger benefits. He did not succeed in his attempt. He ended up with his original benefits and interest. But he succeeded in his claim that the date of accrual of his benefits was not the date of their accrual but the date when his application in terms of the discretionary rule was decided.

In ITC 1557⁶³ it was held that subsidies paid to bus operators by the Department of Transport on the basis of audited claims, accrue only when the claims were approved and paid by the Department, not when the ticket is sold.

⁶²(1990) 53 SATC 56.

⁶³(1992) 55 SATC 218.

In *South African Marine Corporation Ltd v CIR*⁶⁴ it was suggested that when an amount accrues to a taxpayer it must be valued on the date of the accrual. The taxpayer was a South African company carrying on the business of a ship-owner and operator. It operated cargo services between the South Africa and America. The taxpayer entered into a joint venture with an American company. On 18 September 1949 the South African currency, the pound, was devalued relative to the dollar.

The taxpayer had an amount payable to it of \$662 300 held by the American company on its behalf. The taxpayer recorded in its books all items adding up to this amount at the exchange rate that prevailed on the transaction date. When part of these moneys were paid over to the taxpayer, it received £60 920 more than the credit recorded in its books. The taxpayer treated this amount as an exchange profit in its books. The Commissioner included this profit in the ‘gross income’ of the taxpayer and the amount was assessed to tax.

The critical question that had to be answered by the court was, at what point during the year of assessment the accrual had to be valued? The court held that the accrual had to be valued at the date of accrual. In the present case, the date of accrual was the transaction date. In arriving at the judgment Ogilvie Thompson J said the following:⁶⁵

‘It follows that appellant’s trading operations as conducted by States Marine on its behalf – which operation I for convenience call appellant’s American trading operations – attract Union tax: that is beyond dispute and is not questioned in this appeal. As, however, those operations are reflected in American dollars, and because for purposes of Union taxation appellant’s accounts must be expressed in Union currency, it is necessary for appellant in its books to reflect its American trading operations in terms of Union points. In my opinion such conversion of dollars into South African pounds should be made at the rate of exchange prevailing on the date where under the items concerned – whether credit or debit – appear in the general account kept by the States Marine; for it is at such dates that (assuming States Marine’s accounts to have been correctly kept) the accrual or receipt of income occurs.’

Another view was adopted in *Lategan’s* case, when it was suggested that the value of an amount that has accrued to the taxpayer must be determined as at the last day of the year of assessment. In his judgment Watermeyer J said the following:⁶⁶

⁶⁴1955 (1) SA 654 (C), 20 SATC 15.

⁶⁵20 SATC 15 At 20.

⁶⁶At 2 SATC 16.

‘Assuming that the right to receive the instalments was not converted into money by sale or otherwise during the year of assessment, the value to be fixed (apart from any question whether the debt was good or bad) would be the present value worth of the instalments at the end of the year.’

This view was also proposed in *Caltex Oil (SA) Ltd v SIR*.⁶⁷ The issue in the present case was not the accrual or the receipt but whether the taxpayer was entitled to a deduction under section 11(a) for the debts payable by it to the two United Kingdom companies.

Botha J in his judgment said that⁶⁸

‘... [i]n determining the taxable income of a person carrying on any trade in any year of assessment there is, in terms of section 11(a), deductible from such person’s income the expenditure actually incurred by him in the production of the income during that year of assessment. ... It is at the end of that year of assessment that it is possible....’

Therefore in summary with regards to the debt that the taxpayer had not discharged, the amount of the expenditure incurred during the year of assessment has to be brought into account at the end of that year of assessment unless the item was disposed of prior to that date.

There are two conflicting views with regards to time of valuation. One view is that it is the date of accrual. The other view is that it is the last day of year of assessment. In *Matla Coat*⁶⁹ the Appellate Division revisited these two conflicting views but found it unnecessary to choose between them.

⁶⁷1975 (1) SA 665 (A).

⁶⁸At 1 SATC 665.

⁶⁹1987 (1) SA 108 (A), 48 SATC 223.

In *Mooi v SIR*⁷⁰ it was held that when the taxpayer acquired a conditional right, accrual could occur only on the date the condition was fulfilled. It was further suggested that for that right to be an accrual the 'amount' in question must have a monetary value. The taxpayer was an employee of a copper-mining company, namely, Palabora Mining Co. Ltd. On 25 July 1963 the company granted the taxpayer an option to subscribe for 500 ordinary shares at R1, 25 a share. The option had various conditions including the option was not exercisable until six months after the completion of the company's mining at Palabora and the option could be exercised only if the taxpayer was in the employment of the company.

It was common cause that the option was granted to the taxpayer for services rendered so as to induce him to stay in the employment of the company. In October 1966 the taxpayer exercised his option by acquiring 500 ordinary shares at R1, 25 each. The market value of the shares at the time when he exercised his option was R6, 40 a share. Therefore the total market value of the shares exceeded the option price by R5, 15 a share and in rand value terms a total amount of R2 575.

This excess amount was included by the Commissioner in the gross income of the taxpayer for the 1967 year of assessment, the year when the option became exercisable. The taxpayer objected to this inclusion on the grounds that all that had accrued to him for services rendered or to be rendered was the right he acquired on 27 July 1963 to exercise an option at a later date when certain conditions have been fulfilled.

The taxpayer argued further that when he exercised the option, the accrual was not for services rendered. It was held that what accrued to the taxpayer was the right, on the fulfilment of certain conditions, to obtain shares at a price of R1, 25. The accrual took place only when the option to acquire shares became exercisable, that is on 1 September 1966. At that time the taxpayer was in the employment of the mining company. There was a causal relationship between the benefit he obtained in the form of an option and his service to the company.

The benefit then fell within the definition of 'gross income.'

In arriving at his conclusion Ogilvie Thompson CJ said the following:⁷¹

⁷⁰1972 (1) SA 675 (A), 34 SATC 1.

⁷¹ At 34 SATC 1.

'In order to determine the "amount" comprehended by this definition it is necessary, in the case of a right, to establish the value of that right. . . . In my opinion the right acquired by the appellant [the taxpayer] on 27 July 1963 lacked any inherent attribute of income and, but for the provision of paragraph (c) of the definition of "gross income", would appropriately be regarded as a right of a capital nature. The object of paragraph (c) of the definition is of course to bring into the category of "gross income" all "amounts", whether of a capital nature or not accrued in respect of services.

Linguistically inappropriate though the word "amount" may be in this context, when a taxpayer becomes entitled to a right in "in respect of services" a money value must be assigned to that right in order to determine the relevant "amount" to be incorporated as "gross income". . . . In my view the contingent right which appellant acquired on 27 July 1963 did no more than – to borrow a phrase used by Sellers LJ in the court of appeal in *Abbots'* case . . . which said the benefit only accrued when the option became exercisable on 1 September 1966. The real benefit conferred upon appellant . . . was the right to apply for the shares at R1,25 a share and that right arose when, upon fulfilment of the conditions of the option, the latter became exercisable.

'On the facts, the measure of the aforementioned benefit – i.e. the "amount" to be incorporated in appellant's gross income – as at 1 September 1966 was R2 575.' This case does not only deal with the valuation of accrual but it also illustrates the principle of timing of the accrual and the casual link between the accrual and services rendered or to be rendered.'

It is important to note the issue in *Mooi's* case was dealt with under the definition of gross income then and not in terms of section 8A which was enacted years later.

Broomberg⁷² briefly deals with timing of recognition of salary for income tax purposes as follows:

'The so called *Lategan* rule is applied in practice to salaries and wages. The result is that an employee must include in his income all remuneration to which he has become entitled during the year of assessment, even though the amount may no be actually due and payable during the year.... One important exception to the *Lategan* rule is where the employee is entitled to leave pay.

In this case the leave pay is deemed to accrue to the employee only on the date that it is paid to him or is due and payable to him (section 23E).'

⁷² EB Broomberg & Des Kruger *Tax Strategy 3rd Edition* para 18.6.

He also deals with the factor of time ⁷³ when he states that

‘while no special timing of accrual rules apply to companies or trusts, the use of a company or trust may provide some opportunity for deferring the recognition of income in the sense that the income of a company or trust need not be distributed to the end beneficiaries, . . . immediately, thereby avoiding an accrual in their hands at that time’.

The issue of ‘timing and valuation of accrual’ is still controversial because there are different views on the matter. Unfortunately the Act does not provide any clarity on the matter, especially on the valuation of an accrual.

In *Sacks v CIR*⁷⁴ it was held that the profits from a partnership or joint venture can be determined and accrue to individual partners only at the conclusion of the agreed period for the taking of account of the profits. For example, if two persons enter into a joint venture on 1 January and agree that the profits are to be determined on 31 December, when the venture is to terminate, the profits will accrue to the individual partners only on that day. This was valid for a number of years until eventually the legislature decided to put an end to the state of affairs by introducing section 24H. It lays down special rules relating to the trade carried on by all partners.

⁷³EB Broomberg & DesKruger *Tax Strategy 3rd Edition* para 2.9.

⁷⁴(1946) AD31, 13 SATC 43.

Chapter 5

Non-monetary receipts and accruals (including barter transactions)

The definition of ‘gross income’ includes cash or otherwise. This means that an amount of income in a non-monetary form must be included in gross income once its monetary value has been established. Every consideration received in terms of the definition of the ‘gross income’ must be valued because if it does not have a value it cannot be included in gross income. *Meyerowitz*⁷⁵ provides practical situations as to how to determine the value of a consideration under different circumstances:

For shares, their value will be their market value at the date of receipt or accrual whichever comes first. This principle was adopted in *Lace Proprietary Mines Ltd*⁷⁶ when it was suggested that the value of the consideration was R500 000. This value was arrived at by calculating the nominal value of each share by the number of shares allotted to the taxpayer (50 cents x 1 00 000). It was further held that the true intention of the parties to the transaction was that the taxpayer was to be paid in shares. Accordingly, it was assessed on the true value of shares.

On the other hand, if the seller is entitled to claim a cash consideration and there is no obligation on him to use the purchase price to acquire shares, the cash consideration will be included in gross income, even if the seller on his own accord uses the purchase price to acquire shares in the purchasing company.

So when an asset is sold, or services are rendered, and in return a cheque is received, SARS generally accepts that the cash amount stipulated in the agreement is the true consideration for the sale of goods or the remuneration for the services rendered.

⁷⁵David Meyerowitz S.C. *Meyerowitz on Income Tax 2003 and 2004* para 6.43 to 6.48.

⁷⁶(1938) AD 267,9 SATC349.

Once it has been confirmed that a receipt or accrual is in the form of shares, it is important to value the share to determine the amount to be included in gross income. The valuation will be on the basis of the Seventh Schedule if the shares pass from the employer to the employee. When the provisions of the Seventh Schedule do not apply that is, there is no employer-employee relationship; the object is to establish the market value.

There are many factors that must take into account when valuing shares in a private company. It is important to examine any indications that the shares are worth more than their break-up values. One indicator may be provided by the fact that the shares have recently changed hands at a particular price. That amount paid for shares may be a strong indicator of the value of those shares at that time of exchange.

Another way of ascertaining the value of the shares received for goods or services rendered, is to enquire what price could have been obtained for them had some reasonable method of sales been adopted on that date.⁷⁷ Although the market price of the shares on the given date is a relevant factor, it cannot be decisive because it might have been fictitious and momentary. The stability of the market quotation and its approximation to the value is properly tested to some extent by reference to the market quotation before and after that date.

The practice of SARS⁷⁸ is to adopt, as the value of the shares, the middle market price on the date of the agreement conferring the right on the recipient. If the shares are not quoted on the stock exchange, SARS is likely to take into account the prices of actual sales of the shares on or near the date of accrual, and the present or potential value of the shares as shown by the balance sheet of the company.

SARS may value a share at its nominal value when there is insufficient information to value it on any other basis.

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⁷⁷ *Lace Proprietary Mines Ltd v CIR* 1938, AD 267, 9 SATC 349.

⁷⁸ *Income Tax Practical Manual- Sevirce - 2004*

Another amount received otherwise than in cash is when a barter or exchange transaction occurs. In a barter or exchange transaction goods are exchanged for other goods, or services are exchanged for other services. Gross income includes the value of every form of property received by or accrued to the taxpayer. So if an asset is exchanged or bartered for another asset, the value of the new asset constitutes an amount 'received or accrued'.

If the old asset was not held as an asset of a capital nature, the value of the new asset constitutes gross income and it is taxable when it is received or accrues. The test is simple. Has an amount of income been received or accrued?

So barter or exchange transactions are not excluded from the definition of 'gross income' as long as there is proof that the old asset that has been exchanged formed part of the trading stock, and that the asset received in exchange constitutes an amount 'received by' or 'accrued to' with a money value. No further inquiry need be made, for example, whether or not the transaction would be regarded as a realisation by a prudent businessman or in terms of strict accountancy procedures. In terms of the Act, if a trading asset is bartered or exchanged for a new asset whether or not the two are similar, the value of the new asset constitutes 'gross income', the mode of realisation is not relevant.

In a barter transaction on income account, an asset received might be worth more when it is actually received either in the same year of assessment or in the year of assessment following that in which the right to acquire it accrued. The excess amount will be included in gross income and be assessable to tax.

Notwithstanding the principle stated above, section 24A of the Act provides an alternative assessment of transactions dealing with exchange or barter of trading stock made up of fixed property (for example, land and buildings) or shares in any company for a consideration consisting of shares in a public company, quoted by a recognised stock exchange, for example, the Johannesburg Securities Exchange (JSE), or to be quoted within six months of the transaction, or other shares when there is a consolidation or merger of the interests of two or more persons.

The Commissioner and the taxpayer may agree if the situation arises that the consideration will be excluded from taxpayer's gross income for the year of assessment when the shares are received by or accrues to the taxpayer and be taxed only when the shares are disposed of. Section 24A will not operate automatically but will apply when the taxpayer takes the initiative and requests its application. It is unlikely that the Commissioner will take the initiative to apply this provision.

Again it is important to note that the Commissioner will not agree to the application of the provision if he is of the opinion that the taxation of paper profits arising from transactions of this nature will not cause any hardship to the taxpayer in the year of accrual.

*Broomberg*⁷⁹ discusses the tax complications of a barter or exchange or 'payments in kind transactions'. He looks at the seller's position when he receives an asset in exchange for trading stock disposed of by him. *Broomberg* seems to support the principle as set out above, that the seller will include in gross income the value of the asset acquired by him. The value of the asset must be determined at the time the seller acquired the right to the asset. If the asset does not have a value or cannot be converted into money it will not be included in the gross income of the seller. This is the principle that was upheld in *Butcher Bros.*⁸⁰

Statement AC 111 treats barter or exchange transactions slightly differently. It concentrates on the nature of both assets that have exchanged hands rather than concentrating on the asset received as does the Act. But as previously stated the Act is not based on accounting principles with the exception of a few provisions of the Act. Listed below are principles dealing with barter transactions as laid down in Statement AC 111:

- When goods or services are exchanged for goods or services of a similar nature and value, then no revenue arises from that transaction as, in substance, inventory has been swapped for inventory and no sale has occurred.
- When goods or services of a dissimilar nature are exchanged, then the substance of the transaction is a sale of one good or service and the purchase of another.

⁷⁹EB Broomberg & Des Kruger *Tax Strategy* 3rd Edition para 5.1.

⁸⁰1945 AD 301, 13 SATC 21.

Statement AC 431 clarifies by way of an example the accounting for revenue arising from barter transactions involving dissimilar advertising services, with reference to non-barter transactions of the seller.

When the value of the consideration is the right to acquire shares at par, or at another price, the value of the consideration will be the difference between the value of the shares and the purchase price.

When a taxpayer is given a right or option to take up shares, the question that is always asked is what must be valued for the gross income inclusion? Is it the value of the right or option at the date that it is granted, or is it the benefit when the right or option is exercised? The right or option to take up shares is valued at the date of accrual not when the option or right is exercised. But for directors and employees the opposite is true. For directors and employees the right or option to take up shares is valued at the time the option or right is exercised, released, ceded or disposed of. If, however, the gain is made by way of exercise and there is a condition imposed by the grantor or employer of the option then the employee can elect not to include the gain in his gross income until the condition is fulfilled. This is the method of taxation used in section 8A of the Act. The provisions of section 8B or section 8C could apply to share options that arise on or after 26 October 2004.

When the consideration is the right to the use of a property be it land or building or money, the value of the consideration will be moneys worth. For example for the use of property the value will be the rental that could be chargeable in an arms' length transaction or for an interest-free loan the ruling interest rate.

For most considerations given by an employer to an employee the value of the consideration is determined in terms of the Seventh Schedule to the Act.

In *CIR v Butcher Bros (Pty) Ltd*⁸¹ it was suggested that a lease premium is a consideration passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition to, or in lieu of, rental and it must have a considerable money value.

⁸¹1945 AD 301, 13 SATC 21.

The taxpayer acquired land, under a lease over a fifty-year period. The lessee in terms of the lease was obliged to erect and maintain buildings on the leased premises to the value of £55 000. At the end of the lease, the buildings would become the property of the lessor without any compensation to the lessee. The lessee demolished the existing building on the leased premises, and erected new buildings. They were completed in 1955. The Commissioner included the £55 000 in the gross income of the taxpayer for its 1935 year of assessment on the basis that, when completed, the buildings were a premium or like consideration in terms of the Act.

It was held that the advantages accruing to the taxpayer were not capable of being valued in 1935, and were therefore, not an amount. No amount had therefore been received by or had accrued to the taxpayer in its 1935 year of assessment.

In arriving at his conclusion Feetham JA said the following:⁸²

'I have already said, at the following interpretation of the expression "premium or like consideration" as used in paragraph (d) in so far as it refers to relations between lessor and lessee:

'Consideration passing from a lessee to lessor, whether in cash or otherwise, distinct from and in addition to or in lieu of, rent.

'I think, however, we must infer that "like consideration" referred to in paragraph (d) must have an ascertainable money value, and not a merely conjectural value; otherwise it could not, I think, be said to possess the necessary resemblance to a premium In order to give effect to this view I would insert "having an ascertainable money value" after the word "consideration", where it occurs in the above suggested definition. But if, as I think the word "amount", as used in paragraph (d), must also mean an amount have ascertainable money value. . . .'

When this case was decided, the Act did not contain a provision like the current paragraph (h) of the definition of 'gross income'. The case was therefore argued on the basis of whether the lessor's right to have improvements effected on the leased premises was a 'lease premium'. The court then refused to accept the assessment because according to it no amount had been shown to have accrued to the taxpayer in the year of assessment in question.

⁸² At 13 SATC 21.

The court having considered the duration of the lease agreement, the nature of the building erected (a theatre) and the uncertainty as to what the value of the improvements would be at the end of the lease, found it impossible to value the ‘amount’ that had accrued to the taxpayer at the commencement of the lease.

Paragraph (h) of the definition of ‘gross income’ was enacted as a direct result of the decision in *Butcher Bros*. The problem of valuation encountered in this case has been overcome by the formula laid down in that paragraph. The relevance of this case lies in its general decision:

- First, that a lease premium is ‘consideration passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition to, or in lieu of, rent’.
- Secondly, that the word ‘amount’ means an amount having ‘an ascertainable money value’.
- Thirdly, those undertakings that are normal incidents of leases, such as those which require a lessee to pay rates and taxes or to maintain buildings in good repair, do not constitute a lease premium.

It has been argued that the *Butcher Bros*’s decision confirms that the onus of proof which is normally on the taxpayer only comes into operation after Commissioner has proved that there is an ‘amount’ that has accrued to the taxpayer. So the onus is on the Commissioner to prove that what has accrued to the taxpayer is an ‘amount.’ In *Butcher Bros* the Commissioner failed to have his assessment upheld because he could not prove that what had accrued to the taxpayer was an ‘amount’ that had an ascertainable money value. In conclusion *Butcher Brothers* suggests that if the accrual has no value it is not to be regarded as income.

Gross income is the total amount received by or accrued to the taxpayer whether in cash or otherwise. Even if the terms ‘whether in cash or otherwise’ was not in the definition, the definition would include, by virtue of the term ‘amount’, not only money, but the value of any corporeal or incorporeal property earned by the taxpayer that has a money value. Income tax is levied on all receipts or accruals with an ascertainable value.

If the accrual or receipt is not in money's worth, or cannot be converted into money, it cannot be regarded as income. This principle was upheld in *Butcher Bros*. Therefore if a person renders services or sells goods in return for shares, he will have to include in his gross income the value of shares. The value to be placed on non-monetary receipts or accrual is the amount that can be obtained for it on the open market if it was sold in an arms' length transaction between a willing buyer and seller.

But this is a general rule which is modified by paragraph (i) of 'gross income' in section 1 read with the Seventh Schedule. It taxes fringe benefits given to an employee by an employer. The general rule for the valuation of assets other than cash received by the taxpayer must take precedence over any arbitrary or near-arbitrary formula of valuation adopted by SARS in practice. A typical example is the valuation of an insurance policy ceded to a taxpayer for services rendered or to be rendered.

Even if the formula is convenient, it is the true market value that is relevant, and if the taxpayer can prove that the market value is a particular amount, it is that amount that must be included in his gross income. Similarly, the surrender value of an insurance policy as determined by the insurer need not necessarily be the correct amount to be included in employee's gross income.

*Silke*⁸³ is of the view that the practice of SARS for the valuation of an insurance policy ceded to an employee or former employee emerges from an agreement reached between the Commissioner and the Life Offices Association. This agreement was directed at eliminating the avoidance of tax under a deferred compensation scheme.

The practice applies when either paragraph (d) or (m) of the definition of 'gross income' requires the value of an insurance policy ceded by an employer to an employee to be established. The value is arrived at by taking the difference between the present values of all expected future benefits less the present value of all future incomes. If an employee pays or has paid any consideration, those considerations will be deducted to arrive at the value. The present value according to *Silke* is calculated according to the actuarial table entitled Ultimate Mortality of SA 56-62 at 11%.

⁸³ *Silke Silke on South African Taxes Vol 2007* para 2.13.

As pointed out above the principle that if the thing received by or accruing to the taxpayer cannot be turned into money, it cannot be subjected to tax. For example, the benefits enjoyed by a borrower of an interest-free loan or that derived by a taxpayer enjoying the free use of a house or other asset in terms of a will, are not taxable. But when an employer and employees are the parties to the transaction, the benefit will be taxed in terms of the Seventh Schedule.

The issue of non-monetary receipts was also dealt with in *Stander v CIR*.⁸⁴ The taxpayer was chosen as one of the top five bookkeepers of a particular franchise dealer. In recognition of achieving excellent standards performance in financial management, the taxpayer was awarded a prize consisting of an overseas trip that cost the franchise dealer R14 000. The Commissioner included R14 000 in the gross income of the taxpayer and it was assessed to tax. The taxpayer appealed against the inclusion of this amount in his gross income. The court held if the amount was to be taxed it would be included in gross income in terms of paragraph (c) of the definition of ‘gross income’.

For paragraph (c) of the definition of ‘gross income’ to apply the taxpayer must have received an amount. It could include a ‘voluntary’ award. This amount would have to be for services rendered or by virtue of any employment or holding of any office. It was held that having gone on the trip; the taxpayer had not received any property on which a monetary value could be placed in his hands. It did not constitute a right that could be turned into money. It was also held because of ‘that’ particular conditions applicable to the enjoyment of this award, the said trip had no value in the taxpayer’s hands to bring it within the terms of paragraph (c) of the definition of ‘gross income’.

For the reasons stated above it was held that the trip in question did not give rise to an amount and was therefore not to be subjected to tax. It should not have been included by the Commissioner as part of the taxpayer’s gross income.

⁸⁴1997 (3) 59 SA 617 SATC 212.

Conclusion

The definition of 'gross income' gives rise to a number of problems. This is supported by the fact that there are a number of cases dealing with this definition. In addition almost every critical component of the definition is either vague or has no clear meaning as to what it intends. For ease of reference these components are

- the total amount,
- in cash or otherwise,
- received by, or accrued to, or in favour of a person,
- excluding receipts and accruals of a capital nature.

There are no definitions to provide clarity on the above components of the definition of 'gross income'. Instead these components are given their common meaning obtained from judicial decisions. Because the definition of 'gross income' is itself set out in section 1 of the Act and because many of its terms are not defined, makes it difficult to understand what it means. It is difficult to conceptualise why the legislature has for so long ignored these deficiencies in the definition of 'gross income'. It is the corner stone to income tax. Is it because SARS has the financial resources contributed by complying taxpayers that it is able to go to court every time there is an issue around the definition of 'gross income'. If something (of a revenue nature) is not gross income with the exception of certain special provisions, it cannot be taxed in terms of the Act. In a perfect world the legislature should make sure that this, being the most important definition of the Act, contains no deficiencies. It should not be vague and when there is ambiguity, proper interpretation notes should be made available.

The courts have come to the rescue of both the taxpayers and the Commissioner by providing meanings to certain words and terms. These meanings are used in determining whether an amount constitute gross income. In conclusion a summary of these interpretations follows:

Total amount

- There must be an amount received by or accrued to a person before it can be included in gross income. This includes not only money but also the value of every form of property earned by a person. When an asset is exchanged or bartered, the value of the asset acquired constitutes an amount received or accrued and must have monetary value or be convertible in to money.
- For non-monetary receipts the value of the asset must be determined objectively.
- If a receipt or accrual has no ascertainable value, it cannot be included in gross income.

Cash or otherwise

- The term 'cash or otherwise' includes anything that has an ascertainable value or a monetary worth. It includes any the 'cash equivalent of the value' of any benefits received by an employee from an employer.

Received by or accrued to

- An amount is received only if it is received by a person on his own behalf and for his own benefit.
- Certain amounts may be deemed to have been received by a person even though they have neither been received by nor accrued to a person, for example, business income in a partnership or investment income that is shared equally between spouses if they are married in community of property.

Accrued means to become entitled to something

- It also means become unconditionally entitled to something,
- It is important to note that a person is still taxed on an amount even if this amount is donated or disposed of immediately after its receipt or accrual.

The above interpretations adopted by the courts are of assistance while the legislature continues not to redefine or revamp the definition of 'gross income'. It is important to add that these decisions lack economic or accounting principles. The courts have failed in their decisions to identify underlying concepts. Instead they have adopted a narrow and literal meaning when interpreting provisions of the Act. A typical example, without going into details because it has been dealt with in one of the chapters above, is the issue of barter transactions. An accounting approach is to analyse the nature of the transaction before deciding on the value of the receipt or accrual. The tax system including judicial decisions focus on the asset acquired in a barter transaction, without taking into account issues like similarity or dissimilarity of the assets being exchanged. But again it is understood that the tax system with the exception of a few provisions is not based on any accounting or economic principles.

The advantage about accounting or economic principles is that they have clear guidelines of how, what, and when to account or not to account for something. Furthermore the accounting standards are currently being harmonised to be in line with international standards. Maybe it is time for the courts and the tax system to move in this direction. It may take a long time but it will bring into rest the confusion brought about by aspects of the Act not properly defined by the current system.

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