The nature of interest-free loans and the tax implications thereof

Tracy Tennant

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Supervisor: Professor DP Schutte

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ABSTRACT

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The tax world as we knew it was turned upside down on 13 September 2007 when the Supreme Court of Appeal (“SCA”) announced its decision to deem the right to use an interest-free loan as an amount that accrued to the taxpayers in the case Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others 69 SATC 205. The findings of SCA brought about a “great deal of consternation in the business world” (Loubser, 2007:20).

Due to the controversy as a result of this case, SARS drafted an Interpretation Note that illustrates the reasoning and tax treatment of an interest-free loan. On 30 June 2010, Interpretation Note No 58 was finally issued by SARS, providing guidance with regard to “an amount” that “accrues” to a taxpayer for the purposes of the gross income definition.

This Interpretation Note will have a significant impact on a number of taxpayers. The purpose of this study is to understand the nature of an interest-free loan and identify its tax implications. The methodology followed in this study will be that of qualitative research. This will be conducted through analyzing the nature of a loan, specifically an interest-free loan, the gross income definition, including the value and timing of such amount, and whether a deduction may be claimed in respect of an interest-free loan. Notwithstanding the above, the study also includes an investigation of other taxes inter alia capital gains tax, donations tax, value-added tax, secondary tax on companies and newly proposed dividends tax.
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1 CHAPTER 1: THE PROBLEM, SIGNIFICANCE AND STRUCTURE OF THE STUDY

1.1 KEYWORDS

The following words and terms will apply in this study:

- ‘Actually incurred’
- Amount
- Bare dominium
- Capital in nature
- Deduction
- Gross income
- Interest-free
- Loan
- *quid pro quo*
- ‘Received by’ or ‘Accrued to’ or ‘in favour of’
- Services
- Usufruct

1.2 DEFINITIONS

**Connected person**: the following persons are connected persons in terms of the Income Tax Act No 58 of 1962 (“the Act”):

- Any relative with the consanguinity within the third degree of a natural person is a connected person to a natural person. Similarly, if a natural person is a beneficiary of a trust, that natural person is a connected person to the trust.

- Any beneficiary of a trust or any other connected person in respect of a beneficiary is a connected person in relation to a trust.
• Any partner in a partnership, including any connected person in relation to a partner, is a connected person to any other partner.

• A company is:

  • a connected person to any other company that is in the same group of companies as that company if the phrase “at least 70 per cent” in the definition of a group of companies in section 1 of the Act was replaced with the phrase “more than 50 per cent”. For the purposes of this study, the definition of a group of companies has not been investigated further;

  • a connected person to any other person (other than a company), where that person holds, directly or indirectly, either individually or jointly 20% or more of the company’s equity share capital;

  • a connected person to any other company, where the first mentioned company holds 20% or more of the equity shares of a second mentioned company and there is no other shareholder that holds majority shares;

  • a connected person to such other company as is managed or controlled by:

    • a person that is a connected person in relation to that first mentioned company;

    • a person that is a connected person in relation to a person mentioned above. (Income Tax Act 58/1962).

**Shareholder:** means any person that is the registered shareholder of a company’s shares and is entitled to the benefits of the right to participate in the profits, income or capital of the company (Income Tax Act 58/1962).

**Market-related rate:** The rate of interest that is regarded as market-related is treated differently for natural persons and trusts and persons other than natural persons. In respect of a natural person or trust, a market-related interest rate is the average of the official rate of interest in accordance with paragraph 1 of the Seventh Schedule to the Act, for the period of time. In respect of other persons, the following is proposed:

  • Where the financial assistance is rand denominated, the interest rate is equal to the average repurchase rate plus 100 basis points for that period.
- Where the financial assistance is in a currency other than the rand, the interest rate is equal to the average equivalent of the South African repurchase rate in that currency plus 100 basis points for the period (De Koker, 2010).

**Trading stock:** amongst other things, is anything that is produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purpose manufacture, sale or exchange by him (Income Tax Act 58/1962).

### 1.3 ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
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<tbody>
<tr>
<td>BGR</td>
<td>Binding General Ruling</td>
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<tr>
<td>CGT</td>
<td>Capital Gains Tax</td>
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<td>SARS</td>
<td>South African Revenue Services</td>
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<td>SCA</td>
<td>Supreme Court of Appeal</td>
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<td>STC</td>
<td>Secondary Tax on Companies</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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<td>WHT</td>
<td>Withholding tax on dividends</td>
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1.4 INTRODUCTION

1.4.1 Background

Benjamin Franklin (1789) proclaimed that “In this world nothing can be said to be certain, except death and taxes”.

This holds true after the SCA ruled in favour of SARS in the case of the *Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others* 69 SATC 205 (hereafter “*Brummeria*”) on 13 September 2007. In this case it was decided that the granting of the right to use an interest-free loan to a person is an “amount” which has “accrued” to that person for the purposes of the gross income definition in section 1 of the Income Tax Act No. 58 of 1962 (“the Act”) (69 SATC, 2007:208). Therefore, taxpayers benefiting from an interest-free loan may be unaware of the tax implication from such a loan. Implications that may impact the normal income tax implications include taxes such as STC, newly proposed dividend WHT, VAT, donations tax and CGT. In order to determine if the findings of *Brummeria* case were in fact correct, the relevant provisions of the Act should be considered in similar circumstances. This study will investigate these tax implications in the literature review below.

1.4.2 Literature review of the research area

An amount may be included in a taxpayer’s taxable income if the requirements of the gross income definition are met and no exemptions, deductions or allowances are applicable. In terms of the definition, a resident must include all amounts, in cash or otherwise, that is or was received by or accrued to that resident in his/her gross income. From a non-resident perspective all amounts received by or accrued to that non-resident from a source or deemed source of South Africa would be included in his/her gross income. Notwithstanding the above, any amounts of a capital nature will be excluded from a taxpayer’s gross income unless it is specifically included in terms of the provisos to the gross income definition. The individual components of this definition have not been defined within the Act, and therefore it is necessary to turn to case law for guidance. For the purpose of this study, the individual concepts that will be analysed in more detail are “amount”, “accrued to” and “received by”. The cases that will provide guidance on these concepts include *inter alia Lategan v Commissioner for Inland Revenue* 2 SATC 16 (“*Lategan case*”), *Commissioner for Inland Revenue v People’s Stores* (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A) (“*People Stores case*”) and *Commissioner for Inland Revenue v George Forest Timber Co Ltd* 1924 AD 516 (“*George Forest case*”).
In the *Brummeria* case the right to use an interest-free loan was held as “an amount” to be included within the gross income of the taxpayers. In addition to this, the value of this “amount” as determined by SARS was neither accepted nor rejected by the SCA, nor was the value disputed by the taxpayer (Brincker, Schoeman, Vorster & Erasmus, 2007:14). Because the Brummeria case was said to be “the most important case decided in the past 30 years” by for instance Visser (quoted by Jansen van Rensburg, 2008:34), it was expected that there would be a delay in an official guidance provided by SARS. A draft Interpretation Note was released by SARS for commentary, which would provide guidance on the treatment of “an amount” that accrues to a taxpayer from an interest-free loan. After all commentary was received, the Interpretation Note No. 58 (“Interpretation Note”) was issued by SARS on 30 June 2010. This Interpretation Note No.58 states that: “This Note has been published as a result of the judgement of the SCA in the *Brummeria* case. For the purposes of interpreting the definition of “gross income” in section 1, this Note -

- outlines the *treatment of receipts or accruals in a form other than money*; and

- serves as a BGR issued under section 76P on the meaning of the term “amount” as used in that definition” [Emphasis added]

The Interpretation Note articulates that an objective test, as opposed to a subjective test, should be conducted to determine if a receipt or accrual has a money value. The decision held in the *Stander v Commissioner for Inland Revenue* 1997 (3) SA 617 (C) (“Stander case”) was that only receipts or accruals that could be turned into money would be regarded as an “amount” for gross income purposes. However, after the SCA ruled in the *Brummeria* case, the *Stander* case was overturned. In addition to the use of an objective test, the nature of the transaction is discussed in the Interpretation Note, where it states that a *quid pro quo* relationship should exist. This means that the right to use the interest-free loan must be exchanged for goods or services. In light of this the Interpretation Note provides that a right created in benefiting from an interest-free loan constitutes “an amount” accruing for the purposes of the gross income definition. However, it is important to note that this only arises if something is given in return (*quid pro quo*) for such an interest-free loan.

Once an ‘amount’ has been determined to be included in the taxpayer’s gross income, the timing of such inclusion must be taken into account. The principle of determining the timing has been established by the courts in *Lategan* and *Peoples Stores* cases. Following this the Interpretation Note notes that an objective valuation should be conducted for the right to use an interest-free
loan. In this regard the Interpretation Note again refers to the *Brummeria* case. The value determined in the *Brummeria* case was neither accepted nor rejected by the SCA, and was not disputed by the taxpayer. The value placed on the interest-free loan in the *Brummeria* case was calculated with reference to the weighted average prime overdraft rate in relation to the average amount of the interest-free loan for each year of assessment. The Interpretation Note refers to this valuation. However, it states that this method is not cast in stone, and should be evaluated on the merits of each case (SARS, 2010:4).

As previously established, an amount will only be included in a taxpayer’s taxable income if no exemption, deduction or allowance is available. Exemptions and allowances within the Act do not specifically deal with the right to use an interest-free loan, and as such this study will focus its investigation on deductions that may be available. In conducting this investigation a taxpayer must first consider the impact of the general deduction formula contained within section 11(a), read with 23(g) of the Act. The requirements of the general deduction formula are as follows:

- A trade must be carried on
- where there is an amount of expenditure or losses
- which is actually incurred
- in the production of a taxpayer’s income
- However, a deduction may not be claimed for amounts of a capital nature (Income Tax Act 58/1962).

The individual concepts of this definition have similarly not been defined within the Act, which makes it necessary to turn to case law for guidance. For the purpose of this study, the individual concepts that will be analysed in more detail are “carrying on a trade”, “expenditure and loss”, “actually incurred”, “in the production of income” and “not of a capital nature”. The cases that will provide guidance on these concepts include *inter alia* *Pyott Ltd v Commissioner for Inland Revenue* 13 SATC 121 (“Pyott case”) and *Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue* 8 SATC 13 (“PE Tramway case”).

### 1.4.3 Significance and importance of this study

“[T]he games begin”, is a comment made by Brincker *et al* (2007:38) in discussing the SCA judgment in the *Brummeria* case on interest-free loans. The comment was made in light of a letter issued by SARS to a group of companies stating that it is SARS’ intention to tax the right
to use an interest-free loan. This letter indicates that the value to be included in the taxpayer’s taxable income would be determined with reference to the *Brummeria* case (Brincker *et al.*, 2007:38).

To clearly understand why SARS issued that letter, the background facts to the *Brummeria* case should be summarized. There were three Brummeria group companies (the taxpayers) who were developers of retirement villages. Retirees, requiring accommodation, provided an interest-free loan to these companies in exchange for the right to occupy residential units (rent-free). Upon the death of a retiree or on early termination of this agreement, the retiree was entitled to repayment of the loan (*Brummeria* case). This case was first heard in the Tax Court where it was held that the right to retain and use an interest-free loan was regarded as notional amounts. In addition to this, J Goldblatt (67 SATC 230) held that a taxpayer could not be taxed on the possession of money as it was purely used to produce income. Furthermore, J Goldblatt held that the right to use the interest-free loan could not be transferred or ceded, and therefore is not an amount for gross income purpose. Therefore, these amounts could not be included in the gross income of the taxpayer. In overruling the Tax Court, the SCA held that the rights were capable of having a value and should be included within the gross income of the taxpayers. Furthermore, the SCA judgment provided that the provision of an interest-free loan would be considered to be a continuing donation. In delivery of the SCA findings, it was held that even though the rights could not be turned into money, it does not negate the fact that it could be valued. Therefore, even if one is unable to alienate the right, it does not mean that a value cannot be attributed to it for the purposes of gross income. Further, if the loan capital been invested in interest-bearing instruments, that interest would be considered a separate transaction for gross income purposes. In this instance, both the interest received and the right to retain and use the interest-free loan would be included in a taxpayer’s gross income.

After the decision in the *Brummeria* case was announced, tax professionals began raising a number of questions surrounding the “conventional wisdom” created by Appeal Court cases in the past (Ernst & Young, 2007). These cases held that an accrual may constitute “an amount” only if it is convertible into money (Ernst & Young, 2007). The *Brummeria* case is said to have rocked the foundation of the business world. The findings of the *Brummeria* case may thus lead to the tax implications of an interest-free loan being more far reaching than anticipated (Troskie, 2007). This may result in cash flow implications for taxpayers, should they be assessed for tax by virtue of the right to use an interest-free loan (Troskie, 2007).
Brincker et al (2007:10) comment that interest-free or low interest loans in the context of family trusts and between companies in a group may be affected by the findings of the SCA in the Brummeria case. According to Kruger (quoted by Wilmot, 2007:58) the reason for incurring interest-free loans is not to enter into a tax avoidance transactions or schemes, there is business rationale for entering into such transactions. Troksie (2007) moans that this could result in the “Death of Interest-free loans”, and a business’ cash flow may be impaired if interest is charged on loans.

The question remains, to what extent should an interest-free loan be regarded as taxable. The concern that was raised in the SCA is whether a double-tax position may arise as a result of the right being included in the taxpayer’s taxable income (i.e. If the loan capital has been invested, the interest received on the investment would be taxed in addition to the benefit of utilizing an interest-free loan, as the Commissioner will view it as two separate accruals (Brummeria case)). This question may be answered by Wilmot (2007: 58), when she notes that Canadian tax law regards interest-free loans as being taxable in the hands of the borrower, while the lender would be allowed a tax deduction of the same amount. The Brummeria case does not address this matter, nor does the Interpretation Note issued by SARS.

Wilmot (2007: 58) reiterates that no appeal may be made on a SCA decision and notes that should tax legislation be passed, it may be implemented with retrospective implications of at least three years, which would be applied to all relevant taxpayers. Clegg (2007) comments that should retrospective application apply “All hell will break loose”. The issued Interpretation Note does not mention any retrospective application. However, Stretch and Silke (2010) state that the ruling is effective from the commencement of the year of assessment, ending on or after 31 December 2010.

1.5 PROBLEM STATEMENT

The problem statement to be investigated in this study can be formulated as follows:

The uniqueness of interest-free loans and outcome of a recent court case that resulted in uncertainty about the tax treatment thereof. Since interest-free loans are widely used, this is a matter of concern for accountants, tax consultants and their clients.

1.5.1 Research objectives

The purpose of this study is to understand what the nature of an interest-free loan is, and thereafter to determine what the tax implications, if any, may be. The following research objectives have been set in order to achieve this purpose:
• To understand the nature of an interest-free loan;

• To determine if an interest-free loan results in the inclusion of an amount into a taxpayers gross income;

• To determine whether any deduction may be claimed in respect of an interest-free loan;

• To evaluate the timing and valuation to be placed on an interest free loan.

The research objectives may be classified as the main and secondary objectives, which are as follows:

1.5.2 Main objective

The main objective is split into three categories. Firstly, it aims to understand the true nature and intention of an interest-free loan. Secondly, it aims to evaluate whether that intended nature of the interest-free loan would result in the amount being taxable in the taxpayer’s hands. Lastly, it aims to determine whether there are any deductions available to taxpayers.

1.5.3 Secondary research objective

In determining the tax implications for the purposes of the gross income definition and the general deduction formula, other taxes such as STC, proposed dividend WHT, VAT, donations tax and CGT should be considered, as this could have a significant impact on the tax implications a taxpayer would need to consider when obtaining an interest-free loan. In addition to this, the timing and valuation of such an amount would be evaluated.

1.6 Research methodology

In order to address the main objective, a qualitative research methodology will be adopted. This will entail an investigation of the word “loan”, as well as the nature and purpose of these loans. In determining the nature of an interest-free loan, the circumstances in which such a loan would arise will be investigated.

A literature study on the gross income definition, general deduction formula and relevant case law will be investigated. Fundamental and pertinent principles have been held in courts as such Lategan, Peoples Stores, George Forest, Pyott and PE Tramway. Many tax professionals have made comments on these principles of the above cases and compared them to the Brummeria case. Accompanying these investigations will be other literature, inter alia publications, journals, articles, books, seminar and lecture notes and Interpretation Notes to the Act.
The secondary objective will be conducted via a literature review of the relevant provisions of the Act accompanied by court decisions, published articles, seminar notes and Interpretation Notes that directly relate to interest-free loans similar to those of the main objective.

1.7 OVERVIEW

The structure of the study will be as follows:

1.7.1 Chapter 1 – The problem, significance and structure of the study

This chapter states the purpose of this study, introduces the problem, and evaluates the significance of the study. It also presents the research objectives and methodology.

1.7.2 Chapter 2 – Nature of the interest-free loan

An analysis of the nature of interest-free loans will be conducted, together with a literature review of court cases and publications to investigate the very nature of an interest-free loan.

1.7.3 Chapter 3 – Determination of the impact on gross income

A comprehensive investigation and assessment will be conducted on the gross income definition through a literature study to understand the terms “amount” that “accrued to” a taxpayer and “capital nature”. Invariably the value and timing of the amount will be considered and discussed.

1.7.4 Chapter 4 – Determination of the impact on other taxes

A high-level review is performed to identify which other taxes inter alia STC, newly proposed withholding tax on dividends including value extraction tax, CGT, VAT and donations tax within the Act may give rise to taxes as a result of an interest-free loan. A review of the legislation on those taxes will be performed and analysed against an interest-free loan.

1.7.5 Chapter 5 – Determination of the impact on deductions

An analysis of the general deduction formula in section 11(a) will be conducted through a literature review. In that review the term “actually incurred” will be investigated. All those taxes that impact on the amount included in and related to gross income will be investigated for purposes of claiming a deduction for tax purposes.

1.7.6 Chapter 6 – Conclusion

The research objectives will be summarized and a description on how each objective was fulfilled during the study will be disclosed.
In addition this chapter will highlight the potential future studies that may be conducted on interest-free loans and related items.

1.8 SUMMARY

In concluding, this chapter has identified the purpose of this study, provided an introduction to the problem and has evaluated the significance of the study. In Chapter 2, this study will consider the nature and purpose of an interest-free loan.
CHAPTER 2: NATURE OF INTEREST-FREE LOAN

2.1 INTRODUCTION

Approximately two and half years after the findings of the SCA in the *Brummeria* case, SARS issued the Interpretation Note No. 58. This Interpretation Note was issued as guidance on the how taxpayers should treat non-monetary receipts and accruals, and it is held as a BGR in respect of the word “amount”. In view of this, chapter 2 will investigate the nature of a loan with the obligations attached to that loan. This chapter will further investigate the interest element of a loan in order to understand the purpose of issuing an interest-free loan.

2.2 HISTORICAL ANALYSIS OF A LOAN

As early has the biblical times, interest on loans was a topic under much debate. The Old Testament of the Bible prohibited interest from being charged on loans. However, it has been established that there were no such prohibitions found in the New Testament, as the old fathers of the church did not appear to agree on the interpretation of charging interest on loans in the Bible’s text. Later in the John Calvin era, in the sixteenth century, it became acceptable to charge interest. (Otto, 2008).

In more modern times, legislation was promulgated that began regulating the consumer’s ability to be provided with credit. It is illustrated that as early as 1974, the United Kingdom began to draft legislation that governed consumer spending on credit in order to protect consumers. In the mid 1980s, both Australia and European countries promulgated their own consumer credit legislation. Nonetheless, consumer credit legislation was implemented worldwide in an attempt to curb consumer spending on credit to protect them from the negative consequences that may be attached to this credit. (Otto, 2008).

2.3 DEFINITION OF A LOAN

In order to comprehend the nature of an interest-free loan, the meaning of the word “loan” should be sorted. According to the OED (1989), a loan is defined as something, generally a sum of money, that would be borrowed to someone and in return they are expected to repay the amount borrowed. Further, the loan is usually expected to be repaid with interest.

In respect to this, an investigation of the relevant legislation will be conducted in order to determine whether interest would be expected to be repaid on a loan. In that regard we turn to the National Credit Act and its history in South African law.
2.4 BACKGROUND TO THE NATIONAL CREDIT ACT

Over a number of decades, many types of legislation have been drafted regarding loans. Otto (2008) informs us in his historical analysis of loans that as far back as 1926, the first Usury Act was promulgated in South Africa. This Act governed the sales and leases of moveable property, rendering of services and money-lending transactions. Later, in 1942, the Hire-Purchase Act was promulgated, which provided some protection to the purchaser in a hire-purchase contract. However, in 1980 the Hire-Purchase Act was repealed and the Credit Agreement Act was promulgated in its place. The latter Act, however, run into the Usury Act legislation scope, but the two Acts had to be jointly applied. This created many challenges for consumers to ensure that both Acts were adhered to in all respects. (Otto, 2008).

On introduction of the National Credit Act (“NCA”), effective on 1 June 2007, a number of Acts, including the Usury and Credit Agreement Act, were repealed. The NCA has drastically changed a number of credit-related pieces of legislation. This has improved a person’s understanding of what is required in terms of credit providing arrangement from a legislative and commercial perspective. However, there are unfortunate consequences of the Act that have crept up, as found by Scholtz (2008). The most significant consequence is the lack of harmonization of the NCA with our common law principles in respect of certain interpretations, and this has resulted in conflicts (Scholtz, 2008). It is imperative that harmonization be present as on introduction of the NCA. It was retrospectively applied to all existing contracts, which were, amongst other Acts, also using the principles established in our Common Law. Fortunately, Scholtz (2008) continues that “[I]t has even been suggested that they may not pass constitutional muster in all cases”.

2.5 APPLICATION AND IMPLICATIONS OF THE NCA

2.5.1 Application of NCA

Van Zyl (2008) illustrates that the NCA applies to almost all forms of granting credit in South Africa “including loans secured by mortgage bonds (defined as mortgage agreements), the sale of movable goods on credit, credit cards, pawn transactions, personal loans, overdraft facilities and suretyship agreements”. The NCA applies to ALL credit agreements made or effective in South Africa and those credit agreements must be at an arm’s length between both parties.

The credit agreement is defined in section 1 of the NCA as an agreement where any credit is granted and interest or a fee may be charged in respect of that credit. The term “credit” is defined in section 1 as the payment of money that is deferred or the “promise to defer such a payment” or the “promise to advance or pay money to or at the direction of another person”. Therefore an
agreement for which no interest or fee is charged may still qualify as a credit agreement for the purposes of this Act. Notwithstanding this, all credit agreements must be transacted at an arm’s length price, which is the price that may be fetched on the open market between a willing buyer and willing seller. Furthermore, this means that the parties are required to be independent of each other (Van Zyl, 2008). By default, if the credit agreement is not at arm’s length between the parties, the provisions of the NCA (2005) are not affected. A list of such credit agreements is provided for in the NCA and is as follows, although this list is not exhaustive:

- A Subsidiary company making a loan advance to or from its Holding company, including any person who has a controlling interest in the company to whom the loan is advanced;
- Two or more natural persons enter into a credit agreement and those natural persons are in a familial relationship and are co-dependent on each other, or at least one on the other; or
- Any other credit agreement where the parties are not independent of each other and there is no drive “to obtain the utmost possible advantage out of the transaction” or law has held that the parties involved are not dealing at an arm’s length price.

Finally, in determining whether the NCA is applicable in any credit transaction, one should determine whether the credit agreement was “made within, or having effect within” South Africa. Therefore, even if the agreement is concluded overseas and it may have an “effect” in South Africa, the application of the NCA would be relevant. Van Zyl (2008) determines that in this case, the law of contract is critical in respect of determining the effective place of that credit agreement. Regardless of where the credit agreement is entered into, cognisance of the requirements of a credit agreement must be considered “to every transaction, act or omission in respect of that agreement...” (Van Zyl, 2008).

2.5.2 Credit transactions excluded from application of NCA

Provided that all the requirements of a credit agreement are met, the loan would be regarded a credit agreement and the legislation imposed by the NCA would apply. However, the following transactions have been specifically excluded from the application of the NCA:

- Where the consumer in a credit transaction is a juristic person, together with its related juristic persons, and his asset value or annual turnover is more or equal to R1 million
- Where a credit provider enters into a credit agreement with juristic person whose asset value or annual turnover is less than R1 million;
• Where a consumer is a state or organ of the state. However, this exclusion does not apply to an entity controlled by an organ of the state;

• Where the credit provider is the South African Reserve Bank;

• Where the credit provider is located outside South Africa and the consumer has applied for exemption of such agreement from the Minister of Finance;

• A stockvel transaction;

• Where the debt owed for goods or services and the
  • method of payment was by cheque or similar instrument that was dishonoured; or
  • credit facility was subsequently refused by a third person (bank) to the person applying for the credit;

• “The sale of goods or services if payment is made through a charge against a credit facility (such as a credit-card facility) provided by a third party (such as a bank). The credit agreement in these circumstances is between the consumer and the third party with whom he has the credit facility” (Van Zyl, 2008).

• “An agreement in terms of which the supplier of a utility or other continuous service agrees to defer payment by the consumer until the supplier has provided a periodic statement of account, and not to impose any interest unless the consumer fails to pay the full amount due within the agreed period. A consumer must be given at least thirty days after the date on which the periodic statement is delivered to make payment of the deferred amount. Any amount not paid within this period is treated as incidental credit, to which the Act applies. This exemption appears to have been drafted to apply to agreements between municipalities and consumers, although providers of other continuous services, such as security services, would also be able to structure their agreements to fall within this exemption” (Van Zyl, 2008).

Now that the application of a loan has been determined, the interest element of the loan should be considered.

2.5.3 Interest charged on a credit agreement

In respect of the interest being charged on credit, i.e. loan, the NCA provides that a credit provider (the party granting or advancing a loan) may extend credit to a consumer and that the
credit provider has the right to recover the principal debt with interest. Due to interest being charged on the credit, there may be a number of disputes that may arise. Van Zyl (2008) explains that credit providers are in the business of making money, and one of the ways to do so is to charge interest on loans, where the consumer would like to pay the least amount in respect of the credit amount taken out back to the credit provider. Therefore, the rights awarded to the credit providers to charge interest is curtailed by various other sections of the NCA. For the purpose of this study these provisions are not further investigated, but the basic principles of a loan with interest remain. To reiterate, Van Zyl (2008) states that the NCA is applied to protect the consumers against the charge excessive interest rates. Notwithstanding, these provisions do not apply to juristic persons, and this means that juristic parties are free to negotiate the amount of interest and fees charged on credit agreements they enter into. However, this does not mean that those parties are not required to adhere to public policy. Our courts are able to declare those provisions unenforceable by way of Constitutional Law. (Van Zyl, 2008).

Interest is charged on an amount advanced *in lieu* of being provided the right to use that advance over a period of time. The interest rate limitation is linked to the South African Reserve Bank repurchase rate, known as the “repo rate”. The Minister of Finance has also prescribed the method allowed to determine the maximum interest rate. For the purposes of this study, the limitations set out above are not investigated. (Van Zyl, 2008).

2.6 SUMMARY OF THE APPLICATION OF THE NCA

The application of the NCA replaces the Credit Agreement Act and the Usury Act and applies to all credit agreements entered into where the credit providers (lenders) allow consumers to defer their payment over a period of time. This is seen as a right to use credit. This right to charge interest by a lender on that deferred payment amount is limited in terms of the provisions in the NCA. In addition, there are a number of specific exclusions the NCA provides for, and one in particular is that the NCA does not apply to certain juristic persons. In summary, public policy by way of the Constitution places governance on their ability to charge interest, ensuring it is fair for all South African persons. Therefore, it may be noted that interest charged on loans, advances or debt is a right granted to a credit provider. It is not legislated that interest is required to be levied on loans and it is at the discretion of the lender whether to charge that interest or not.

The NCA imposes the law of certain credit transactions as seen above. In respect to those credit transactions that are not governed by the NCA, we turn to common law principles to understand the nature of such credit transactions.
2.7 COMMON LAW PRINCIPLES

As previously established, a loan is an advance or the granting of a sum of money with deferred repayment terms. Interest is not essential and the law does not require interest on a loan, it is rather a contractual agreement between two parties that interest be charged on that loan according to Van Blerk (quoted by Brincker, 2010). The charging of interest is at the discretion of the parties. This is confirmed by regulations imposed by the NCA. Therefore, if no specific interest is charged, no right accrues to the credit provider to earn interest.

2.7.1 Nature of a loan in terms of common law principles

To determine the nature of the loan, cognizance should be taken of the Roman Dutch Law. There are two types of loans per Roman Dutch Law, one being loans for consumption (mutuum) and the other being loans for use (accommodatum). A loan for consumption is an agreement whereby one party (lender) transfers something that will be consumed by another party (borrower), who is required to return a similar kind of something that was borrowed to the lender. The repayment usually occurs over a period of time that is agreed upon by both parties. A reward may be charged, i.e. interest charge, on such a loan. On the other hand, a loan for use is where the lender provides a thing gratuitously to a borrower for a fixed or determinable period of time with a specific purpose in mind (Joubert & Henning, 2008). The difference between these two types of loans is that the loan for use grants no reward for its use, while a loan for consumption grants a reward for its use (Brincker et al, 2007:35). For the purpose of this study, the loan for consumption or mutuum will be further investigated as interest is regarded as a reward.

The loan for consumption entitles the borrower to take ownership of units of fungible things. The borrower is obliged to return the same number of units of that type of fungible thing to the lender over a period of time agreed upon by all parties involved. From the time a loan for consumption was introduced, it was mainly used for short-term financing between natural persons, and in almost all cases interest was not charged on those loans. However, when these types of loans were brought into the commercial realm, interest was charged by the lender and reciprocal obligation was bestowed on the borrower to repay that loan with interest. Such contracts were concluded verbally and known as stipulatio, and was independent from the mutuum. From this it may be seen that the obligation existed from one side only, this being the borrower’s obligation to repay interest. (Jansen van Rensburg, 2008:42).

Jansen van Rensburg (2008:43) illustrates that a loan for consumption has changed over time, in that a loan imposes an obligation on the lender and the borrower. The lender has a passive
obligation that requires him to deliver the loan to the borrower, whilst the borrower has an active obligation that requires him to repay the loan over the agreed upon period. The right attached to that obligation is the borrower’s right to use the loan as he wishes as he has ownership of that loan. Notwithstanding, the obligations established above, interest repayable becomes the third obligation when a loan contract arises. However, as has been previously established, there is no regulation in law that requires interest to be charged on a loan, if this was the case the issuing of interest-free loans would be held illegal. This is supported by the regulations of the NCA and statement made by Van Blerk (quoted by Brincker, 2010). Even religious communities as such those under Muslim law require that no interest be charged on loans provided.

In order to provide clarity on what is considered to be a right for the purposes of an interest-free loan, one would turn to Roman-Dutch Laws to establish its meaning.

### 2.8 RIGHTS

According to Roman-Dutch Law, rights are classified as either being a real right (*jus in rem*) or a personal right (*jus in personam*). These rights will be discussed in detail below:

#### 2.8.1 Concept of real rights

This right entitles any one person to a thing and is enforceable against all persons (SARS, 2010:38). For simplicity purposes, this can best be explained by way of an illustration. Once a person has acquired a thing and ownership transfers, i.e. by way of delivery and the buyer accepts the delivery, the buyer upon taking delivery acquires a real right (his ownership). According to Van der Vyver (quoted by Jansen van Rensburg, 2008:41) possession is not regarded as a real right as this does not mean that ownership has in fact transferred. Therefore, the right to claim that possession may be seen as a personal right.

#### 2.8.2 Concept of personal rights

This right awards one party the right to a thing and imposes an obligation against another party in the same transaction to perform. The SARS (2010:38) highlights that there are two types of personal rights and they are as follows:

- A right to claim delivery of a thing (*jus in personam ad rem acqirendam*)

- A right to claim performance or an act (*jus in personam ad faciendum*)
On the other hand, Badenhorst (2003:51) submits that a personal right involves a thing where “…a person becomes bound to the holder of the right to render a particular performance, that is, to do or not to do something”. One could view this as an agreement where in concluding a contract, both parties agree to their obligations under the agreement. Knowing this, there is two sides to the agreement; one is a passive side, being the duty of one to perform, and the active side, being the personal right to the performance (Jansen van Rensburg, 2008:41).

Van Blerk (quoted by Brincker, 2010:12) expressed his view that as interest is not inherently charged on a loan, the borrower does not have an obligation to pay any interest. Therefore on the one hand, the lender provides the borrower with a sum of money, being the loan. The lender acquires the right to receive repayment of that loan. The borrower receives the right to use the loan for his own purposes. Therefore, if no interest is charged, the only right the lender receives is the right to repayment of the loan and the borrower receives the right to retain the loan for the period of the loan and no obligation to pay any interest exists. In the event that interest is charged, the lender receives the right to the payment of loan capital and interest and the borrower does not receive any benefit and is obliged to make such a payment.

2.8.3 Summary of rights

As seen above, interest is an amount of money or, for clarity purposes, is a potential payment. If no interest is required to be charged on a loan, there is no personal right as there is no right to claim payment, and there is no right to claim performance as no performance in respect of interest is required in terms of the loan agreement.

Now that we have established that interest is not an essential part of granting a loan in terms of the NCA and the common law principles, an investigation follows into what the purpose of issuing an interest-free loan is.

2.9 PURPOSE OF AN INTEREST-FREE LOAN

According to Brincker (2010), the general purpose of obtaining a loan is to obtain financing in order to fund a need in ones business and/or for business operational purposes and once fulfilled, to repay that loan advanced. It is believed that interest is not payable unless it has been agreed upon and entitled to in terms of an agreement between the parties (Brincker & Mopusa, 2009: 468-479). This type of transaction is encountered and may be seen in various scenarios (Brincker, 2010). Below is a list of some of the more frequent types of interest-free loans encountered, to name but a few:
- Loans to a family trust
- Loans between employers and employees
- Loans to and from companies within the same group of companies
- No interest charged on late repayments
- Low-interest rate loans instead of interest-free loans
- Loans to and from non-residents
- Loans to and from shareblock companies

In these scenarios Brincker (2010) elaborates that no interest charged may be purely as a result of the party that would be liable for the interest not having sufficient cash to pay the interest. However, the practice today between all independent parties is to charge interest on a loan, irrespective of whether they are able to repay the loan with the interest or not. However, as has been previously established, interest is levied on a loan as a result of a contractual arrangement between the lender and the borrower. According to Brincker and Mopusa (2008:468-479) interest is usually payable if both parties agree and understand that the interest will be paid. From a group of companies’ perspective, a loan that is issued to a subsidiary by a holding company may be without interest and are usually repayable on demand. This may be due to the subsidiary not having sufficient cash to repay any interest. These loans, however, are repayable on demand in most cases as most holding companies subordinate these loans. The minority judgement in the Burman v CIR 53 SATC 63 at 78 (AD) held that shareholder’s loans should be treated differently from other normal (independent parties) loans. This means that shareholder loans should be capitalised to the investment in that subsidiary. Therefore, the sale of shares would be accompanied by the shareholder’s loans. For this reason, where a taxpayer receives the benefit of not having to pay interest on a loan, it should be regarded as capital in nature. Similarly, a family trust may also not be obliged to pay interest as this would deplete its trust’s cash position and have an impact on the beneficiaries’ eventual gains and/or interests. (Brincker, 2010).

2.10 CONCLUSION

It has been established in this chapter that the purpose of a loan is to provide funding to a borrower to assist them with their need for cash. They are then entitled to retain that amount over the period agreed by both parties (lender and borrower). The interest charged or not is a contractual matter that must be agreed upon by both parties. No right, either a real or personal
right, is created as there is no ownership of a thing or any performance required to take place with respect to an interest-free loan.

In chapter 3, an investigation will be conducted as to whether the gross income definition with respect to the benefit obtained on an interest-free loan will be included in a taxpayer’s gross income and establish the grounds of taxability of that amount.
3  CHAPTER 3: DETERMINATION OF IMPACT ON GROSS INCOME

3.1  INTRODUCTION

It has been established in chapter 2 that the nature of a loan is the lending of an amount of money by a lender to the borrower, which imposes an obligation on the lender to transfer that money. At the same time there is a reciprocal obligation on the borrower to return that money, either the same or of an equal quantity, to the lender after or during an agreed upon time. A lender does, however, have an entitlement to charge interest, but there is no legislation governing that any lender is required by law to charge interest. Therefore, the borrower obtains the benefit of utilizing the loan capital without being required to pay any interest.

This chapter will investigate whether this benefit constitutes an amount that is taxable. In order to determine whether the above mentioned benefit is taxable, the gross income definition will be investigated, especially after the findings of the Brummeria case where the interest-free loan was determined to be a benefit to the taxpayers, resulting in an “amount” that “accrued to” the taxpayers.

3.2  DEFINITION OF GROSS INCOME

At the time of the study, the gross income definition in section 1 of the Act reads as follows:

“…in relation to any year of assessment”, means –

(i)  in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic;

During such year of assessment, excluding receipts or accruals of a capital nature…”

A taxpayer is required to determine whether there is a tax liability for any year of assessment. In respect of that year, any resident shall include in his gross income for tax purposes any “total amount”, whether it is in cash or not, which has been received by or may accrue to that resident. Similarly, any non-resident shall include in his gross income for tax purposes any “total amount”, which may be in cash or not, that has been received by or accrued to that non-resident from a source in South Africa or at least deemed to be from such a source.
The amount to be included in the gross income of a taxpayer excludes any amounts received or accrued to that taxpayer of a “capital nature”. However, certain amounts of a capital nature have been specifically included in that said definition and this results in those amounts, of a capital nature, being held as taxable.

3.3 CONCEPTS OF GROSS INCOME

For the purposes of this study the following concepts of the gross income definition will be investigated to determine whether any “amount” has in fact been “received by or accrued to” by virtue of any benefit contained in an interest-free loan:

- “total amount”
- “received by”
- “accrued to”
- “capital nature”

3.3.1 Meaning of the word “Amount”

The word “amount” has not been defined in the Act and we turn to case law for guidance to understand its meaning.

3.3.1.1 Principles of the word “Amount”

The most pertinent case that enunciated the meaning of the word “amount” was the Lategan case. In that case, the taxpayer, a wine farmer, produced wine and sold it to third parties. The payment of the wine sold would be settled in instalments, with a portion of the amount being paid before 30 June of that tax year, and the remaining amount in the following year. The Commissioner included the total amount of the wine sold in the taxpayer’s gross income in the tax year in which the wine was sold, as they believed that a right, being a personal right, was created in respect of the future payment and that right could be turned into money in that first year. (Williams, 2005:87).

The principle that arose in Lategan case was that the word “amount” had a wider meaning and it is not only the cash that has been received or accrued to a taxpayer, but the “value of every form of property” that has been received by or accrued to that taxpayer (Williams, 2005:82). Here the court considered the right to future payment to be property that had been received by the
taxpayer and it was consequently regarded as an “amount” for “gross income” definition purposes.

Later, in the Butcher Bros case, the taxpayer (lessee) who owned land, leased it to a third party (lessee). The benefits (a building that was erected on the land by the lessee) arose in terms of a lease agreement that the Commissioner wished to include in the lessor’s gross income. The lease agreement stipulated the erection and maintenance costs should be expended by the lessee. On expiry date of the lease, the building would become the property of the lessor and there would be no acquisition costs incurred by the lessee on that date. In 1935, the lessee completed the erection of the new building.

In short, Judge JA Feetham held that there was uncertainty at that time as what the value of the improvements would be at the end of the lease. Therefore, no amount was included in the gross income of the lessor. Here the court held that the benefits in terms of the lease did not have an amount, but were considered to be property with no value at that point in time (Williams, 2005:82,317-318). On delivering judgement, Carlisle J (13 SATC 21:46) stated that the benefit of using the building would only be obtained at the end of the lease and that the benefit had “accrued to” the lessor in 1935, but due to the long period in the lease and that the benefit does not have an ascertainable money value (could not be turned into money at that point in time) in that tax year, no accrual of an “amount” could be found. The word “amount” was under much scrutiny in 1990 in the People’s Stores case. The Lategan case was referred to in the People’s Stores case where judge Hefer, JA held that “The first and basic proposition is that income, although expressed as an ‘amount’ in the definition, need not be an actual amount of money but may be ‘every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value…including debts and rights of action’.” It is submitted that even though no cash has been received or accrued to a person, rights that have a money value would be regarded as an “amount” and therefore included in gross income. (William, 2005:82).

Jansen van Rensburg (2008:37) argued that there are two questions that should be answered in order to understand the concept of “amount” after the SCA provided its judgement in the Brummeria case. First, there is a question of whether a taxpayer should include receipts that he may turn into money in his gross income, or does it apply “to all receipts that have an objective monetary value”. The second question that was asked was: what should the nature of those receipts and accruals be to constitute an “amount” for “gross income” definition purposes.
In answering the first question, this study turns to the Butcher Brother case. That case held that the Commissioner is required to prove the value of the amount that would accrue to a taxpayer and thereafter, in terms section 82 of the Act, the onus is on the taxpayer to prove that the amount determined by the Commissioner is not taxable for purposes of the “gross income” definition. This question was the matter in question in the Brummeria case, and it was held by the SCA that the all receipts with an objective monetary value should be included in a taxpayer’s gross income (Jansen van Rensburg, 2008:37). This would mean that the Commissioner would no longer be required to prove that a receipt has a value. This may be in contravention to the principles established in the Butcher Bros case.

In further considering whether all receipts have an objective monetary value, the Stander case should be evaluated. The background facts in that case were that the taxpayer was awarded an overseas trip by Delta Motor Corporation (Pty) Ltd, who was not his employer. The value of the trip was included in the taxpayer’s gross income by the Commissioner. The judge, Friedman JP, found that there was no property accrued to the taxpayer prior to the taxpayer going on the trip, and therefore no value could be placed on the amount for gross income definition purposes. This case held that not all non-monetary rights have money value and therefore does not constitute an “amount” for gross income definition purposes. (Jansen Van Rensburg, 2008:38).

As a result of the findings in the Brummeria case, the judgement of the Stander case was found to be incorrect. Rights of a non-monetary nature should be evaluated to determine whether they have a money value as opposed to those rights being turned into money, hence there is an objective test and not a subjective test (Brincker et al, 2007:13). From the Lategan and People’s Stores case, it has been established that an amount, whether of a monetary nature or not, that accrues to a taxpayer, that has a value that may be realized, must be included in a taxpayer’s gross income. According to William (2005:93), the facts of the transaction will determine whether a non-monetary amount has a value, and it should be objectively determined. The SCA held that it is not only receipts and accruals that can be turned into money, but rather all receipts and accruals have a monetary value (Olivier, 2008:153).

Further, Jansen Van Rensburg (2008:37) only factually addresses the second question. However, it is highlighted that both questions are inseparable and should be investigated together. The word “benefits” has a wider meaning than the word “property”. It is submitted that it would seem that our courts have not really exercised care in their use of these words or terminology, i.e. in respect of the words being used interchangeably. They have rarely considered whether an
“amount” of receipts or accruals constitutes “property” for the purposes of the “gross income” definition.

This may be seen in the Butcher Bros case where the word “benefits” was applied and it was said that the amount for gross income purposes was the benefits that accrued to the lessor. The benefits that accrued to the lessor were in terms of a lease agreement and were in fact personal rights (as the lessor had a right to claim the newly erected building on expiry of the lease agreement). These personal rights were held as property for the purposes of gross income. In light of this it would seem that the wider meaning of the word “amount” was not insofar as the meaning was intended was applied in that case (Jansen van Rensburg, 2008: 39).

As seen in the above cases, the phrase “every form of property…which has a monetary value” as stated in the Lategan and People’s Stores case is regarded as an “amount” for the purposes of the gross income definition. Jansen van Rensburg (2008:34) argued that an “amount” “requires the existence of property” and not benefits. However, SCA in the Brummeria case held that the word “benefit” was taxable. It is imperative to understand whether it is regarded as property for the purposes of the gross income definition. According to Jansen van Rensburg (2008:39), as no reference is made in the Lategan and People’s Stores case to benefits as being taxable, one would need to establish whether the word “benefits” is included in the definition of the word “property” so as to determine whether benefits are in fact taxable for the purposes of the gross income definition.

3.3.1.2 The meaning of property for the gross income definition purposes

The meaning of the word “property” has been further investigated by Jansen Van Rensburg (2008:39), and it has been found that due to the word having such a vast number of meanings and there being no universal meaning, the traditional reference to subjective rights was applied for the purpose of that paper.

Badenhorst et al (2003:1) confirms this and further states that due to the word being such a “complex term” there is no exact definition and therefore the context of the manner in which the word is used, will guide the meaning of the word.

With reference to the above, South African law traditionally refers to “property” as being subjective rights that exist between parties with respect to a legal object (Badenhorst et al, 2003:1). This being said it is where a legal subject (person) alone has a right to claim a legal object. The legal objects for the purposes of property are real and personal rights as seen in
chapter 2. Rights may also refer to “powers and entitlements that the holder of a subjective right has to deal with a legal object by virtue of that right”. The value to be placed on the rights (legal objects) should either be an economic or sentimental value. It is imperative that this fact be considered, as only a legal object with an economic value would be regarded as “property” for the purposes of the gross income definition. The above may be illustrated by an example, i.e. the owner of a house has a real right of ownership and a lessee of such a house would have a personal right to use that house. However, it is cautioned that not all real and personal rights have economic value. (Jansen van Rensburg, 2008:40-41).

Therefore, it is irrespective of the value to any one person, rights which have a monetary value are an “amount” for “gross income” purposes. To reiterate, both the rights, real and personal rights, are included in the rights referred to in the Peoples Stores case and are included as part of “property”.

The Commissioner in the Brummeria case stated that a benefit of not being charged interest on a loan should be taxed as it is a “right which has an ascertainable money value and which accrued to the companies”. In the Tax Court, J Goldblatt found that the rights referred to by the Commissioner could not be transferred or ceded. Therefore, the taxpayers have a right to retain the money borrowed from the retirees until a predetermined event occurs. He further held that the right to retain the money lent is not separable from the liability to repay it, and obviously does not have money value. (Jansen van Rensburg, 2008:44).

However, Cloete JA (69 SATC 205) rejected this view and said that an objective value should be determined irrespective of the fact one is unable to separate the right from the liability to repay. Moreover, this does not mean that the right does not have a money value. Therefore, the right to retain the money lent on an interest-free basis is an amount that has accrued to a taxpayer. The word “property” may also be regarded as a “benefit” for the purposes of determining the latter meaning. A benefit is an advantage granted to a person, and is not a right to which any one person is entitled. In view of this, “benefit” it is not a real right (ownership transferred) or a personal right (claim to a performance) any one person is entitled to.

3.3.2 Meaning of the words “received by” and “accrued to”

Now that it has been established what the meaning of the word “amount” is, this study will now investigate the words “received by” or “accrued to”. Each of the words “amount”, “received by” and “accrued to” are not unrelated to each and should be collectively considered (Williams, 2005:83).
3.3.2.1 “Received by” meaning

Any amount received by a taxpayer must be received by him on his own behalf and for his own benefit. This principle was established in the *Geldenhuys v CIR* case. The background facts to this case were that a farmer and his wife had a joint will, which stated that the survivor would be entitled to the fruits generated from the farming operations and their children would be the heirs of the estate. On the death of the farmer, his wife accepted all income related to all assets. In particular, a flock of sheep was part of those assets and were valued at 1 451 pounds. Due to a drought, the flock barely survived and the widowed wife decided to sell the flock of sheep. She realised 4 941 pounds on the sale of the flock of sheep. The Commissioner included the difference of 3 490 pounds in the widowed wife’s taxable income. (William, 2005:84).

In this case, the widow did not receive the differential amount on her own behalf for her own benefit as she only had the right to use the assets on the farm to earn income, i.e. being the fruits, and the children were the owners of the flock of sheep. Therefore, the children, the heirs, should be taxed on that differential amount. (William, 2005:84).

To further illustrate the meaning of “received by”, a pertinent principle was held in the *CIR v Genn & Co (Proprietary) Limited* (“Genn case”), where a loan capital amount may constitute a receipt. However, it does not constitute “gross income” for the purpose of section 1 of the Act. Schreiner JA (20 STAC 113, 2008:122 -123) in delivering his findings stated “It is difficult to see how money obtained on loan can, even for the purposes of the wide definition of ‘gross income’, be part of the income of the borrower, any more than the value …. It certainly is not every obtaining of physical control over money or money’s worth that constitutes a receipt for the purposes of these provisions. …At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed.” [Emphasis added]

Therefore from the above, any money borrowed that is expected to be repaid does not constitute “gross income” for the purposes of that definition.

In the original assessment issued by SARS in the *Brunneria* case, the Commissioner included the loan capital amount received by the taxpayer in the taxpayer’s gross income. Later, this was withdrawn by the Commissioner in view of the *Genn* case (Brincker, 2010) as the loan capital
amount is not an amount received from gross income purposes, and this was correctly withdrawn.

3.3.2.2 “Accrued to” meaning

Where a taxpayer is entitled to receive something, it may accrue to that person. Therefore, a right that is created may be turned into money. This is best illustrated in the Lategan and People’s Stores case, discussed as part of the word “amount”. As established previously, this occurs when a taxpayer obtains an unconditional right to that amount, irrespective of whether any money has been received to date.

A further illustration of “accrued to” lies in the Cactus Investments case, where it was held that in order to determine if an amount has accrued to the taxpayer, one should take cognisance of whether a reciprocal obligation exists. If one party is required to perform, then rightly so should the other party. This is known as a quid pro quo, in that something is exchange for something (Williams, 2005:92-93). The findings of the Brummeria case was on a similar basis, in that the taxpayer was granted or benefited from the right to use the retiree’s money and not being obliged to pay interest in exchange for granting occupation of the residential units to the retirees. This was regarded as being the quid pro quo in the transaction.

Jansen van Rensburg (2008:39) argues that there is a link between the concept “amount” and “accrued to”, and states that the “existence of a subjective right as represented by the concept of property”. As seen above, an amount has accrued if a right has been acquired. This was illustrated by discussing the ITC 1810 case, where the taxpayer invested his money in a pyramid scheme owned by A. A went insolvent and did not pay any of the interest on the investments he was paid. The Commissioner wished to include the unearned interest that the investee was entitled to in his gross income. Jansen J, delivering his findings, referred to Fourie NO and Others v Edeling NO and Others, which held that any promise to pay any returns to an investee under pyramid scheme were nullified. He therefore held that the investee was not unconditionally entitled or did not have the right to claim the interest payment from A, and as such the interest had not accrued to him for the gross income definition purposes.

Brincker (2007:15-16) submits that our courts have found that a right should be valued objectively. One case in particular where this may be found is in the Ochberg v CIR 5 SATC 93 case. In this case additional shares were issued to the shareholder, who already owned all the shares, in exchange for services rendered. De Villiers CJ (5 SATC 93) in delivering his
judgement said that it is irrelevant whether a taxpayer has benefited from a transaction, and the substance of the transaction should be more closely examined.

In light of the concepts discussed above, it is imperative to determine the value of the amount and the timing of when that value should be included in a taxpayer’s gross income. This study will investigate the valuation and timing of an amount that accrues to a taxpayer.

3.4 VALUATION AND TIMING OF AN ACCRUED AMOUNT

The valuation and timing of an accrued amount is vital from a cash flow perspective. The SCA in the *Brummeria* case did not address these areas as it was not under dispute per the notice of appeal. However, if it is found that an interest-free loan should be taxable, it is crucial to understand the timing and valuation.

3.4.1 Timing of an accrued amount

The principle that should firstly be considered is when the amount should be taxed, on receipt or accrual, or would these words allow the taxpayer a choice when they should be taxed. Judge CJ Steyn (30 SATC 199, 1969) found that taxpayers do not have the right to elect whether an amount should be included in his gross income in the tax year of receipt or accrual. Therefore, the taxpayer will be taxed on the amount at the earlier of receipt or accrual of that amount. The date on which the taxpayer becomes unconditionally entitled to an amount is the date of accrual for tax purposes. This is confirmed by the *Mooi* case, *Lace Proprietary Mines* cases (Williams, 2005:100) and Interpretation Note 58. Furthermore, the timing of each accrual must be based on the merits of each case. Importantly, the Interpretation Note 58 states that the benefit of having the right to retain an interest-free loan is only required to be included in a taxpayer’s gross income in the first year of that right accruing, and not in any subsequent years in respect of the same loan.

3.4.2 Valuation of an accrued amount

Invariably a non-monetary accrual must be of such a nature that it has a money value attached to it (Brincker *et al*, 2007:12). Therefore the opportunity to earn income is not regarded as an amount that accrued to a taxpayer, but it will rather be included as part of the gross income as a right with a money value. As previously established, the valuation method in the *Brummeria* case was accepted by the SCA.
In the *Ochberg* case (1931), Roos JA held that “…he received them as ordinary income for service to be rendered…and therefore as ordinary income, which he himself values at a certain figure.” In 1933, Wessel CJ reiterated the principles established in the *Lategan and Peoples Stores* case when he said that “T[he] tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not money’s worth or cannot be turned into money, it is not regarded as income”.

From the cases presented above it becomes clear that an objective test must be followed to determine the value of an amount. The *Butcher Bros* still prevails in that the burden of proof is still on the Commissioner to quantify the amount that should be included in a taxpayer’s gross income.

An issue brought up in the *Brummeria* case was whether a taxpayer would be in double tax position if the loan capital was invested and the taxpayer earned interest. The SCA held that there would be two separate accruals. Brincker *et al* (2007:15) agrees that there would be two separate accruals. He illustrates this by highlighting that if a taxpayer was granted the right to use a motor vehicle for services rendered, and that taxpayer rents that motor vehicle out to a third party, he would be taxed on the consideration received in respect of the services he rendered and the rental income he would earn. Therefore separate values would be included in the taxpayer’s gross income.

The Interpretation Note 58 issued by SARS highlights general principles on the valuation of interest-free loans and provides that the first question to be answered is whether the non-monetary receipt or accrual has a money value. However, it has been stated in that note that if a receipt or accrual cannot be turned into money it does not mean that it does not have a money value. Therefore an objective test should be followed and not a subjective test. This confirms the principles established above.

Furthermore, the Interpretation Note 58 states that the arm’s length principle of valuing amounts must be applied, and the facts of each case should be considered to determine such a value. SARS admits that the valuation method presented in the SCA was never challenged by the taxpayer in the *Brummeria* case, and the SCA “did not rule on the basis in valuing the right”. However, Brincker and Mapusa (2009) argue that the valuation is under much scrutiny as a lender would not ordinarily be entitled to an interest rate of prime since the lender is not a financial institution. Moreover, the valuation method applied in the *Brummeria* case may not be the most appropriate method to determine the value of a right to use an interest-free loan. Again,
each case should be evaluated based on the facts of that case and the burden of proof is on the taxpayers with regard to the valuation method they used.

### 3.5 ACQUISITION OF PROPERTY

As seen previously, the lender has an obligation to deliver the money lent to the borrower, in turn the borrower has a right claim the money borrowed. Therefore, the borrower has acquired a personal right with respect to the loan capital. Once the lender actually transfers, or releases, the amount to the borrower, the borrower takes ownership and he acquires a real right with regard to the loan capital (Jansen van Rensburg, 2008:41). In the event of an amount of money being transferred from lender to the borrower, there is no amount for gross income definition purposes as seen in the *Genn* case. Both the Tax Court and the SCA accepted the findings of the *Genn* case in respect of the loan capital amount (SCA 99 (RSA): 12).

As established in the chapter 2, the law does not require any interest on loan capital. Accordingly, the right of the lender to request a reward, being the interest, is only enforceable once all parties in a loan agreement have agreed thereto. Jansen van Rensburg (2008:46) states if the parties agree not to charge interest, there is no right on the lender and there is no duty on the borrower to not pay interest. However, there is a benefit that the borrower receives in not having to pay any interest. By not charging interest, there is no right to claim a performance or act, or is there a right to claim a thing as the benefit only affords a person the ability to not pay interest. As there is no property, there is no amount for the “gross income” definition purposes.

The facts in the *Brummeria* case are specific as the taxpayers obtained an interest-free loan *in lieu* rent free accommodation. It was submitted that this transaction was a barter transaction and that one should distinguish that case from other interest-free loans. In the case of an interest-free loan being provided as a financing arrangement, the use of the loan is not provided as consideration. (Kriel, 2007/2008).

In view of the above, Jansen van Rensburg (2008:46) considers whether the right to retain loan capital is property that accrues to a borrower for the “gross income” definition purposes. It was submitted that there is a once-off obligation of the lender to provide the loan capital to the borrower, and the borrower, on becoming the owner of the loan capital, is obliged to repay that loan and there is no accrual for gross income. Therefore, no property is acquired as no other right is gained with respect to retaining and using the loan capital interest-free. Brincker and Mopusa (2009:468-479) submitted that the Tax court and the SCA reached different decisions in the *Brummeria* case using the same facts. The SCA finally held that income is not only an amount
actually received, but includes non-capital nature rights that accrued to the taxpayer that has a money value.

Jansen van Rensburg (2008:47) cautions that if the lender had a continuous contractual duty to provide the borrower with loan capital interest-free, there may be the risk that the borrower acquired a right to claim that loan capital (personal right), and as such an amount would accrue, this is assuming that there is an objective value. An example of this may be an access bond with no interest charge, where the borrower repays the loan capital and continues having access to that loan capital repaid. According to Brincker and Mopusa (2009:468-479) an interest-free loan used as a financing instrument is not a right where the borrower expects any performance from a lender, unless it is contractually acquired. Therefore, the lender is not rewarded for his capital being employed.

The Tax Court in the Brummeria case held that the Commissioner wished to treat the opportunity to earn income as income, and this was rejected. This court continued that if a loan does not attract interest, there should be no impact on gross income, as this is a capital receipt. Jansen van Rensburg (2008:47) highlights that the SCA never considered whether the right to retain and use the loan capital was regarded as property acquired by the taxpayers. The SCA rather found that the right has an objective value and accepted that an amount in terms of the gross income definition was present. Further, the SCA argued that the Commissioner taxed the taxpayers on the basis that a right to use the loan and not having to pay interest is a benefit irrespective of whether the taxpayer used the loans or not. No explanation was provided on how the benefit accrues and whether the benefit was property. (Jansen van Rensburg, 2008:47).

Jansen van Rensburg (2008:49) concludes her arguments by discussing the future implications and application of the Brummeria SCA judgement. It was submitted that taxpayers may challenge similar or other aspects of an interest-free loan, i.e. the valuation method accepted by the SCA. Now that the SCA held that all benefits (regardless of whether they are property or not) will be regarded as an amount that accrues to a taxpayer, there may be far reaching implications in that revenue-natured benefits may fall within the scope of par (c) of the gross income definitions, even through those benefits are not property as required by the word “amount”.

3.6 SUMMARY OF THE AMOUNT OF THE ACCRUED FOR AN INTEREST-FREE LOAN

For the purposes of determining whether an interest-free loan is capital in nature or not, one would need to provide clarity on the above implications. For the purposes of the gross income
definition, the benefit the borrower obtains is not a right to claim any performance or claim of any one thing. As there is no right, there cannot be any property acquired, and as such there is no amount for the purposes of the gross income definition (Jansen van Rensburg, 2008:46).

On the other hand, if a lender provides an interest-free loan to a borrower and the borrower provides a service or goods to that lender, there may be a risk of an accrual for gross income purposes, as seen in the Ochberg case. If such an event occurs, the principle laid out in the Cactus Investments case may also be applied. As seen previously, an accrual arises where there is a reciprocal transaction that could take place. De Koker (2010) highlights that services rendered are obviously revenue in nature and should be included in the gross income of any person.

A more common type of loan to be considered in this regard is a debtor-creditor relationship. This is where a Person A will sell its goods or services to Person B and allows the payment for such goods or services to be made after a period of time. During this loan period there is usually no interest charged. The transaction that takes place is the sale of assets where the real right of ownership transfers to Person B on accepting delivery. The interest-free loan portion is the method of payment, as this does not usually extend over a long period of time. If it does extend over a long period of time, more likely than not that the amount will be under dispute and will need to be resolved. The transactions are inseparable and the interest-free loan in this regard is merely the method of payment of an acquisition of an asset, and not a right or benefit for the purposes of previous arguments.

3.7 MEANING OF “CAPITAL NATURE”

3.7.1 Determination of whether an amount is capital in nature

The last concept in determining the gross income of a taxpayer is to determine whether an amount is capital in nature or not. If the amount is regarded as capital in nature, the amount may fall within the parameters of the Eighth Schedule to the Act. This schedule deals with the disposal of capital assets, the value of proceeds and base cost to determine any capital gain or loss. This will be dealt with in more detail in the Capital gains tax section of the next chapter.

Stiglingh et al (2010:27) highlights that determining whether an amount is capital or income natured, is a challenge for tax purposes. The best way to determine this was illustrated in the judgement by Judge Corbett in the Elandsheuwel Farming (Edms) Bpk v SBI (1978). He held that the first question a taxpayer should be asked is whether the sale of an asset that generated
the income was a realization of a capital asset, or whether it was in pursuant of carrying on his trade and had the intention to make a profit. Where a taxpayer holds an asset for a period of time and/or is using it to earn income, the realization may be regarded as capital in nature. The opposite is true for a revenue natured asset, where the asset is used as stock-in-trade by the taxpayer who has the purpose of reselling it at any opportunity that presents itself.

Therefore, Judge Corbett further highlights that the intention at the time of acquisition and at the time of selling the asset must be taken in account. However, these are not the only factors that should be considered, as one should also consider what the activities of the taxpayer’s business are, and that being said, what his business operations as a whole are. Stiglingh et al (2010:28) illustrates that courts would consider the following in determining whether an amount is capital in nature or not, but not limited to:

- What the taxpayers behaviour was in relation to the transaction
- What the business purpose and nature is
- The frequency of a similar transaction
- The period of time the assets are held
- How regularly these transactions are conducted
- The objectives of the directors of a company
- What activities were conducted up to the date of transaction
- Documents or policy of the underlying transaction
- Historical holding that resulted in the amount
- The accounting treatment followed by the taxpayer
- The financial resources at disposal of the taxpayer
- Whether there is a potential profit-making scheme

As a result of the above factors being taken into account, the following statement was delivered in the judgement in the *CIR v Visser* case by Maritz J: “If we take the economic meaning of “capital” and “income”, the one excludes the other. “Income” is what “capital” produces, or is
something in the nature of interest or fruit as opposed to principal or tree. This economic
distinction is a useful guide in matters of income tax, but its application is very often a matter of
great difficulty, for what is principal or tree in the hands of one man may be interest or fruit in
the hands of another. Law books in the hands of a lawyer are a capital asset; in the hands of a
book-seller they are a trade asset. A farm owned by a farmer is a capital asset; in the hands of a
land jobber it becomes stock-in-trade.”

In light of this statement, in the *Brummeria* case, the interest-free loan was provided *in lieu* of
the right to occupy the retirement village by the retired persons, and was regarded as the “fruits”
obtained in their business with the “tree” being the residential unit that was still owned by the
taxpayers in that case. The Commissioner maintained that interest-free loan was the benefit
obtained and was the taxable consideration. Strydom (2008) agrees with the view of the
Commissioner in the *Brummeria* case as he believes that there was a *quid pro quo* between the
benefit of obtaining an interest-free loan and right to occupy the residential units in that
retirement village.

In the case of an interest-free loan where no services are rendered and there is no capital being
employed by the taxpayer, i.e. trust (borrower). Therefore, the benefit a taxpayer receives on not
paying interest on a loan is not in return for any services rendered, but rather a benefit in that the
profits of that trust are not reduced as a result of interest being charged. The benefit obtained
from not paying interest is capital in nature as “it was not received in return for the application of
the business activities of the trust”. (Strydom, 2008).

In view of an interest-free loan being provided from lender to borrower where the borrower has
the obligation to return that same or similar loan capital to the lender after an agreed upon time,
there is no capital being employed or any services rendered by the borrower to the lender for the
receipt of the interest-free loan. Therefore, the interest-free loan may be regarded as capital in
nature. In agreeing with this view, Brincker *et al* (2007:42) presents that it may have been
difficult for the taxpayers in the *Brummeria* case to have argued that the interest-free loan was of
a capital nature as it was received in exchange for services rendered *inter alia* occupation of the
residential units. It was noted that an interest-free loan provided between a Holding and
Subsidiary company is merely a disposition and not necessarily a *quid pro quo* type of
transaction, therefore there are arguments to support that such a benefit would be capital in
nature (Brincker *et al*, 2007:42). However, in terms of the gross income definition paragraph (c)
of the Act where an amount is received by or accrued to a taxpayer as a result of any services
rendered regardless of whether it is capital nature, that amount may be included in the gross income of a taxpayer.

3.8 ANTI-AVOIDANCE PROVISIONS

In the event that a non-resident and resident that are connected persons enter into a loan agreement, cognisance should be taken of the anti-avoidance, amongst others. Brincker (2008) questioned whether the decision in the *Brummeria* case would trigger same kind of legislative intervention as other countries. According to Rudnicki and Alence (2004:69-74), SARS imputed an amount of interest in the hands of either party, where the taxpayers in a loan agreement were residents or non-residents. It was argued that in difficult times South African companies may have lent an amount to a foreign subsidiary and as such not charged interest. In such times the foreign subsidiary is unable to obtain financing from a third party, and as such the interest charged between unrelated parties would have been R nil.

With regard to a loan provided by a non-resident to a resident that are connected persons, the thin capitalisation rules stipulated in section 31(3) of the Act may be triggered. However, this happens only upon the financial assistance (Loan capital) being regarded as being excessive in relation to the fixed capital. Regardless of whether the loan capital is excessive, no amount would be disallowed as no interest would be charged on an interest-free loan. Notwithstanding this, the provisions of section 31(2) should be considered. That subsection requires that any supply of services between residents and non-residents and not between residents should be at an arm’s length price (Income Tax Act 58/1962). Paragraph (c) of that section, the services definition, specifically includes a loan as a service for the purposes of the anti-avoidance provisions. For the purposes of determining whether the interest-free element in an interest-free loan is a service as defined in subsection 31(1) for the purpose of section 31(2). The definition of services provides that anything that is done or has to be done is regarded as a service. Specific inclusions have been provided in that definition, in particular “the granting, assignment, cession or surrender of any right, benefit or privilege” (Income Tax Act 58/1962).

A loan that carries no interest between a resident and a non-resident that are connected persons is a service as defined in section 31(1). For the purposes of subsection 31(2) those services may not be at an arm’s length price as an arm’s length price would be at a market-related rate between independent willing buyers and sellers. From this the Commissioner may make an adjustment to a taxpayer’s taxable income to reflect an arm’s length interest amount in an interest-free loan transaction (Mitchell & Kolitz, 2008).
3.9 GENERAL ANTI-AVOIDANCE RULES

As a result of the anti-avoidance provision above, the provisions of Part IIA of the Act relating to General Anti-Avoidance Rules (“GAAR”) should be investigated. The GAAR provisions may apply to any transaction that is regarded as an impermissible avoidance arrangement. However, in order to determine whether these provisions apply, one should first determine whether there was an arrangement. An arrangement is specifically defined as “any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof...”. This arrangement’s sole or main purpose must be to obtain a tax benefit. The Smith v CIR 26 SATC 1 case it was held that where a taxpayer is able to escape an anticipated tax liability, a tax benefit would be derived. The GAAR provisions in section 80G presumes that the sole or main purpose of an avoidance arrangement is to obtain a tax benefit, which therefore requires a taxpayer to disprove that presumption. In order to disprove that presumption the taxpayer must prove that their intention was to arrange their tax affairs efficiently so as to minimize their tax liability as seen in the CIR v Conhage (Pty) Ltd 61 SATC 391. If the transaction gives rise to such a benefit, one should further determine whether such transaction was an abnormal transaction; whether it lacked commercial substance, or whether there was misuse of the provisions of the Act. For the purposes of thoroughness, each of the above will be investigated.

A transaction would be regarded as an abnormal transaction if it would not normally have been entered into for bona fide business purposes. Secondly, section 80C of the Act determines that a transaction lacks commercial substance if there is a significant tax benefit and there is no significant effect on the business risk or cash flow to a party in the transaction. Specific provisions to this section indicate that transactions where the legal form differs, or is even inconsistent with the substance of the transaction, where there is round trip financing (section 80D), where there are tax indifferent parties to the transaction (section 80E) or “elements that have the effect of offsetting or cancelling each other”, is a transaction that lacks commercial substance. Lastly, the act of determining whether a transaction is entered into results in the misuse of the Act. There must be a gap found in legislation which, on interpretation by taxpayers, may not be the true intention of the legislator. (Klue, 2009).

In view of the above, to determine whether an interest-free loan is subject to the provisions of GAAR, one should first determine whether a tax benefit was obtained. The benefit of not paying any interest would not be included in the taxpayer’s gross income where no quid pro quo relationship exists as established above, which results in a tax benefit. As previously established,
an interest-free loan is common practice where a taxpayer does not have sufficient cash to pay that interest and therefore, an interest-free loan is not an abnormal transaction and it is entered into for bona fide business purposes. Therefore the provisions of the GAAR would seem not to apply to such a transaction.

3.10 CONCLUSION

As seen above, the views of various tax professionals maintain that the findings of SCA in the Brummeria case have a number of interpretations. In summary, where a taxpayer is provided with an interest-free loan where he is expected to return that loan capital by rendering services to the lender, the interest-free loan would be regarded as income in respect of the services rendered (Kriel (2007/2008)). This study agrees with Brincker et al (2007:14-16, 42) in that where an interest-free loan is provided in lieu of services or goods, it would result in a taxable consideration, as seen in Ochberg and Cactus Investments case. In respect of Jansen van Rensburg (2008:44) arguments, it is submitted that no right is acquired and the no property exists for the purposes of an amount accruing to the taxpayer. Further, Strydom (2008) submits that if there was an amount that accrues to a taxpayer, it would of a capital nature.

In chapter 4, this study will conduct an investigation into whether any deductions may be claimed in respect of interest-free loans considered to be taxable in the hands of a taxpayer.
CHAPTER 4: DETERMINATION OF THE IMPACT ON DEDUCTIONS

4.1 INTRODUCTION

As seen in the background facts to the Brummeria case, the SCA held that the benefit the taxpayers received was the interest-free element of the loan capital in lieu of the right given to retirees to occupy retirement village residential units rent free. It was agreed that rental income would have been earned by the taxpayer, but instead they received the benefit of an interest-free loan. The Commissioner wished to include the value of the benefit as determined by them, as previously discussed, in the taxpayer’s gross income. However, it was not clear in the findings of the Brummeria case whether a deduction with respect to the interest-free loan was considered.

This chapter will investigate whether any deduction may be available on the inclusion of the benefit of the interest-free loan in the taxpayer’s hands where a quid pro quo relationship exists. In conducting such an analysis the general deduction formula of the Act, trading stock provisions of the Act and comments made by tax professionals will be considered.

4.2 GENERAL DEDUCTION FORMULA

As seen in chapter 1, the general deduction formula is provided for in section 11(a) read with section 23(g) of the Act. However, the meanings of the concepts in that provision are not specifically defined in the Act. Therefore, case law would provide the best guidance in determining whether any deduction may be claimed in terms of the general deduction formula.

The question was whether the taxpayers in the Brummeria case claimed any deductions with respect to the residential units constructed and provided to the retirees. No evidence was presented to the courts in this regard. If a deduction was claimed, one would wonder what the taxpayers’ reasons were for claiming a deduction as the occupation of the residential units that were constructed did not realise any income (no rental income that is). The deduction of any costs incurred would be denied where they are not in the “production of income” of the taxpayers. Furthermore, if the intention of the interest-free loans was to be provided as security no deductions should be allowed. Where the right to use the interest-free loan is regarded as an amount and included in a taxpayer’s gross income, then that taxpayer would be allowed to claim a deduction of the non-capital expenditure. This
was not under dispute in the Tax Court or SCA. However, due consideration should be taken with regard to claiming a deduction. (Brincker et al, 2007:21).

For the purposes of this study, the concepts of “carrying on a trade”; “expenditure and losses”; “actually incurred”; “in the production of income” and “capital nature” will be investigated. In determining whether the term “carrying on a trade” warrants further investigation one would need to consider the facts of each case. In view of this, it is noted that the taxpayers in the Brummeria case would have either earned their revenue by way of selling the retirement village units or providing the use of those units to the retirees (SATC, 2007:210). The term “trade” is specifically defined in the Act and includes the letting of property. This reinforces the idea that an interest-free loan provided in lieu of the lifelong rights would be conducted in the ordinary operations of the taxpayers, and therefore for the purposes of “carrying on a trade”. Similarly, if the interest-free loan was provided for financing purposes to a taxpayer, as previously established, and no interest was charged so as not to deplete the cash resources of the borrower, such transaction would be entered into for the purposes of carrying on a trade. Therefore, the term “carrying on a trade” is met as the transaction would not take place if it was not in the ordinary course of business.

Our analysis will only consider the general deduction formula in section 11(a), read with section 22. This study has not considered the provisions of other sections and the remaining part of section 11, as with no apparent evidence to the contrary, no other section specifically deals with an interest-free loan transaction.

4.2.1 Case law supporting general deduction formula

4.2.1.1 The meaning of “expenditure and losses”

According to Stiglingh et al (2010:111) the word “losses” has a “somewhat obscure” meaning and it is unclear whether its meaning is different to the word “expenditure”. It was submitted that it is not only cash that is seen as an expense that is deductible, but amounts in forms other than cash are also included. Watermeyer CJ (13 SATC 354) held that a loss is involuntary deprivation suffered, and expenditure, on the other hand, is voluntary payments made by a taxpayer.

4.2.1.2 The meaning of “actually incurred”
In determining whether any amount is regarded as an expenditure or loss that is deductible, it must have been actually incurred by a taxpayer in terms of the Act. Therefore any expense or loss incurred for an event that is believed to take place in the future, referred to as a contingent liability, would not be regarded as having been actually incurred. This is confirmed by Davis AJA (13 SATC 121), who held that a contingent liability would not be regarded as an expense that has actually been incurred and this is evidenced by his statement: “It is a reserve out of income to provide for a contingent liability, and, as such, it seems to me the very thing which is forbidden by the sub-section in question.”

Despite expenditure or losses being held as contingent liability, Watermeyer AJP (8 SATC 13) held that even if one businessman incurs expenditure due to inefficiencies that occurred in that businessmen’s company for which another businessman does not incur, that does not mean that the first businessman did not actually incur that expenditure or loss. These expenditures and losses that are therefore not necessary to be incurred, may still be allowed to be claimed as a deduction for tax purposes.

The most important requirement that must be met with regard to the concept “actually incurred”, is to determine whether a taxpayer incurs an obligation. If that obligation is subject to certain conditions and will only be honoured once it becomes unconditional, the obligation will only then be considered a deductible expense or loss ((3) SA 549 (A)).

In determining when an amount of expenditure or loss has been actually incurred, it was submitted by Botha JA (Williams, 2005) that the tax year in which an expenditure or loss is actually incurred is the year in which a taxpayer may claim that deduction, and not in the year it is paid.

**4.2.1.3 The meaning of “in the production of income”**

According to Williams (2005:364), the most pertinent case that laid out the principle with respect to any expenditure and loss actually incurred in the production of income is found in the Port Elizabeth Electric Tramways case. Watermeyer AJP (8 SATC 13) holds that if the taxpayer would earn (produce) income by performing an act and that the expenditure incurred is closely linked to that act, that expenditure or loss would be
regarded as being conducted in the production of that taxpayer’s income (William, 2005: 364).

This case has been referred to in many other cases heard before our courts and is referred to as the board test in respect to determining whether it is “in the production of income”. However, it is not necessary that expenditure incurred must have produced any part of the income for the tax year in question. This was affirmed by Centlivres JA (15 SATC 381), where he states that as long as expenditure has been laid out for the purpose of earning that income, it is deductible irrespective of whether it has in fact produced income in the tax year in which the expenditure has been incurred.

4.2.1.4 Meaning of “capital in nature”

Our courts have generally applied a standard test to determine whether expenditure is of a capital nature. That being whether expenditure is incurred for the purpose of growing or improving the taxpayer’s business (income earning structure) or whether it is incurred as part of the ordinary course of the taxpayer’s income earning operations. In the first mentioned part, the expenditure is capital expenditure. Whereas, if the expenditure was more closely linked to the ordinary operations as mentioned in the second part; it is likely to be of a revenue nature (14 SATC 155). In applying this test, our courts consider various factors. Some of these factors, amongst others, to be considered are (1) whether the expense creates an enduring benefit or (2) whether the expense settles a matter once and for all (Williams, 2005: 392-393). Most taxpayers incurred expenditure that inevitably contributes towards the growth of a business, without that expenditure resulting in an identifiable asset (Williams, 2005: 392). Therefore, it is a difficult task to prove whether an expense is capital in nature or not.

4.2.2 Trading stock provisions of the Act

Brincker et al questioned whether the Brummeria group of companies regarded the lifelong rights as trading stock. “It is further questionable whether such rights would have a deductible value as trading stock”. If the taxpayers in the Brummeria case incurred costs in respect of reselling the residential unit, they would have been claimed in terms of section 11(a). However, where the costs were incurred and the residential units were neither developed nor sold in that year, the provisions of section 22 would have been applied (Brincker et al, 2007:67).
Any expenses incurred by a taxpayer will generally be allowed as a deduction in terms of section 11(a). However, in the case of trading stock, cognisance of the provisions of section 22 should be taken into account. That section provides that the cost will only be deductible if it is acquired and disposed of in the same tax year. Section 22(1) requires that the value of trading stock on hand and not disposed of in any one tax year be accounted for in the taxable income of a taxpayer as the closing stock value that is added back for tax purposes. This value mentioned is either the taxpayer’s cost price of that trading stock or the value the Commissioner considers just and reasonable as being the value that the trading stock has been diminished by, amongst others, and which is satisfactory to the Commissioner. In the following year, section 22(2) of the Act provides that the closing balance that is carried forward from the prior year will be deducted in determining a taxpayer’s taxable income (Income Tax Act 58/1962).

The cost price of trading stock, amongst other costs, is the cost incurred to acquire the trading stock, and is governed by the provisions of section 22(3). However, for trading stock that is acquired for no consideration or where the consideration is not measurable in money, section 22(4) provides that on that acquisition date the current market price of such trading stock will be deemed to be the cost price incurred by the taxpayer. One should keep in mind that section 22(4) purely values the trading stock and does not provide for a deduction. The deduction of trading stock is provided for in subsection (1) and (2) read with section 11(a).

4.2.3 Availability of any deduction with respect to interest-free loans

As has been previously established, in the event that interest-free element of loan capital is provided in exchange for any services rendered or goods delivered, a taxpayer should consider whether any deductions would be available to him.

In addition, it has been established that where a lender and borrower agrees to lend an amount of money to the borrower with no interest, that is the benefit the borrower receives. Now the question that arises is whether there are any deductions available to that borrower or lender with respect to an interest-free loan.

Brincker et al (2007:67) questions how the taxpayers in the Brummeria case accounted for the lifelong rights provided to retirees as no evidence of this was provided in the court proceedings. If one is provided with information on how the taxpayer’s disclosed and
accounted for the transaction, it would be easier to determine whether a deduction would be available.

If the taxpayers in the Brummeria case developed the units with the intention of selling them, those units would be regarded as trading stock. In addition, if the taxpayers rented the units to retirees, a rental income would be earned and units would be regarded as fixed assets. In the hands of the retirees, they would either pay a rental expense or the purchase price of the unit sold. The retirees would not be entitled to a deduction, in respect of the rental expense, in terms of section 11(a) due to section 23(b). That section disallows the deduction of any domestic or private expenses, including rental expenses. This means that the deduction may not be available if the premise occupied was used for non-trade purposes. This is based on the assumption that the retiree would no longer actively carrying on a trade. Further, if the retiree acquired the residential unit, the provisions of the Eighth Schedule would be considered. This study will not focus on these provisions as it is not pertinent to this argument. If one now substitutes the rental income with the interest-free loan, the tax treatment would remain the same as previously established where there is a *quid pro quo* relationship. Similarly, if the rental expense is substituted with an interest-free loan, the tax treatment discussed above would be followed. If the interest-free loan was provided *in lieu* of other services or goods that are similar in nature to retiree’s rental expense and those services or goods were provided for the purpose of carrying on a trade, one would need to consider whether those services or goods would warrant a deduction.

Wilmot (2007:58) commented that the tax authorities in Canada deems interest-free loans taxable, however, the lender is entitled to a deduction of expenses in the same transaction. In order to determine whether this statement is true in terms of the general deduction formula, the first step is to determine whether there was any expenditure or loss. As seen above, there must be a deprivation suffered. The lender paid the loan capital to the borrower, who is expecting services to be rendered or goods be delivered in return for granting an interest-free loan. The loan capital amount would be the deprivation suffered, however, it attracts no interest and therefore no further deprivation in respect of interest occurred. Further, there is no unconditional obligation on the lender other than the layout of the loan capital which will be repaid after a period of time. However, in the event that loan capital will not be fully repaid on termination of the loan period or earlier due to stipulations in the loan agreement, the lender would have an unconditional obligation to the borrower who rendered the services or delivered the goods and that amount not repaid
would be the deprivation suffered. Moreover, the services rendered or the goods delivered must closely linked to earning that income and there must be the intention to earn income. If that is the case, the interest-free loan is received in lieu of the services rendered or goods delivered and therefore in the production of the taxpayer’s income. In the case of the arguments of Jansen van Rensburg (2008:34-50), there is no amount that accrued to a taxpayer for an interest-free loan, therefore there would no income resulting in no deduction available as there is no amount actually incurred in the production of income. If the interest-free loan is provided in lieu of services rendered or goods delivered is found to be capital in nature, the interest-free element of an interest-free loan may be regarded as income in terms of paragraph (c) of the gross income definition, as previously established. Therefore, the amount may be in the production of income. However, if the argument of Strydom (2008) is followed that the interest-free loan would be regarded as capital in nature in respect of the financing arrangement, there would no deduction available in terms of the general deduction formula as it is capital in nature.

This study will illustrate the above by way of examples.

First example:

If A lends an amount of R100 interest-free to B in year 1 and repayment of the loan amount would take place over a period of time. A would pay the loan capital of R100 and raise a corresponding receivable of R100 in its accounting records expecting that amount will be returned. B, on the other hand, would receive the loan capital and raise a corresponding liability for that amount to be repaid to A. Therefore, there would be no income receivable. Based on the arguments of Jansen van Rensburg (2008:34-50) no amount has accrued to the taxpayer, therefore, no amount of the benefit would be included in B’s taxable income. Hence, no deduction in the hands of A or B would be available. Based on the argument of Strydom (2008), the benefit would be capital in nature and not included in B’s taxable income either. Therefore A or B would not be entitled to a deduction as no deprivation has been suffered and there is no unconditional liability incurred.

Second example:

This example has the same facts as in the first example, except that the loan capital amount is repaid at an amount of R90. B is then relieved of debt owed to A by R10. The shortfall
of R10 may either be taxed as gross income or in terms of the Eighth Schedule, refer to discussion on this in chapter 5. If the shortfall is closely linked to the act of performing the services or delivering the goods and not of a capital nature, there may be arguments to support the ability of A deducting the R10.

As previously stated, if the taxpayers in the Brummeria case developed the units with the intention of selling them, and that is the sole purpose of the taxpayer, then those units would be regarded as trading stock. Therefore, if the taxpayers developed them in year 1 and sold the units in the same year, a deduction in terms of section 11(a) would be claimed by the taxpayers. This is due to the residential units, being costs actually incurred with the purpose of producing income. The costs incurred to construct the residential units are closely linked to earning income. Notwithstanding this, if taxpayers developed the units in year 1 and sold them in subsequent years, the provisions of section 22 would become applicable as those residential units would become trading stock saleable in the future.

Where the taxpayers provide the right to use the units in exchange for an interest-free loan, the tax treatment is not as simple. One would then need to determine the basis of allocating the costs incurred in respect of developing the unit. It has been submitted that the costs incurred in developing the units would be fixed assets with the right to use attached to it. Therefore, “the value to the developer in this instance lies in the lifelong rights and not the bare dominium.” (Brincker et al, 2007:68).

There are two alternatives that Brincker et al (2007:68) suggests, and for the purpose of this study, these will be analysed. The first alternative is to say that in receiving the interest-free loan, the loan capital was used to incur costs to create the lifelong rights to occupy those residential units by the retirees, and that bare dominium (ownership) was insignificant. The second alternative is the inverse of the first, hence the lifelong rights were insignificant and the costs were mainly incurred to construct the residential units (Brincker et al, 2007:68).

*First alternative: the costs are allocated to right of use (usufruct) and an insignificant portion is allocated to the bare dominium*

Here the costs incurred on acquisition of materials to construct the residential units are allocated mainly to the lifelong rights (usufruct), with an insignificant portion being allocated to the cost of the building (bare dominium). As established previously, the expenditure actually incurred would be in the production of the taxpayer’s income and
therefore deductible in terms of section 11(a) (Brincker et al, 2007:71). Brincker et al (2007:71) comments that a section 11(a) deduction would be available when allocating the cost mainly to the usufruct. However, in the year that the residential units are constructed and in a subsequent year, the services or goods related rights are rendered or delivered, the ordinary principles of trading stock in section 22(1) and (2) above should be considered. As the trading stock has been valued, Brincker et al (2007:71) highlights that section 22(4) discussed above would not apply. However, he further indicates that at a later stage (on the lifelong rights (usufruct) being reverted to the taxpayer) section 22(4) may become applicable. Brincker et al (2007:71) illustrates his views by way of an example:

**Scenario 1**: The costs incurred to develop the residential units (bare dominium) allocated to lifelong rights (usufruct) is R60 000. The interest-free loan benefit (gross income) is valued at R100 000. Here the costs were incurred in year 1 and disposed of in the same year. The tax implications may be as follows:

<table>
<thead>
<tr>
<th>Provisions of Act affected</th>
<th>Amount</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>R100 000</td>
<td>Per the <em>Brummeria</em> case there is a <em>quid pro quo</em> in respect of the lifelong rights (usufruct) that were acquired in exchange for an interest-free benefit on loan capital</td>
</tr>
<tr>
<td>Opening stock (section 22(2))</td>
<td>R Nil</td>
<td>There is no amount of trading stock in the prior year</td>
</tr>
<tr>
<td>Section 11(a) deduction</td>
<td>R 60 000</td>
<td>The lifelong rights are allocated with the cost of development and actually incurred in the production of income as the R100 000 is included in the taxpayer’s gross income.</td>
</tr>
<tr>
<td>Provisions of Act affected</td>
<td>Amount</td>
<td>Reason</td>
</tr>
<tr>
<td>---------------------------</td>
<td>--------</td>
<td>--------</td>
</tr>
<tr>
<td>Closing Stock (section 22(1))</td>
<td>R Nil</td>
<td>The lifelong rights were disposed of during the year and therefore there is no closing balance for trading stock purposes.</td>
</tr>
</tbody>
</table>

If this scenario was posed over two years, then the general principles of the amount of R60 000 would be added back as closing stock in terms of section 22(1) and claimed as a deduction in terms of section 22(2) in year 2.

*Second Alternative: the costs incurred are mainly allocated to the bare dominium and insignificant portion to the usufruct*

The costs incurred would be allocated to the bare dominium, which would be regarded as capital in nature. This is due to the enduring benefit created in developing the units. Therefore, no deduction may be allowed with respect to these costs incurred. Furthermore, no deduction would be allowed as no costs were “actually incurred” with respect to the lifelong rights (in this case trading stock). If a unit was constructed in year 1 and the granting of the lifelong rights occurred in year 2, the provisions of section 22 would become applicable. Further, if the lifelong rights were granted in the year of constructing the units, no deduction would be claimed, as previously established. Section 22(4) will provide the value to be placed on the lifelong rights as, in this instance, none of the costs incurred in constructing the units would be allocated to the lifelong rights. In this year, the value of lifelong rights would be treated as closing stock for the provisions of section 22(1). (Brincker et al, 2007:69).

Brincker et al (2007:69) illustrates his views by way of an example:

*Scenario 1*: The lifelong rights (usufruct) are acquired and disposed of in the same tax year. The interest-free loan benefit is valued at R100 000. The tax implications for the usufruct may be as follows:
### Scenario 1

<table>
<thead>
<tr>
<th>Provisions of Act affected</th>
<th>Amount</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>R100 000</td>
<td>Per the Brummeria case there is a <em>quid pro quo</em> in respect of the lifelong rights that were acquired in exchange for an interest-free benefit on loan capital</td>
</tr>
<tr>
<td>Opening stock (section 22(2))</td>
<td>R Nil</td>
<td>There is no amount of trading stock in the prior year</td>
</tr>
<tr>
<td>Section 11(a) deduction</td>
<td>R Nil</td>
<td>The lifelong rights (usufruct) are insignificant as the interest-free loan was mainly used to incur costs for the bare dominium.</td>
</tr>
<tr>
<td>Closing Stock (section 22(1))</td>
<td>R Nil</td>
<td>The lifelong rights were disposed of during the year and therefore there is no closing balance for trading stock.</td>
</tr>
</tbody>
</table>

### Scenario 2

The same facts as in scenario 1 of alternative 2, except that the lifelong rights (usufruct) are acquired in year 1 and disposed of (terminated) in year 2. The lifelong rights (usufruct) are valued as R60 000 in accordance with section 22(4). The tax implications may be as follows:

<table>
<thead>
<tr>
<th>Provisions of Act affected</th>
<th>Amount</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening stock (section 22(2))</td>
<td>R Nil</td>
<td>Same reason as scenario 1</td>
</tr>
<tr>
<td>Section 11(a) deduction</td>
<td>R Nil</td>
<td>Same reason as scenario 1</td>
</tr>
<tr>
<td>Provisions of Act affected</td>
<td>Amount</td>
<td>Reason</td>
</tr>
<tr>
<td>------------------------------------</td>
<td>----------</td>
<td>------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Closing Stock (section 22(1))</td>
<td>R60 000</td>
<td>The lifelong rights have been acquired and not yet disposed of at year end.</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>R60 000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Year 2**

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>R100 000</th>
<th>Same reason as scenario 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Stock (section 22(2))</td>
<td>R60 000</td>
<td>Was held as closing stock in year 1 and therefore is opening stock in year 2.</td>
</tr>
<tr>
<td><strong>Taxable income</strong></td>
<td><strong>R40 000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Both these scenarios provide the same effect. Brincker et al (2007:70) indicates “that it is SARS’ practice to allow a deduction for opening stock in year 1 based on the value as determined in section 22(4)”. It has been highlighted that if section 22(2)(b) is read simplistically, there are arguments to support that a taxpayer may be able to claim a deduction for trading stock it acquired for no consideration. Therefore the taxable income in scenario 1 and 2 would be reduced to R40 000. (Brincker et al, 2007:70).

Brincker et al (2007:72) concludes his argument by advising taxpayers that have similar transactions to the taxpayers in the Brummeria case to obtain a professional opinion with respect to claiming a deduction in terms of section 22 and section 11(a). If this argument is successful, one would consider whether costs incurred with respect to properties used to earn rental income could give rise to the right to use these properties as trading stock. For this argument to be successful, one would argue that properties are held on revenue account and not on capital account.

### 4.3 SUMMARY OF DEDUCTION AVAILABLE ON AN INTEREST-FREE LOAN

To summarise, in the event that a taxpayer acquires a benefit of an interest-free loan in lieu of any services rendered or goods delivered, no deduction may be available to the lender if only the loan capital borrowed is repaid on termination of the loan agreement. However, if
the amount repaid is less than the amount the loan capital amount, one should consider whether the shortfall would be deductible in the hands of the lender. In a quid pro quo relationship, deprivation is suffered in that a portion of loan capital in not repaid. This may be a non-capital unconditional liability, being the services rendered or goods delivered. The act of performing the services or providing the goods, for the amount included in the taxpayer’s income.

If the borrower incurs costs to construct residential units as seen in the Brummeria case, the provisions of section 11(a) read with section 22 may be available to him in respect of those costs incurred (Brincker et al, 2007:67-72). The costs incurred in constructing the residential units, may be regarded as trading stock. This depends on the whether the costs incurred are allocated to the usufruct or the bare dominium associated with the residential units. There are arguments that the cost will either be allocated to the bare dominium or to the usufruct. In both situations a deduction will be available to the taxpayer. This argument may be strong in terms of acquiring goods, and not necessarily an argument for services rendered.

In the event that a lender lends an amount of money to a borrower where no interest is charged, there would be no amount to be included in the income of the taxpayer as previously established by Jansen van Rensburg (2008:34-50) above. Alternatively, an interest-free loan may be regarded as capital in nature as proclaimed by Strydom (2008) above and therefore no deduction would be available to the borrower or the lender in respect of the interest-free loan.

From the chapter 3 and 4, the normal tax implications have been established. However, to determine the total tax implications, this study will investigate the other taxes to understand their impact on an interest-free loan in chapter 5.
CHAPTER 5: OTHER TAXES WITH RESPECT TO INTEREST-FREE LOAN

This chapter aims to establish what, if any, other taxes implications, i.e. CGT, Donations tax, STC, newly proposed dividends and VAT may be applicable with respect to an interest-free loan. Each of these taxes will be investigated and evaluated separately below.

5.1 CAPITAL GAINS TAX

As contemplated in chapter 3, where the lender lends money to the borrower for no reward of interest, the benefit may be capital in nature. Hence, for the purpose of this study the capital gains tax provisions as dealt with in Eighth Schedule will be investigated with respect to an interest-free loan.

5.1.1 Background

For a capital gains tax event to be triggered, there must have been an asset disposed of by a resident and, in certain circumstances, by a non-resident. In view of the criteria being met, a disposal is the event that triggers the CGT. A disposal includes any act, event, forbearance or operation of law that creates an asset. That is variation of an asset, transfer or extinction of an asset. CGT is not a separate tax, but rather a tax on income and it forms part of the normal income tax charge of a taxpayer. The link between the Eighth Schedule to the Act and the Act is section 26A, where it provides for tax on income. (SARS, 2010:24-26).

An asset is any property, including real and personal rights, whether corporeal or incorporeal, movable or immovable, and excludes any currency. It also includes any right to or in any such property. It does not limit the meaning of property to mean only touchable things, but includes all types of property. (SARS, 2010:26).

In case of any debt (loan) that is waived or when a taxpayer is relieved or discharged of any debt, the provision of paragraph 12(5) of the Eighth to Act should be considered as a deemed capital gains tax event that may be triggered. That paragraph applies where a borrower is relieved or discharged of any debt and therefore is deemed to have “acquired a claim to that portion of the debt that was reduced or discharged for no consideration or, if a consideration was paid, to so much of the reduction or discharge as exceeds the consideration” (SARS, 2010:85). In this instance the base cost of the debt acquired will be R nil and the amount of debt he was relieved of will be the proceeds on such a disposal. In respect of the lender, he will be the person that relieved or discharged the borrower of the
debt. Where the debt has been discharged as a result of any operation of law, this means that the lender would still have been the person that discharged or relieved the borrower of any of that debt. However, there are provisions within this paragraph that prevents the debt so relieved or discharged from having CGT implications and these are as follows:

- Where that debt is relieved or discharge, which results in the base cost of an asset being recovered in terms of paragraph 3(b)(ii) of the Eighth Schedule
- Where the relief or discharge of debt results in a recoupment of deduction previously claimed and that recoupment is in terms of section 8(4)(m)
- Where the debt so relieved or discharged is taken into account by the borrower in determining it’s assessed loss
- Where the debt amount relieved or discharged is in respect of an asset disposed of, there may be double tax triggered. To illustrate this, if a seller disposed of an asset for R100 with a base cost of R70, a capital gain of R30 would arise. If the seller discharged R50 of the purchase price owed by the buyer, he would only receive R50. Therefore, the capital gain of R30 has already taken into account that full purchase price on the sale, and the buyer would be subject to tax on the capital gain of R50. Therefore the R50 proceeds would be subject to tax twice.
- Where the borrower and the lender are in the same group of companies, this exemption will not apply if:
  - the debt was acquired from a member not in the same group of companies and entered into to avoid any tax in terms of the Act; or
  - both parties become members of the same group of companies after the debt arose and was entered into to avoid any tax in terms of the Act.

Where the borrower (company) is a connected person in relation to the lender and an amount of debt is discharged due to the borrower being liquidated or facing liquidation, being wound-up, being deregistered or its corporate existence being finally terminated. This will only be valid to the extent that the debt discharged or relieved does not exceed the creditor’s expenditure in respect of the debt amount. However, this exemption will not
apply if both parties become connected persons after the debt arose and this transaction was entered into to avoid any tax in terms of the Act. (De Koker:2010).

5.1.2 Application of an interest-free loan for CGT purposes

In the hands of a lender, there is an amount of money (loan capital) that is an amount owing to him. Therefore, a loan amount is an asset for CGT purposes. When the loan amount is transferred to the borrower, there is no disposal for CGT purposes as the amount of money was transferred to the borrower. In the event that a taxpayer sells an asset for an amount, the taxpayer has the right to claim payment. A claim to receive payment is a personal right, but this does not mean that an asset is created. This was illustrated previously in the debtor-creditor relationship. It may be merely a method of payment and not made in exchange for any capital employed or services rendered. (SARS, 2010:39).

In the hands of the borrower, he is required to repay the amount of money (loan capital) and therefore, he is not in possession of an asset. He obtains the benefit of not paying interest on the loan capital. This benefit may be capital in nature as there is no services being rendered or capital employed (Strydom, 2008). Furthermore, he has no claim to a performance (personal right) from the lender with respect to not being charged interest, and he has no claim to a thing (real right). This may be illustrated by way of an example: If A (lender) provided B (borrower) with a loan and no interest is charged, B has the benefit of not repaying the loan capital with interest. There is no real right, as there is no claim to a physical thing, and there is no personal right, as there is no claim to performance as no right has been exercised by A. Therefore, the benefit that B receives would not be an asset.

In view of the above, one should turn to whether any amount of debt has been relieved or discharged. As previously established, no real or personal right is obtained in not charging interest as the lender does not exercise its right to charge interest. Therefore there is no relief or discharge of any debt with respect to not charging interest on a loan, and paragraph 12(5) would not apply.

According to Surtees (2008:84), where a daughter borrows money from her father and that loan is bequeathed to her on his death, it is submitted that there may be CGT implications on the debt and there is no impact on whether interest is charged or not.
5.1.3 Conclusion

In view of this, the interest-free element of loan capital is not an asset being created. Therefore, it would seem no capital gains tax implications would arise with respect to an interest-free loan.

5.2 DONATIONS TAX

5.2.1 Background

The act of providing an interest-free loan to a borrower was found to be a continuing donation by the SCA in CIR v Berold 34 SATC 729. This decision was, however, made with reference to section 7 of the Act, and not in respect of donations tax (Strydom, 2008). The provisions of section 7 of the Act deals with the act of making a donation, settlement and other disposition by a donor to a donee so as to have the donee benefit from such a transaction. An interest-free loan would fall within the scope of a donation, settlement and other disposition for the purposes of section 7 as seen in the decision made in the C:SARS v Woulidge (2002 (2) SA 199 (A)). This study will not investigate these provisions as they specifically include interest-free loans in specific circumstances in a taxpayer’s taxable income. However, this study will and has investigated other provisions to determine whether those provisions would be held as taxable. As established by Jansen van Rensburg (2008:34-50), the making available of an interest-free loan may not be a continuous act.

Within the Act there are provision governing that donations be taxed. Part V of the Act deals with the taxes in this regard, and is known as donations tax. A donation for the purposes of the donation tax in section 55 means any property that is gratuitously disposed of. This includes the gratuitous waiver or renunciation of a right (Oosthuizen, 2009:732-733). We have also received guidance from our courts, where the SCA held in the CSARS v Estate Welch’s 66 SATC 3030 that donations only exist if they are motivated by “pure liberality” or completely a “disinterested benevolence”. For the purposes of the meaning “property”, it is the right in or to property that is movable or immovable, corporeal or incorporeal, and situated anywhere. As established previously property includes any personal and real right.

Later in the Act, there are deeming provisions for donations tax purposes. These deeming provisions are found in section 58 of the Act, where it finds property that is disposed of for a consideration that the Commissioner believes to be an inadequate amount as a donation for donations tax purposes.
5.2.2 Tax implications of interest-free loan

There is no legal right imposed on a lender to charge interest on a loan, and therefore there is no right that is waived, as previously established. Stiglingh et al (2010, 732) states that in order for a person to determine whether a right has been waived, one should first refer to the loan agreement. Where a lender is entitled to charge interest with respect to a loan and he waives that right stipulated in that agreement, a gratuitous waiver would result and would therefore be regarded as a donation. This confirms the statement made by Jansen van Rensburg (2008:34-50) on the fact that it is not a legal right, but rather a contractual right that is waived, which may result in a donation for donation’s tax purposes.

Moreover, Strydom (2008) states that it is not SARS’ practice to treat interest-free loans as a donation for donations tax purposes, and that a taxpayer should keep in mind that a donation for the anti-avoidance provisions in section 7 of the Act bears the same meaning as for donations tax. However, they are not treated the same for tax purposes.

5.2.3 Conclusion

As previously established, an interest-free element on the loan capital is not a real right or a personal right, and therefore is not regarded as property. From this, it is believed that no donations tax would arise as a result of the provision of an interest-free loan, unless specifically stated in a loan agreement that the interest is waived.

5.3 STC OR DIVIDENDS WHT

Any distribution declared to a shareholder (including parties that are entitled to participate in profit and/or benefits of the company) may be regarded as a dividend for STC purposes, unless it is found to be capital in nature, at which time the specific provisions in the Eighth Schedule may be applicable, i.e. paragraph 74-78. This may be read in the opening paragraph in the dividend definition in section 1 of the Act, and will be further explained in this chapter.

For the purpose of this study the STC implications and the proposed new dividends tax implications will be investigated on an interest-free loan issued to a shareholder. The newly proposed dividends tax legislation that will be investigated will relate to provisions written to date of this study, and no reference will be made to future legislation in this regard. The reason for including this newly proposed dividends tax as part of this study is that the Minister of Finance has stated in a previous budget speech that this legislation will
instituted and will simplify the existing legislation. No effective date has been announced by the Minister as yet, but it is expected to be implemented in the coming years. (De Koker, 2010).

5.3.1 **STC implications with respect to an interest-free loan**

The dividend definition has a wide meaning and incorporates a general inclusion, specific inclusions and provisos. The general part of the definition in section 1 reads as follows at this time:

“any amount distributed by a company (not being an institution to which section 10(1)(d) applies) to its shareholders, and in this definition the expression “amount distributed” includes…”

A dividend is regarded as an amount distributed to a shareholder. In respect of the definition any amount **transferred to a shareholder** will be included as a dividend. One should keep in mind that if any STC is triggered, 10% tax will be levied on such a distribution.

In view of a loan granted and/or provided to a shareholder with the expectation that it will be repaid, there will no dividend that arises in respect of the loan. This is as a result of the fact that the loan is provided to a shareholder as a borrower and not in his capacity as shareholder In relation to the interest-free element of the loan capital, there is no transfer of an asset or cash as no right (real or personal right) is created in the granting of interest-free loan, as emanated from previous sections in this study.

5.3.2 **Deemed dividend**

For the purposes of counteracting taxpayers’ escaping the STC net, the anti-avoidance provisions in section 64C were enacted. As seen above, if the amount is deemed to be a dividend, a tax of 10% will be levied on such a distribution. This section provides that any amount with respect to section 64C(2) will be regarded as a deemed dividend, and the STC will be levied thereon. However, that section also provides that certain amounts will not be held as deemed dividends if the provisions of subsection (4) are met. (De Koker, 2010).

With respect to a loan issued or granted to a shareholder, a taxpayer should take cognisance of the provisions of section 64C(2)(e) of the Act, in order to determine whether there are any STC implications on such a loan. Once it is determined that this provision
applies, a taxpayer should consider whether any one of the following exemptions may apply with respect to the loan granted:

- Where an amount distributed exceeds the profits or reserves that are available for distribution, the amount in excess will not be regarded as a deemed dividend. The proviso to this part disregards any policy acting to the contrary of this exemption;

- Where loans are granted at an interest rate that is less than the “official rate of interest” as defined in paragraph 1 of the Seventh Schedule to the Act;

- A loan that is granted to a shareholder that is in the employ of the company or the company’s ‘associated institution’ as defined in paragraph 1 of the Seventh Schedule. This loan granted must comply with the normal ‘terms and conditions’ of a loan schemes that available to all other employees of the company or its associated institution who are not shareholders.

- Any loan granted / provided that
  - is repaid by no later than the end of the immediately succeeding year of assessment;
  - the amount of the loan must not be included in any other or subsequent loans to the same shareholder or a connected person to the shareholder;
  - these provisions must have been applied in the current year for the first time.

- Any loan granted or provided for the benefit of a shareholder who forms part of the same group of companies as the company who granted and/or provided that loan. The proviso to the above states that if the profits of the company granting the loan is reduced as a result of the dividend, then these provisions apply only to the extent that the profits of the shareholder increased accordingly.

- Any loan granted or provided for the benefit of company A by company B if:
  - the company A (whether alone or together with any other company in the same group of companies) directly or indirectly holds at least 20% of the total equity share capital of company B;
  - that company B must not hold any equity shares in the company A or in any company in the same group of companies of company A.
In summary, the loan capital in the interest-free loan would be regarded as a deemed dividend for the purposes of STC. However, if one of the exceptions contained in section 64C(4) applies, the deemed dividend would be reduced by that amount and therefore no or minimal STC consequences will arise. In respect of the interest-free element of the interest-free loan, one should carefully analyse what would be regarded as a deemed dividend. Three subparagraphs of subsection (2) have been considered for the purposes of this study.

The first consideration is whether section 64C(2)(a) applies. This subparagraph requires that cash or an asset that is transferred or distributed for the benefit of the shareholder would be regarded as a deemed dividend. As seen previously, the loan capital amount is not included as it is dealt with in section 64C(2)(g). SARS (2010) provides guidance regarding the terms distribution and transfer. It is submitted that distribution refers to something that is provided and there is no obligation to return it to the company distributing it. In the case of the interest-free element of a loan, there is no obligation to return any interest on a loan. However, nothing was legally provided. Unless it is stated in the loan agreement that interest is waived, there is no contractual obligation provided. A transfer, on the other hand, refers to a provision of an asset for the benefit of a shareholder (SARS: 2010). The interest-free element is not a real or personal right as there is no legal claim to a thing or performance, and therefore there is no asset. Hence, no transfer has taken place either.

Secondly, one would need to consider whether any shareholder was released or relieved of any debt as this could result in a deemed dividend in terms of section 64C(2)(b) (SARS: 2010). As the shareholder is not required to repay any interest, this can be said to be a legal matter, or contractually, he would not be relieved of any debt by not being charged any interest and therefore subsection (2)(b) will not apply to an interest-free element of such a loan.

Finally, where a company uses or applies any amount in any other manner to the benefit of the shareholder, it may be regarded as a deemed dividend in terms of section 64C(2)(d) (SARS: 2010). An amount must be used or applied for the benefit of a shareholder. The interest-free element on the loan capital is not a real right or personal right, as previously established. This would mean no amount was provided for the use and application of a shareholder even though there is a benefit.
5.3.3 Newly proposed dividend potential tax implications

The provisions discussed below have not yet been promulgated into legislation. However, these provisions that may be promulgated will be investigated.

5.3.3.1 Dividend definition

First, one should consider whether the dividend definition will be met in order to determine whether this WHT will apply. Once this definition has been met, a flat rate of 10% will be withheld by the declaring company from the dividend payable and paid over to SARS on the date the shareholder is entitled to that dividend declared (De Koker, 2010).

The proposed dividend definition at the time of this study reads as follows:

“...any amount transferred or applied by a company for the benefit of any shareholder in relation to that company by virtue of any share held by that shareholder in that company, whether

(a) by way of a distribution; or

(b) as consideration for the acquisition of any share in that company, but does not include any amount so transferred or applied by the company to the extent that the amount so transferred or applied

(i) results in a reduction of contributed tax capital;

(ii) constitutes shares in that company;

(iii) constitutes an acquisition by a company of its own securities as contemplated in para 5.67 of s.5 of the JSE Limited Listings Requirements, where that acquisition complies with the requirements prescribed by paras 5.67 to 5.84 of s.5 of the JSE Limited Listings Requirements; or

(iv) constitutes a redemption of a participatory interest in an arrangement or scheme contemplated in para (e)(ii) of the definition of “company”. [Paragraph (e)(ii) refers to a ‘foreign collective investment scheme’, which is an arrangement or scheme carried on outside the Republic in pursuance of which members of the public are permitted to invest in a portfolio of a collective investment scheme, where more than one
De Koker (2010) explains that a dividend for WHT purposes refers to a transfer of cash or in kind from a company to a shareholder. However, this applies to the extent that it is not a return of Contributed Tax Capital. Furthermore, the transfer should result in a diminution of the company’s value.

5.3.3.2 Application of dividend definition to interest-free loans

In view of the above, in applying the dividends tax dividend definition to an interest-free loan transaction from a subsidiary to a holding company (shareholder), it is submitted that the shareholder is not required to pay any interest on the loan, as such he benefits from the transaction. However, there is no transfer of profits, and therefore there is no dividend declared to the shareholder.

5.3.3.3 Value Extraction Tax

Similar to section 64C, anti-avoidance provisions to close the net on taxpayers has also been provided for in the newly proposed dividends tax. At the time of this study, the provisions may be found in section 64O to 64R of the Act and are referred to as the value extraction taxes.

According to de Koker (2010) the value extraction tax applies to four types of transactions:

1. A loan or advance provided to any connected person in relation to that company. In respect of this requirement the rate of interest charged is compared to a market-related rate;

2. Any obligation that is measurable in money that is owed by any connected person to a company and that company undertakes to release or relieve them of any debt;

3. Any debt that is paid or settled to a third party by a company on behalf of any connected person and that connected person is not required to repay that debt;

4. A cessation of companies as a SA resident.
As seen above, the value extraction dividend is wider than the deemed dividend provisions in section 64C as the connected person definition is referred to as opposed to the connected person to a shareholder as required by section 64C. De Koker (2010) states that the exemptions found in section 64C(4) of our current legislation are similarly made available to companies with respect to the value extraction tax. These exemptions are categorized into two components, one being a general exemption, which is similar to the dividends withholding tax. The second category is also similar to the deemed dividends as per section 64C, in fact it deems the extraction value tax to be nil when:

1. Where goods, services or rights are provided in respect of that loan as part of the companies trading activities;

2. Where the company conducts money lending activities as their trade;

3. Relative employees trusts;

4. Loans provided by holding companies to their subsidiary company.

- Where the holding company (lender) provides a loan and releases or relieves any debt or makes a payment to settle any debt to a third party on behalf of the subsidiary company (borrower). For the purposes of this exemption, the lender, alone or together with another company that forms part of the same group of companies, must hold at least 20%, whether directly or indirectly, in the borrower. In addition, the borrower must not hold equity shares in the lender or any other companies that form part of the same group of companies as the lender.

With respect to the first type of value extraction tax dividend, where a loan granted or provided to a person who is a connected person, a dividend for value extraction tax purposes may arise on an interest-free loan as it is at an interest rate lower than the defined market-related rate. Despite this, another exemption may be available, that being a loan that is provided in respect of that persons business operations, or if the loan was made by a lender that was in a money-lending business. There is a risk that the loan capital may be a dividend for value extraction tax purposes if the loan carries no interest, unless it is held for business operational purposes.
A “special exemption” has been provided for on downward loans according to De Koker (2010). This may be a saving grace for the companies in a group of companies’ situation, however only if there is at least 20% shares held by lender in the borrower, and borrower does not hold any shares in any company in that group of companies.

With respect to the second type of value extraction tax dividend there is no relief or release of debt, as interest is not required to be legally charged, unless it is contractually agreed upon and waived, as has been established in previous chapters. Therefore, there is no dividend for value extraction tax purposes on the interest-free loan of the loan.

5.4 VALUE-ADDED TAX (“VAT”)

For the purposes of determining the normal income tax implications of an interest-free loan, this study will investigate the VAT implications of an interest-free loan. The reason for this investigation is that section 23C of the Act requires that any amount of VAT that is claimed by a taxpayer in their VAT return may not be claimed for normal tax purposes. Therefore, the amount of VAT levied on a transaction should be excluded from the deduction claimed or to be claimed for normal income tax purposes. (Value-Added Tax Act 89/1991).

Insofar as VAT is concerned, it has been established by De Koker and Kruger (2009) that VAT is the tax imposed on the value goods or services each vendor produces or distributes, bearing in mind that it must be a taxable supply. Therefore VAT is payable on each taxable supply, which requires the seller to levy VAT on the supply and the purchaser is required to pay that amount of VAT. However, he may be allowed to claim an input tax credit in respect of that supply. (Value-Added Tax Act 89/1991).

For the purposes of thoroughness, the VAT amount levied on a taxable supply must be paid over to SARS in the relevant VAT period per section 16 of the VAT Act. Similarly, the purchaser may claim the VAT input credit in his tax period. However, the purchaser may only claim a VAT input credit if he is in possession of a valid tax invoice. If the purchaser is not a registered VAT vendor, the VAT amount may be a cost incurred, and the principles laid out in section 4 of this study should be taken into account. For the purposes of this study, the VAT administration rules will not be examined as they are not relevant to this study. (Value-Added Tax Act 89/1991).
It is important to note that there are two types of supplies, one being a taxable supply and the other being exempt supplies (Non-taxable supply). The taxable supplies are further separated into zero-rated supplies (0%) and standard rated supplies (14%). Zero-rated supplies are specifically defined in section 11 of the VAT Act and so are exempt supplies in section 12 of that Act. To determine whether taxable supplies are levied at the standard rate, the general principles in section 7 of the VAT Act should be investigated.

5.4.1 **General principles**

At the time of this study, output VAT is levied on the supply of goods and services made in the Republic of South Africa by any registered VAT vendor in the course or furtherance of his enterprise that is carried on by him in terms of section 7 of the VAT Act. In addition, Output VAT is levied on any goods imported by any person into South Africa or on any imported services supplied to a non-vendor, or where imported services are supplied to a vendor who supplies non-taxable supplies. (Value-Added Tax Act 89/1991).

For the purposes of this study, the concepts of “supply” and “services” will be further investigated with respect to interest-free loans. The remaining concepts are not relevant for the purposes of this study.

5.4.1.1 **“Supply” with respect to interest-free loans**

The definition in section 1 of the VAT Act reads as follows:

“includes performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of “supply” shall be construed accordingly”

De Koker and Kruger (2009) highlight that the definition is intended to include all types of transactions. It was submitted that the meaning includes the provision and the making available of anything or service. Therefore the definition is extremely wide and includes all forms of things or services that are furnished or provided to a person.

Beneke (2009) states that a supply can only arise if there are at least two parties to the transaction, namely the supplier and recipient. A recipient has been specifically defined in the VAT Act as the person to whom the supply of goods or services is made. By default,
this would mean that the supplier is the person who supplied or provided the goods or services to the recipient.

5.4.1.2 “Services” with respect to interest-free loans

The meaning of services is defined in section 1 of the VAT Act, which reads as follows:

“…anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (c) of the definition of “goods”.”

This definition is extremely wide, and according to De Koker and Kruger (2009) this definition includes an agreement between parties to act or refrain from acting in certain circumstances.

An important aspect to take into account is whether the services rendered are financial services for VAT purposes. If the services rendered meets the definition of financial services in section 2 of the VAT, those services will be regarded as exempt supplies in terms of section 12(a), and as such no VAT is levied on those services.

According to Beneke (2009), the South African VAT system is limited in comparison to other countries’ VAT systems as the exempt financial services includes money lending activities, long-term insurance operation activities and retirement and medical aid benefit operation activities. However, the fees charged on such activities are not exempt in terms of the financial services provided. There are a number of financial services specifically included in that said definition. More specifically for the purpose of this study, section 2(1)(c) may be applicable. This subsection provides that where there is an issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security is made, that provision would imply a financial service for VAT purposes. A debt security is any interest provided or right to be paid money or an obligation to return money. (Beneke, 2009).

In addition, financial services would include any transactions where credit is provided in terms of which money or money’s worth is provided to any person by any other person. Both parties must agree that an amount will be paid in the future and that amount would be greater than the amount borrowed in that transaction. (Beneke, 2009).
5.4.1.3 Application of the concepts of “supply” and “services”

According to Beneke (2009), in the context of fringe benefits, if a benefit does not result in a supply of goods or services, then it is not a taxable supply. In that respect we would need to consider whether the interest-free element of a loan gives rise to a service. A service includes the surrender of any right. As the lender is surrendering his right to charge interest if it is contractually held as such, there will be a service for the purposes of this definition. Despite this, as there is no legal requirement to charge interest, no service would be apparent.

In view of this if there is a contractual right, one would be required to determine whether those services would be regarded as financial services. The surrendering of the right, being the benefit, may be regarded money’s worth in excess of the loan provided, and may constitute a financial service.

In addition to this one should consider whether a supply has in fact taken place. The benefit is granted to the borrower in not having to repay the loan with interest. However, this is not something that is made available, and no provision is made as the lender is not exercising his ability to charge the interest.

For the purposes of discussing the findings in the Brummeria case, Brincker et al (2007:24) suspects that the taxpayers in that case claimed the full VAT input credits on acquiring and constructing the residential units to be provided to the retirees. Brincker et al (2007:24) highlights that where an interest-free loan is provided in lieu of the lifelong right to occupy the property, a taxpayer is not entitled to claim the VAT input credits as there is a supply of residential units. This matter was not discussed in the case and as such no conclusive evidence can be provided. In instances where interest-free loans are provided in lieu of goods or services that are not non-taxable supplies, VAT may be required to be levied on those transactions. This would be due to the fact that a provision or availability has been made of those goods or services, and the right to receive payment is a financial service, which is an exempt supply for VAT purposes.

Therefore, with respect to the loan capital carrying no interest, there may be a service rendered in relation to a contractual right. However, where there is no legal right, as established above, there will be no services. These services would be regarded as financial services. Notwithstanding the above, no supply is made in respect of an interest-free loan.
5.5 CONCLUSION

In this chapter, the study explored other tax implications, CGT, donations tax, STC, newly proposed dividends tax and VAT. In summary the following has been submitted as the tax implications in respect of an interest-free loan for those taxes discussed:

- Donations tax is not applicable as no property exists in respect of the interest-free element on loan capital;

- The benefit of not paying any interest on an interest-free loan does not appear to give rise to an asset, and therefore there may be no disposal for CGT purpose;

- A dividend is defined as a distribution of profits or reserves to a shareholder, as an interest-free loan is a benefit provided to a shareholder. However, it could appear to have not been distributed or transferred for the purposes of STC.

- However, the loan provided with no interest charge may give rise to a deemed dividend, but the exemptions allow for that loan not to be regarded as a deemed dividend. A shareholder and its subsidiary should be careful when issuing such loans and should ensure that the provisions of the exemptions are available on such loans;

- Similarly, the newly proposed dividend tax is not applicable as no distribution or transfer takes place. Therefore there is minimal risk with respect to that loan being regarded as a dividend;

- Again, similar to the provisions of a deemed dividend in section 64C, the new value extraction tax should be considered by a company issuing an interest-free loan to any connected person, and not only a shareholder;

- The value extraction tax provides for a more stringent approach to issuing interest-free loans to any connected person. The more important type of value extraction dividend that a company should be careful of is where any loan issued is issued at an interest rate below the market related rate as defined in that proposed section. Again, if any of the other exemptions apply, the risk is minimized in that regard.

- From a VAT perspective, an interest-free element of an amount of loan capital would not attract VAT as there is a financial service and there is no supply. However, in the event that an interest-free loan is provided in lieu services being supplied, there may be
supply of the goods or service for a consideration. Hence the latter may result in VAT being levied on the goods or services supplied.
CHAPTER 6: CONCLUSION

6.1 INTRODUCTION

Once the SCA in the Brummeria case held that interest-free loans is “an amount” that “accrued to” a taxpayer, a number of tax professionals and the business world began to raise questions on the past and future tax treatment of interest-free loans.

This study aimed at understanding the nature of an interest-free loan to be able to determine the purpose of its orientation. This information would allow a tax professional to be able to advise a taxpayer on what the tax implications would be. In determining the tax implications, this study investigated the gross income definitions and possible deductions that may be allowed to be claimed. In that respect, the timing and valuation of those tax implications was also investigated. In order to fully understand what the total tax implications would be, this study further investigated other tax implications \textit{inter alia} Donations tax, CGT, STC, newly proposed dividends tax and VAT, within and applicable to the Income Tax Act.

Only those taxes mentioned above were investigated. The tax implications in terms of the Income Tax Act to the date of this study were evaluated.

In order to meet the first objective, being to provide an evaluation of the nature and purposes of an interest-free loan, the history of a loan and accompanying legislation was investigated.

6.2 HISTORY OF A LOAN AND APPLICATION OF VARIOUS LEGISLATION

Loans have been in existence since the biblical times, as seen in chapter 1. Moreover, an amount of interest charged on such a loan was a topic under much debate even in those times (Otto, 2008). On the introduction of a number of customer credit legislations and regulations, more controversy arose (Otto, 2008). A loan is a defined as an amount of money that is lent to a person that is later expected to be repaid (OED, 1989). At the time when that loan amount is repaid, that amount should be accompanied by interest either over the period or on termination of the loan agreement. In that respect, this study turned to credit legislation for guidance on whether interest is required to be charged on a loan. Specifically in this study, the NCA was investigated in detail in order to provide clarity in this regard. One of difficulties identified by Scholtz (2008) was the lack of harmonisation of the NCA with the Common Law principles established over a number of decades.
In this regard, the right to charge interest by a lender on that deferred payment amount is limited in terms of the provisions in the NCA. In addition, there are a number of specific exclusions the NCA provides for, and one in particular is that the NCA does not apply to certain juristic persons. Public policy, by way of the Constitution, places governance on their ability to charge interest, ensuring it is fair to all South African persons. Therefore it may be noted that interest charged on loans, advances or debt is a right granted to a credit provider, that at the discretion and by way of an agreement between all parties party to a loan agreement, interest may be levied on those loan amounts. Therefore it is not legislated in the NCA that interest be charged on a credit agreement.

The NCA imposes law only on certain credit transactions as seen in chapter 2. With regard to those credit transactions that are not governed by the NCA, this study turned to Common Law principles to understand the nature of those types of credit transactions. The Common Law principles according to Van Blerk (quoted by Brincker, 2010), it is not required that interest be charged, it is a contractual agreement between all the parties whether interest should be charged or not.

In view of this, one should note that there are two types of loans, one being loans for consumption (mutuum) and the other being loans for use (accommodatum). According to Joubert & Henning (2008), loans for consumption are loan amounts that are lent to the borrower, who is expected to return those amounts to the lender. Either the same or a similar kind of what was borrowed must be returned. This amount may be repaid over a period of time. However, according to Brincker et al (2007:35), a loan for use is where a lender grants no reward for its use. From the above, it is established that the loan for consumption entitles the borrower to take ownership of units of fungible things. The borrower is obliged to return the same number of units of that type of fungible thing to the lender over a period of time agreed upon by all parties involved. Here the return of the loan capital creates a right to that loan capital or a similar amount. The right mentioned here was addressed through an investigation of the Roman-Dutch Law principles established.

Rights are categorised into two types, one being real rights and performance rights. The real right is anything that a person is entitled to, whereas a performance right is a right to claim an act (performance) from another person. If no interest is required to be charged on a loan, there is no personal right as there is no right to claim payment. In addition, there is no right to claim performance as no performance in respect of interest is required in terms of legislation or contractual agreement, unless specifically stated to the contrary in the loan agreement.
6.3 PURPOSE OF AN INTEREST-FREE LOAN

Obtaining an interest-free loan, from a business perspective, is an extremely viable way of obtaining financing. This assists a business in generating cash from its operations without having to deplete its cash flow by paying interest. Hence there is a business rationale behind such a transaction (Brincker, 2010). However, this is not what is expected between independent parties, being willing buyers and sellers. This is true as the lender would want to make as much money as possible, i.e. by charging interest, and the borrower would want to pay the least amount, according to Van Zyl (2008).

Therefore, it has been established that a loan amount is expected to be returned by a borrower to a lender over or after a period of time. This amount is not expected to be repaid with interest in terms of any legislation, unless it is contractually agreed upon by all parties involved. Hence a benefit arises on behalf of the borrower as a result of not paying the interest.

An investigation in the gross income definition was conducted to determine whether the benefit above is included in a taxpayer’s taxable income.

6.4 DETERMINING WHETHER THERE ARE ANY GROSS INCOME IMPLICATIONS

The gross income definition is specifically defined in the Act as any amount received by or that accrues to a taxpayer during any year of assessment that is not of a capital nature. Specific concepts were investigated in this study, namely “an amount”, “accrued to”, “received by” and “capital nature”. From case law that was investigated, it was established that an amount had a wider meaning and did not only include cash, but the “value of every form of property” that has been received by or accrued to that taxpayer (Williams, 2005:82). The SCA in the Brummeria case held that an amount had an objective monetary value. This may be in contravention with the principles held in the Butcher Bros case. Jansen van Rensburg (2008:37) questioned which types of receipts or accruals are regarded as “an amount”. It was concluded that the SCA in the Brummeria case did not seem to state whether the judges consider whether the benefit was actually a property, or whether this was a continuous benefit the taxpayers obtained during the loan period for the purposes of the gross income definition. It was further submitted that the SCA accepted that all the requirements of the gross income definition were met and that the right, being the benefit of an interest-free loan, “had an objective monetary value” (Jansen van Rensburg, 2008:50). This study highlights that the benefit of not paying interest on a loan has never been assessed for tax by SARS. The Interpretation Note issued by SARS similarly
highlights that only transactions where there is a *quid pro quo* relationship will be taxed. From the above, in terms of an interest-free loan that was provided as financing transaction and not as consideration in a transaction; Jansen van Rensburg (2008:50) established that no tax implications should prevail.

Similarly, Strydom (2008) highlights that even if the interest-free loan is found to meet the requirements of the gross income definition, the concept of “capital nature” should prevail as that benefit should not be included in the taxpayers gross income as it would be the “tree” as opposed to the “fruits”.

Hence it is evident from the argument laid out in chapter 2 that where there is an interest-free loan provided *in lieu* of any services rendered or goods delivered, there is consideration and it is therefore taxable. However, where an interest-free loan is provided as a financing arrangement there is no right being provided and the benefit may be regarded as capital in nature. Therefore, no taxable income arises in the hands of the borrower.

In the hands of the taxpayer where the interest-free loan is provided *in lieu* of services rendered or goods delivered, the timing and valuation has been established in chapter 3. The Interpretation Note provides that consideration will only be included in a taxpayer’s gross income in year one and not in any subsequent year. Furthermore, the value should be determined by the taxpayer and SARS will evaluate that value based on the facts of that case. The arm’s length price principles should be applied in making such valuation.

When a non-resident and resident enter into a loan agreement, the Commissioner may at his discretion make an adjustment to an interest-free loan transaction as provided for in section 31 as the interest-free element of such a loan may not be at an arm’s length price (Mitchell & Kolitz: 2008). Furthermore, the GAAR provisions were considered and it was established that issuing an interest-free loan is not an abnormal transaction; this transaction was entered into for *bona fide* business purposes. Therefore, an interest-free loan may not be subject to the GAAR provisions.

From the above, once a taxpayer has been assessed for tax to include the consideration in their gross income, this study investigated whether a deduction would be available against which that amount may be claimed.
6.5 DETERMINATION OF WHETHER ANY DEDUCTIONS MAY BE CLAIMED

In the event that a taxpayer acquires a benefit of an interest-free loan *in lieu* of any services rendered or goods delivered, no deduction may be available to the lender if only the loan capital borrowed is repaid on termination of the loan agreement. However, if the amount repaid is less than the amount the loan capital borrowed, one should consider whether the shortfall would be deductible in the hands of the lender. In a *quid pro quo* relationship, a deprivation is suffered in that a portion of loan capital in not repaid. This may be a non-capital unconditional liability, being the services rendered or goods delivered. The act of performing the services or providing the goods, for the amount included in the taxpayer’s income.

If the borrower incurs costs to construct residential units as seen in the *Brummeria* case, the provisions of section 11(a) read with section 22 may be available to him in respect of those costs incurred (Brincker *et al.*, 2007:67-72). The costs incurred in constructing the residential units, may be regarded as trading stock. This depends on the whether the costs incurred are allocated to the usufruct or the bare dominium associated with the residential units. There are arguments that the cost will either be allocated to the bare dominium or to the usufruct. In both situations, a deduction will be available to the taxpayer. This argument may strong in terms of acquiring goods, and not necessarily an argument for services rendered.

In the event that a lender lends an amount of money to a borrower where no interest is charged, there would be no amount to be included in the income of the taxpayer, as established by Jansen van Rensburg (2008:34-50) quoted above. Alternatively, an interest-free loan may be regarded as capital in nature as proclaimed by Strydom (2008) and therefore no deduction would be available to the borrower or the lender in respect of the interest-free loan.

Now that the provisions of gross income definition and the general deduction formula have been established and concluded on, the provisions in respect of other taxes will be concluded.

6.6 THE TAX IMPLICATIONS OF THE OTHER TAXES

From the analysis of the other taxes, i.e. CGT, Donations tax, STC, newly proposed dividends tax and VAT, the following was found applicable for the purposes of determining the tax implications of an interest-free loan:

- Donations tax is only triggered where there is a waiver of a right to property. As established that waiver should be documented in a loan agreement. However, if no interest is charged on
a loan and no mention is made in the agreement of this, there is no right waived as there is no legal right to charge interest;

- The benefit of not paying any interest may be deemed to be capital in nature; however, there is no asset that is disposed on the issuance of an interest-free loan. Therefore there is no capital gains tax implication on granting an interest-free loan;

- Regardless of whether there is a benefit that a shareholder may receive in not having to pay interest on a loan, there is no distribution or transfer for the purposes of the dividend definition in respect of STC or the newly proposed dividends tax;

- However, the loan provided with no interest charge may give rise to a deemed dividend, but the exemptions allow for that loan not to be regarded as a deemed dividend. A shareholder and its subsidiary should be careful when issuing such loans and ensure that the provisions of the exemptions are available on such loans;

- Similarly, the newly proposed dividend tax is also not applicable, as no distribution or transfer takes place, and therefore there is minimal risk in respect of that loan being regarded as a dividend.

- Again, similar to the provisions of a deemed dividend in section 64C, the new value extraction tax should be considered by a company issuing an interest-free loan to any connected person and not only a shareholder. The value extraction tax provides for a more stringent approach in issuing interest-free loans to any connected person. The more important type of value extraction dividend that a company should be careful of is where any loan issued is issued at an interest rate below the market related rate, as defined in that proposed section. Again, if any of the other exemptions apply, the risk is minimized in that regard;

- From a VAT perspective, an interest-free element of an amount of loan capital would not attract VAT as there is a financial service and there is no supply. However, in the event that an interest-free loan is provided in lieu goods or services being supplied, there may be supply of the goods or service for a consideration. Hence the latter may result in VAT being levied on the goods or services supplied.

6.7 FUTURE STUDIES IN RESPECT OF INTEREST-FREE LOANS

Due to the significance of interest-free loans issued by taxpayers, there may be a significant impact on tax treatment for such transactions. Each of the tax implications inter alia CGT,
donations tax, VAT, STC and newly proposed dividends tax, have been discussed and considered, taxpayers should investigate their use of an interest-free loan to ensure the tax treatment has been correctly followed. Further research should be conducted on a comparison of the South African legislation with other countries in respect of interest-free loans. By performing as such a comparison, investment in South Africa may be more encouraged. Should such a comparison result in such investment being unfavourable, investigation of other countries tax legislation should be investigated and leveraged from. Two items that were identified in this study was that an interest-free loan is a benefit that is not regarded as an amount for tax purposes, and this benefit may be regarded as capital in nature. These issues should be compared to the tax treatment followed in other countries to identify the tax treatment of such a benefit.
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