

**AN ANALYSIS OF THE TAX DEDUCTIONS IN LIFE RIGHT EXCHANGE
AGREEMENTS**

Mini dissertation by

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GLOSSARY OF TERMS

Accounting Practices Board	APB
Binding General Ruling	BGR
Commissioner for the South African Revenue Service	CSARS
Generally Accepted Accounting Practice	GAAP
International Accounting Standard	IAS
International Accounting Standards Board	IASB
International Financial Reporting Interpretations Committee	IFRIC
International Financial Reporting Statement	IFRS
Income Tax Act 58 of 1962	ITA
Income Tax Court	ITC
Interpretation Note	IN
South African Institute of Chartered Accountants	SAICA
South African Revenue Service	SARS
Supreme Court of Appeal of South Africa	SCA



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ENGLISH SUMMARY

AN ANALYSIS OF THE THE TAX DEDUCTIONS IN LIFE RIGHT EXCHANGE AGREEMENTS

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The purpose of this study was to examine whether the general expenditure incurred by developers constructing residential units, whereby life rights are exchanged for interest free loans, are deductible in terms of the provisions of the Income Tax Act (58/1962). Furthermore to determine whether the judgement in **CSARS v Brummeria Renaissance (Pty) Ltd and others**, 2007 (4) All SA 1338 (SCA) 69 SATC 205, and its findings in law and of fact affects the deductibility of expenses incurred by developers, especially in relation to the “amount” and nature of the “amount” in the hands of the taxpayer. The research also sought to determine whether the accounting of amounts in life right exchange agreements, especially as relates to the quantification of such amount, assist in quantifying the amount for tax purposes.

The research object was determined by critically analysing the relevant provisions of the ITA (58/1962) with reference to case law and commentators and a critical evaluation of **Brummeria Renaissance case supra (2007:205)** to determine its affect on the deductibility of the expenses relating to the quantum and nature of the benefit amount received under the life right. Furthermore, an evaluation was done of the relevant accounting standards in relation to the transactional facts to determine whether an alternative valuation model of the benefit is available.

It was determined that firstly permissible and then prohibited deductions must be addressed in accordance with the ITA (58/1962). It was further evaluated whether the provision of the right of use, through the life right, can constitute an expense for the

developer. It was concluded that incurring general expenses meet the requirements of section 11(a), subject to a single qualification, would be deductible. It was also submitted that the provision of the life right as expenditure should be permissible as deduction against income. However, in both these cases the deductibility in question was held to be subject to the amount received as envisaged in **Brummeria Renaissance case supra** (2007:205) being revenue in nature.

The deductibility of the repair or preparation costs was also examined in terms of section 11(d). The distinction between repair and improvement was discussed and established. It was determined that the determination of when the “income is receivable” was critical in determining the deductibility. It was concluded that this requirement was met if the property was in a condition to receive such income irrespective of whether legal rights to such income had been established at such time that the expenses were incurred. The application of this section is also subject to the amount received, as envisaged in **Brummeria Renaissance case supra** (2007:205), being revenue in nature.

The requirement of “income” is critical in the application of section 11(a) and section 11(d) of the ITA (58/1962), because if the amount is found to be capital in nature no deduction is permissible. The nature of the rights, timing of the accrual and the valuation method of the amount were not decided in the judgement in **Brummeria Renaissance case supra (2007:205)**, and as a result, formed part of the research.

The nature of the amount was analysed and it was concluded that the amount was income in nature. The various case law and commentators, including SARS’ IN 58, was also analysed to determine which valuation method of the benefit amount would be the most appropriate in the application of the provisions of the ITA (58/1962). To this extent it was submitted that three possible valuation methods could apply, namely the valuation of the benefit as arms length interest on the loan, the valuation of the benefit as the sale of a usufructuary interest or that the benefit amount could be represented as market related rentals in an arm’s length transaction.

It was concluded that in order to determine the value and the timing of the benefit the most suitable valuation method would be to calculate interest on the face value of the

loan using a market related interest rate. The benefit would be recognised over the term of the loan by calculating the interest on an annual basis on value of the loan.

The various applicable accounting standards were evaluated to determine which best represents the measurement of the benefit as envisaged in **Brummeria Renaissance case supra (2007:205)**. It was concluded that the most appropriate of the various possible accounting standards was IAS 32 which prescribed that the benefit should be determined and valued on a yearly basis in relation to the loan as a financial instrument. It was concluded that the basis for valuing and recognising the benefit for accounting purposes interrelates with the suggested accrual and timing thereof for tax purposes.

AFRIKAANSE OPSOMMING

'N ONTLEDING VAN DIE BELASTINGAFTREKKINGS VAN LEWENSREG RUILOREENKOMSTE

deur

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Die doel van die navorsing was om ondersoek in te stel of die algemene uitgawes aangegaan deur ontwikkelaars in die konstruksie van residensiële eenhede waar lewensregte geruil word vir rentevrye lenings, aftrekbaar sal wees in terme van die bepaling van die Inkomstebelastingwet (58/1962). Daar is verder ook ondersoek ingestel om vas te stel of die uitspraak in **Kommisaris van die Suid Afrikaanse Inkomstediens v Brummeria Renaissance (Edms) Bpk en andere**, 2007 (4) All SA 1338 (SCA) 69 SATC 205, die aftrekbaarheid van die uitgawes aangegaan deur die ontwikkelaars affekteer, veral in verband met die “bedrag” en aard van die “bedrag” in die hande van die belastingbetaler. Met die navorsing word daar bepaal of die rekeningkundige hantering van bedrae in lewensreg ruiloreenkomste, veral ten opsigte van die kwantifisering daarvan, kan bydrae tot die kwantifisering daarvan vir belastingdoeleindes.

Die navorsingsdoelstelling is vasgestel deur die relevante bepaling van die Inkomstebelastingwet (58/1962) met verwysing na hofsake en kommentaar, ‘n kritiese evaluasie van **Brummeria Renaissance saak supra (2007:205)**, om vas te stel wat die uitwerking daarvan is op die aftrekbaarheid van die uitgawes wat verband hou met die hoeveelheid en die aard van die voordeel bedrag ontvang in terme van die lewensreg, asook die evaluering van die relevante rekeningkundige standarde ten opsigte van die feite van die transaksie om te bepaal of ‘n alternatiewe waardasie model van die voordeel beskikbaar is.

Daar is besluit dat die aftrekkings wat eerstens toegelaat en dan verbied word aangespreek moet word in ooreenstemming met die Inkomstebelastingwet (58/1962). Daar is verder bepaal of die voorsiening van die reg om te gebruik deur middel van die lewensreg, 'n uitgawe in die hande van die ontwikkelaar kan wees. Daar is tot die gevolgtrekking gekom dat die aangaan van algemene uitgawes voldoen aan die vereistes van artikel 11(a) en aftrekbaar is. Dit is ook vasgestel dat die voorsiening van die lewensreg as uitgawe aftrekbaar sal wees teen inkomste. In albei hierdie gevalle is die aftrekbaarheid onderworpe daaraan dat die bedrag ontvang soos vasgestel in **Brummeria Renaissance saak supra** (2007:205) inkomste van aard is.

Die aftrekbaarheid van die herstel- of voorbereidingskoste is ook ondersoek in terme van artikel 11(d). Die onderskeid tussen herstel en verbetering is bespreek en bepaal. Daar is vasgestel dat die bepaling van wanneer die “inkomste ontvangbaar” is, krities is in die bepaling van die aftrekbaarheid daarvan. Daar is tot die gevolgtrekking gekom dat die vereiste nagekom is as die eiendom in 'n toestand is om inkomste te ontvang ongeag of die reg tot die inkomste bepaal is teen die tyd dat die uitgawes aangegaan is. Die toepassing van hierdie artikel is ook onderworpe daaraan dat die bedrag ontvang soos bepaal in **Brummeria Renaissance saak supra** (2007:205) inkomste van aard is.

Die vereiste van “inkomste” is krities in die toepassing van artikel 11(a) en artikel 11(d) van die Inkomstebelastingwet (58/1962) omrede geen aftrekking toegelaat sal word indien die bedrag kapitaal van aard is nie. Geen besluit is geneem oor die aard van die regte, die tydstip van die toevalling en die waardasiemetode van die bedrag in die uitspraak in **Brummeria Renaissance saak supra** (2007:205), en as gevolg daarvan vorm dit deel van die navorsing.

'n Analise van die aard van die bedrag is gedoen en daar is tot die gevolgtrekking gekom dat die bedrag inkomste van aard is. Die verskillende hofsake en kommentaar, insluitende SARS se IN 58, is ook analiseer om te bepaal watter waardasiemetode van die voordeel mees gepas sal wees in die toepassing van die

Inkomstebelastingwet (58/1962). Tot hierdie mate is dit aanvaar dat daar drie moontlike waardasiemetodes van toepassing kan wees, naamlik die waardasie van die voordeel op die lening in 'n armslengte transaksie, die waardasie van die voordeel as die verkoop van 'n vruggebruik of die voordeel van die bedrag kan verteenwoordig word deur die markverwante huurinkomste in 'n armslengte transaksie.

In bepaling van die waarde en die tydstip van die voordeel is die gevolgtrekking gemaak dat die mees gepaste waardasiemetode sal wees om rente op die sigwaarde van die lening te bereken deur 'n markverwantrentekoers te gebruik. Die voordeel sal dan erken word oor die tydperk van die lening deur die die rente jaarliks te bereken op die waarde van die lening.

Die verskillende rekeningkundige moontlikhede is ondersoek om die metode te bepaal wat waardasie van die voordeel soos in **Brummeria Renaissance saak supra** (2007:205) die beste verteenwoordig. Daar is tot die gevolgtrekking gekom dat die mees gepaste rekeningkundige standpunt IAS 32 is waarvolgens die voordeel op 'n jaarlikse basis bepaal word in verhouding met die lening as 'n finansiële instrument. Daar is tot die gevolgtrekking gekom dat die metode van die waardasie en erkenning van die voordeel vir rekeningkundige doeleindes regstreeks verband hou met die voorgestelde toevalling en tydstip daarvan vir belastingdoeleindes.

CHAPTER 1

INTRODUCTION AND BACKGROUND

1.1 BACKGROUND TO THE RESEARCH

The elderly face many challenges including securing proper accommodation for the remainder of their lives. The future frailty of the elderly is an important consideration (Joubert, 2006:215) when choosing accommodation as they would have to ensure that nursing and other frail care services are readily available to them at their place of accommodation, effectively preventing them from remaining in their own homes.

This factor limits their choices to old age homes, retirement villages and staying with family. The latter being a last resort as the elderly feel that being a burden on their families is degrading (Mail Online, 2009).

State financed old age homes have decreased from 101 in 1998 to 71 in 2011 and according to Ms Hendrika Kruger, Democratic Alliance spokesperson for Gauteng Social Development, more than 3000 elderly people were without homes in Gauteng alone (Ngomane, 2011).

The state of these old age homes is also deteriorating rapidly with press reports during 2011 stating that two old age homes had been closed down in Gauteng due to allegations that the human rights of the residents had been violated. Health MEC Ntombi Mekingwe stated that the living conditions in the facilities was harmful to the physical and psychological wellbeing of residents and that their rights had been grossly violated and compromised (The Sowetan, 2011).

The availability and state of old age homes in South Africa thus forces retirees to carefully consider their alternatives for procuring accommodation and the quality of life they require on retirement. This, combined with the rise in living expenses, complicates their decisions and often leaves the elderly trapped in their communities (IOL, 2008).

Developers were quick to identify the need and started creating alternative forms of accommodation. One of the available alternatives for a retiree to consider is purchasing occupational life rights. The life right system is a retirement option that provides retirees with the right to occupy a unit in a retirement village for the remainder of their lives. Basically the purchaser pays an amount in respect of a specific unit in the scheme and in return the purchaser as well as his/her spouse receive the right to live in that unit for the remainder of their lives (Sunday Tribune, 2008).

With life right schemes there is no purchase of real estate, but rather a purchase of the right to live in a specific unit, therefore the ownership is retained by the developer and is not transferred to the purchaser (Property 24, 2007).

On the death of one spouse, the surviving spouse is in many instances entitled to continue living in the unit until death. The sum of money that is paid is a market-related and a pre-determined amount that is often viewed as a lifetime of rental paid in advance. The payment of the sum is set out in the sale agreement between the parties (Property 24, 2007).

The benefit to the tenant for entering into a life right agreement is that there is no transfer duty or registration fee payable. Upon the resale of the unit, the outgoing resident (or deceased estate) may also receive a percentage of the market-related resale price (Property 24, 2007), depending on the agreement with the developer.

The financing of this type of accommodation for retirees takes on many forms and is not limited to outright cash or financed purchase. In the case of **CSARS v Brummeria Renaissance (Pty) Ltd and others**, 2007 (4) All SA 1338 (SCA) 69 SATC 205, that also provided such life right accommodation, the life right was acquired by the retiree by making an interest free loan available to the developer over the life of the retiree. On the death of the retiree and his or her spouse the loan would be repaid to the estate.

However, the South African Revenue Service (hereafter “SARS”) questioned the tax implications of this method of finance and contested it in court. In 2007 the Supreme

Court of Appeal dealt with this matter (**Brummeria Renaissance case supra 2007:205**). The court held that the benefit of an interest-free loan given by the retiree to the developer constituted an “amount” in itself separate from the loan and that this “amount” fell within the ambit of the gross income definition in section 1 of the Income Tax Act (58/1962)(hereafter “ITA”).

This decision by the court has resulted in a lot of controversy and commentators have differed in their views as to the implications of the judgement (Phasa, 2009:2).

One of the questions arising from the judgement, which has remained unanswered, is whether the expenditure incurred by the developers in leasing and maintaining the units would be deductible against this “amount” received or accrued in respect of the interest-free loan. Furthermore, the accounting treatment and valuation of this transaction also raises questions as to whether a similar amount exists which has to be accounted for in the financial records of the developer.

1.2 RESEARCH OBJECT

The research object is to determine whether the general expenditure, inclusive of repairs, incurred by developers of units in life right exchange agreements and financed through interest-free loans are deductible for the purposes of the provisions of the ITA (58/1962). Furthermore it will be determined whether the judgement in **Brummeria Renaissance case supra (2007:205)** affects the deductibility of expenses incurred by developers, especially in relation to the “amount” and nature of the “amount” in the hands of the taxpayer.

In addition to the general expenses applicable to the developer, it will also be specifically evaluated whether the provision of the right of use through the life right can constitute an expense for the developer.

The research also seeks to clarify the accounting implications of these transactions relating to the existence of a similar amount in respect of interest free loans. This is done to determine whether an interrelation between the accounting and tax

implications, as pertains to possible measurement of the benefit value of the interest free loan, exists.

1.3 RESEARCH METHOD

The research object will be determined by analysing the relevant provisions of the ITA (58/1962) with reference to case law and commentators. A critical evaluation is also to be done to determine the deductibility of the expenses relating to the benefit amount received under the life right. Furthermore the relevant accounting standards are critically evaluated in relation to the transactional facts to determine whether an alternative valuation model of the benefit is available.

1.4 RESEARCH LIMITATIONS

The main sections in the ITA (58/1962) dealing with deductions are sections 11 to 19 and section 23, however the scope of the research is limited to section 11(a) and section 11(d) of the ITA (58/1962) and the general expenses that normally fall within the ambit of these provisions such as sales commissions, marketing costs and repair costs. The prohibitions are limited to section 23(g) of the ITA (58/1962)

Furthermore the provision of a life right by a developer to another person within a life right arrangement and whether it constitutes expenditure in terms of the provisions of section 11(a) is specifically analysed.

CHAPTER 2

PERMISSIBLE AND PROHIBITED DEDUCTIONS

2 INTRODUCTION

The deductibility of expenditure for tax purposes is conditional on that amount conforming to the provisions of the ITA (58/1962) as can be seen in the dictum of the court in **Sub-Nigel Limited v CIR** 1948 (4) SA 580 (A) (15 SATC 381:389) which stated:

“Regard, therefore, must be had to the Act and the Act alone in order to ascertain whether the deductions sought to be made by the Company are permissible.”

When it has to be determined whether an amount is deductible for income tax purposes the amount should be measured against the requirements of the specific provision to determine whether it is permissible. However, the amount will not be deductible, notwithstanding that it is permissible if it is prohibited (**Sub-Nigel case supra** (1948:389)). The latter requirement should, however, be determined after the permissibility of the amount to be deducted, has been established.

The scope limitations imposed on the research in Chapter One requires that even though the main sections in Part I of Chapter II of the ITA (58/1962) dealing with deductions are sections 11 to 19 and section 23, this chapter focuses on section 11(a) and section 11(d) of the ITA (58/1962) as the “permissible” sections and section 23(g) as the prohibition provision.

General expenses incurred such as marketing costs, sales commission, repairs and maintenance should be the test against which permissible deductions should be measured for the provisions of the ITA (58/1962). However, in lieu of the nature of the agreement it is also relevant to determine whether the contractual right of use given to the life right holder possibly conforms to these provisions.

2.1 SECTION 11(a) – “THE GENERAL DEDUCTION FORMULA”

Section 11(a) of the ITA (58/1962) states:

“For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived-

- a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;”

The requirements of section 11(a) are thus:

- Expenditure or losses;
- Actually incurred;
- In the production of income;
- Not of a capital nature.

No specific requirement is made in the ITA (58/1962) that the expenditure should be incurred during the year of assessment. However in **Concentra (Pty) Ltd v CIR** 1942 CPD 509 (12 SATC 95:100) the court held that the intention of the legislature was to fix a specific day on which all the assets employed in the business of the taxpayer should be determined. This case does not directly deal with expenditure being deductible in a particular year of assessment but rather whether asset balances roll over to the next year and are limited to such year. However, the intention of the legislature in this regard was later clarified in **Sub-Nigel case supra** (1948:390) where the court stated:

“For the whole scheme of the Act shows that, as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular tax year can be deducted.”

Furthermore, in **Caltex Oil (SA) Limited v SIR** 1975 (1) SA 665 (A) (37

SATC 1:11) it was held that:

“It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment

This principle is thus codified in our tax law as to which year of assessment expenses must have been incurred. To prohibit the deduction of future expenditure actually incurred during the current year of assessment, section 23H was introduced by section 31(1) (Act 30/2000) to limit expenses actually incurred during a year of assessment to those to which the taxpayer became entitled to during such year of assessment (SARS’ Explanatory Memorandum to the Taxation Laws Amendment Act 30 of 2000:35).

2.1.1 Expenditure and losses

2.1.1.1 Expenditure

In **CSARS v Labat** (669/10) [2011] ZASCA 157 the Supreme Court of Appeal had to determine the meaning of “expenditure”. The court held (**CSARS v Labat Africa case supra** (2011:12)) that the term is not defined and that the ordinary meaning must be attributed to it and which it held was:

“...the action of spending funds; disbursement or consumption; and hence the amount of money spent.

The court also expands this meaning within the confines of the ITA (58/1962) by stating that (own emphasis) (**CSARS v Labat Africa supra** (2011:12)):

“In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not

mean that the taxpayer will, at the end of the day, be poorer because the value of the counter performance may be the same or even more than the value expended.”

It is unclear whether the court requires that the expenditure itself needs to diminish the assets of the taxpayer or whether the expenditure results in the diminution via its payment. It is submitted that only the payment in cash or otherwise for expenditure such as sales or marketing commissions would result in the diminution of the assets of the taxpayer.

It is, however, difficult to reconcile the courts view that expenditure is separate of the obligation (**CSARS v Labat Africa case supra** (2011:8) and liability to incur such obligation as the diminution of assets can only result from settling the obligation as the “expenditure” does not in itself result in such diminution. However, the same court has on various instances in previous judgements confirmed that payment or settlement is not a requirement for section 11(a) to apply but the undertaking of an obligation to pay (**Ackermans Ltd v CSARS** 2010 (1) SA (SCA) 73 SATC 1:5). Thus expenditure incurred on credit does not lead to an immediate diminution of assets but does lead to a future diminution as the concomitant obligation for such future diminution does not reduce the assets of the taxpayer. The courts’ interpretation of the meaning “expenditure” seems nonsensical; especially as relates to services where no assets of the taxpayer can diminish at the time the “expenditure” is incurred.

It is submitted that in the exploration of the normal grammatical meaning of “expenditure” without reference to obligation, the court in **CSARS v Labat Africa case supra** (2011:12) should have relied on the word “consumption” as cited as a dictionary clarification or a word synonymous to it. “Consumption” or “use” refers to an act by the taxpayer which diminishes or consumes whatever is provided to him, whether services or goods. This would not lead to any diminution of assets of the taxpayer at that time as per **CSARS v Labat Africa case supra** (2011:12), but at most to the diminution of the assets of the other party of things, however no asset diminution would exist for services. The taxpayer’s assets as noted only diminish on settlement of the expenditure. It is submitted that “consumption” more appropriately

indicates a grammatical meaning for “expenditure” and it also makes more sense in relation to the rest of the requirements of section 11(a), especially as relates to services.

Thus a deduction would be allowed under section 11(a) when a taxpayer consumes or uses a thing or service (expenditure) and incurs a legal liability or binding obligation (actually incurred) and that thing or service was used or consumed for the purpose of producing the income of the taxpayer (in the production of income) and such things’ or service’s consumption relates to the profit-making activities and not the capital structure or does not create an asset (not of a capital nature).

The above clarification also makes more sense in relation to the other requirements of section 11(a) whereas the “clarification” in **CSARS v Labat Africa case supra** (2011:8) contradicts the other requirements and previous findings of the same court as to the meaning of the other requirements.

2.1.1.1.1 Right of use as “expenditure”

The more difficult application of this test would be against the right of use provided by the developer as lessor to the life right holder as lessee. This is, notwithstanding the criticism, tested against the meaning propagated by the court in **CSARS v Labat Africa supra** (2011:8) as well as the meaning propagated as an alternative.

“Property”, which would include an asset as defined in the Eighth Schedule to the ITA (ITA 58/1962), is defined in the Merriam Webster dictionary as:

“Something (as an interest, money or land) that is owned or possessed.”

“Property” in its normal grammatical meaning must also be interpreted in relation to the concept of “property” as contained in section 25 of the South African Constitution (106/1996). In this regard “property” includes all things and rights, including contractual rights, that have a distinct economic value (Van der Walt Constitutional Property Law (2005) at 66) as the concept of property should not have an exhaustive

definition (**First National Bank of South Africa Ltd t/a Westbank v Commissioner, South African Revenue Service** 2002 4 SA 768 (CC), 2002 7 BCLR 702 (CC): 54–60).

McAllister (2010:50) confirms this position with his conclusion that an asset is anything that can be disposed of and turned into money. McAllister (2010:50) also states that contractual rights are assets for the purposes of the Eighth Schedule to the ITA. “Property” that is contractual rights would include personal rights and real rights acquired by such contract (**CIR v Estate C P Crewe & another** 1943 AD 656, 12 SATC 344:352).

Similarly a lease agreement is contract for the right to use fixed property on the terms as contained in the lease agreement. The right to use is thus by nature an asset.

The right of use of immovable property can be sold by granting a personal right to the lessee and thus exploiting the inherent economic value of this asset. It thus does have economic value as required in **Labat case supra** (2011:12).

However, the question does arise whether this asset existed prior to being given to the life right holder and thus led to a diminution of the assets of the developer or whether the asset, as a personal right, came into existence by agreement and thus did not result in the diminution of the assets of the taxpayer but is merely a personal obligation on the taxpayer.

It is thus important to distinguish between a real right held by the taxpayer and given to the life right holder and a personal obligation imposed on the taxpayer, the latter which would not in itself result in a diminution of the assets of the taxpayer, but which may place an obligation on the taxpayer to diminish his assets. This distinction is also relevant for the distinction made in **CSARS v Labat Africa supra** (2011:8) between expenditure proper and the imposing of an obligation, as the imposition of an obligation or a liability is not synonymous with expenditure but is the subject matter of such obligation. The court thus concludes that the liability or obligation must be discharged by means of expenditure.

2.1.1.1.2 Subtraction from dominium test

McAllister (2010:240) is of the opinion that the granting of the right of use is a part disposal of an asset, thus inferring that the right is part of asset and thus in pre-existence. Many tests have been developed by our courts to determine real rights or rights that attached to immovable property as opposed to personal rights that deal with obligations by persons (Badenhorst, Pienaar & Mostert 2005:50).

In **Cape Explosive Works Ltd and another v Denel (Pty) Ltd and others** (2001) 3 All SA 321 (A) :328 the court sets two tests to determine real rights:

- The intention of the person who creates the real right must be to bind himself and all successors in title; and
- The nature of the right must be such that it leads to a subtraction from dominium.

The “subtraction from dominium” test formulated in **Ex Parte Geldenhys** 1926 OPD 155:162 states:

“One has to look not so much to the right, but to the correlative obligation. If that obligation is a burden upon the land, a subtraction from the dominium, the corresponding right is real and registrable; if it is not such an obligation, but merely an obligation binding on some person or other, the corresponding right is a personal right, or a right *in personam*, and it cannot as a rule be registered....”

The reasoning behind this test (Badenhorst *et al.* 2005:56) is that rights that do subtract from dominium, or limited real rights, diminish the owner’s ownership (dominium) over his or her thing by:

- conferring on its holder certain entitlements inherent to the right of ownership ;or
- to some extent prevents the owner from exercising his or her right of ownership.

Perpetual leases, including life-long leases, were already recognised as a real right in the closed rights system in Roman Dutch law (Badenhorst *et al.* 2005:48). The right continues to be recognised as a limited real right in the South African common law, especially with the incorporation of the Roman Dutch law principle of “*huur gaat voor koop*” which makes the right of the lessee not only enforceable personally against the lessor but against all his successors in title (Badenhorst *et al.* 2005:48). Use of an immovable asset is thus an inherent right of ownership and the conferring of this right on the life right owner is a limitation of the real rights thereon.

2.1.1.1.3 Conclusion

The right of use of immovable property is an asset with monetary value, which when granted or transferred to another diminishes that asset, if only temporarily, and this is expenditure as held in **Labat Africa supra** (2011:12), even if it does not arguably make the taxpayer poorer. On the interpretation followed by the court the giving of the right of use would arguably be expenditure, as held by the court. However, if the suggested alternative interpretation is used that expenditure is something used or consumed, then the giving of the right could only be expenditure in the hands of the lessee, who consumes or uses the right of occupation, unless the expenditure is what is consumed in the creation of the right. Due to this ambiguity the rest of the requirements of section 11(a) (ITA 58/1962) will still be measured against the expense principles in **Labat Africa supra** (2011:12) and the alternative proposed.

2.1.1.2 Losses

In **Joffe & Co (Pty) Ltd v CIR** 1946 AD 157, 13 STAC 354:60 the court in trying to distinguish expenditure from losses states:

“in relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money”

In some of the first decisions on the matter the court (**Joffe case supra** 1946:360) struggles with the distinction between expenditure and loss and questions whether a distinction does in fact exist. It however concludes that loss may mean something different in that it may apply when no income is earned.

However, in **CIR v Felix Schuh Ltd SA (Pty) Ltd** 1994 2 All SA 329 (A) (56 SATC 57:69), the court reconfirms the principle held in various preceding court cases that the distinction between losses and expenditure is that the former is mere involuntary and fortuitous expenditure whereas the latter is voluntary. It is submitted that the principles held in **Labat Africa supra** (2011:12) would therefore equally apply as to what is a loss, with only an “involuntary and fortuitous” requirement being added.

Furthermore the reliance on the normal grammatical meaning of the word “expenditure” in **Labat Africa supra** (2011:12) to determine its meaning is as important as in some instances the normal grammatical meaning can include a technical meaning, including the accounting concept of such word. In the **Association of Amusement and Novelty Machine Operators v Minister of Justice and another** 1980 (2) SA 636 (A): 660 the court states the principle that words contained in a statute should not as a rule be interpreted as having a technical meaning as they are addressed to the general public.

However, in **City of Johannesburg Metropolitan Municipality v Gauteng Development Tribunal and Others** 2010 (2) BCLR 157 (SCA) :169, the court confirms that the ordinary meaning of a word may not always be appropriate and the court held that the meaning of the word “plan” should be interpreted within the context of municipal activities where it held a clear meaning. Also in **Interlink Postal Courier SA (Pty) Ltd v South African Post Office Ltd** (2003) 2 All SA 134 (SCA):138, the respondent in argument cites the general nature of statutes as stated in the **Association of Amusement case supra** (1980:660), however, the court rejects this contention on the basis that the intention of the legislature would not be met by applying this rule of interpretation and only relying on the normal grammatical meaning. The court holds that the intention of the legislature would only be met if the statute was interpreted by attributing the meaning of the word “delivery” its meaning as used in the courier services trade.

Thus the “ordinary meaning” basis of interpretation is subject to the qualification that technical words must be understood in that context and not necessarily by means of the ordinary meaning. Technical words may be those related to a specific trade and those peculiar to the law (Du Plessis 1986:110). In this context it is submitted that the word “loss” may also within a financial context be ascribed its accounting meaning as opposed to its normal grammatical meaning.

2.1.2 Actually incurred

Expenditure is “actually incurred” if the amounts are incurred in terms of a legal liability (**Port Elizabeth Electric Tramway Co Ltd v CIR** 1936 CPD 241, 8 SATC 13:15) and therefore a debt only has to exist, it need not be due and payable, only due (**Commissioner for Inland Revenue v Peoples Stores (Walvis Bay) Ltd 1990** (2) SA 353(A), 52 SATC 9:22) The expenditure is actually incurred in the tax year in which the liability for the expenditure is incurred and not in the year in which it is paid (**Caltex Oil case supra** (1975:3).

The general expenses with regard to the units incur a legal liability towards the renderer of the services or goods and are “actually incurred” liabilities, irrespective of when actually paid.

Furthermore, the obligation to make available the right of use to the life right holder is an actual legal liability for which an “unconditional obligation” exists which is not dependent on the mechanism of payment (**Edgars Stores Ltd v Commissioner of Inland Revenue** 1988 (3) SA 876 (A) 50 SATC 81:86).

2.1.3 In the production of income

In **Port Elizabeth Electric Tramway case supra** (1936:16) the court clarifies the term “in the production of income” requirement as follows:

“income is produced by the performance of a series of acts, and attendant upon them are expenses. Such expenses are deductible

expenses, provided they are so closely linked to such acts as to be regarded as part of the cost of performing them.

and

“The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.”

The court also states that (**Port Elizabeth Electric Tramway case supra** 1936:17) all expenses attached to the performance of a business operation performed bona fide for the purpose of earning income, are deductible whether such expenses are necessary for its performance or attached to it by chance or are incurred bona fide for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

The general expenses incurred by the developer such as sales commission and marketing costs are incurred with the object of earning income in the course of and as part of its normal income-producing business activities of the developer, namely the construction and sale or lease of immovable property.

The enquiry is not concerned with whether a particular item of expenditure produced any part of the income, but whether that item of expenditure was incurred for the purpose of earning income (**CIR v Allied Building Society** 1963 (4) SA 1 (A), 25 SATC 343:358).

If it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation of the sale or leasing of the immovable property then it would fall within the ambit of the “in the production of income” requirement (**CIR v Genn & Co (Pty) Ltd** 1955 (3) SA 293 (A) (20 SATC 113:120).

The various income sources of the developer in life right arrangements should, however, be looked at separately and the expenses attributed accordingly. A developer in a life right arrangement may earn interest on the loans received, he may receive proceeds from sale of property and lastly he may accrue an amount as envisaged in **Brummeria Renaissance case supra** (2007:205) or SARS’

Interpretation Note 58. In the latter instance, where this amount is income in nature, it is submitted that the general expenses form part of the series of acts that produce the income, or at least for the purpose of earning such income.

A similar connection would exist for the right of use disposed of which is a concomitant of the life right arrangement and in fact no income would be earned without this expense being incurred.

The quantum and nature of the amount received envisaged in **Brummeria Renaissance case supra** (2007:205) is of critical importance as well as the quantum of such amount, as the benefit value may be nil, thus rendering no income amount. These principles will be analysed in more detail in Chapter 3.

2.1.4 Not of a capital nature

Notwithstanding that an expense meets all the other criteria; if it is capital in nature it is still not deductible under provisions of section 11(a) (ITA 58/1962). In determining the capital or revenue nature of an amount the courts have stated that there is no one conclusive test to determine the nature of an amount and that the conclusiveness of the test would be based on the facts of each case (**CIR v African Oxygen Ltd** 1963 (1) SA 681 (A), 25 SATC 67:74). In **New State Areas Ltd v CIR** 1946 A.D 610, 14 SATC 155:170) the dictum below is regularly cited by the courts in lieu of the distinction between revenue and capital expenditure namely (own emphasis):

“The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be enquired into it in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor: if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure, even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the

equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in a lump sum.”

To make the distinction it should be determined how close the connection is between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually affects. (**Genn case supra** 1955:121)

The purpose of the sale commission and marketing cost is to find lessees for the immovable property, for which an amount of income is possibly realised. The income earning operations of the developer is to sell the life rights and therefore it is submitted that these expenses are more closely linked to these operations than the capital structure of the developer and thus not of a capital nature.

The provision of the life right as expense seems less clear. This expense begs the question as to whether it relates more to the property itself, which is capital, or the capital loan financing, which is capital or the income of the taxpayer. It is a right given which diminishes the capital structure of the developer by diminishing his rights to such assets. However, as the right never extinguishes but is returned at the end of the life right period it has to be part of fixed capital as commonly used in the “income” revenue vs. capital tests (**CIR v George Forest Timber Co Ltd** 1924 AD 516, 1 SATC 20:23–4). In applying these tests of income, the disposal of fixed capital within a scheme of profit making results in revenue and not capital amounts, with the inference that if something of revenue nature is given then something of revenue nature is received. For example if a developer in a scheme of profit making sells capital houses, then both the houses are revenue expenditure and the amounts received are revenue income.

This also raises the question whether immovable property that has various components attached it, such as dominium and the right of use, should be measured on the components and not the whole. Thus, whether the dominium held as fixed capital can be separated from the right of use as revenue, the latter being fixed capital used in a scheme of profit making, or in fact floating capital. It is submitted that if the two can be separated in law then they should be separated for tax

purposes as well, each with its own tax nature. It is submitted the right of use may be exploited in such scheme separate from the dominium, where the latter is held on capital account. On this basis it is submitted that the expenditure incurred should not be attended on the right given but the costs incurred in acquiring that right which may require apportionment (**CIR v Nemojim (Pty) Ltd** 1983 (4) SA 935 (A), 45 SATC 241:259) of the shared expenses in creating the immovable property as an inseparable whole.

2.1.5 Conclusion

The incurral of general expenses in lieu of providing the life rights are revenue in nature and are just subject to the amount received as envisaged in **Brummeria Renaissance case supra** (2007:205) being revenue in nature. Should this be the case then the expense is permissible.

The provision of the life right as expenditure has raised various questions throughout this analysis. In the first instance, it questions the approach followed by the court in **Labat Africa supra** (2011:12) as to what constitutes expenditure. In this regard it would be expenditure if the interpretation is followed and it is submitted that if the alternative interpretation of use or consumption is used, the right itself would not be. However, as submitted, the separation of various fixed capital elements may result in the costs incurred in creating the right of use, which clearly meets the definition as proposed, being deductible against any amount of income received from the exploitation of such right in a scheme of profit making. It is submitted that such expenditure from the authorities provided would be, and in the proper scheme of things, should be properly permissible as deduction against such income. This proposition is, however, also subject to the caveat that the amount as envisaged in **Brummeria Renaissance case supra** (2007:1338) is not capital in nature or prohibited which is discussed separately.

2.2 DEDUCTION OF REPAIR EXPENDITURE

The holding and leasing of immovable property is occasioned by continual repair or preparation costs e.g. painting, plastering, waterproofing etc., more so with a higher tenant turnover rate (Du Plessis:2011).

Section 11(d) of the ITA allows the deduction of expenditure actually incurred during the year of assessment on “repairs” of property:

- (i) Occupied for the purposes of trade, or
- (ii) In respect of which income is receivable,
- (iii) Including any expenditure so incurred on the treatment against attack by beetles or any timber forming part of such property and sums expended for the repair of repairing machinery, implements, utensils and other articles used by the taxpayer for the purposes of this trade.

In respect of immovable property the third criteria is not discussed in the analysis as it is a factual case on the one hand in that it is subject to the first two criteria i.e. beetle attacks and items that are not immovable property.

Only repairs, as opposed to improvements, are deductible under section 11(d), hence the meaning of this word and its exact scope is of the utmost importance.

2.2.1 Meaning of “repair”

There is no definition for “repairs” in the ITA and therefore the meaning is examined with reference to its normal grammatical meaning for purposes of the ITA (58/1962). The word “repair” is defined in the Merriam Webster Online Dictionary (2011) as:

“To restore by replacing a part or putting together what is torn or broken”.

In case law the meaning of “repair” has been held to be distinct from “replacement” or “improvement” with the latter being held to be capital in nature. In **Rhodesia Railways Ltd v Collector of Income Bechuanaland** 1933 (6 SATC 225:231), the court makes this distinction from the authorities cited on the basis that the replacement is “a charge against capital”. This distinction seems peculiar as section 11(d) of the ITA (58/1962) has no prohibition against capital nature of the expenditure as it is in many instances inherently capital in nature as the underlying asset can be capital, be it building, plant or machinery which are all items of the taxpayer’s capital structure. however, in this context it seems that the court wanted to address additions to capital as opposed to the concept of renewing the current capital structure as seen in **Rhodesia Railways case supra** (1933:229) where the court states (own emphasis):

“It did not result in the creation of any new asset; it was incurred to maintain the appellants’ existing line in a state to earn revenue. .

This differentiation is thus of the utmost importance in trying to apply the provisions of section 11(d) (ITA 58/1962).

In **Flemming v KBI** 1995 (1) SA 574 (A) (57 SATC 73:79) the court confirms that there are no exact guidelines as to what constitutes a repair as opposed to an improvement with great difficulty even being experienced by the English courts in making this distinction.

In **Rhodesia Railways case supra** (1933:229), as accepted by our courts (**CIR v African Products Manufacturing Co Ltd** 1944 TPD 248 (13 SATC 164:169), the court tries to interpret the distinction by stating (own emphasis):

“Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.”

The contradiction is, however, that a repair inevitably results in an improvement of the thing being repaired. Furthermore, the test of renewal also seems unclear as the replacement of a broken part also constitutes renewal. In **African Products case supra** (1944:167) where the court incepts this English court concept it states:

“Repair” and “renew” are not words expressive of a clear contrast and “repair” is restoration by renewal or replacement of a subsidiary part of the whole. Renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion”.

The court now goes beyond the grammatical meaning of the word and sets a test in that a “repair” is equated to a “subsidiary part of a whole”. It is submitted that this test is no more useful than the normal grammatical meaning as cited above. It now requires a matter of degree to be applied without any guidance as to when the “Rubicon” is crossed from repair to renewal and leaves the matter purely at the discretion of the purveyor of the test, namely the court.

The conundrum in applying this test was illustrated in **Rhodesia Railways case supra** (1933:229) where the court had to make this decision. The taxpayer was a railway company that had 588 miles of railway line in three jurisdictions. The taxpayer, after many found the track to be dilapidated, endeavoured to repair it. On 33.5 miles of the line, the taxpayer replaced the rails, fasteners and sleepers of which some of the rails were the original iron ones and some new steel ones. The taxpayer also replaced only the sleepers on 40.5 miles of the line. In the test cited above it would be clear that had he replaced one sleeper it would definitely be a repair and if he replaced all the sleepers and rails on the line it definitely would be an improvement. The court deals with similar English case law in specific regarding the replacing of the iron rails with steel rails that was held to be an improvement over the original. The court held as follows (own emphasis):

“The contrast between the cost of relaying the line so as to restore it to its original condition and the cost of relaying the line so as to

improve it is well brought out in the passage just quoted, and while the former is recognised as a legitimate charge against income, the extra cost incurred in the latter case in the improvement of the line is equally recognised as a proper charge against capital. In the present instance the renewals effected constituted no improvement; they merely made good the line so as to restore it to its original state.”

The contradiction of the principles laid out previously of renewal as distinct from repair is clear from the above passage. It is submitted that the distinction between repair and improvement on the above test remains only to be applied by the courts on the facts specific to a particular case as it provides no guidance to the taxpayer in making such a determination on matters which rest not on the outer extremes of the test but in the muddy centre.

2.2.2 Occupied for purposes of trade

This requirement is twofold namely requiring occupation and a purposive test, namely of trade.

The first requirement begs the question whether it requires *de facto* occupation or legal entitlement to occupy? In **R v Sibanda** 1964 (1) SA 317 SR 318 it was held that for a property to be occupied the occupier had to exercise some form of control over the property. In **R v Lombard** 1948 2 SA 31 (T) the court held that the “occupier” was the person who, though not the owner, had the same rights of residence on and control over the property as the owner would have had. In **37 Gillespie Street Durban (Pty) Ltd v National Director of Public Prosecutions** 22/2011:23, the court held that possession or control may be exercised by an agent on behalf of another but held that in that case the state had not taken such possession or control.

Thus for the property to be occupied the taxpayer must exercise some form of control over the property e.g. by possessing the keys to the property or physical possession. It is submitted that it would also be a requirement for the taxpayer to legally occupy such premises by having rights of residence for the property for the physical possession or other form of control to equate to occupation in the legal sense.

The meaning of “purpose of trade” is discussed below and forms the basis of the discussion in the prohibitions that is dealt with in detail in that section. However, the two requirements are connected in that not only must the property be occupied but for some purpose. Where such purpose or intention does not exist for the taxpayer the deduction is not permitted.

However, as the property is made available for use and possession to the life right holder, the developer would not qualify in terms of the “occupied for purpose of trade” requirement and would have to rely on “meeting the income is receivable” requirement.

2.2.3 Income is receivable

The “income” requirement is addressed in detail separately as it affects several of the discussions above. Where the amount as envisaged in **Brummeria Renaissance case supra** (2007:205) is capital in nature then both the expenses under the general deduction formula and sought under this provision are not permissible.

The word “receivable” is not a defined term and therefore is using its normal grammatical meaning as defined in the Merriam Webster Online Dictionary (2011) as:

“Capable of being received” or “subject to call for payment”.

In ITC 1475 (1989) 52 SATC 135 the property was unoccupied and no rental income was being received as a tenant could not be found while the repairs were being made. The Commissioner disallowed the repair expense as a deduction and on objection the Court held that the repairs were deductible as the words “income is receivable” in section 11(d) of the ITA(58/1962) signify income “capable of being received”.

This term “capable of being received” also indicates a timing requirement in that the occupation must have occurred at the time that income was capable of being received at such date. In **ITC 162 (1930) 5 SATC 76** the court held

repairs done in lieu of acquiring bond finance to purchase the property were not incurred when the property was capable of income being received but in lieu of the purchase and part of capital cost, notwithstanding that the cost was for repairs.

This principle was further expanded in **ITC 163 (1930) 5 SATC 77:78** where the court confirmed that income is capable of being received not from the date of possession but the date of the contract being signed, thus when legal rights of control were provided to the occupier. However in **ITC 243 (1932) 6 SATC 370** the court rejects the above by stating that “capable of being receivable” only requires that the property be in such state that it has the potential to generate such income and not that such income is generated, therefore not even a signed agreement is required to meet these criteria. The court distinguishes between property which is inhabitable but needs repairs and property which needs repairs to be inhabitable, the latter in the courts’ opinion is not incurred for income capable of being received.

The above requirements would thus enable the developer to repair and maintain the immovable property subject to the life right during the period of occupation but also in preparation of such occupation if it is done to enable the taxpayer to receive income from activities in relation to leasing the property.

However, is submitted that the requirement set for “income is receivable” is not expressly limited to the interpretation “capable of being receivable” as the auxiliary verb “is” infers the present tense, thus that income is currently receivable. “Receivable” is defined in the Encarta Dictionary (2011) as “suitable to be received” or “awaiting payment” or in the Merriam Webster Dictionary (2011) above, “subject to call for payment”. The latter it is submitted, indicates a more proper interpretation and conforms to the principle in **ITC 163 (1930) 5 SATC 77:78** that the agreement had to have been signed at such date as then the income would have been “awaiting payment” or “suitable to be received”, with actual occupation being an irrelevant consideration other than as a determinant as to legal right to

receive the income by the taxpayer. However with **ITC 243** being the most recent persuasive authority on the matter the most reliance will be placed on it in concluding on this requirement, namely that actual legal rights are not necessary.

2.3 PROHIBITED DEDUCTIONS

2.3.1 Laid out or expended for the purposes of trade – section 23(g)

In **Port Elizabeth Electric Tramway case supra** (1936:14) the court laid down that section 11(a) and section 23(g) of the ITA (58/1962) should be read together when one considers whether an amount may be tax deductible. However, section 23(g) is as a prohibition of general application and is not specific to section 11(a). Section 11(d)(i) of the ITA (58/1962) also requires that the occupation should be for the purposes of trade.

Section 23(g) (ITA 58/1962) prohibits any moneys, claimed as a deduction from the income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.

“Expended” is not a defined term but it is submitted that it is synonymous with the word expenditure, the one being a verb grammatically and the other a noun. Accordingly expended should equate to the “act of incurring expenditure”. Its meaning would thus be similar to that held in **Labat Africa supra** (2011:12) or as submitted, rather being a thing or service consumed by the taxpayer.

“Laid out” is a verb that means “to spend” or “to use up” or “pay out” (Merriam Webster Dictionary (2011)) which is a similar meaning to “expended”. Like the word “loss” used in section 11(a) (ITA 58/1962), “laid out” may merely be an alternative as to the voluntary nature of the expenditure, thus “laid out” is a factual question irrespective of choice whereas “expended” infers as discussed, a voluntary spend.

The amounts expended or laid out have to be for a specific purpose. In **Burgess v Commissioner for Inland Revenue** 1993 (4) SA 161 (A) (55 SATC 185:194) the

court held that if a taxpayer carries on a trade his motive for doing so is irrelevant. It is only relevant what the taxpayer intends to do with the thing which is the subject matter of moneys expended or laid out in the course of trade and his motive for acquiring such thing is irrelevant (**COT v BSA Co Investments Ltd** 1966 (1) SA 530 (SRD) (28 SATC 1:6)). In **CIR v Sunnyside Centre (Pty) Ltd** 1997 JOL 508 (A) (58 SATC 319:325) the court states that the taxpayer must have expended the amounts for the taxpayer's own trade.

An evolvement of this concept by the court of even greater concern is its further statement that it would not be necessary to enquire as to which purpose was dominant and the mere existence of another purpose results in the failure of the trade requirement. However, it is submitted that this would contradict the apportionment criteria noted in **Nemojim case supra** (1983:259) stated by the same court, even though dealing with the income requirement, which stated (own emphasis):

“It is a practical solution to what otherwise could be an intractable problem and in a situation where the only other answers, *viz* disallowance of the whole amount of expenditure or allowance of the whole thereof, would produce inequity or anomaly one way or the other. In making such an apportionment the court considers what would be fair and reasonable in all the circumstances of the case “

The court (**Nemojim case supra** 1983:259) also notes that although apportionment is not expressly contained in the ITA (58/1962) it is a device to resort to where a dual purpose applies and (**Nemojim case supra** 1983:266) finds that such apportionment principle cannot be negated by section 22 (ITA 58/1962) It is submitted that this principle equally applies to section 23(g) (ITA 58/1962).

“Trade” is defined in section 1 of the ITA (58/1962) and includes the following:

- Every profession, trade, business, employment, calling, occupation or venture
- The letting of any property
- The use of or the grant of permission to use patent, design or other property of a similar nature

The definition of “trade” should be given a wide interpretation (**Burgess case supra** 1993:196) which is also clear from the fact that the “definition” in section 1 is in fact not a definition but an extension of the normal grammatical meaning as it just “includes” the stated items and is not limited to such items.

In the situation where developers construct units in life right exchange agreements, the development of the units forms part of their main business, for which they carry risk in order to make a profit and this would therefore constitute a trade.

2.4 CONCLUSION

The amounts sought for deduction have to comply with both a permissive and prohibition test. The permissive requirements under section 11(a) indicate that an amount sought for deduction must constitute “expenditure” which, though controversial is confined to those voluntary amounts as defined in the **Labat Africa supra** (2011:12) with “losses” being involuntary amounts as defined..

However, on proper application and interpretation it is concluded that within the framework given by this case and in fact using its cited grammatical meaning the word should rather be applied as meaning “consumed” by the taxpayer. On application of both these concepts it is concluded that general expenses would constitute “expenditure”. However, it was also explored whether the right of use transferred to the life right holder constituted expenditure and it is concluded that it does, even though its timing and quantum should be determined with reference to the costs that created such rights through the building of the immoveable property, similar to trading stock, which is expended on acquisition and not sale.

The legal obligation to incur such expenditure or losses is held to apply to both the general expenses and “right of use disposed of”. On analysis of the attachment of these amounts of expenditure to the income producing activities, whether planned or by chance, it is found that such attachment exists for both the general expenses and the right of use to the exploitation of the immoveable property that is the income producing activity. The latter requirement of “income”, being the subject matter of the

next chapter, however, is critical because if the amount is found to be capital in nature no deduction is permissible.

The last requirement is that the amounts are not capital in nature and need to be more closely linked to the income-producing activities than the capital structure. To this extent the general expenses are within the ambit of the requirement but a less clear linkage exists for the right of use. It is concluded that the right of use as floating capital may be separated from the dominium as fixed capital with the former attaching more closely to the income producing activities and the latter forming part of the capital structure.

Accordingly both the general expenses and right of use, subject to the nature of the amount produced, should be properly deductible from such amount in terms of section 11(a) (ITA 58/1962).

In relation to section 11(d) and the repair and maintenance expenditure attended on the deduction it was clear that no real guidance as to what constitutes a repair exists and that is matter of degree, however with no indication as to where the Rubicon lies between repair and improvement. A developer may face this problem regularly with multiple living units being subject to repair simultaneously. For example if the worn insulation in all the units is replaced with an upgraded material is this a repair or improvement? If all the units are partially replastered and painted with more durable materials is this a repair or improvement?

These questions, it is submitted would only be answerable by the courts who apply the “substantial part of whole” test to the facts as only the court could in its discretion determine the degree when the Rubicon is crossed. “Occupied for the purpose of trade” is not relevant to the scope of discussion therefore reliance had to placed on the “income is receivable” requirement. In this regard it was found that the criteria would be met if immovable property was in a state suitable for occupation that would produce income, thus capable of receiving income.

The timing of when the property is so capable is less clear with courts finding that occupation or at least legal entitlement to occupation being a minimum requirement

to ensure sufficient linkage to the income requirement and contradictory that such legal entitlement was not such a requirement but a motive of the taxpayer. It is, however, submitted that the latter interpretation suits the developer better as it allows preparatory repairs to be deductible.

The application of this section is, however, once again subservient to the condition that the amount realised by the developer on the interest free loan is income.

As to the prohibition against deduction in section 23(g), it submitted that the developer would have expended the amounts for both section 11(a) and 11(d) for the purposes of trade as the motive of the taxpayer in all instances is to use the expenditure in relation to its trade which is the making available of the property to which attaches a risk to the developer.

CHAPTER 3 AN AMOUNT

3.1. INTRODUCTION

In order to calculate the liability for normal tax, the taxable income of a taxpayer needs to be calculated.

The calculation of taxable income can be determined as follows (De Koker & Williams, 2011:1.11):

Gross income	Rxxx
Less: Exempt income	(xxx)
Income	<hr/> Rxxx
Less: Deductions and allowances	(xxx)
Taxable income	<hr/> Rxxx

The starting point for the determination of taxable income is to include gross income in the taxable income calculation. Thereafter exempt income and expenditure and allowances that qualify as deductions need to be determined. According to section 1 of the ITA, gross income includes the following:

“...the total amount, in cash or otherwise, received by or accrued to or in favour ... during such year of assessment, excluding receipts or accruals of a capital nature ..”.

In life-right exchange agreements it can be difficult to determine what to include in gross income and especially to determine what constitutes an amount. The following issues relating to life-right agreements needs to be clarified in addition to analysing the facts and legal nature of the benefit amount in **Brummeria Renaissance case supra** (2007:205):

- The most appropriate valuation of the amount;
- The timing of the accrual; and

- The capital or revenue nature of the rights.

3.2 BRUMMERIA JUDGEMENT

3.2.1. Factual analysis

In **Brummeria Renaissance case supra** (2007:205), the taxpayer company had developed retirement villages and received interest free loans from investors in exchange for the life-right of occupancy in one of the units. The interest-free loan was utilised by the taxpayer company to develop the unit. On cancellation of the agreement or death of the longest living spouse the loan would be repaid.

SARS attacked this agreement on the basis that the taxpayer received an “amount” as per the gross income definition in section 1 of the ITA (58/1962). The amount SARS contended was received was a quid pro quo for the interest free loan, thus inferring that there was no interest free loan. However SARS did not on the basis of their argument raise section 103 against the taxpayer.

Furthermore, SARS did not contend that the actual receipt of the loan capital resulted in the receipt of the amounts for the purposes of the definition of gross income, but rather the right to use the loan capital, interest-free, which constituted the right which had a value and accrued to the companies.

The judgement in **Brummeria Renaissance case supra (2007:207-8)** can be summarised as follows:

- rights of a non-capital nature and which are being capable of valued in money are included in gross income;
- the value of such right must be included in the respondents’ gross income for the years in which such rights accrued to them and the making of the interest free loan constitutes a continuing donation to the borrower which confers a benefit upon the borrower;
- even though the rights could not be turned into money, it does not mean that a value cannot be attached to it;

- it was not correct that unless a benefit of the nature contemplated fell within para (i) of the definition of gross income and the Seventh Schedule to the ITA (58/1962) then it was not taxable;
- that the Commissioner taxed the respondents on the basis of the benefit consisting of the right to use the loans without having to pay interest on them and that benefit remained;
- The fact that a right cannot be alienated, does not negate a value.

The essence of the case is therefore that gross income is not only limited to income actually received but, as stated in **CIR v Cactus Investments (Pty) Ltd v CIR**, 1996 61 SATC 43 (1996:152), also includes rights of a non-capital nature which accrue to a taxpayer and are capable of being valued in money.

However, the commercial purpose of the transactions under life-right agreements in **Brummeria Renaissance case supra (2007:205)** is difficult to understand and nonsensical. According to the facts in **Brummeria Renaissance case supra (2007:206)** the standard agreement entered into provided that:

“... interest free loans were utilized solely as the source of financing by the companies and for the development of the units and nothing was invested in income-earning investments while the repayment of the loan was financed by the granting of a new loan ...”.

No profits or losses were therefore generated during the duration of the agreement and the question arises whether there was any “commercial purpose” to the transaction.

Although the respondents in **Brummeria Renaissance case supra (2007:206)** were property developers and “... the intention of the companies was ultimately to sell the units at a profit”, the units are not necessarily stock in trade as commented by the court. In **John Bell and Co (Pty) Ltd v Secretary for Inland Revenue**, 1976 38 SATC 87 (1976:103) Wessels JA said:

“The mere fact, therefore, that a person deliberately delays the disposal of a capital asset because, upon his “reading” of the property market, “the hand of time” is needed in order to realise the asset to best advantage cannot, in my opinion, result in a change in the character of the asset so as to alter it from a capital asset, held for the purpose of advantageous disposal, to stock-in-trade, held for the purpose of earning income in the course “of an operation of business in carrying out a scheme for profit-making” [*Natal Estates* at 199A-B].”

The intention of the developers was to “ultimately” sell the properties. The sale of the property would not be sooner than the termination of the agreement and it can be concluded that it would probably not be in the near future. It is therefore submitted that the units are capital assets, as opposed to trading stock, in the hands of the developers.

Another question that arises from the judgement in **Brummeria Renaissance case supra** (2007:207) is as a result of the statement made that:

“... the making of an interest free loan constituted a continuing donation to the borrower ...”.

If the benefit is indeed a donation, a liability for the payment of donations tax will arise in the hands of the lender. One would assume that nothing is expected in return as a result of a donation to another party and the interest free loan was provided by the lender as *quid pro quo* for the right of occupation. The statement of the court that the benefit constitutes a donation does not make sense in lieu of the fact that the lender did indeed receive something in return and thus was not out of pure liberality or disinterest as held in the same court (**Welch’s Estate v CSARS** 2004 2 All SA 586 (SCA) 66 SATC 303) which distinguishes it from the older authority cited of **Commissioner for Inland Revenue v Berold** 1962 (3) SA 748 (A).

3.2.2. Legal nature of the “amount”

To be able to quantify the amount it is useful and possibly necessary to establish what the legal nature of the amount was, especially in relation to valuing the amount. During the **Brummeria Renaissance case supra** (2007:205) this was not addressed even though it could be inferred that such benefit amount, being in relation to the loan, would be akin to interest. The subsequent IN 58 issued by SARS as well as a later judgement by the same court on simulation (**CSARS v NWK Ltd** 2010 73 SATC 55) also confuses the matter further.

If the amount was akin to interest this was not how SARS in issuing IN 58 treated the nature thereof where they have treated the amount as being a sale of a usufructuary interest. Furthermore in **NWK case supra** (2010:71) the court states (own emphasis):

“In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an object other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.”

The judgement raises the possibility that tax-motivated transactions may be regarded as simulated where there is no commercial purpose to the transaction other than to obtain a tax benefit. The questionable commercial rationale for the transaction has already been discussed. Thus if interest had been paid on the loans, the deductibility

thereof might be in question as the interest was paid for money borrowed for the acquisition of capital assets. According to De Koker and Williams (2011:7.36), interest paid for money borrowed for the acquisition of fixed or floating capital in respect of a business would constitute expenditure actually incurred for the production of income. However in **Genn case supra** (1955:121) the court states:

“Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital. There might of course be the further question whether or not, because of its association with the fixed capital into which the loan is turned, interest on such a loan may not properly be said to be expenditure of a capital nature”

It is not within the scope of this research to determine whether such interest would be properly deductible; however it does raise the possibility that it would not be so deductible due to the connection between the loans and the building of the capital held immovable property. Where such interest wholly or partially is non-deductible and the rental income received in exchange for the occupation of the property is taxable it is submitted that it brings the transaction within the ambit of the **NWK case supra** (2010:71) as the purpose of the transaction can conceivably be to obtain a tax benefit for the lessor. If the transaction is a simulated transaction as stated in **NWK case supra** (2010:71), the transaction would be stripped of its ostensible form and given effect to the true nature of the transaction. The developer would therefore be taxed on market related rental income and get the interest deduction, based on a market related interest rate on similar loans.

The question is therefore if the nature of the amounts when valuing the benefit of the interest free loan under life-right exchange agreements should be treated for tax purposes according to the judgement of **Brummeria Renaissance case supra** (2007:205), SARS' IN 58 or according to the judgement of **NWK case supra** (2010:71).

The valuation method of the amount, the timing of the accrual and the nature of the rights under the life-right transaction will be examined in the rest of the chapter.

3.3 THE VALUATION METHOD

3.3.1 Valuation in terms of *Brummeria* judgement

The benefit that accrues to the developer is in a form other than cash. The accrual of the benefit was laid down by the court in ***Brummeria Renaissance case supra*** (2007:205), but the difficulty lies in the valuation of the amount that has accrued to the taxpayer. In order to determine the value of the amount in relation to the loan to be included in the gross income of the developer the “fair market value” of the benefit should be determined.

The fair market value of the benefit will be the interest calculated on the value of the loan in an arms length transaction. Due to the time value of money, the net present value of the loan will decrease over time and the benefit will decrease accordingly in the hands of the borrower. SARS will probably not agree with this view and would determine the benefit by calculating the interest on the face value of the loan.

In ***Brummeria Renaissance case supra*** (2007:206) SARS calculated the “amount” by applying the weighted average of the prime rate during the year and included that in the taxable income of the company. SARS included the amount in each of the years that the company received interest free loans. The approach of SARS was upheld by the SCA.

3.3.2 Valuation in terms of IN 58

According to IN 58 paragraph 7 / BGR 8 the monetary value of the right to use the interest-free loan in the year in which it is granted and paid must be determined by multiplying the amount of the loan by the present value of R1 a year for the lifetime of the life-right holder and the weighted-average prime overdraft rate determined for the relevant year of assessment. The amount so calculated is then reduced by 93,1%.

The percentage is the allocation of the monetary value of the life right of a unit, as opposed to the value of the complete ownership of the unit.

The basis of the valuation method is confusing as the present value of the benefit of the interest free loan is calculated, but is subsequently reduced by the monetary value of the life-right of a unit in order to determine the monetary value of the right of use of the interest free loan. If the benefit is the interest-free portion of the loan, that should be valued in relation to the loan capital and market related interest and surely not by taking the value of the life-right of the property into account.

In **Kommisaris van Binnelandse Inkomste v Anglo American (OFS) Housing Co Ltd** 1960 (3) SA 642 (A) 23 SATC 446 (1960:448) the court, in dealing with the term “fair market value” states that in deciding what the property would realise, the valuator must take into consideration every circumstance which would be likely to affect the minds of intending purchasers, including the uses to which it is capable of being put.

As to what constitutes an “arm’s length transaction” it was held in **Hicklin v SIR** 1980 (1) SA 481 (A) 41 SATC 179 (1980:195) that:

“It connotes that each party is independent of each other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself”.

In **Kangra Holdings (Pty) Ltd v Minister of Water Affairs** 1998 (3) All SA 227 (A) the appellant was the owner of certain registered coal rights which were expropriated by the respondent. The court dealt with the valuation of the rights and in his judgement Howie JA (**Kangra Holdings case supra** (1998:231)) held that in arriving at a reasonable value for the rights that were expropriated such value (own emphasis):

“... should reflect the level of the financial loss to (appellant) as a result of the expropriation ... (T)here is no readily acceptable market value for such rights

as held by a reputable company intent on their exploitation, and the only feasible approach is to follow the net present value technique ...”.

In the case of a life-right agreement there is, however, an acceptable market value for the right of occupation, which should be reasonably easy to determine due to an active market. The acceptable market value constitutes rental payments made by lessees to lessors in an arm's length transaction. The problem with this type of valuation is that it is too subjective and the determination of the value would more likely than not, result in dispute between the taxpayer and SARS.

In SARS' Guide on Valuation of Assets for CGT purposes (South African Revenue Services, 2006:6), it is noted that the value placed on fiduciary, usufructuary and other like interests should be determined by calculating the present value of future benefits discounted at 12% per annum over the life expectancy of the person entitled to the asset. The Commissioner may approve a discounted rate of less than 12% if it can be justified.

This is a transparent and accurate method for determining the value, but it is difficult to calculate the value of the benefit if it accrues over the term of the agreement, as opposed to once-off.

3.3.3 Valuation in terms of NWK case

If the true nature of the transaction in accordance with **NWK case supra** (2010:71) is applied, the benefit constitute the rental income and be calculated as the market value of rental income applicable to similar properties.

3.4 THE TIMING OF THE ACCRUAL

According to the gross income definition in section 1 of the ITA (58/1962), it is only income that has been accrued or received that forms part of gross income and therefore subject to tax in that particular year of assessment. To determine if income has been received is normally easy to establish. It may, however, be difficult to determine when an amount accrues to a taxpayer.

The following proviso to the definition of gross income addresses the difficulty by establishing an accrual rule:

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

IN 58 paragraph 6.1.2 provides the following guidance with regards to the timing of the accrual:

- The timing of an accrual of an amount in a form other than money must be determined in accordance with general legal principles. In this regard, the courts have determined that an accrual can only take place when the taxpayer has become unconditionally entitled to the amount.
- The timing of an accrual of an amount in a form other than money must therefore be determined in each individual case having regard to the law and the facts and circumstances of each case.
- The borrower in the retirement village industry is assessed on the right to use the interest-free loan in exchange for granting a right of occupation only in the year in which the borrower becomes entitled to the right to use the loan.

The court in **Brummeria Renaissance case supra** (2007:205) did not decide on the nature of the amount but the quid pro quo cannot be for the disposal of the unit under sectional title as the bare dominium of the property is never transferred to the lessee.

The timing of the accrual also affects the quantum of the accrual in a specific year of assessment. The timing of the accrual can also be once-off or spread over the term of the agreement (i.e. accrued annually).

3.4.1 Accrual once-off

In **Lategan v CIR**, 1926 CPD 203, 2 SATC 16 (1926:20) it was held that the meaning of the words “accrued to” was “entitled to”. In **Brummeria Renaissance case supra**

(2007:207), the borrower became entitled to the right to the interest free loan on the day that the loan was given to them by the lender. The court however does not make an express statement on timing of the accrual even though it is accepted that it was held that the date of accrual was the date the borrower received the capital interest-free loan. The suggested treatment in IN 58 agrees herewith by stating that the benefit accrues on the date that the borrower receives the money.

This view however does not agree to the true nature of the transaction. The quid pro quo given in return for the benefit of the interest free loan is the right of occupation over the period of the agreement. The benefit of the interest is also “consumed” over the period of the agreement and can surely not accrue on the inception of the agreement.

3.4.2 Spread over the term of the agreement

It is understandable that the accruals to be included in gross income according to section 1 of the ITA (58/1962) cover amounts that have not been received, but it is important to identify if the taxpayer is entitled to the amount.

It can be argued that for an entitlement to claim payment, the payment has to unconditionally be due to the taxpayer. In the case of **Brummeria Renaissance case supra** (2007:205) the benefit of the interest-free loan, to be included in gross income, is based on the life expectancy of the life-right holder. If the life-right holder lives for a period shorter than his life-expectancy the calculation of the benefit is incorrect as there is a condition to the benefit. It could therefore be argued that the benefit accrues to the taxpayer as and when this condition is met.

The effect is that the consideration accrues to the taxpayer as and when the condition is met and only then will he become entitled to the benefit.

The benefit should therefore not accrue to the taxpayer as a once-off amount on the date that the borrower receives the money, but only when the interest-free portion unconditionally accrues to the taxpayer on a day-by-day basis. It is submitted that this better represents the timing of the accrual of the amount.

Furthermore, if the judgement in **NWK case supra** (2010:71) is applied, the true nature of the transaction must be determined. The interest free loan is provided over the period of the agreement in exchange for the right to occupy the property over the period of the agreement and would therefore constitute interest payable over the period in exchange for rental income received over the period. The benefit will therefore be taxed over the period of the agreement as rental income. This concurs with the submission above and is submitted is a more appropriate and fair application of the accrual principles.

3.5 CAPITAL vs. REVENUE

One of the issues that was not decided in **Brummeria Renaissance case supra** (2007:211) (this was not an issue before the tax court), was the nature of the transaction, i.e. whether it was of a capital or revenue nature.

The definition of gross income in section 1 of the ITA (58/1962) excludes receipts and accruals of a capital nature. Unfortunately the ITA (58/1962) does not define income of a capital nature and therefore other factors such as economics, accountancy and previous court cases needs to be examined in order to determine the nature of income.

In **CIR v Visser** 1937 TPD 77 8 SATC 271 (1937:276) the courts states that “income” is what “capital” produces, or is something in the nature of interest or fruit as opposed to principal or tree. The property is the “tree” exclusively held by the lessor to produce the fruit, namely the right of occupation which is a concomitant to the interest free loan and the amount it produces.

In **Commissioner of Taxes v Booyens Estates Ltd**, 1918 32 SATC 10 (1918:15), Wessels J stated the following:

“... it may safely be asserted that the revenue or profit which is derived from a thing without its changing owners is rather to be considered as income than as capital.”

According to De Koker and Williams (2011:3.1), amounts received by a taxpayer for allowing the use of an asset, e.g. interest and rent, to another person, partake of the nature of income and fall within the definition of gross income and further stated that “as long as the amount is received for the right of use of an asset without any change in ownership of the asset, it is in the nature of income.”

In **CIR v Pick ‘n Pay Employees Share Purchase Trust**, 1992 54 SATC 271 (A) (1992:277) the court states (own emphasis):

“... when the shares were realised, there was a realisation of floating capital; thus the receipts could not be receipts of a capital nature”.

An important test to distinguish between the capital and revenue nature of an amount is to look at the “fixed vs. floating capital” test, even though this pertains to expenditure. In Chapter 2 it was concluded that the right of use as floating capital may be separated from the dominium as fixed capital with the former attaching more closely to the income producing activities and the latter forming part of the capital structure.

In **Crowe v CIR** (4) SATC 133 1930 AD (1930:136), the courts states the following:

“Though the words of the definition direct attention only to the economic meaning of capital, in finding that meaning it is helpful to consider whether the receipt in question can, from an economic standpoint, possibly be regarded as income.”

In **ITC 1738**, 2000 65 SATC 37 (2000:38), the court held that a franchisor (lessor) could not simultaneously utilise the same asset at the same time and place as the franchisee (lessee), but that this did not mean that the franchisor had parted with the asset or that the consideration paid was capital in nature. Similarly, the right to use an immoveable asset is not the same as acquiring the asset, the former being an incidental cost to the income producing structure and the latter a capital asset. Thus

the payment for use of such asset is not compensation for parting with it and thus capital in nature and it therefore can be revenue in nature.

In the judgement of **Lategan case supra** it was said (own emphasis):

“... the word ‘amount’ had to be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer whether corporeal or incorporeal which has a money value.”

On this basis the value of an asset that is exchanged for another asset should constitute an amount received or accrued. If the old asset was held as an asset of a revenue nature, the value of the new asset is also of a revenue nature and therefore constitutes gross income. Therefore barter transactions are included in gross income as long as it can be shown that the old asset (right to use the property) formed part of trading stock and the new asset that has been received in exchange (interest free loan) constitutes an amount received or accrued with a money value (De Koker & Williams, 2011).

As determined from the background in the case (**Brummeria Renaissance case supra** (2007:205) it was stated that the taxpayers received a *quid pro quo* for services rendered (making available the occupation rights) and the income would therefore be revenue in nature.

According to IN 58 paragraph 6.3, each and every transaction will have to be evaluated on its own merits and against the background of its own facts and the intention of the parties to establish the tax nature of the amount.

In paragraph 9 of IN 58 it is submitted that the benefit of the interest free loan in life right exchange agreements in exchange for the right of occupation, will not be subject to capital gains tax. This could suggest that SARS views the nature of the amount as revenue.

If the judgement in **NWK case supra** is applied, the true nature of the transaction must be determined. The interest free loan is provided over the period of the agreement in exchange for the right to occupy the property over the period of the agreement and would therefore constitute interest payable over the period in exchange for rental income received over the period. The rental income would be revenue in nature.

3.6 CONCLUSION

The purpose of this chapter was to determine what to include in gross income, as a result of life-right exchange agreements. It was specifically important to clarify the legal nature of the benefit amount, how it should appropriately be valued and most importantly whether it was capital or revenue in nature for tax purposes. The valuation of the amount, the timing of the accrual and the nature of the rights was examined and compared to the judgement in **Brummeria Renaissance case supra** (2007:205), IN 58 issued by SARS and **NWK case supra** (2010:.71).

In **Brummeria Renaissance case supra** (2007:205) it was held that an amount accrued to the taxpayer as a result of the right to an interest free loan. The valuation, timing and nature of the amount were, however, not clarified in the judgement even though a once off approach may be inferred. In order to value the amount of the benefit, various valuation methods were identified.

Based on the argument that the amount would accrue to the borrower over the period of his life expectancy, the most suitable method in calculating the value of the amount is to determine the benefit in respect of the value of the loan as interest on the loan using a market related interest rate over the period of the agreement. This method differs from the method suggested by SARS in IN 58 due the difference in view to the timing of the accrual. The valuation method in IN 58 is also nonsensical due to the fact that the benefit is determined as the benefit of the right of occupation in the hands of the lessee and not the benefit in the hands of the lessor.

Should the transaction be treated as a simulated transaction according to **NWK case supra** (2010:71) it is also concluded that the income would accrue to the lessor over

the period of the agreement as rental income. The amount would be valued as the market related value of rental payments.

Although the borrower receives the right to the interest free loan on the day that the loan is given to them by the lender, it is argued that he is not unconditionally entitled to it as the benefit is based on the life expectancy of the lender and therefore depends on this condition (life of the borrower) to accrue. This treatment differs from the view of SARS in IN 58, which is not correct given the nature of the transaction, that the amount would accrue once-off on the date which the borrower becomes entitled to the right of the use as supposed to accruing for it over the period of the loan. If the transaction is treated as a simulated transaction according to **NWK case supra** (2010:71) it was also concluded that the income would accrue to the lessor over the period of the agreement.

The nature of the transaction, i.e. whether it is of a capital or revenue nature, was established by examining the items that were exchanged in the agreement. The taxpayer receives a benefit as a *quid pro quo* for services rendered (making available the occupation rights) and the income is therefore revenue in nature. This agrees to the view of SARS according to IN 58. This also agrees if the transaction is treated as a simulated transaction according to **NWK case supra** (2010:71) where the true nature of the transaction must be determined. The benefit would constitute rental income received over the period. The rental income would therefore be revenue in nature.

It is submitted that calculating the value and accruing the benefit amount over the real time period per year of assessment represents a more appropriate method than the once off method proposed by SARS as it is compatible with both **Brummeria case supra** (2007:205) and **NWK case supra** (2010:71)..

CHAPTER 4

FINANCIAL REPORTING OF LIFE RIGHT EXCHANGE AGREEMENTS

4.1 INTRODUCTION

In order to determine the tax implications of life right exchange agreements, it is necessary to look at the applicable tax law but it is also important to examine and understand the way it is accounted for in the financial records of a business. The possible uses of accounting concepts in tax law has also been discussed (**Interlink Postal Courier case supra** 2003:138) where such concepts relate to a technical term as used in the specific trade for the purposes of interpreting a statute such as the ITA (58/1962).

Furthermore, with no prescriptive common law as to the valuation of the benefit amount, as envisaged in **Brummeria Renaissance case supra** (2007:1338), other than the “arms length transaction” test (**Hicklin case supra** (1980:195)), it is conceivable to use the accounting concepts of valuation to represent the value of such benefit, once it is understood how that value is determined in accordance with the various accounting standards. However, the measurement criteria in the accounting standards do not operate in isolation and cannot be applied unless the reporting requirements are also understood.

In South Africa, accounting standards are issued by the Accounting Practices Board (“APB”) of the South African Institute of Chartered Accountants (“SAICA”). SAICA subscribes to the goal of international acceptance and compliance with the standards of the International Accounting Standards Board (“IASB”), which issues their accounting standards in the form of International Financial Reporting Standards (“IFRS”).

The International Financial Reporting Interpretations Committee (“IFRIC”), a committee of the IASB, provides guidance on newly-identified financial reporting issues which are not specifically addressed in IFRS’s, or issues where unsatisfactory

or conflicting interpretations have developed, or seem likely to develop. If entities describe their financial statements as being prepared in accordance with IFRSs they have to apply to the consensus views set out by IFRIC interpretations and an IFRIC consensus view is withdrawn when an IFRS, which overrides or confirms a previously issued IFRIC consensus view, becomes effective (Vorster, Koornhof, Oberholster & Koppeskaar (2010:3-4)).

The prescriptive nature of the accounting standards in terms of IFRS may indicate or clarify the economic position of the parties involved in these transactions. The accounting treatment of income may therefore assist in the determination quantum of the amount as envisaged in **Brummeria Renaissance case supra** (2007:205).

4.2 FINANCIAL REPORTING OF LIFE RIGHT EXCHANGE AGREEMENTS

Section 29(4) of the Companies Act (71/2008) allows the Minister of Finance to make regulations as to which financial reporting standards have to be adhered to with section 29(5) compelling the use of IFRS by public companies.

None of the older IAS or current IFRS's specifically prescribes a standard for the accounting treatment of life right exchange agreements and therefore the standards available under IFRS, being the newer standards, are examined to determine those applicable to these transactions.

The recognition and measurement of the benefit amount received as envisaged in **Brummeria Renaissance case supra** (2007:205) in the records of the developer, are addressed. IFRS is used to determine whether the underlying benefit has to be recognised and measured as part of an asset of property, plant and equipment or investment property or in relation to the interest-free loan as a financial instrument.

As a result of the recognition and measurement of these balance sheet items, there are also adjustments to the income statement that needs to be classified in terms of IFRS. In the absence of IFRS applying to a specific transaction, IAS 8.10 states that management should use its judgement in developing and applying an accounting policy.

The IASB Framework (“Framework”) sets out the concepts that underlie the preparation and presentation of financial statements. One of the purposes of the framework is to assist preparers of financial statements in applying International Accounting Standards (International Accounting Standards Board, 2001). The four cornerstones of the framework are the concepts of assets, liabilities, income and expenses as reflected below.

An asset of an entity is described in paragraph 49 of the Framework as:

- A resource;
- That is under the control of the entity;
- That is expected to result in future economic benefits flowing to the entity; and
- That originated as a result of past events.

A liability of an entity is described in paragraph 49 of the Framework as:

- A present obligation;
- Arising from past events;
- The settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Income is described in paragraph 70 of the Framework as:

- Increases in economic benefits during the accounting period;
- In the form of inflows or enhancements of assets or decreases of liabilities;
- That result in increases in equity other than those relating to contributions from equity participants.

Expenses are defined in paragraph 70 of the Framework as:

- Decreases in economic benefits during the accounting period;
- In the form of outflows or depletion of assets or incurrence liabilities;
- That result in decreases in equity other than those relating to distributions to equity participants.

These definitions are used in conjunction with the standards of IFRS to determine the recognition of the elements of the financial statements.

Two possible applicable accounting scenarios have been identified as the basis for determining the accounting treatment and measurement of the benefit as envisaged in **Brummeria Renaissance case supra** (2007:1338) namely:

- Valuing the benefit in relation to the property made available for lease either as investment property or owned for use; or
- Valuing the benefit in relation to the loan as a financial instrument

Once the requirements of any of the standards have been met, the valuation criteria and their suitability are addressed thereafter.

4.2.1 Benefit value in relation to the property leased

To use the accounting standards in this respect as a valuation method it first has to be determined who accounts for the ownership of the property, i.e. the developer or the investor, as if it is the latter it would not be applicable or appropriate. It is also important to determine if the property is classified as property in terms of IAS 16 or investment property in terms of IAS 40.

In terms of life right exchange agreements all the risks and rewards incidental to ownership of an asset do not transfer to the investor. The investor is merely entitled to the lifelong use of the property. The investor therefore does not take on the owner's responsibility in respect of the asset.

The substance of the agreement is that the investor does not use the asset during the major part of its economic life and does not generate the economic benefits over this period. The asset would therefore be accounted for in the developer's accounting records and not in the records of the investor.

The reason for investigating the accounting treatment of the property in relation to the benefit amount is to determine if the change in the value of the property (assume the

face value of the loan is equal to the fair value of the property on the agreement date), as a result of the applicable accounting valuation method, reasonably equates to the benefit amount as envisaged in **Brummeria Renaissance case supra** (2007:205).

4.2.1.1 Investment property

IAS 40 prescribes the accounting treatment, including the recognition, measurement and disclosure, for investment property. IAS 40 defines “investment property” as property that is held:

- To earn rental income; or
- for capital appreciation; or
- both.

It is submitted that in life right arrangements the property is always held for capital appreciation as the growth of such appreciation may change the intention with which the property is held. However, it would be debatable that it is held with an intention to sell concomitant with such capital appreciation. Thus unless the property is held to earn rental income it is questionable whether the standard applies.

A life right exchange agreement is an arrangement that legally may take the form of lease and not convey ownership rights (Pam Golding 2011:2), however where the right is registered it conveys a real right on the lessee rather than imposing an obligation on the lessor as do normal leases (Badenhorst et al. 2005:48).

Furthermore in terms of section 4A of the **Housing Development Schemes for Retired Persons Act** (65/1988) the right to occupy for persons envisaged in that act would have the same rights as those of persons who have a registered lease against the title of property. However, it does not deem it to be so registered. It is arguable whether or not all life rights, based on the common law, should constitute a real right but legally it seems a distinction does exist between non-registered life right leases and registered or similarly deemed life right arrangements.

It is submitted that IAS 40 would apply to both groups as it does not specify the same distinction requirements and only requires property held for a specific purpose. Furthermore the subtraction from the dominium of the right of use does not in law prevent the developer from still holding ownership as required in IAS 40 as such ownership rights are limited.

As the existence of a lease is essential to IAS 40, applying the nature of the lifelong right must from an accounting perspective be measured against the standard requirement. IFRIC 4 provides guidance on when such arrangement is or may contain a lease. If it is determined that an arrangement contains a lease, the lease should be accounted for in accordance with IAS 17. IAS 17 defines a “lease” as an agreement conveying the right to use assets for an agreed period of time in exchange for a payment, or series of payments, by the lessee to the lessor (IAS 17.4).

Leases can be divided into two categories, namely “finance leases” and “operating leases”. A life right exchange agreement qualifies as a lease as the investor is entitled to use the property for an agreed period of time. A “finance lease” is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset (IAS 17.4).

An “operating lease” is a lease other than a finance lease (IAS 17.4). The lessee of an operating lease does not take on the owners’ responsibility in respect of the asset. The lessee generally uses the asset over a shorter period than the economic life of the asset. Therefore an operating lease can have a number of lessees during the economic lease of the asset.

The “economic life” of an asset, as a determining factor, refers to either the period over which an asset is expected to be economically usable, or the number of production or similar units expected to be obtained from the asset (IAS 17.4). “Useful life” refers to the estimated period over which economic benefits are consumed by the entity (IAS 17.4).

The following illustrates examples of situations that would normally result in leases being classified as finance leases (Vorster *et al* 2010:263):

- The lease agreement provides for the transfer of ownership of the asset to the lessee at the conclusion of the lease term;
- The lessee has an option to purchase the leased asset at the end of the lease at a value sufficiently lower than its fair value. The exercising of the option is reasonably certain at the inception of the loan;
- The term of the lease is for the major part of the economic life of the leased asset;
- The present value of the lease payments, at the inception of the lease, more or less amounts to the fair value of the leased asset;
- The leased asset is of a specialised nature and can only be used by the lessee, without major modifications being made.

In the case of life right agreements the ownership of the asset never transfers from the lessor to the lessee and the lessee occupies the property over a period shorter than its useful life and therefore it could not constitute a finance lease. The income should be treated as operating lease income and accounted for in terms of IAS 17.

More guidance as to what constitutes a “lease” is provided by IFRIC 4 that determines whether an arrangement is a lease or contains leases. In terms of this standard a “lease” is based on the substance of the arrangement, which means assessing if:

- Fulfilment of the arrangement is dependent on the use of a specified asset or assets; and
- The arrangement conveys a right to use the asset or assets.

In terms of a life right exchange agreement the fulfilment of the arrangement is dependent on the use of the property by the investor/lessee who will be entitled to a right to use the property for the agreed period. Property under life right exchange

agreements does not fall within the ambit of the prohibitions specified in IAS 40.4 and would therefore not be excluded.

Thus the requirement of a “rental” is met as fulfilment of the agreement and is dependent on the specified immoveable property and the arrangement conveys a right of use of such property. However, IAS 40 does not require just a “lease” but “rental income” to be earned. “Income” in the IASB framework is defined to include all economic benefits during an accounting period as well as enhancements of assets. Income specifically includes at paragraph 74 both revenue, namely income in the normal course of business, and gains. The framework clarifies gains as:

“Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this *Framework*.”

In this respect it is submitted that the amount in the **Brummeria Renaissance case supra** (2007:205) can constitute such an amount of income in the form of a gain as the interest free loan enhances the capital assets of the developer and potentially decreases the liabilities by not having an interest charge, both of which it is submitted result in increased economic benefits. It is therefore concluded that the property should be accounted for in terms of IAS 40 as the requirements would be met.

4.2.1.2 Property held for use

Property held for use is dealt with in terms of IAS 16.2 that states that the standard needs to “be applied in accounting for property, except when another standard requires or permits a different accounting treatment”.

IAS 16.6 describes property that is subject to the standard as:

“Tangible items that:

Are held in the production or supply of goods and services, for rental to others, or for administrative purposes; and
Are expected to be used for more than one period.”

It is submitted that the definition above indicates that the intention of IAS 16 was that the property should be used in the production of income and not sold or held as an investment for the purposes of sale.

To determine if the property should be accounted for in terms of IAS 16, the purpose of the owning of these units should be examined and measured against the requirements of IAS 16.6. The property in any life right arrangement is used over a period longer than one financial period as it is over the life of the holder of the right, but it is not owner occupied and is not held in the production or supply of goods and services, or for administrative purposes.

However, it would fall within the ambit of IAS 16 as it is rented to others but that is only to the extent that it is not investment property as in IAS 40 (Pretorius, Venter, Wingard 2011:9.1.2). Accordingly, as IAS 40 has been held to apply, IAS 16 does not apply and it submitted that it should therefore not be included as a basis of valuing the benefit amount.

4.2.2 Financial instrument

As a result of a life right exchange agreement, the investor provides an interest-free loan to the developer, which will be repaid by the developer on termination or cancellation of the agreement. In order to account for the loan, the standard that applies to the accounting of the loan needs to be identified.

According to IAS 32 paragraph 11, the definition of a financial instrument is “any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity” (International Accounting Standards Board, 2001).

A “financial asset” is described in paragraph 11 of IAS 32 as any asset that is:

- Cash;
- An equity instrument of another entity;
- A contractual right:
 - To receive cash or another financial asset from another entity; or
 - To exchange financial assets or liabilities with another entity under conditions potentially favourable to the entity.
- A contract that would or may be settled in the entity's own equity instruments and is:
 - A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - A derivative that would or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

A financial liability is described in paragraph 11 of IAS 32 as any liability that is:

- A contractual obligation:
 - To deliver cash or another financial asset from another entity; or
 - To exchange financial assets or financial liabilities with another entity under conditions potentially unfavourable to the entity.
- A contract that would or may be settled in the entity's own equity instruments and is:
 - A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - A derivative that would or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

The loan received constitutes a cash amount in the hands of the developer and he has a contractual obligation to deliver the cash to the investor at the termination of the agreement, which terminates on the death of the investor. It is therefore clear that transactions in terms of life right exchange agreements give rise to financial assets in the records of the investors and financial liabilities in the records of the developers in terms of IAS 32.

IAS 39 defines four categories of financial assets and liabilities (Vorster *et al* 2010:664), namely:

- Financial assets/liabilities at fair value through profit and loss;
- Held to maturity investments;
- Loans and receivables; and
- Available for sale financial assets.

Life right exchange agreements would give rise to a financial liability categorised as loans and receivables. This standard is therefore applicable to life right arrangement.

4.3 MEASUREMENT OF ELEMENTS OF FINANCIAL STATEMENTS

4.3.1 Investment property

According to IAS 40, investment property is initially measured at cost. The general rule for subsequent measurement of investment property is to choose between the following as its accounting policy (as illustrated in figure 1):

- Fair value model – At subsequent measurement the entity measures investment property at fair value. The gains and losses are recognised in the profit and loss section of the statement of comprehensive income
- Cost model – The cost model in IAS 16 needs to be used. According to the cost model, an entity is recognised as an asset at its cost less any accumulated depreciation and impairment losses

The fair value model is only applied if the fair value is considered to be reliably measurable (IAS 40.53). As there is an active market for similar properties, the fair value model should be a good indicator of its fair value and a suitable model for subsequent measurement. The cost model is not as precise as the fair value model and would be useful when the fair value cannot be determined. Management is required to choose between the application of the fair value model and the cost model and apply it consistently to all investment properties.

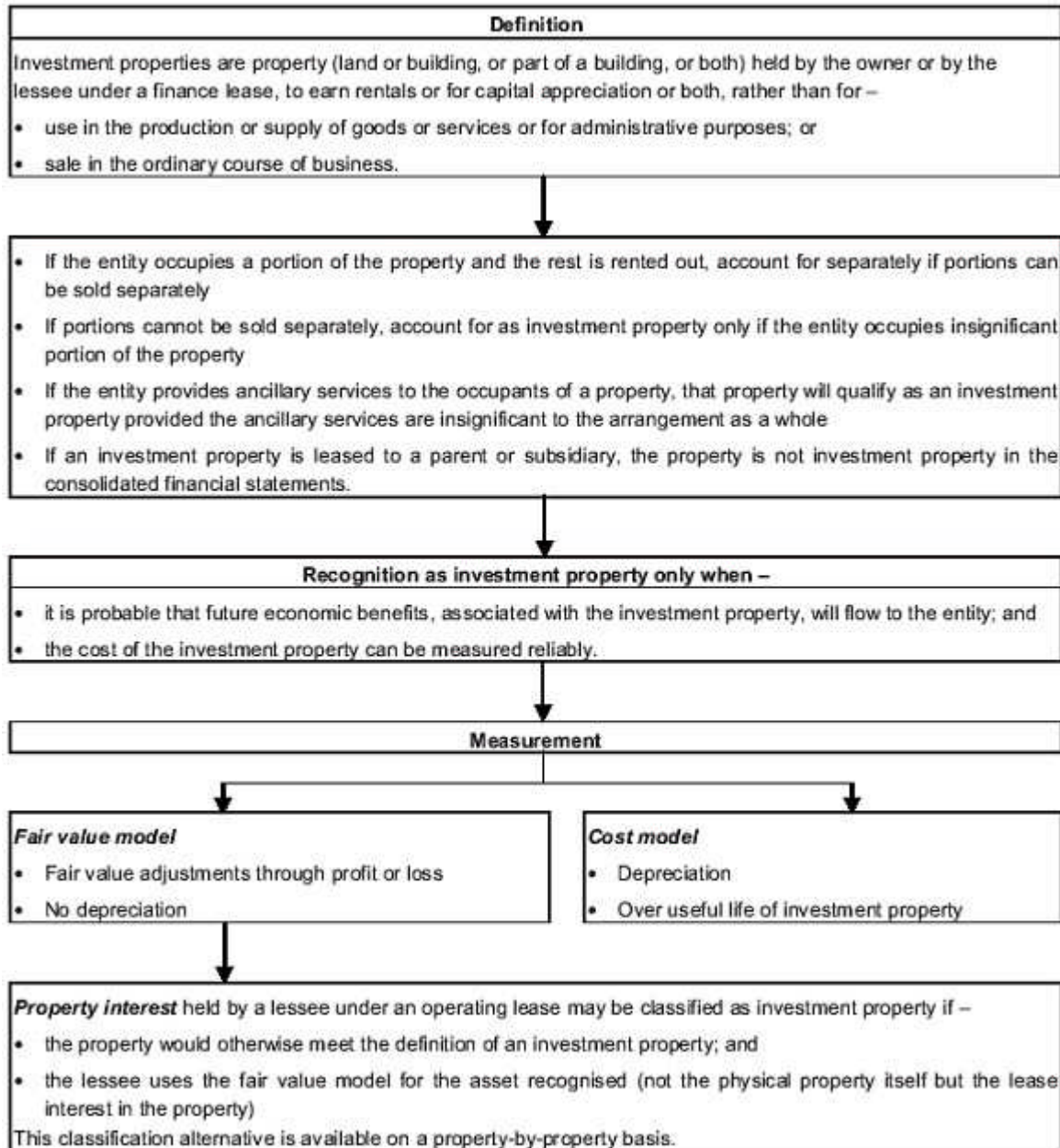


Figure 1: Summary of IAS 40 – Investment Property (Pretorius, 2011):

As the fair value model would result in a more accurate value, the property should therefore be classified as investment property and measured as follows:

- Initial measurement – at cost

- Subsequent measurement – fair value model

The value of the benefit for accounting purposes would therefore be the difference between the fair value of the property and the cost at initial measurement. The valuation of the benefit is done and accounted for at least annually on reporting of the Annual Financial Statements.

4.3.1.1 Operating lease

The lease instalments of an operating lease are recognised in the profit or loss section of the statement of comprehensive income in the Annual Financial Statements (IAS 17.33). The operating lease income is usually recognised on a straight-line basis over the lease term (IAS 17.34). The other option is to recognise the lease payments on another systematic basis if it relates better to the time pattern of benefits expected from the leased asset (IAS 17.34).

Some South African companies incorrectly assumed that “another systematic basis” meant accounting for rental expenses and income on the basis of cash flows and that it related better to the time pattern of the benefits expected from the leased asset (SAICA, Circular 12/2006). IAS 17 focuses on the time pattern of lease income and expenses. As cash flows very rarely agree to these time patterns, cash flows are rarely an appropriate basis for the recognition of lease income or expenses. Differences between straight line of income and expenses and the actual cash flow result in rental debtors or accrued expenses. The gains which originate as a result of the exchange of the right of occupation constitute an operating lease and need to be recognised in profit on a straight-line basis over the term of the contract.

The term of the contract might be indefinite in the case of life right exchange agreements (agreement for the remainder of the lessee’s life) and IFRS does not specifically provide guidance in this case. ED 288 - Exposure draft of an Amendment to Statements of Generally Accepted Accounting Practice Leases (August 2010) has been released for public comment in South Africa by the Accounting Practices Committee. Comments received on the international exposure draft would be considered when drafting a submission to the IASB.

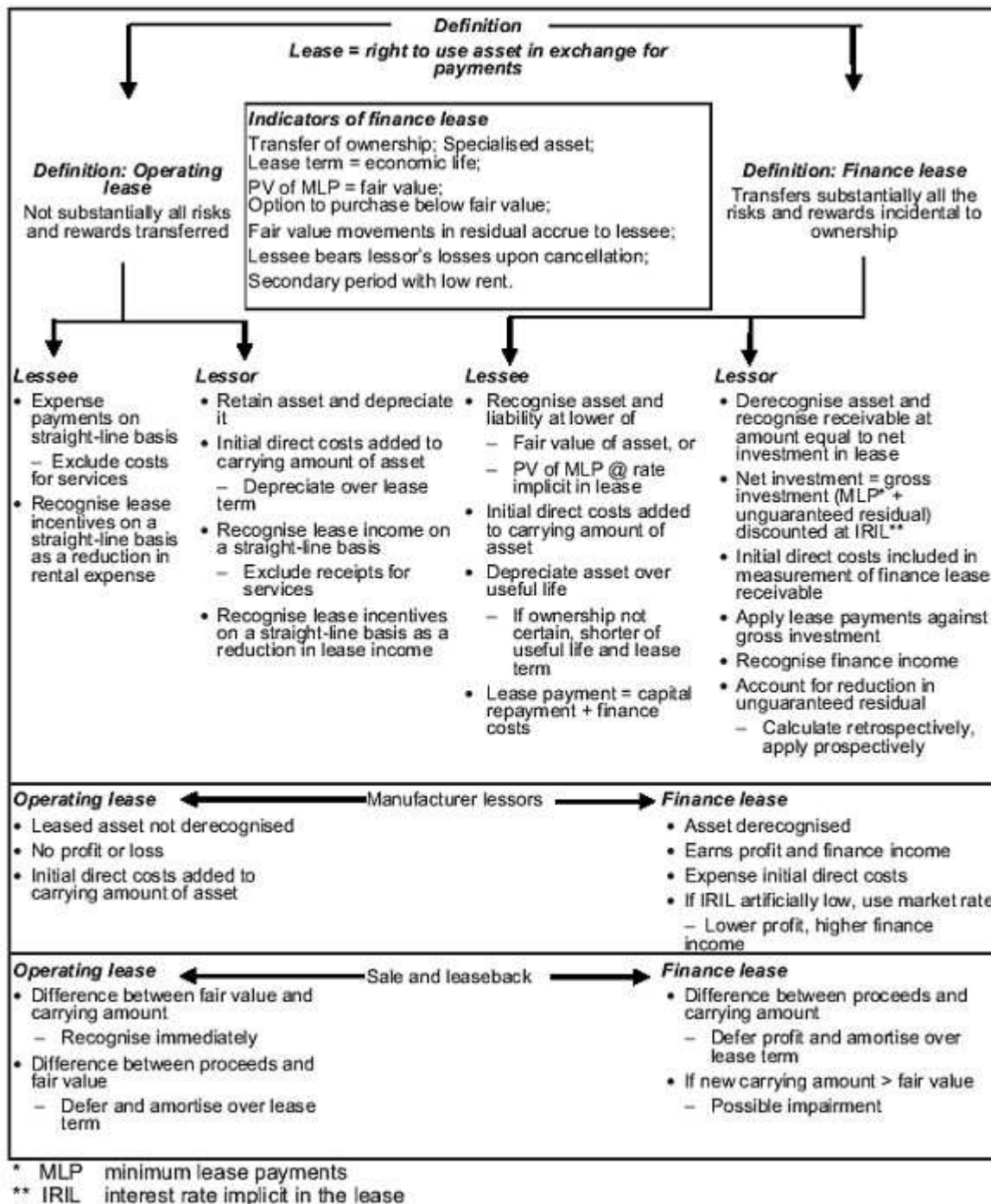


Figure 2: Summary of IAS 17 - Leases (Pretorius, 2011):

As the term of the contract is for the remainder of the life of the lessee or his spouse, it is suggested that the life expectancy table be used to determine the term of the contract. The gain therefore needs to be spread yearly on a straight-line basis over the expected life of the lessee or his spouse.

4.3.2 Financial instrument

The interest free loan received by the developer constitutes a financial liability in terms of IAS 39. The value of the loan for accounting purposes needs to be determined to measure the benefit for accounting purposes and to agree the benefit amount for tax purposes.

Under IFRS, debt or loans are generally initially recognised at an amount equal to the proceeds received/paid or the fair value of the consideration received/paid. The debt would subsequently be measured at amortised cost using the effective interest method (unless a fair value option is selected). IFRSs base the effective interest rate calculations on estimated cash flows over the expected life of the instrument. Under IAS 39 contractual terms of debt are only used if it is not possible to estimate the cash flows otherwise (Zack, 2009, 120).

Recognition refers to when items are accounted for in the entity's financial records and the initial recognition of an item refers to the timing of the recognition of financial instruments (Vorster *et al* 2010:654).

A financial asset or liability needs to be recognised when, and only when, it becomes a party to the contractual provisions of the instrument (IAS 39.14).

A financial liability should initially be measured at fair value plus, in certain situations, transaction costs (IAS 39.43). The standard defines fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction (IAS 39.9).

Given that fair value is the price that arm's length market participants would pay or receive in a routine transaction under the market conditions at the date at which the asset or liability is to be measured for accounting purposes (the measurement date), it follows that a financial instrument's initial fair value would normally be the transaction price (IAS 39.AG64).

In some circumstances the consideration given or received may not necessarily be the financial instrument's fair value. In the case of life-right exchange agreements a long-term payable that carries no interest is not equal to its face amount and, therefore, part of the consideration received is something other than its fair value.

As the long term payable would initially have to be recorded at its fair value, its fair value has to be estimated. According to IAS 39.AG76, the instruments fair value may be evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets.

For a long-term loan or payable with no stated interest, the fair value may be estimated by using a discounted cash flow valuation method. Under this method, the fair value can be estimated as the present value of all future cash payments discounted using the prevailing market rate of interest for a similar instrument with a similar credit rating issued at the same time.

Vorster *et al* 2010:669 state that the fair value of loans granted which bear interest at below-market rates or bear no interest would subsequently be measured by "discounting the expected cash flows to be received from these loans at a market-related rate on the date of granting the loan". It would therefore be the same method used for initial measurement.

To determine the fair value of the loan for measurement for accounting purposes the following information is critical:

- The prevailing market rate of interest for a similar instrument
- The period of the loan
- The timing and the amounts of the future cash flows

In the case of life-right exchange agreements it might be difficult, if not impossible, to determine the period of the loan as it comes to an end on the death of the investor, cancellation by either party to the contract or a predetermined date agreed between the parties. The most accurate way of determining the period of the life right agreement / loan would be by using a life expectancy table to determine the remaining life expectancy of the investor or his spouse. If the date of cancellation of

the contract was agreed between the parties, the specified period should be used. The fair value of the loan may subsequently be determined using the present value method.

If the present value can be determined the financial instrument should be measured at the fair value. In the developers' accounting records the consideration received is therefore for two things – the fair value of the loan and the investor's right to future economic benefits (right of occupation). The developer should therefore recognise the loan at its fair value, which accretes to the full face value of the loan over the term of the loan using the effective interest rate method. The difference between the consideration received and the fair value would not be a financial liability, but rather income, since it is received in return for future economic benefits other than the right to receive payment on the loan.

To explain the accounting treatment the journal entries would be discussed based on the following scenario:

- Interest free loan – R 500,000
- Term / period of contract or loan – 20 years
- Prevailing market rate of interest for a similar instrument – 10%

The R 500,000 would be repaid on conclusion of the contract.

Based on the abovementioned information the present value on day one is calculated as R 74,322. The journal entries in the accounting records of the developer would be as follows:

Day 1

Dr Bank	R 500,000	
Cr Loan		R 74,322
Cr Deferred revenue		R 425,678
<u>Fair value of initial amount received</u>		

Year 1 to 20

Dr Deferred revenue	R 425,678	
Cr Income		R 425,678

Recognise the “rental income” over 20 years – R 21,283.90 per year

Dr Finance cost	R 425,678	
Cr Loan		R 425,678

Calculate and recognise the interest per year using the effective interest rate method

End of year 20

Dr Loan	R 500,000	
Cr Bank		R 500,000

Being the repayment of the loan.

It can be concluded that the benefit of the interest-free loan is the difference between the present value of the loan and the actual payment received. The income or benefit should be calculated on a yearly basis by calculating interest on the present value of the loan as at year end.

4.4 CONCLUSION

As a result of the analysis of the possible accounting scenarios identified, the scenario which best represents the measurement of the benefit as envisaged in **Brummeria Renaissance case supra** (2007:205) should be determined.

The benefit in relation to the property was determined as the movement in the fair value of the property in terms of IAS 40 and needs to be determined and recognised on a yearly basis. The valuation method is not be an accurate measurement of the benefit received by the developer in terms of the agreement as it relates to the capital appreciation of the property and not as a result of the interest-free loan received from the investor in exchange for the right of occupation.

The other possibilities are to examine the valuation of the accounting treatment of the “lease income” in terms of IAS 17 and the finance cost in terms of IAS 32. The value

of the lease income and the finance cost would be equal over the period of the agreement and calculated as the difference between the face value and the present value of the loan on the date of the agreement and originates as a result of the interest-free loan.

According to IAS 17 the lease income has to be straight-lined over the period of the lease and does not take any economic factors, e.g. inflation on the lease income, into account and is not a true reflection of the recognition of the benefit over the period of the agreement.

In terms of IAS 32 the loan should be measured at present value and interest should be calculated yearly on the present value of the loan using the prevailing interest rate of similar financial liabilities. This is a good method of valuing the benefit of the interest free loan for income tax purposes as it takes a lot of relevant economic factors, such as future cash flows and the market rate of interest for a similar instrument, into account. It would also correspond with section 24J of the ITA (58/1962) which spreads the interest over the period or term of the financial arrangement by compounding the interest over fixed accrual periods using a predetermined rate.

It is therefore concluded that the basis for determining the accounting treatment and measurement of the benefit as envisaged in **Brummeria Renaissance case supra** (2007:205) is to value the benefit on a yearly basis in relation to the loan as a financial instrument in terms of IAS 32.

CHAPTER 5

CONCLUSION

The research object was firstly to determine whether the general expenditure, including the right of use, incurred by developers constructing residential units constituted permissible deductions in terms of the provisions section 11(a) of the ITA (58/1962) and the requirements of that section namely expenditure and losses, actually incurred, in the production of income that is not of a capital nature. Furthermore it would also be determined whether section 23(g) did not prohibit the deduction.

It was found that “expenditure” as determined in **Labat case supra** (2011:12) required an investigation into whether something was used which resulted in the diminution of the assets of the taxpayer. It is submitted that this test is not ideal in trying to distinguish expenditure from the case law dealing with actually incurred as envisaged by the court. It was thus concluded that in lieu with the grammatical meaning held by the court that the concept of consuming or using something as interpretative of the concept of expenditure was better suited. It was also submitted that based on either meanings that the right of use or more correctly, the expenses incurred in creating the right of use given to the lessee would also qualify as expenditure. This right as expenditure was also submitted to be separate from the bare dominium of the property as fixed capital. Losses were found to merely constitute expenditure of an involuntary nature.

The requirement of actually incurred was found to require that a legal obligation to incur the expenditure existed notwithstanding that it was not due and payable. The enquiry into the “in the production of income” was held to be determined by looking to whether the expenses attached to the performance of a business operation for the purpose of earning income. The amount would be in the production of income notwithstanding that it did not directly create income or was incurred by chance to the business operations.

In this regard it was pertinent to determine whether the developer would earn any income in the form of the benefit amount on the interest free loan. It was submitted that the nature of the benefit amount could be either akin to interest or rentals if the transaction was deemed to be a simulation as held in **NWK case supra** (2010:71). It was also found that the quantum of the amount could be determined by applying either an arm's length interest or rental value depending on the nature of the amount determined above with accrual on a per year of assessment basis. SARS' valuation method in SARS' IN 58, though found to be generous by automatically allowing the deduction of the right of use against the benefit amount, was submitted to be technically flawed as a direct result of compounding these two separate concepts of income and expenditure and for treating the amount as accruing once off over the expected life of the lessee and not on a per year of assessment basis.

The quantifying of the amounts was also discussed in relation to the various accounting standards including IAS 40, IAS 17, IAS 16, IAS 39 and IAS 32. It was concluded that, if relying on accounting standards for the valuation, valuing the benefit according to IAS 32 would be the most prudent for tax purposes whereby the benefit would be calculated as the present value of the loan using the prevailing interest rate. This method would be similar to the one applied by SARS except that the amount would be calculated on an annual basis and not once off.

It was also concluded on the basis of the authorities cited that the benefit amount, irrespective of the legal nature determined, would be revenue in nature. This would also apply to both the general expenses and the right of use, thus concluding that both were incurred in the production of income.

The amounts were also analysed to determine whether they would be capital in nature. The basis of this determination was found to relate to various tests with the purpose of the expenditure and to what it relates being critical. It was concluded that the general expenditure relating to the normal day to day activities without creating an asset or enduring benefit would be revenue in nature. The right of use analysed against these tests was found to be less clear in application but it was submitted that the right of use would be revenue in nature, notwithstanding its capital nature, as it

was submitted that it possibly was more akin to floating capital than fixed capital, such as the dominium of the property.

The repair and maintenance expenditure was also evaluated in relation to section 11(d) of the ITA (58/1962) which required a repair of property either occupied for the purposes of trade or in respect of which income is receivable. It was found that a distinction had to be drawn between repairs, which are revenue, and improvements which are capital expenditure and not deductible in terms of this section.

It was concluded that the test formulated by the courts, namely was the thing replaced substantially part of a whole, required applying a degree of discretion to the facts. However the exact reference of what constitute the whole to which the part had to be measured for determining the substantial nature of the replacement was submitted to be undetermined. Once the cross-over point of “substantially” had been established then it was an improvement not a repair. The usefulness was however submitted to be limited and difficult for taxpayers to apply.

The requirement of occupied for the purposes of trade was discussed but it was concluded that due to the nature of the facts in life right exchange agreements that this requirement would not be relevant. The alternative requirement was found to have indifferent views with some courts finding that for income to be receivable the property must be occupied or at least have given the lessee a legal right to occupy. The most recent case law however suggested that legal occupation was not the requirement but only that the property was in a condition to occupy and thus have the potential to earn income. The latter was criticised on the basis that it did not represent the normal grammatical meaning of the words; however the interpretation was supported as to meeting the possible intention of the legislature and being the most beneficial to the taxpayer. The deduction, being subject to the same income requirement as section 11(a), was held to conform on the basis that the benefit amount as discussed was, as submitted, revenue in nature and a quantifiable amount.

The last requirement was that the expenses should not be prohibited by section 23(g) namely that the moneys were not laid out of the purposes of trade. It was found that

the relevant enquiry was what the taxpayer intended to do with thing so acquired and that his motive for acquiring such thing was however irrelevant. It was submitted that money's laid out for the general expenses and the expenses to create right to occupy was done so to use these things in the trade of the taxpayer, namely the sale or leasing of occupational rights to immoveable property. The latter was submitted to constitute a trade as defined in section 1 of the ITA (58/1962). It was therefore concluded that the permissible expenditure was also not prohibited by section 23(g).

Accordingly it is concluded that the general expenses and expenses incurred for the creation of the right of use is permissible expenditure under section 11(a). Furthermore it is concluded that the repairs, though difficult to always determine, would be deductible in terms of section 11(d) and that all this expenditure would not be prohibited in terms of section 23(g).

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