



**IN THE SUPREME COURT OF APPEAL
OF SOUTH AFRICA**

**REPORTABLE
CASE NO 641/05**

In the matter between

CHARLES DOUGLAS NEWMAN STEVENS

Appellant

and

COMMISSIONER FOR THE SA REVENUE SERVICE

Respondent

**CORAM: HOWIE P, MTHIYANE, BRAND MAYA JJA et
 COMBRINCK AJA**

Date Heard: 6 November 2006

Delivered: 28 November 2006

**Summary: Para (c) of definition of ‘gross income’ in Income Tax Act 58 of
 1962: whether *ex gratia* payment an amount received in respect
 of services or employment.**

**Neutral citation: This judgment may be referred to as *Stevens v CSARS* [2006]
 SCA 145 (RSA)**

J U D G M E N T

HOWIE P

HOWIE P

[1] The appellant taxpayer was group company secretary of Safmarine and Rennie Holdings Limited ('Safren'). Under the company's share incentive scheme he acquired the option to buy 51 000 Safren shares at R3.70 per share. By reason of circumstances referred to below the option was rendered worthless. As a result the company's directors resolved, in their discretion, to pay all R3.70 option holders 75 cents per share *ex gratia*. In consequence the appellant received R38 250. That was in the 2001 tax year. The Commissioner took the view that the receipt fell within the terms of paragraph (c) of the definition of 'gross income' in s 1 of the Income Tax Act 58 of 1962 and accordingly assessed the appellant to tax. An objection and appeal to the Cape Tax Court having failed, the appellant appeals, with the necessary leave, to this Court.

[2] Before the Court below a statement of agreed facts was admitted into the record and supplemented by evidence from the taxpayer. The statement reads as follows:

1. The appellant is the holder of share options in terms of the Safren Employees' Share Incentive Scheme ("the Scheme").
2. The *ex gratia* payments in question were not made to all holders of Safren options. They were made only to those participants in the Scheme who held options granted on 6 August 1998 at R3.70 per share ("the R3.70 options").
3. Holders of the R3.70 options were in terms of the rules of the Scheme not in a position to exercise their options by the time a special dividend was declared by Safmarine and Rennie Holdings Limited ("Safren") on 4 October 1999. This is because clause 5.2 of the rules of the Scheme precluded option holders from exercising their options for a period of three years from the date of the grant of the options. Thus the R3.70 option holders would not have been able to exercise the R3.70 options until 5 August 2001, which was *after* the declaration of the special dividend on 4 October 1999.
4. At the time of declaration of the special dividend, ie on 4 October 1999, it was announced that Safren would be voluntarily liquidated.

5. Option holders who were in a position to exercise their options prior to 4 October 1999 were not offered any *ex gratia* payment whatsoever.
6. The *ex gratia* payments were offered on 16 February 2000.
7. Acceptance of the *ex gratia* payment did not affect the position of the R3.70 option holders in any other way: they continue to hold their R3.70 options, and they did not exercise, surrender, cede or release their R3.70 options.
8. During the 2001 year of assessment the appellant, as holder of R3.70 options, received an *ex gratia* payment of R38 250 in the circumstances described above.
9. The issue for determination is whether or not the said amount of R38 250 received by the appellant constituted 'gross income' in his hands in terms of the relevant provisions of the Income Tax Act, 58 of 1952, as amended.'

[3] The resolution to make the *ex gratia* payment reads as follows:

'It was further noted that –

prior to the declaration of the special dividend of R1 per share on 4th October 1999 participants under the scheme who held options over Safren shares at R3.70 per share, could reasonably have expected to have realised a profit on exercising their options prior to the proposed liquidation of the company when it was at that time anticipated that the net realisable value per share would be approximately R4.45. As the special dividend on shares subject to unexercised options accrued to the Trustees and not participants, holders of options at R3.70 per share had thereby been denied the realisable profit which they would otherwise have made, since the net asset value per share on liquidation had now been estimated at some R3.55 per share.

Since the Board's resolution of 2nd December 1998 to lift the embargoes on the exercise of options had not become effective and the holders of the R3.70 option rights had accordingly been deprived of the opportunity to realise a profit which they would otherwise have made, it was RESOLVED that an *ex-gratia* payment of 75 cents per share be made (R4.45-R3.70) to those participants holding options over Safren shares at R3.70 per share to compensate for the gain which they had reasonably expected to make prior to the declaration of the R1 special dividend.'

[4] The Scheme included the following provisions which are relevant.

‘2. PURPOSE OF THE SCHEME

The scheme is intended to promote the retention of employees of ability and expertise who are primarily responsible for the profitability and continued growth of Safren and ... by giving them an opportunity to acquire shares in Safren.

3. ELIGIBILITY

The persons who may participate in the scheme and to whom the board shall be entitled to cause to be offered ... options over scheme shares ... shall be such employees of Safren ... as the board, in its absolute discretion, considers play a role in the management of Safren ... and contribute to its growth and profitability.’

The board referred to was the board of directors and participants in the scheme included an option holder’s heirs. The scheme was implemented by trustees but it was the board that decided which employees were to be offered shares or options by the trustees.

[5] In all there were 125 R3.70 option holders and the present matter is in the nature of a test case. Predominantly the option holders were, in the relevant year, current employees but some were retired employees and there was one option holder which was the estate of a deceased employee. They were all made an offer of the *ex gratia* payment and all accepted it.

[6] The testimony of the taxpayer highlighted several features of the case which are important. He said the option rights were awarded to people because they were employees and in recognition of their services rendered or to be rendered . He went on to say:

‘The purpose of a Share Incentive Scheme was for the senior employees of the company or the group to be given an opportunity to have a stake in the company and, if I might add, for the obvious reason that to have a stake in a company is going to give you a greater reason to be committed to the company and to work hard or harder perhaps so

that the results can be good enough or better to result in the share price increasing and therefore you to have a capital asset which you can have in addition to your remuneration’.

[7] As regards the decision to make the *ex gratia* payments he said:

‘My memory of talking to the chairman and attending the board meeting at the time was that the board had, was concerned that it had overlooked the effect it was having on these option holders and, I think, it was quite a credit to the members of the board that they felt sympathetic to such option holders and because the option holders were, I say this for myself, important members of the Safren team it was felt that the decision, you know, was a just one and obviously it could not be made only to current employees of Safren who held such options. It would have to apply to all R3.70 option holders ...’

[8] The taxpayer testified that the *ex gratia* payment was to make up for the drop in the capital value of the shares that could have been acquired had the option been exercisable, that is to say, the fall from a then market value of R4.45 to at least the level of the option price of R3.70. In other words it was to compensate for the option holders’ loss. He added it would not necessarily have constituted adequate compensation if, having exercised the option, they could have held on until the eventual distribution on liquidation ‘which might well have been more than R4.45 per share’.

[9] It remains to mention his comment that with liquidation imminent the board, in awarding the *ex gratia* payment, would not have been particularly concerned about rewarding services either being rendered or to be rendered.

[10] The question for decision is whether on the facts of this case the amount received by the taxpayer fell within the relevant part of paragraph (c) of the definition of ‘gross income’. That part includes in ‘gross income’:

‘any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount ... received or accrued in respect of or by virtue of any employment or the holding of any office ...’

[11] In passing I should remark that because the taxpayer's option was never exercised s 8A of the Act does not apply, and that it was accepted by the parties that no other provisions of the definition of 'gross income' applied either.

[12] The Tax Court decided in the Commissioner's favour because in its view the taxpayer's services and employment were directly linked to the amount received. Such services and/or employment, so it held, constituted the reason why the board exercised the discretion it did, even in the cases of the retirees and of the deceased employee's estate.

[13] Counsel for the appellant disavowed acceptance of the taxpayer's reference to compensation for loss. Counsel argued that the amount paid was not to compensate for any loss but for the unfairness which the R3.70 option holders would have suffered as a result of the special dividend and its effect on the value of Safren shares had the *ex gratia* payment not been made.

[14] Counsel also placed reliance on the decision of this Court in *CIR v Shell Southern Africa Pension Fund*¹ in contending that, in the language employed in that case, the taxpayer's services and employment constituted no more than an 'historical antecedent or background feature'² and that the legally causative factor in this case was the declaration of the special dividend and its unforeseen effects on the R3.70 option holders.

[15] In the *Shell* case the issue was whether a lump-sum payment from a pension fund to the widow of a deceased member – payment being in the discretion of the fund's administering committee – was a benefit recoverable 'in consequence' of the death of the member. It was held that upon the grant of the pension to the widow, the member's death ceased to have any operative effect

¹ 1984 (1) SA 672 (A).

² At 679F-G.

on the payment. It was held that the committee's decision was an independent, unconnected and extraneous cause which isolated the death from the payment.³

[16] It was the declaration of the special dividend, said the taxpayer's counsel, which led to the board's discretionary decision and the payments in issue, which were made to no other option holders. Again in the language used in *Shell*, the special dividend declaration was, he said, an 'independent, unconnected and extraneous causative factor or event'.⁴

[17] There may have been a shift of focus in counsel's approach. The Tax Court records his argument there (the same counsel appeared for the taxpayer in both courts) as being that it was the board's decision to make the *ex gratia* payments that was the legally causative event, not the board's earlier declaration of the special dividend. The advantage to the taxpayer apparently inherent in focusing on the latter is that, being a matter essentially between the company and its shareholders, the special dividend declaration was not connected to the employment relationship between the company and its employees. Hence the opportunity to argue that the employment chain, to call it that for convenience, was broken by a decision independent of, unconnected with and extraneous to the employment relationship.

[18] Accordingly, submitted counsel, the *ex gratia* payment was not aimed at compensating the R3.70 option holders as employees or ex-employees. In other words it was not intended to give them that benefit by reason of their services or their employment. It was meant to compensate only them; it was not made to any other option holders, not even those who could have excised their options before the special dividend declaration but did not do so. The R3.70 option holders were singled out not because of their seniority, prominence or quality of service but

³ At 279G-H.

⁴ At 679G-H.

because their option price was below the market value when the special dividend was declared and it was they who were deprived of a contemplated profit.

[19] Counsel also sought to make something of the contention that the supposed benefit inherent in the options was no more than the opportunity to benefit in future subject to many contingencies which might, even adversely, have affected the market price of the shares by the time the options were exercisable. In my opinion this argument ignores the realities. By the time the special dividend had lowered the share value, liquidation was in sight and but for the amount of the special dividend it was tolerably clear what shareholders would get on liquidation, and therefore that the R3.70 option holders had missed out on achieving a capital benefit of near enough 75 cents per share. The relevant resolution recognises as much.

[20] Turning to an evaluation of the appellant's argument, there is no material difference between the expressions 'in respect of' and 'by virtue of' in paragraph (c).⁵ They connote a causal relationship between the amount received and the taxpayer's services or employment.⁶

[21] There can be no doubt that the R3.70 option was a benefit directly linked to the taxpayer's employment. Options were given as a benefit to those whose past services prompted the employer's wish to secure their future services. The taxpayer's counsel emphasised that the options remained intact after the declaration of the special dividend, which was some indication that it could not have been the board's intention to substitute the *ex gratia* payments for the options. However, the declaration of the special dividend rendered the R3.70 options (and others with higher option prices) worthless. As a result the intended capital benefit which the board had wished the taxpayer to have was unquestionably lost.

⁵ See *De Villiers v Commissioner for Inland Revenue* 1929 AD 227 at 232-3; and *Stander v Commissioner for Inland Revenue* 1997 (3) SA 617 (C) at 624I-625B.

⁶ *Mooi v Secretary for Inland Revenue* 1972 (1) SA 675 (A) at 684G-H.

[22] It is true that the effect of the declaration operated unfairly on the R3.70 option holders and that the board intended to ameliorate their position but it seems unhelpful to argue that the *ex gratia* payment was aimed at compensating unfairness, not loss. The question which requires answering is not: what was the factor or event which prompted the board to decide to make the *ex gratia* payment? Undoubtedly the right answer to that question is 'the effect of the special dividend declaration'. The question to answer is rather: why was the payment made to those who received it? The answer to this question is that the recipients were employees (or ex-employees or the deceased employee's estate) who had enjoyed a benefit directly linked to their employment, who had lost that benefit and who, in the board's discretion, were deserving in the particular circumstances of a substitute *ex gratia* payment. The point is that the self-same quality of service which motivated the grant of the option to them in the first place was still operative in motivating the award of the *ex gratia* payment to them. That other option holders were not recipients, whatever their worth as employees, does not detract from the Commissioner's case. Their option prices were above the relevant market value and they sustained no loss. And those with lower option prices than R3.70 had been able to exercise their options but failed to do so. It was open to the board in any event to choose one group of employees as more deserving than another. As long as the motivation was to give the recipients a benefit in recognition of their service in Safren's employment – as I think the evidence shows it was – then there was an unbroken causal relationship between the employment on the one hand and the receipt on the other.

[23] In the present matter the board's decision to make the *ex gratia* payment was made as employer *vis a vis* employee, not, as in the *Shell* case, as some independent body *vis a vis* a member's dependant. The decision to make the *ex gratia* payment did not deprive the taxpayer's employment of 'operative effect'. Payment was made because the recipients were employees whose standard of

service – past or current – warranted, in the light of their loss, the *ex gratia* payment. Even if it be supposed that the employment and the special dividend declaration were dual causes the former was in my view clearly the dominant one.⁷ And as pointed out in *De Villiers*, it does not matter that payment was made gratuitously rather than under an obligation.⁸ The amount in issue was therefore received in respect of or by virtue of employment.

[24] It follows, in my view, that the decision of the Tax Court was right. In regard to costs, the Commissioner asked for the costs of employing senior counsel. That is a matter for the Taxing master who will, no doubt, tax according to seniority in any event. The appeal is dismissed, with costs.

CT HOWIE
PRESIDENT
SUPREME COURT OF APPEAL

CONCUR:
Mthiyane JA
Brand JA
Maya JA
Combrinck AJA

⁷ Cf. *De Villiers* at 230.

⁸ At 233.