REPORTABLE

CAPE TAX COURT

BEFORE

The Honourable Mr Justice D Davis	President
Mr H Kajie	Accountant Member
Mr R B Justus	Commercial Member

In the matter between

CASE NO. 11134

(Heard in Cape Town on 17 November 2004)

JUDGMENT

CAPE TOWN 25 November 2004

DAVIS J:

Introduction

This appeal concerns the taxation of an *ex-gratia* payment received by appellant as an option holder of certain options in terms of the S Employees' Share Incentive Scheme ("the Scheme").

The factual matrix

Briefly the facts were as follows:

Appellant was and still is, the holder of R3.70 share options in terms of the Scheme. The 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 S on 4 October 1999.

Pursuant to clause 6.2 of the rules of the Scheme, option holders were precluded 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 their options until 6 August 2001, which was after the declaration of the special dividend which took place on 4 October 1999.

The declaration of the special dividend on 4 October 1999, which resulted from a decision to "unbundle" S, had the effect of depressing the S share price, and accordingly of reducing the value of the R3,70 options, which, as I have already noted, were not yet exercisable.

At the time of declaration of the special dividend on 4 October 1999, it was announced that S would be voluntarily liquidated.

Because the declaration of the special dividend had the effect of reducing the value of the R3,70 options, and because the R3,70 option holders had not been in a position to exercise these options at the time the special dividend was declared, the board of directors of S decided to offer an *ex-gratia* compensation to these option holders.

The purpose of the offer of the *ex-gratia* payments was to compensate those option holders, being the R3,70 option holders, who had not been in a position to exercise their options prior to the declaration of the special dividend.

Option holders who were in a position to exercise their options prior to 4 October 1999 were not offered any *ex-gratia* payment.

Acceptance of this *ex-gratia* payment did not affect the position of the R3,70 option holders in any way; they continued to hold their R3,70 options, and they did not exercise, surrender, cede or release these options.

Although these options were only acquired by persons in the employment of the S group of companies on 6 August 1998, the *ex-gratia* compensation was offered on 16 February 2000 to all option holders, including those who had retired from employment and the estates of any deceased persons who had held these options.

During the 2001 year of assessment the appellant, as a holder of R3,70 options, received an *ex-gratia* payment of R38 250. At all material times he held his option as a capital asset, (this appears to be common cause) with the intention of exercising the option in order to acquire S shares as a capital asset once he was in a position to so do.

The crisp issue for determination was whether the amount of R38 250 which was received by appellant constituted “gross income” in his hands in terms of the provisions of the Income Tax Act, 58 of 1962, as amended (“the Act”).

When the case was argued before this Court, the scope of this issue was further reduced to the applicability of paragraph (c) of the definition of “gross income” section 1 of the Act to the *ex-gratia* payment. Ms Collins, who appeared on behalf of the respondent, did not seek to rely on any other basis for the assessment.

<u>Appellant’s case</u>

Mr Emslie, who appeared on behalf of the appellant, submitted that the issue in relation to paragraph (c) of the definition of “gross income” was whether the amount in question was “in respect of services rendered or to be rendered” or “in respect of or by virtue of any employment or the holding of any office”. Paragraph (c) of the definition of “gross income” provides :

> ***“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 …”***

In Mr Emslie's view, before an amount can be said to have been received in respect of services rendered or to be rendered, there must be a causal relationship between the payment of the amount received and services rendered or to be rendered.

Mr Emslie cited the decision of Stander v CIR 1997 (3) SA 617 (C) where Friedman JP held that this phrase means that services rendered or to be rendered must be the ***causa causans*** of the amount received and that it was not sufficient if such services were merely a ***causa sine qua non*** of the amount received.

A particular ***causa sine qua non*** **,**being a factual cause, is not a ***causa causans,*** being a legal cause, if an independent, unconnected and extraneous causative fact or event intervenes which isolated the services of the employee from the final result, thereby relegating the ***causa sine qua non*** to the status of a mere historical antecedent or background feature.

Relying upon the decision in CIR v Shell Southern Africa Pension Fund 1984 (1) SA 672 (A) at 679F Mr Emslie submitted that this was a case where the distinction between the ***causa sine qua non*** and the ***causa causans*** could be applied. On the present facts, the ***causa causans*** of the receipt of the amount in question by the appellant was the decision by the directors of S to compensate the R3,70 option holders for the reduction in the value of the shares in respect of which they held these options as a result of the declaration of the special dividend. The decision by the directors of S to grant the *ex-gratia* payment was a ***novus actus interveniens*** which isolated the receipt from the ***causa sine qua non*** in the form of services rendered or to be rendered. According to Mr Emslie, it thus followed that

the requisite causal link to the services rendered or to be rendered and the amount received was not present.

Mr Emslie contended that the same reasoning was applicable in respect of the phrase "in respect of or by virtue of any employment or the holding of any office" which was a requirement of paragraph (c). In this regard he noted that it was significant that the Court in Stander's case held that the words "by virtue of" do not bear a meaning materially different from the words "in respect of". (at 624I).

Accordingly, he submitted that the amount received by the appellant did not constitute "gross income" in terms of paragraph (c) of that definition. In this connection Mr Emslie placed great emphasis on the fact that the compensation paid by SAFREN to the R3,70 option holders was paid to all R3,70 option holders including retired employees and the deceased estates of these option holders.

For this reason the payment had been given to option holders to compensate for the hole created in the capital amount, being the benefits granted as a result of or by virtue of services rendered. The present amount had been granted by virtue of these persons being option holders. There was a significant distinction between the legal cause of the receipt of the option on the one hand and the *ex-gratia* payment on the other.

Respondent's case

Ms Collins contended that paragraph (c) deals disjunctively with two situations, being amounts (including any voluntary awards) received or accrued in respect of services

rendered or to be rendered and secondly amounts received or accrued in respect of or by virtue of any employment or the holding of any office.

The words "in respect of" are employed in paragraph (c) both in relation to "services rendered" and in relation to "employment or the holding of office". The words "or by virtue of" are only used in relation to employment or the holding of office and as an alternative to the words "in respect of".

The words "in respect of services rendered" first received judicial analysis in De Villiers v CIR 1929 AD 227. The case concerned a government employee who at date of retirement had an accumulated leave credit. In terms of a Circular issued by the Treasury, vacation leave standing to the credit of an officer of the Public Service at the date of his retirement could have been commuted for a cash payment. It was however provided that the option of commuting such leave for cash at the termination of the officer's period of services rested with the Government.

The Government decided to commute the leave paid due to the employee taxpayer by a payment in cash upon his retirement. The issue in dispute was whether such amount could be said to have been paid "in respect of services rendered". Curlewis JA held thus :

> ***"The appellant, when he retired with leave standing to his credit, had in that leave an advantage which was directly related to the services rendered by him; he would not have possessed it had he not rendered the qualifying services; when therefore, that leave credit was commuted for a money payment, the amount so received stood equally in direct***

> ***relationship to the services rendered, and by virtue of that relationship was received "in respect of services rendered" and as such, under the provisions of sec 7(1)(b) of Act No 40 of 1925, it must be included in gross income of the recipient, whether it was paid in accordance with an obligation or gratuitously."***
> (at 232 - 233)

Ms Collins also referred to the recent consideration of the phrase "in respect of services rendered" in Stander v CIR 1997 (3) SA 617 (C). As Mr Emslie also relied on this case for support for his argument, it is necessary to look at this case in some detail.

Appellant was a bookkeeper of a franchise dealer of Delta Motor Corporation (Pty) Ltd (Delta). In terms of the franchise agreement, the dealer was required to furnish monthly financial reports to Delta. These reports were drawn up by the appellant and forwarded by the dealer to Delta. Delta, in recognition of appellant achieving excellent standards of performance in financial management awarded appellant a prize consisting of a seven-day overseas holiday for himself and his wife. The cost to Delta of the airfares and accommodation for the appellant and his wife amounted to R14 000-00.

In this case the court was not required to consider the second part of paragraph (c). The issue in dispute was whether the amount was received in respect of services rendered, as it appears in the first part of paragraph (c).

In assessing the meaning of the phrase "in respect of", the court referred to the case of De Villiers *supra* and then, in dealing with the issue of causality , Friedman JP said :

> ***"The manner in which the franchise holders' employees performed their work, was obviously of benefit to Delta. The fact that the appellant was an employee of Frank Vos Motors, was a sine qua non to his receiving the reward. Had he not been an employee of a Delta Franchise holder he would not have been eligible to receive the reward. This fact does not, however, provide the necessary causal link between the services which he rendered to his employer and his obtaining of the award. Those services did not constitute the causa causans of the award. He did not seek the prize by entering the competition … nor did he expect to receive anything from Delta for the work he performed for Frank Vos Motors. He merely performed his normal duties for which he was remunerated by his employer. The fact that these duties were performed in a manner which Delta considered to be excellent was what qualified him to receive the prize. … The sine qua non referred to above does not provide the necessary causal link between what Stander did and the award he received."***

The court also considered Stander's position in relation to the well known decision in Moore v Griffiths (Inspector of Taxes) [1972] All ER 399. This case concerned the captain of the English soccer team which won the World Cup in 1966 and who received, as a bonus from the Football Association, a sum of money which was held to be taxable. The court in that case held that the true purpose in making the payment was to mark the

taxpayer's participation in an exceptional event, namely the winning of the World Cup Championship. The payment had the quality of a testimonial or accolade rather than the quality of remuneration for services rendered.

In Stander, the causal link between the services and the award was held to be absent because the amount received by Stander was not received for conducting services as financial manager; it did not have the quality of remuneration for services rendered, but it was a prize for achieving excellent standards of performance in financial management. To repeat the ***dictum*** at 624 "His duties were performed in a manner which Delta considered to be excellent was what qualified him to receive the award." The motive of the payment was not to remunerate services rendered but "to motivate the people involved in Delta's field distribution of retail vehicles."

Ms Collins also referred to the treatment of the phrase "in respect of services rendered" in CSARS v Kotze 64 SATC 447, which case concerned a businessman from Springbok who received an amount of R200 000 from the South African Police Services after giving them information regarding a possibility of an illegal purchase of uncut diamonds. The issue of causality was also considered by the court. In this regard Foxcroft J said :

> ***"I do however agree with his submission that the case is distinguishable from the present one. In Stander's case one was concerned with an employee who received an award not from his employer, but from a third person. It is also clear from the judgment in that case that the mere fact of employment had not provided the necessary causal link between what Stander had done and the award he received. Not only was the reward***

> ***given to him by someone who was not his employer, but it also had the quality of a testimonial or accolade rather than the quality of remuneration for services rendered. … The payment on the present facts is clearly not one of the nature of a testimonial or accolade, but is, as was said in Moore v Griffiths, one which has 'the quality of remuneration for services rendered. … In my view the money was paid, albeit after a discretion had been exercised, to the very person who had provided the police with the opportunity to convict criminals, confiscate a substantial sum of money and reward the respondent with a portion of the proceeds. The discretion could not have been exercised without the prior act of giving of information, which was directly linked to the receipt of the reward to the provider of that information. Once the discretion was exercised, the money was clearly paid in respect of services rendered and not as a reward for good conduct or the exercise of a civic duty. I am therefore of the opinion that the Special Court erred in holding that there was no sufficient link between the service rendered and the payment of the reward."***
>
> (at 454).

The court therefore concluded that there was a direct link between the provision of the information and the receipt of the payment. The discretion exercised by the appropriate officer in the SAPS was not sufficient to relegate the information to a mere background factor. In this regard, the court referred to the judgment in Shell Southern Africa Pension Fund *supra* and commented thus:

> ***"the death of the member was a historical fact present, but did not affect the exercise by the committee of its discretion to commute the pension under Rule 37(3). In the present case the Police Commissioner, exercised his discretion to award R200 000 to the appellant because of the disclosure of information by the appellant."*** (at 454).

On the basis, of these ***dicta***, Ms Collins submitted that the discretion of the board of S did not isolate appellant's employment and services from the cause of the receipt of the ***ex gratia*** payment for the purposes of para (c) .

Evaluation

Appellant was in the employment of S. He rendered services to S which was the main or dominant factor in persuading the Board of Directors to make the *ex-gratia* payments. It was always the intention of S that the appellant should benefit from his participation in the share option scheme granted to him in reward for his services rendered to the company. When this did not happen , S compensated the employee by means of the payment of the *ex-gratia* amount. In my view, this train of events establishes a direct link between the services rendered and the amount received. The services constituted the reason why the Board exercised its discretion in favour of appellant. The past services were the reason why the estate of an ex-employee would have also benefited in similar fashion.

The employment with or the services rendered by the appellant to S could not be regarded as a mere background factor for the purpose in making the *ex-gratia* payment by S. The services rendered by the appellant to S was ultimately the motivation as to why S was prepared to come to the aid of these particular option holders.

Indeed, the appellant conceded in his evidence that the Board was concerned with the welfare of the option holders, many of whom he described as "key members of the (S) organisation."

There is additional support for this conclusion The phrase "by virtue of employment" was examined in Kotze's case *supra where* Foxcroft J said at 451:

> ***"I would say in passing that the additional words 'or by virtue of' in the second part of the paragraph, relating to employment, or office, would seem to be included with the intention of providing for a situation where a sum of money was received by an employee, not for work actually done as part of his employment, but connected to the fact of his employment 'or by virtue of' such employment. In my view the words 'by virtue of' do not widen the extent of the relationship between the respective parties, but merely cater for the situation which I have mentioned."***

In applying this ***dictum*** to this case, S made the offer to obtain option rights to the appellant as a direct result of his employment with S. The fact of his employment was inextricable linked to his rights as an option holder.

If the decision of Curlewis JA in the De Villiers case *supra*, is applied to these facts, an advantage was gained which is directly related to employment; in other words, an advantage which would not have been possessed if the taxpayer was not in the employment of the company. It is clearly an advantage which falls within the section. The advantage

received by means of an ***ex-gratia*** payment stood in direct relationship to his employment and by virtue of that relationship it was received in respect of services rendered.

To the extent that Shell Southern African Pension Fund ***supra*** was cited as being applicable to the present case, the discretion of the S Board was exercised to fill a hole in the benefit granted to employees by virtue of their employment; the discretionary award was designed to safeguard a benefit which had flowed to employees pursuant to services rendered by them .

In any event, when paragraph (c) is examined, it expressly covers voluntary awards; that is awards made pursuant to the discretion of the payer as opposed to the fulfilment of an obligation. To express the position in Hohfeldian terms, paragraph (c) envisages an employer exercising a liberty or a privilege to make a payment to which the employee has no antecedent right ; hence this section covers discretionary acts, being a ***causa*** for the receipt or the accrual which thus fall within the paragraph.

In this case thus, the discretion is not sufficient to justify a conclusion that there was a material legal difference between a causal factor, being the employment and a further relevant causal factor being the discretion exercised by the Board. The existence of a discretion is envisaged in the provision; para (c) is designed to bring amounts received or accrued into the ambit of gross income. For this reason, the distinction drawn in the Shell Pension Fund case does not appear to be applicable to the application of paragraph (c).

For these reasons therefore, the appeal is dismissed and the assessments are confirmed.

D DAVIS - PRESIDENT

This judgment should be reported **YES**

Mr T S Emslie (SC) instructed by Mallenicks, appeared on behalf of the appellant.

Ms A Collins represented the Commissioner : South African Revenue Service.