REPORTABLE

IN THE CAPE TAX COURT

Before :

The Hon Mr Justice J G FOXCROFT	President
Mr R J De Beer	Accountant Member
Mr T M Pasiwe	Commercial Member

IN THE CASE OF

CASE NO 11466

[Heard at CAPE TOWN on 16TH MAY 2005]

JUDGMENT : 14TH NOVEMBER, 2005

FOXCROFT J G : This is an appeal against assessments by the South African Revenue Service *['SARS']* for the 2000 and 2001 tax years.

In accordance with Rule 11, a Statement of Grounds of Appeal was handed up at the commencement of the hearing in a volume constituting Volume 2 of the Dossier. Mr *Emslie,* who appeared for Appellant, informed the Court from the Bar that he had also received this second volume of the Dossier only on the morning of the appeal.

In accordance with the statement of 'Grounds of Appeal', Appellant was the managing director of a company named A *['A']* having entered into an agreement with A in respect of his appointment as managing director. This agreement entitled him to a gross annual salary of R550 000,00 commencing on 1 April 1999. It was common cause that the employment agreement embodied a restraint of trade arrangement in terms of which Appellant was entitled to acquire, free of consideration, the proceeds of the sale of one million A shares, subject to certain terms and conditions. It was also not disputed by Mr *Tsele*, who appeared for the Commissioner, that the Appellant had not received the promised cash in respect of the proceeds of the said one million shares. He did not accept the further allegation in the Statement of Grounds of Appeal that

> *"By agreement with (A) an amount of R1 890 000 was credited to a loan account in the Appellant's name to reflect the fact that money was owed to the Appellant in respect of the restraint of trade."*

This became one of the issues at the appeal.

Central to the appeal was a letter, typed on the face of it on 15 September 1999, which appears at p60 of Volume 1 of the Dossier. That letter is as follows :

> *"We hereby confirm that we initially agreed to a remuneration package of R45 833,33 per month plus benefits.*
>
> *In order to assist the company with its cash flow requirements, it is hereby recorded that it is agreed between you, the employee, and (A), the employer, that the cash portion of your remuneration package will be reduced to R2 000,00 per month until further notice.*
>
> *You will be entitled to all fringe benefits relating to the use of assets you currently enjoy. You agree that you will be re-entitled to the full cash portion of this remuneration package of R45 833,33 per month once the employer is in a financial position to pay the cash portion of your remuneration package.*
>
> *Furthermore, once the employer is in a financial position to resume paying the full salary to which you are entitled then the employer will also pay your "arrear" salary. This "arrear" salary will thus accrue and be paid to you at the earlier of :*
>
> 1) *When the company is in the financial position to pay the remuneration.*
> 2) *Termination of your services.*

The full salary will accrue and be paid to you as a lumpsum due and payable on the earlier of any of the above two conditions being fulfilled."

Appellant's case is that after that agreement was reached, he received the following amounts from A :

8 October 1999	-	R 20 000
19 November 1999	-	R 50 000
7 December 1999	-	R 15 000
7 February 2000	-	R 15 044
29 February 2000	-	R 20 000
7 April 2000	-	R 30 000
18 May 2000	-	R 200 000
2 June 2000	-	R 43 000
28 June 2000	-	R 41 844
20 July 2000	-	R 41 844

These sums of money were drawn by Appellant against his loan account, that is to say these amounts were paid by A to Appellant in reduction of the amount owing to him in respect of the cash due to him by A after sale of the shares promised to him as consideration for his signing of a restraint of trade agreement. It is further Appellant's case that the amounts set out above were erroneously recorded in A's books as an expense to the

directors' fees expense account.

There was evidence by Appellant and the erstwhile financial director of A, Mr C, which supported this allegation of a ***bona fide*** error, and it is further Appellant's case that his services with A were not terminated as envisaged in the letter dated 15 September 1999, nor were A ever in a position to pay "arrear" salary during the Appellant's 2000 or 2001 years of assessment, or at all.

It appears from the Respondent's Dossier Volume 2 that A was placed under provisional liquidation on June 20, 2001 and the Appellant was quite fairly, in my view, entitled to say during his evidence that he was unaware of the legal position flowing from the fact of liquidation in regard to whether his services had been terminated or not in terms of the contract reached on 15 September 1999.

The grounds of appeal which appear at p4 of Volume 2 of the Dossier, are as follows :

"1. The amount credited to the Appellant's loan account in the books of (A) was of a capital nature, being an amount received as consideration for the Appellant undertaking the restraint of trade, and

2. Save for R2 000 per month, the amounts received by the Appellant between October 1999 and July 2001 were of a capital nature, being payments of capital by (A) to the Appellant in reduction of his loan account."

Appellant testified under oath that he was a qualified chartered accountant having worked for D prior to an approach by A. Having been persuaded that A was a company in good standing, he resigned from his former position with D and entered into the Employment Agreement which appears at p43 of Volume 1 of the Dossier.

That contract included Clause 8, headed *'RESTRAINT OF TRADE'* and provided in Clause 8.8 that in consideration of Appellant having entered into the restraint of trade undertaking he

"shall be entitled to acquire free of any consideration the proceeds of the sale of 1 million shares in the COMPANY subject to the further following terms and conditions :

(a) 500 000 of the shares are to be traded immediately and

the proceeds transferred to the MANAGING DIRECTOR within 30 days of the Signature Date.

(b) The balance of the 500 000 shares are to be dealt with by the MANAGING DIRECTOR in his sole and absolute discretion..." .

There were then certain conditions imposed upon trading in those shares in the first year subsequent to the listing date of October 1998. Appellant testified that he had never received the cash proceeds of the sale of any of these shares and that the company was therefore in breach of its contract with him.

He went on to explain that soon after taking on the position of managing director of A, he discovered that this company had been based on fraud. Massive contraventions of the Companies Act were uncovered, and at a full board meeting on 14 July 1999, the directors who Appellant alleged had been responsible for the irregularities, resigned. Appellant had started in his position as managing director in April of that year.

Appellant explained that he had been distressed by what he had

uncovered, and since he had done his articles at X, he consulted the senior partner of that firm of auditors as to what he ought to do. He was persuaded to stay on with A in an attempt to salvage some of the damage which had been caused, in the interest of shareholders. He continued to be actively employed by A until the liquidation of that company, as he put it, in late May/early June of 2001.

Appellant testified as to his fight for the survival of A, which involved reducing the staff from somewhere between 15 and 20 to three persons. The advice of senior counsel was obtained in regard to the situation of the breach of the agreement by A in regard to the cash consideration for the restraint of trade undertaking. He said that senior counsel at the Cape Bar had advised that a loan account needed to be raised reflecting the company's indebtedness to Appellant. A calculation based on the trading price of the shares was made and agreement was reached, according to Appellant, that the sum of R1 890 000,00 was reflected in the books of account as being due to Appellant. This sum is shown in part 15 of Appellant's tax return for the 2000 tax year, where it is reflected as an accrual of a capital nature described as *'Restraint of Trade'*. There are references to the status of the loan account on pages 12 and 14 of

Volume 2 of the Dossier. On 12 October 2000 an entry in the general ledger shows *'Repayment of loan account R450 000',* leaving a cumulative closing balance at 30 August 2001 of R1 374 247,07 due to Appellant.

This correct allocation of a repayment of the loan account led to a certain amount of cross-examination from Mr *Tsele,* suggesting that there was no error in the accounts as suggested by Appellant.

It is so that the cash book entries reflected at p 15 of Volume 2 of the Dossier show what are called *'Directors Fees'* of R41 843,55 being paid to Appellant on 20 July 2000 and salaries and wages including Appellant's salary on 26 August 2000 again of R41 843,55. The entry for 27 September reverts to the previous formulation of directors fees for the Appellant in the same amount.

Mr *Tsele* referred to these later payments in the reduced sum of R41 659,00 or R41 843,00 as had been the payment in August and September 2000, submitting that this showed that the company had reached the

stage where it was able to comply with its earlier obligations to pay Appellant his full salary. As Mr *Emslie* pointed out, this in itself is no indication that the company was in the financial position to pay full remuneration as agreed. In any event, the amounts are different, being some R4 000 less per month than the agreed salary.

Appellant's evidence was that there were tremendous pressures in the company's office at the time of the cash flow problem and that errors in the books of account were not picked up.

Mr C, the Financial Director at the time and also a chartered accountant, testified to the same effect.

The letter at p60 of Volume 1 of the Dossier is of crucial importance, since it supports Appellant and Mr C in their evidence that Appellant was only to receive a cash portion of his remuneration package in the sum of R2 000,00 per month until further notice. The letter also records that

> *"You agree that you will be re-entitled to the full cash portion of his*

> ***[sic]*** *remuneration package of R45 833,33 per month once the employer is in a financial position to pay the cash portion of your remuneration package."*

The use of the word *'re-entitled'* suggests that it was clear to the parties that an entitlement to a cash portion of monthly salary had been abandoned.

Mr *Tsele* submitted that this letter dated 15 September 1999 did not truthfully reflect its contents since, according to his submission, this letter had been generated at some later stage and backdated to 15 September 1999 once the Appellant realised that he was in difficulty with the South African Revenue Service. This was strongly denied by Appellant, who added that he resented the accusation.

Mr C confirmed that he had signed this letter as Financial Director on the date reflected, namely 15 September 1999, and that the letter had been delivered to the Appellant on the same day. Mr C added that he had received an identical letter signed by the company's secretary and by Appellant.

Appellant was obviously not a stranger to this agreement which was reached between the company and its directors. The arrangement had, on his evidence, been necessitated by the financial difficulties of the company.

Mr *Tsele* submitted that Clause 11 of the employment contract [I, 56] providing in 11.2 that

> *"No amendment of this Agreement or any consensual cancellation thereof or any part thereof shall be binding on the parties unless reduced to a written document and signed by them"*

precluded the arrangement for payment to directors reached as reflected in the letter dated 15 September 1999.

I do not understand the clause to prevent such abandonment of rights by directors. The agreement to take a much smaller salary in the interests of the company was clearly reached by the remaining controlling minds of the company, and the evidence is clear that they agreed to abandon their entitlement to salary given the circumstances of the company. Appellant had been party to the arrangements and had agreed to accept the terms of the letter dated 15 September 1999, and the

evidence is that the company directors proceeded on that basis. Indeed, the Appellant had signed an identical letter to Mr C which he received, according to C, on the same day.

Importantly, Appellant also testified to the fact that the advice of a tax consultant had been obtained in regard to the company's difficulties, and that he had drafted the letter dated 15 September 1999.

A letter by the same consultant appears at p23 of the Dossier, Volume 1, dated 14 November 2001. This was the letter of objection to the 2000 and 2001 assessments. At p23 there is reference to the fact that the company issued a

> *"letter to certain of the senior employees including the taxpayer in terms of which the salaries were effectively reduced to a retainer of R2000 per month until further notice."*

At p24 the following appears in the middle of the first paragraph of the letter :

> *"We enclose herewith a letter from the employer, which is evidence that the retainer of R2 000 per month was paid."*

Mr *Emslie* submitted that in the light of the evidence, the letter which the consultant was referring to was in all probability that of 15 September 1999, where there is reference to the fact that

> *"the cash portion of your remuneration package will be reduced to R2 000 per month until further notice."*

The letter of the consultant dated 14 November 2001 also makes the point that

> *"Please note that the SARS assessments are based on confusing the repayment of loan account by the employer company as remuneration received by the taxpayer."*

This certainly accords with the evidence of both the Appellant and Mr C.

Mr *Tsele* submitted in argument that he had a witness who could show that this letter was backdated and that the witnesses were deliberately

falsifying what had happened, but that the witness was unable to attend the hearing for a reason which was not disclosed. No request for a postponement in order to call this witness was made, and Mr *Tsele* appeared to accept that, in these circumstances, the Court could not have regard to what his witness might say in the absence of that witness.

As Mr *Emslie* pointed out, if the Respondent's insinuations that the entries in the books of A were correct, then this would necessarily mean that the letter dated 15 September 1999 was a fraud. It would also mean that A would have paid employees tax to Respondent. As Mr *Emslie* submitted, it is clear that A did not do so, otherwise these amounts would have been reflected on Appellant's IRP.5 Certificate, and he would have paid tax on the amounts in question.

I agree with Mr *Emslie's* submission that the probabilities favour the likelihood that the letter of 15 September 1999 is what it purports to be and that the entries in A's books were incorrect, as stated by both witnesses. In my view, Applicant has shown that he did forfeit his right to salary, save for the R2 000 per month which he had agreed to receive.

He took the chance of receiving some capital compensation and did, on the face of it, receive that capital compensation. On the evidence there was certainly no accrual of gross income during the disputed months, save for the R2 000 per month admittedly earned as salary.

In the premises, I consider that the appeal should be allowed and that the assessments be reversed and revised on the basis that the amounts in question were capital in the hands of the Appellant.

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J G FOXCROFT - PRESIDENT

REPORTABLE?	YES	NO