COMMISSIONER FOR SOUTH AFRICAN REVENUE SERVICE *v* McRAE
64 SATC 1

Division: Cape Provincial Division
Judges: SELIKOWITZ J, TRAVERSO DJP and ROSE-INNES AJ
Date: 17 August 2001

Income tax - Capital and revenue - Taxpayer receiving lump sum payments from his employer in terms of certain Stock Unit Plan aimed at providing incentives to employees who make a direct and important contribution to company's success before their retirement - Plan also restraining taxpayer from going into competition with his employer on retirement or termination of employment - Whether court a quo had correctly decided that one half of the amounts received by taxpayer was of a capital nature and therefore not gross income - Whether said amounts were received in respect of services rendered or in respect of restraint element in agreement or in respect of both services and restraint - Held that applicable principles were those enunciated in Tuck v CIR 50 SATC 98 even though in casu taxpayer actually received benefits prior to termination of his employment - Held that it was clear from terms of agreement that it contained elements both of service and restraint - Held further that quid pro quo given by taxpayer in return for the award of the units comprised elements of service and restraint and each element was a causally relevant factor - Held accordingly that apportionment made by court a quo on basis of 50% of such receipt constituting income was correct.

Respondent was the managing director of Readers Digest Association SA (Pty) Ltd ('Readers Digest') until his employment ended in September 1996.

Respondent's employment with Readers Digest had commenced in 1958 and during the next thirty-eight years he held various positions in the company, becoming managing director in 1985 until his employment ended in 1996.

The system of awarding units to key employees was one that had been in operation for some time within Readers Digest in America and respondent had been the first South African employee of Readers Digest to receive such an award.

He testified that Readers Digest was faced with considerable competition in South Africa from other businesses that offered similar products.

Readers Digest endeavoured to ensure that respondent remained in its employ and it did so by awarding units to him subject to the terms of clause 5(*b*) of the agreement which provided for a forfeiture of these benefits should he compete with Readers Digest.

The preamble to the agreement records that respondent is through his ability and diligence able to make direct and important contributions to the company's success and that the company wished to provide him with an incentive to continue his employment as it wished to retain the services of a senior and experienced employee.

Readers Digest agreed to award respondent 40 000 equivalent stock units with each unit being deemed to be the equivalent of one share of the Class A non-voting common stock of Readers Digest Association Inc.

It followed from the relevant provisions of the agreement that respondent's entitlement to the payment of incentives in respect of the units was in effect subject to two conditions - firstly, his employment should not have been terminated for cause as contemplated by clause 5(*a*) and, secondly, he must not have competed with Readers Digest contrary to clause 5(*b*).

It was, however, not in issue that both conditions had been met.

Respondent received four payments from Readers Digest during the 1993-6 years of assessment in terms of an equivalent stock unit agreement concluded between it and respondent on 15 November 1990 ('the agreement').

Appellant had assessed the entire amounts received by respondent as gross income in terms of s 1 of the Income Tax Act 58 of 1962.

Respondent contended that one half of these amounts had been received by him in respect of services rendered by him and one half in consideration for a restraint element in the agreement and in his income tax returns he therefore apportioned these amounts equally between capital and revenue.

Respondent noted an appeal to the Cape Special Court for Hearing Income Tax Appeals (see *ITC 1703* (1999) 63

SATC 247) where Davis P held that one half of the amounts in question was of a capital nature and appellant was directed to assess the amounts received in the 1993-6 years of assessment on the basis that only 50% of such receipts constituted taxable income in the hands of respondent.

Appellant appealed against the judgment and order of the Special Court to a full bench of the Cape High Court.

The issue on appeal was whether the Special Court had correctly decided that one half of the four amounts received by respondent had been of a capital nature and was therefore not gross income and this turned on the question whether the amounts had been received in respect of services rendered, in which case they were income, or in respect of a restraint element in the agreement, in which case they were capital, or in respect of both services and the restraint.

Appellant contended that the entire amount paid to respondent was to be regarded as gross income.

Held

(i) That the legal principles applicable to a case such as this were considered in *Tuck v Commissioner for Inland Revenue* 50 SATC 98 where the facts were similar to the present matter and the fact that in the present matter respondent actually received the benefits prior to the termination of his employment did not affect this conclusion.

(ii) That it was clear from the terms of the agreement that it contained elements both of service and restraint as the payment of an incentive to respondent by way of the units was partly in consideration for the services which respondent had and would in the future render and the agreement also contained the restraint provisions found in clause 5(*b*) and the incentive payments were also conditional upon respondent not competing with Readers Digest.

(iii) That therefore the *quid pro quo* given by respondent in return for the award of the units comprised elements of service and restraint and each element was a causally relevant factor and it followed that the amounts received by respondent were in respect of services rendered and the restraint element in the agreement.

(iv) That the apportionment made by the court *a quo* to treat the amounts received on the basis that 50% of such receipt constituted income was not challenged on appeal and no basis existed for interfering with such apportionment.

Appeal dismissed with costs.

ROSE-INNES AJ: [1] The respondent was the Managing Director of Readers Digest Association SA (Pty) Limited ('Readers Digest') until his employment ended in September 1996. Readers Digest made four payments to the respondent during the 1993 to 1996 years of assessment in terms of an equivalent stock unit agreement concluded between it and the respondent on 15 November 1990 ('the agreement'). The respondent took the view that one half of these amounts had been received in respect of services rendered by him and one half in consideration for a restraint element in the agreement. In his income tax returns he therefore apportioned these amounts equally between capital and revenue. The appellant however assessed the entire amounts received by the respondent as gross income in terms of s 1 of the Income Tax Act 58 of 1962. On appeal the Cape Income Tax Special Court[1] (Davis P and members) decided that one half of the amounts in question was of a capital nature and therefore not gross income. The appeal accordingly succeeded and the appellant was directed to assess these amounts received in the 1993, 1994, 1995 and 1996 years of assessment on the basis that only 50 *per cent* of such receipts constitute taxable income in the hands of the respondent. The appellant now appeals against the judgment and order of the Special Court.

[2] The issue on appeal is whether the Special Court correctly decided that one half of the four amounts received by the respondent was of a capital nature and was therefore not gross income. This turns on the question whether the amounts were received in respect of services rendered, in which case they are income, or in respect of a restraint element in the agreement, in which case they are capital, or in respect of both services and the restraint. This requires consideration firstly of the relevant terms of the agreement.

[3] The agreement of 15 November 1990 was preceded by two earlier agreements. The first agreement concluded between the respondent and the American Company Readers Digest Association Inc was replaced by a further agreement on 7 September 1988 between the respondent and Readers Digest on 15 September 1988. The agreement of 15 November 1990 in turn amended and restated the prior agreement as a consequence of the listing of Readers Digest Association Inc on the New York Stock Exchange.

[4] The preamble to the agreement records that the respondent (who is defined in the agreement as 'the Executive') is through his ability and diligence able to make direct and important contributions to the company's success and that the company wishes to provide the respondent with an incentive to continue his employment. Readers Digest agreed to award to the respondent 40 000 equivalent stock units ('the units'), with each unit being deemed to be the equivalent of one share of the Class A non-voting common stock of Readers

Digest Association Inc. The agreement contained a formula for determining the value of the units. Provision was also made for the payment of an amount to the respondent in respect of dividends declared in respect of the units.

[5] Clause 4(*a*) of the agreement conferred upon Readers Digest the right, exercisable at the time prescribed in that clause and on 90 days notice to the respondent, to terminate the award and pay to the respondent his share of the appreciation in the units in an amount and in the manner provided in cl 4(*b*) of the agreement. Clause 4(*b*) regulates the consequences that flow from a termination of the respondent's employment as a result of death, retirement or for reasons other than 'cause' (a term defined in the agreement). It provides that:

> 'Upon termination of the Executive's employment by death, or retirement, or severance of employment for reasons other than cause, as hereinafter defined, and prior to receipt of notice from the Company of its intent to exercise its rights under paragraph (*a*) above, the Executive, his estate or designated beneficiary, as the case may be, shall be entitled to receive for each such ESU credited to his ESU Account, in five equal annual instalments, half of the positive difference between $12.928 and the value of each such ESU on the date of his termination of employment; provided, however, that at the sole discretion of the Company, it may pay such amounts in a single lump sum if the aggregate amount due to Executive is less than US $5,000.'

[6] Clause 5(*a*) of the agreement provides that if the respondent's employment is terminated for cause he shall not be entitled to any rights or benefits under the agreement. A termination for cause would therefore result in a forfeiture of the benefits to which the respondent would otherwise have been entitled in respect of the units. 'Cause' is defined as meaning:

> 'a discharge from employment occurring by reason of the Executive's embezzlement, proven dishonesty, fraud, conviction of felonious or other charge involving moral turpitude, improper communication of confidential information obtained in the course of employment with the Company or conspiracy against the Company.'

[7] In terms of clause 5(*b*) of the agreement:

> 'If without the written consent of the Committee, the Executive shall become a proprietor, director, partner or employee of, or otherwise become connected with any business that is in competition with the Company (other than a stockholder with a non-substantial interest in any such business) all rights and benefits of the Executive under this Agreement may be terminated at the discretion of the Committee . . .'

If the respondent competed with Readers Digest contrary to this clause the committee had the right, in the exercise of its discretion, to terminate the respondent's entitlement to the benefits arising from the award of the units or to condone his conduct.

[8] Pursuant to the provisions of clause 4(*a*) of the agreement Readers Digest paid the respondent the amounts of R374 838, R330 917, R371 631 and R348 930 during the 1993, 1994, 1995 and 1996 years of assessment respectively. The respondent's employment with Readers Digest terminated in September 1996.

[9] It follows from the relevant provisions of the agreement referred to above that the respondent's entitlement to the payment of incentives in respect of the units was in effect subject to two conditions. Firstly, his employment should not have been terminated for cause as contemplated by clause 5(*a*). Secondly, he must not have competed with Readers Digest contrary to clause 5(*b*). In either event respondent would (subject to condonation) forfeit any right he had to the payment of such incentives. It is however not in issue that both conditions were met.

[10] Mr *Marais*, on behalf of the appellant, advanced two principal contentions in submitting that the entire amount paid to the respondent is to be regarded as gross income. He argued firstly that on a proper construction of clause 5(*b*) of the agreement it did not apply in circumstances where the respondent left Readers Digest without his employment being terminated for cause as defined in clause 5(*a*) of the agreement. In such a case, so the argument proceeds, the respondent would not forfeit the benefits of the agreement were he to compete with Readers Digest. Consequently the payments received by the respondent did not constitute the *quid pro quo* for any sterilisation of his income-earning capacity. Reliance was placed on certain differences in language between the agreement and the earlier agreements and in particular the use of the word 'executive' (as distinct from 'an employee or former employee') to describe the respondent.

[11] I am unable to agree with this construction. It is not supported by the ordinary meaning of the words of the agreement nor by the context in which they appear. The agreement does not contain any direct prohibition against the respondent competing with Readers Digest such as that typically found in an agreement in restraint of trade. In fact the respondent and Readers Digest concluded such an agreement only upon the termination of his employment, in terms of which he was restrained for a period of two years from competing with Readers Digest as against the payment to him of consideration in the sum of R550 000.

[12] The agreement does however contain, in clause 5(*b*) thereof, an indirect restraint against competition. As pointed out by Mr *Emslie* for the respondent, but for the subsequent restraint of trade agreement, the respondent was free to resign his employment with Readers Digest and compete with his former employer. Had he done so he

would however have forfeited any entitlement to benefits arising from the units. Clause 5(*b*) would therefore penalise the respondent if he chose to compete with Readers Digest and serve as a powerful disincentive for him doing so. This is entirely consistent with the purpose of the agreement being an endeavour by Readers Digest to retain the services of a senior and experienced employee.

[13] Clause 5(*b*) does not state that it is only to operate during the respondent's employment with Readers Digest. It contains no express time limitation. To read any such limitation into the clause would be inconsistent with the plain meaning of the clause and the purpose of the agreement. It would have the surprising result that had the respondent competed with Readers Digest after the termination of his employment for reasons other than 'cause', he would still have been entitled to the benefit of the units which were intended to serve as an incentive to retain his employment. Such a construction cannot reflect the intention of the parties to the agreement.

[14] The second argument advanced on behalf of the appellant is that it was not established that the payments received by the respondent in terms of the agreement did in fact compensate him for the partial sterilization of his income-earning capacity. I am of the view that the evidence did establish this. The respondent and the then chief legal officer of Readers Digest, Christiane Yvonne Duval ('Duval') were the only witnesses to testify, and their evidence was not materially disputed.

[15] The respondent's employment with Readers Digest commenced in 1958. During the next thirty-eight years he held various positions in the company

becoming managing director in 1985, a post he held until his employment ended in 1996. Readers Digest is primarily a publishing company, publishing magazines, books, music and videos. It also markets certain financial products. Most of the business is conducted through mail order. The respondent was directly involved in the mail order side of the business and this was one of his main areas of expertise. He testified that Readers Digest was faced with considerable competition in South Africa from other businesses that offered similar products. A number of these competitors had employed former employees of Readers Digest. The respondent had himself received a number of approaches from competitors inviting him to leave Readers Digest. He declined these invitations because they would not have benefited him financially.

[16] The system of awarding units to key employees is one that had been in operation for some time within Readers Digest in America. The respondent was the first South African employee of Readers Digest to receive such an award. He was the senior employee in Readers Digest and had over the years developed a high level of expertise. Had he left Readers Digest to join a competitor or set up business in opposition it may potentially have been most harmful to Readers Digest. Readers Digest therefore endeavoured to ensure that the respondent remained in its employ. It did so by awarding units to him subject to the terms of clause 5(*b*) of the agreement which provided for a forfeiture of these benefits should the respondent compete with Readers Digest.

[17] The legal principles applicable to a case such as this were considered in *Tuck v Commissioner for Inland Revenue* 1988 (3) SA 819 (A)[2] a case which dealt with facts similar to the present matter. Corbett JA, as he then was, doubted whether it was appropriate to apply the principles of causation, as developed particularly in the criminal law and the delictual field when considering, from an income tax point of view whether a taxpayer's receipt should be characterised as income or as capital. He held (at 833D-E)[3] following the decision in *Commissioner for Inland Revenue v Lever Bros and Unilever Ltd* 1946 AD 441 at 450[4] that:

> 'In a case such as the present, however, it seems to me that most problems of characterisation could appropriately be dealt with by applying the simple test indicated by Watermeyer CJ in the passage quoted from his judgment in the *Lever Bros* case *supra, viz* by asking what work, if any, did the taxpayer do in order to earn the receipt in question, what was the *quid pro quo* which he gave for the receipt?'

The court found on the facts of *Tuck*'s case that the *quid pro quo* given by the employer had two main elements. Firstly, there was an element of service given to the company, in return for which the employee received shares, which element was of a revenue nature. Secondly there was an element of restraint of trade, which required the employee to refrain from competing with his employer as a prerequisite for receiving shares. The restraint of trade element was of a capital nature. Consequently the court held that the *quid pro quo* given by the employer for the receipt of shares comprised both elements of service and compliance with the restraint and that both elements were causally relevant factors.

[18] Applying these principles to the facts of the present case leads to the same conclusion. The only significant difference between the facts of *Tuck*'s case and the present matter is that in *Tuck*'s case the delivery of shares only commenced after the taxpayer's retirement whereas in the present case payment of the five annual instalments could, depending on the circumstances, commence either before or after the respondent's employment terminated. The fact that in the present matter the respondent actually received the benefits prior to the termination of his employment does not in my view affect this conclusion.

[19] It is clear from the terms of the agreement that it contained elements both of service and restraint. The payment of an incentive to the respondent by way of the units was partly in consideration for the services which the respondent had and would in the future render. The agreement also contained the restraint provisions found in clause 5(*b*) and the incentive payments were also conditional upon the respondent not competing with Readers Digest. The *quid pro quo* given by the respondent in return for the award of the units therefore comprised elements of service and restraint. Each element was a causally relevant factor. It follows that the amounts received by the respondent were in respect of services rendered and the restraint element in the agreement.

[20] The apportionment made by the court *a quo* to treat the amounts received on the basis that fifty *per cent* of such receipt constitute income was not challenged on appeal. No basis exists for interfering with such apportionment.

[21] I am therefore not persuaded that the decision of the court *a quo* was wrong. The appeal is accordingly dismissed with costs.

Traverso DJP and Selikowitz J concurred.

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Footnotes

1 *ITC 1703* (1999) 63 SATC 247.
2 50 SATC 98.
3 50 SATC (*supra*) at 113.
4 14 SATC 1 at 8-9.