A New Capital Revenue Tax Decision

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On 13 June 2013 the Cape tax court delivered judgment on a capital/revenue case, which resulted in a partial victory for both sides. The taxpayer was a company whose sole purpose was to hold a parcel of shares. The question in issue was whether, when the company sold the parcel, the gain was capital or revenue in nature. As was to be expected, in arriving at its decision the court had to determine the intention of the company in holding and then disposing of the shares, and to do this it had to establish the intentions of the directors and shareholders, the controlling minds of the company. The court also commented on the current relevance of the "holding for keeps" enquiry in determining whether a taxpayer is holding an asset as trading stock or as a long term capital investment.

In 2003 a listed company, M Ltd, in the retail furniture industry was in dire financial difficulty. As part of a rescue operation initiated by M Ltd's banker, funding in the form of equity and loan capital, and management expertise, were acquired. A complex series of transactions followed, which culminated in December 2003 in the taxpayer acquiring an interest in M Ltd together with a Mr Z, a German resident, who was destined to play a major role in the matter, Mr O, executive chairman of the FG group who held half the equity, and Mr Y who had initiated the approach to Mr Z. Mr Z was a director of the taxpayer, all the shares of which were held by a company KL. Neither the taxpayer nor KL conducted any business other than to hold shares; in KL's case, in the taxpayer; and in the taxpayer's case, in FG, which ultimately owned M Ltd.

The taxpayer assumed two liabilities along with its acquisition of shares in FG: an indemnity to the bank; and what was referred to as an “equity kicker”. The equity kicker arose from a loan that the taxpayer procured in order to acquire the FG shares. A condition of the loan agreement was that on maturity the lender would be entitled to a sum based on the change in value of the FG shares during the term of the loan.

In April 2004 Mr O approached E Bank to procure a purchaser for his interest in the FG group. The bank was interested only if it could get a large block of FG shares to place, because a large block would be more attractive to a potential buyer. All along Mr Z had made it clear that, if he wanted to sell his shares, he expected Mr Y to do likewise and not act as a block to a sale. In due course and after much negotiation, the shares were sold to the bank. The taxpayer was liable for, and duly paid, R55 million in respect of the indemnity to the bank and some R45 million in respect of the equity kicker. The question then arose as to whether the proceeds were capital or revenue in nature and, in consequence, the deductibility or otherwise of the indemnity and the equity kicker. The taxpayer reflected the proceeds as capital in nature and paid tax accordingly. SARS challenged this decision and treated the proceeds as revenue in nature.

Several witnesses gave evidence in relation to the matter. Mr O told the court that in his experience deals like this took time to put to bed and he expected his fellow investors to be behind him. The implication of this evidence is that Mr O saw the investment as a long term one. However, Mr O also stated that by April 2004 the transaction had been so successful that he had no objection to the disposal to E Bank.

Mr Z, who appears to have been the major witness, supported Mr O’s evidence about the transaction needing time to bear fruit. At the same time he made it clear that he expected his fellow investors to agree with whatever decisions he made. When the E

Bank deal arose, he supported it because by that time he felt that his exposure to South Africa was too great. On his own evidence it did appear that he was always willing to realise an investment if the price was Mr Y stated that he would have preferred the funding to be available for five years but the limit seems to have been three years. He acknowledged that he would always defer to Mr Z in business dealings.

The court stated that, in determining the intention of a taxpayer at acquisition of the asset, and whether there had been a change of intention leading to the disposal, one had to analyse the evidence of the witnesses "through the prism of the objective facts presented to the court". The result of this analysis might well be of decisive importance in arriving at a conclusion. The constant theme of Mr Z's evidence was that he wanted the freedom to do with his investment as he saw fit. The nature of the equity kicker supported the argument that the loan repayments were to be funded through the sale of the shares, because the taxpayer had no other resources from which to do so.

The court found that Mr Z, the controlling individual, had at all times kept his options open when to sell. In essence, this pointed to a mixed intention on his part: whether to hold or sell; for how long to hold the shares; whether to obtain a controlling interest in FG; or whether to acquire more shares. The evidence suggested anything but a long term intention. Consequently, the shares were trading stock in the taxpayer's hands and the proceeds were revenue in nature.

Pursuant to that finding, the liability for the equity kicker, which the taxpayer had assumed as part of the cost of acquiring the shares, was part of the cost of acquiring the trading stock and was therefore deductible. Similarly, the indemnity payment was also part of the cost of acquiring the trading stock.

The taxpayer had made provisional tax payments based on its

view that the proceeds were capital in nature. The court found that this decision had been reasonably made and that the taxpayer was not liable for interest on what, as a result of the court’s decision, was an incorrect basis.

An interesting observation by the court related to a time-honoured indicator of whether a taxpayer’s intention towards an asset was capital or revenue in nature; the question whether the taxpayer had acquired the asset “for keeps”. The Appellate Division asked this question in Barnato Holdings Ltd v SIR 40 SATC 75 (AD) [1978], and it has been quoted in a number of cases since. In the present matter the court found that the idea of holding shares “for keeps” was “reflective of an old, static economic order that no longer exists”. This would seem to ease the burden on taxpayers, although it did not assist the taxpayer in the present matter.