

TAX

SCA judgments: Capstone & Kluh

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In our November 2014 edition of *Legalwerks*, we discussed the decisions of the Full Bench of the High Court of the Western Cape regarding the capital or revenue nature of the disposal proceeds of shares owned for a relatively short time period, and the meaning of "farming" for tax purposes.

INTRODUCTION

Both High Court decisions were taken on appeal and both were recently confirmed by the Supreme Court of Appeal ("SCA") in the taxpayers' favour. In addition, the taxpayer's cross-appeal in the first case was decided in its favour.

[Click here](#) for our November 2014 Legal Brief.

CAPSTONE – CAPITAL NATURE OF SHARE SALE PROCEEDS

Very briefly, it will be recalled that:

- The taxpayer, as part of a consortium, committed to purchasing a substantial percentage of the shares in a distressed listed entity during June 2002, which shares were formally transferred in December 2003.
- During mid-2004 the shares were sold at a substantial profit.
- The distressed company made a positive turnaround much earlier than expected.
- The decision to sell the consortium shares was the prerogative of the consortium partner.
- The consortium partner decided to sell the shares when it became aware of the possibility to sell the shares by way of a book building exercise, coupled with a weak Rand and the fact that the company's rescue mission was successfully completed.
- The Tax Court found that the sale proceeds were revenue in nature, but that finding was overturned by the High Court when it found the proceeds were capital in nature.
- As part of the arrangements, the taxpayer incurred amounts in the form of an equity kicker and an indemnity obligation. It was accepted, on appeal, that the amounts incurred in terms of the equity kicker constituted interest, one-third of which qualified to be included in the taxpayer's base cost for the shares. The taxpayer, however, appealed against the High Court's finding that the amounts incurred in terms of its indemnity obligations do not form part of the shares' base cost.

The Supreme Court of Appeal (SCA) in *Commissioner: SARS v Capstone 556 (Pty) Ltd*, handed down a strong judgment in favour of the capital nature of the disposal proceeds of the shares and concluded that the indemnity payment formed part of the base cost of the shares.

The SCA gave clear guidelines to determine the capital or revenue nature of the proceeds derived from the sale of an asset.

It confirmed that where a profit is the result of the sale of an asset, the intention with which the taxpayer acquired and held the asset is of great importance. The mere intention to profit from an acquisition and holding of an asset is not conclusive – it is only when a profit motive is coupled with 'an operation of business in carrying out a scheme for profit-making' that the proceeds would be revenue in nature.

Apart from the taxpayer's intention, other relevant factors to consider when categorising sales proceeds as either capital or revenue include:

- the nature of the business activities in which the taxpayer is ordinarily engaged;

- the period for which the asset was held and the period which it was anticipated to be held when initially acquired;
- the nature of the risk undertaken to determine whether the exercise is directed at building up the value of the taxpayer's capital or directed at generating revenue and profit; and
- the commercial reality that often there is no clear intention at the outset must be recognised and accepted. Such indeterminacy should then simply be factored into the enquiry.

The SCA confirmed the High Court's approach to scrutinise the taxpayer's intention in acquiring the shares at the time it entered into the binding commitment (in June 2002), which was approximately 18 months prior to the formal acquisition/transfer of the shares. Such an approach takes into account the commercial transaction as a whole.

The SCA strongly expressed the view that the directing mind of the taxpayer, in both its acquisition and sale of the shares, was that of its consortium partner. In analysing the "directing mind", the SCA took into account the following:

- that a positive turnaround of the business was anticipated and that such a positive turnaround was expected to result in an increased share price. Importantly, though, the SCA found this to be "neutral", as it says nothing about the aim of the acquisition of the shares, as *"virtually every capital asset is purchased in the hope and anticipation that it will increase in value and in contemplation of the possibility that it may in future be sold at a profit"*;
- the resale of the shares at a profit was only one of several possibilities at the time of effective acquisition and the tradability of the big block of shares was regarded as low. The capital was committed for an indeterminate period;
- at the time of the effective acquisition of the shares their disposal at a profit was by no means inevitable as the prospects of the rescue operation succeeding were uncertain and the risks involved were substantial; and
- the first and primary purpose of the acquisition of the shares was to rescue a major business and in the process also an attempted salvaging of an existing investment.

The above factors led the SCA to believe that *"all of this was consistent with an investment of a capital nature that was realised sooner than initially expected because of skilled management and favourable economic circumstances"*.

In relation to the indemnity payment made by the taxpayer the SCA found that the payment qualified as 'expenditure actually incurred' in respect of the acquisition of the shares and should form part of their base cost, notwithstanding the fact that the payment was incurred after the sale of the shares. This is so because the indemnity payment was incurred in substitution for an earlier contingent obligation which was clearly related to the acquisition of the shares. On this basis, the acquisition of the shares remained the *causa causans* of the indemnity payment.

KLUH – FARMING OPERATIONS

In the second case of *Commissioner: SARS v Kluh Investments (Pty) Ltd*, the SCA, on 1 March 2016, dismissed SARS' appeal and confirmed the decision of the full bench of the Western Cape High Court, to the effect that the taxpayer was carrying on farming operations.

The brief facts were:

- Steinhoff Southern Cape (Pty) Ltd ("Steinhoff") was looking to acquire a plantation in Knysna, but had a group policy not to own fixed property in South Africa at the time.
- The taxpayer acquired land and growing timber and Steinhoff acquired the equipment and personnel required to carry on farming operations on the plantation.
- It was agreed that Steinhoff, at its own cost, could harvest the timber for its own account, subject to Steinhoff maintaining and managing the plantation.
- The taxpayer had no equipment and no employees and earned no income and incurred no expenses of an operational nature.
- After two years, Steinhoff bought the land and trees from the taxpayer.

If the taxpayer qualified as a "farmer", the sale proceeds are deemed, under tax legislation, to be revenue in nature. The legislation provides that a farmer is a person carrying on farming operations.

The SCA agreed with the High Court's finding that the taxpayer's involvement was limited to the acquisition of bare ownership of the land and the timber, which did not amount to the carrying on of farming operations.

The SCA considered the further branches of SARS' argument, namely that:

- the purpose of the relevant tax legislation is to extend tax liability by treating the proceeds of the disposal of a plantation as gross income;
- the mere disposal of a plantation constitutes the conduct of farming operations; and
- the farming operations were conducted by Steinhoff "on behalf of" the taxpayer.

CONCLUSION

The SCA dismissed these arguments on the following grounds:

The provision which deems the proceeds of the disposal of a plantation as gross income cannot in itself determine who qualifies as a farmer. SARS' contention is thus fallacious, as a deeming provision that will only apply if Kluh is a farmer cannot be applied to determine whether Kluh is a farmer.

The relevant tax legislation simply provides that the proceeds on disposal of a plantation by a farmer must be included in the farmer's gross income. That cannot be interpreted to mean that a disposal of a plantation is tantamount to farming.

Thirdly, even if Steinhoff in some sense acted on behalf of Kluh, that would not make Kluh a farmer, given that Kluh did not have the right to the yield of the plantation nor the use of the land or the plantation and Kluh did not derive any income from the land and the plantation, as the use thereof was granted to Steinhoff to farm for its own benefit. Thus the only entity which could be regarded as a 'farmer' in relation to the plantation owned by Kluh, was Steinhoff.

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