High Court delivers well-reasoned judgments on tax law

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The Full Bench of the High Court of the Western Cape recently delivered two well-reasoned judgments on topics which often find their way into the tax litigation arena, namely the capital or revenue nature of the disposal proceeds of shares, and the application of the tax legislation relevant to farmers.

Both judgments were in favour of the taxpayer (although the Court, in the farming matter, alluded to the loophole available to taxpayers had it found in favour of SARS).

In the first case of Capstone 556 (Pty) Limited v Commissioner: SARS (A49/14) [2014] ZAWCHC 123 (handed down on 26 August 2014) the taxpayer (Capstone) appealed to the full bench of the High Court against an order of the tax court. The main issue in dispute related to the categorisation of the proceeds derived on the disposal of shares as either revenue or capital in nature - the tax court found that the proceeds were revenue in nature.

Related to the main issue was the tax treatment of amounts incurred in the form of an equity kicker and an indemnity obligation, both of which related to the share acquisition, but the tax treatment of which would be subject to the rules applicable to establish a 'base cost' (which are different to the rules applicable to tax deductibility) if the proceeds are of a capital nature.

Trading stock

SARS argued that the shares were not acquired on capital account, but rather as trading stock in pursuance of a scheme of profit-making. This argument was premised on the contention that the facts, and in particular the short period for which they were held, indicated a trading motive on the part of Capstone.
The distinction between capital or revenue proceeds on disposal of an asset is no stranger to our tax courts. Seldom, though, is a judgment on the topic as well-reasoned and clear as the judgment of Griessel, J in the Capstone matter.

The facts relevant to the main issue were, in a nutshell, as follows:

- During June 2002 the taxpayer, as part of a consortium, committed to purchasing a substantial percentage of the shares in a listed entity. The shares were only transferred to, and thus formally acquired by, the taxpayer during December 2003.
- Less than five months after the formal acquisition of the shares by the taxpayer they were sold at a substantial profit.
- The undisputed evidence of the taxpayer indicated that the shares were acquired (in terms of the binding commitment in June 2002) as part of a rescue operation of a company in the furniture retail industry. At the time, the transaction was entered into amidst great economic uncertainty and was considered to be subject to considerable risk. It was generally accepted (or hoped, at best) that the rescue operation would take between three to five years before there could have been the possibility of a turnaround.
- Contrary to these expectations, however, the world economy changed in 2003/2004 and that fact, together with the 'unique turnaround strategy' employed for the furniture company in question resulted in the turnaround being achieved much sooner as initially hoped or expected.
- The taxpayer invested in the listed entity as part of a consortium with a foreigner. As part of the consortium agreement, the taxpayer undertook to leave the decision to sell the listed shares to the foreign consortium member.
- Despite the positive uptick in the world economy alluded to above, the South African Rand weakened significantly during late 2003/early 2004.
- Early in 2004 the consortium members became aware of the possibility of selling the shares by way of a book-building exercise, which exercise countered the negative impact normally associated with a disposal of a substantial amount of shares in a listed entity.
- This information triggered the idea of a sale of the consortium's shares by the foreign member of the consortium, which resulted in the sale being pursued and concluded.
- The decision to sell was supported by the fact that the rescue mission was completed at that stage.

Based on these facts, the court held that in considering the period during which the shares were held, it is not appropriate to simply look at the date of their formal acquisition by the taxpayer. The court duly took into account the fact that, in the circumstances, the appropriate period commenced during June 2002 when the taxpayer entered into a binding commitment to formally acquire the shares.

The court confirmed the principle that the main factors in determining whether disposal proceeds are to be classified as revenue or capital is the taxpayer's intention. Given the rescue mission and the undisputed evidence that the likely period to achieve the operation, if at all, would be between three to five years, the court was satisfied that the taxpayer acquired the shares with a view to hold them for purposes other than trading.

Different circumstances

The decision to sell was held to be the result of a nova causa interveniens, being the information about the possibility to sell the shares in terms of a book-building exercise. This unforeseen, but lucrative, opportunity presented itself to Capstone in circumstances that prevailed at that time (early 2004) which were much different to the circumstances at the time when the investment was initially made (mid-2002). The court also took into account the fact that Capstone, as the junior partner in the rescue consortium, had no say in whether it wanted to sell the listed shares - Capstone's intention, with the sale, was simply to honour its commitment to its consortium partner.

The above led the court to find that Capstone's intention, both at the time of entering into the transaction which culminated in its acquisition of the listed shares, until and as well as at the time of the decision to sell, was in line with an intention to hold the shares on capital account.

The court did not only look at the taxpayer's intention - it held that the following factors confirmed its view that the shares were held as capital assets:

- The fact that Capstone was a purely passive investment holding vehicle, which was precluded from doing anything

else, strengthened the inference that the shares were held as fixed capital.
- Capstone's financial statements reflected the shares as 'non-current assets', and not trading stock.
- As Capstone was so inactive - it did not even hold board meetings - it is not possible that a trade could be conducted, and absent a trade there could not be floating capital.

On the two related issues, namely the tax treatment of the equity kicker and indemnity payment, the court applied the rules applicable to whether an amount qualifies to be included in an asset's base cost for capital gains tax purposes. Based on the facts, the court found that:

- The equity kicker constituted part of the borrowing costs of the taxpayer, and as the capital borrowed was utilised to acquire listed shares, one-third of the equity kicker qualified for inclusion in the taxpayer's base cost for the listed shares; and
- the indemnity was not an amount which was incurred as part of the acquisition of the shares, but rather as part of the cost of disposal of the shares, as the indemnity obligation was, factually, unconditionally incurred only after the shares were sold.
- The judgment is particularly helpful in that it establishes a basis for the following principles which we believe are good and sound principles providing some handrails in an area of the tax law where uncertainty is rife:
- The tax law tends to ignore any transactions which are conditional, and it only recognises a transaction as soon as it becomes unconditional. The court demonstrated its openness to commercial reality - that transactions are not closed overnight. Although the transaction only materialised upon its becoming unconditional, the mere fact of the transaction being subject to a condition (especially a condition, the fulfilment of which is not under the taxpayer's control) does not devoid the date when the transaction is entered into (albeit conditionally) from any relevance for tax purposes. This is particularly relevant where, as in the case of a revenue vs. capital enquiry, the time period for which an asset is held often plays an important role.
- The tax legislation provides for a safe haven of three years as a holding period which is regarded as sufficiently long, generally, to regard the proceeds on disposal of shares as capital in nature. That safe haven does not apply to assets other than shares. This judgment goes a long way to provide clarity on what kind of period should be regarded as sufficiently long to avoid a strong trading inference. We believe it is fair to say that the court's approach suggests that a three- to five-year period should, generally, be regarded as a holding period indicative of a capital intention.

The second case of Kluh Investments (Pty) Ltd v Commissioner for the South African Revenue Service (A48/2014) [2014] ZAWCHC 141 (handed down on 9 September 2014) also deals with the capital or revenue nature of proceeds realised by the taxpayer (Kluh) on the disposal of a plantation. However, unlike the Capstone matter, the Kluh judgment was not about the principles relevant to distinguish between capital and revenue receipts, but focussed on whether the taxpayer conducted farming operations.

The judgment was delivered in the context of tax legislation which provides that the taxable income of a person carrying on farming operations must be determined subject to the provisions of the First Schedule to the Income Tax Act. The First Schedule refers to a person carrying on farming operations as a 'farmer', and provides that proceeds on the disposal of a plantation are deemed to be revenue in nature if the proceeds are received by a farmer.

Critical question

The critical question, therefore, was whether the taxpayer was a 'farmer', which in turn led to the question of whether the taxpayer carried on farming operations.

The background facts, in short, were that Steinhoff Southern Cape (Pty) Ltd (Steinhoff), a company forming part of a group operating in the furniture manufacturing industry, was looking to acquire a plantation, as a going concern, in Knysna. The Steinhoff group had, at the time, a policy in terms of which the group preferred not to own any fixed property in South Africa.

As a result, Steinhoff acquired the machinery and equipment (including a sawmill) from the seller, and the taxpayer acquired the remaining assets. The remaining assets consisted of the land, the trees as well as some 'other assets', which other assets were sold forthwith by the taxpayer to third parties. The taxpayer was, therefore, left with the land and the growing timber.

Terms of agreement

The taxpayer agreed with Steinhoff that Steinhoff, at its own cost, could harvest the timber for its own account, subject to Steinhoff maintaining and managing, in terms of prescribed standards, the plantation in such a manner that, upon termination of the agreement, the plantation would be restored in the state it was at the commencement of the agreement. The taxpayer had no equipment and no employees and earned no income or incurred no expenses of an operational nature.

Within two years, though, Steinhoff decided that it would be more beneficial for the group to own the plantation. Steinhoff then entered into an agreement in terms of which it acquired the assets of the taxpayer.

The court held that in order to trigger the deeming provisions of the First Schedule, a two-fold enquiry is required:

- as a first requirement, the taxpayer must be determined to be a person carrying on farming operations during the year of assessments concerned; and
- only if the first requirement is met, the second requirement comes into play, and that would be to determine whether the income sought to be deemed revenue was derived from such farming operations.

SARS contended that the proceeds realised by Kluh should, in terms of the legislation alluded to above, be deemed gross income. SARS based its contention on two arguments:

- Firstly it argued that the mere disposal of an operating plantation by a taxpayer constitutes, in itself, a farming operation. According to this argument, it is not required to determine that the taxpayer, before the disposal, carried on farming operations.
- Secondly it argued that there was a sufficiently close connection between the disposal proceeds and the conducting of the plantation operations by Steinhoff, to bring the disposal proceeds within the ambit of the farming tax provisions.

The High Court rejected the first of SARS' arguments on the basis that the purpose of the deeming tax legislation is simply to deem a particular type of receipt as revenue rather than capital. The deeming provision only comes into play if the amount is received by a farmer. Consequently, the taxpayer needs to conduct farming operations as a minimum threshold for the application of the deeming provision.

It was held that, in order for the taxpayer to conduct farming operations, there must be conduct by the taxpayer apart from the mere disposal of the plantation, which constitutes the carrying on by the taxpayer of farming operations. The deeming provision does not extend to deem the recipient of the amount (deemed to be revenue) to conduct farming operations.

The SARS argument based on the closeness of the connection between Steinhoff's farming operations and the receipt of the proceeds was also rejected by the court. It was found, on the facts, that Steinhoff did not more than carrying on its own farming operations, while at the same time managing the taxpayer's plantation.

Contractual obligation

It was also held that Steinhoff's contractual obligation to maintain and restore the plantation in accordance with prescribed standards was not sufficient to attribute Steinhoff's farming operations to Kluh. The High Court's view was explained by means of an analogy to contract of lease: it cannot be inferred from the obligation of a lessee to maintain and restore property in a specific manner that the landlord is conducting the business of the lessee.

SARS did not, in the alternative, contend that the proceeds on disposal of the plantation were subject to income tax in terms of ordinary tax principles (other than the deeming provisions of the First Schedule).

The court made a final and interesting observation by noting that taxpayers generally seek to bring themselves within the ambit of the First Schedule of the Income Tax Act because of the favourable allowances available to farmers. If SARS' contentions in the Kluh matter had been upheld, it would likely have opened a Pandora's box for many opportunistic taxpayers.

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