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TAX AND EXCHANGE CONTROL ALERT

IN THIS **ISSUE**

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VENDOR BEWARE: CAPITAL GAINS TAX ON INSTALMENT SALES

The taxpayer disputed the 2007 assessment as the sale was cancelled and, accordingly, no CGT was payable.

The court held that the original assessment could not be altered, and that the taxpayer had to account for the full CGT in the 2007 tax year.

Taxpayers should take great care when selling assets where the price is paid in instalments as the transaction may trigger some tricky capital gains tax (CGT) consequences.

Consider the case of *New Adventure Shelf 122 (Pty) Ltd vs The Commissioner of the South African Revenue Service* (7007/2015) [2016] ZAWCHC 9 (17 February 2016). In this case the taxpayer acquired immovable property in 1999. In the taxpayer's 2007 tax year it sold and transferred the property to a third party for a profit. The buyer had to pay the price of the property in instalments over more than one tax year.

The taxpayer accounted for CGT on the entire purchase price in its 2007 tax return. The South African Revenue Service (SARS) assessed it accordingly.

However, in its 2012 tax year the taxpayer and the buyer agreed to cancel the sale agreement as the buyer could not proceed with the intended development of the property. Under the cancellation agreement the buyer would transfer the property back into the name of the taxpayer, and the taxpayer would keep the amounts already paid by the buyer. The amount kept by the taxpayer was significantly less than the initial price.

Put simply, the taxpayer disputed the 2007 assessment as the sale was cancelled and, accordingly, no CGT was payable.

The taxpayer and SARS agreed that the 2007 assessment was correct. However, the taxpayer contended that SARS had to amend the assessment on the ground that the proceeds on the disposal of the property had been reduced in 2007 as a result of the cancellation of the sale agreement in 2012; in other words that SARS had to change the amount of CGT due in the 2007 tax year.

The court held that the original assessment could not be altered, and that the taxpayer had to account for the full CGT in the 2007 tax year.

The court case was based on legislation that has since been changed. The position, however, remains the same and can be summarised simply as follows:

- CGT is triggered on the disposal of an asset.
- A taxpayer must account for CGT on the difference between the proceeds on the disposal of the asset, and the base cost of the asset.
- The proceeds from the disposal of an asset are equal to the amount received by or accrued to the taxpayer.

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To the extent that the taxpayer does not have an unconditional entitlement to the proceeds in the current tax year, the taxpayer must account for CGT in the tax year during which the proceeds actually accrue.

- Where during the current tax year the taxpayer becomes entitled to any amount which is payable in a subsequent tax year, the full amount must be treated as having accrued to the taxpayer in the current tax year. A taxpayer is considered to be entitled to an amount if the entitlement is unconditional. For instance, in the *New Adventure* case, while the second instalment of the price was only due in a tax year after the sale and transfer of the property, the full price had accrued to the taxpayer in the 2007 tax year as the taxpayer had become unconditionally entitled to the amount.
- To the extent that the taxpayer does not have an unconditional entitlement to the proceeds in the current tax year, the taxpayer must account for CGT in the tax year during which the proceeds actually accrue. However, a capital loss realised by a taxpayer in the year of disposal must be carried forward and deducted in the year that the proceeds do accrue, subject to certain rules relating to the determination of capital losses. For instance a taxpayer sells immovable property to a purchaser for R2 million in tax year one. Of the price R500,000 is only payable in tax year two if the purchaser is successful in rezoning the property. The taxpayer will account for CGT on R1,5 million in tax year one only and will account for CGT on R500,000 in tax year two if the condition of rezoning is fulfilled. Conceivably, the parties in the *New Adventure* case could have made the payment of the second instalment contingent on the purchaser being successful with the development, in which case the taxpayer would only have had to account for the part of the price actually received during the 2007 tax year.
- If a person during a tax year disposes of an asset for consideration that cannot be quantified in full during that tax year, then so much of the consideration as cannot be quantified is deemed not to have accrued to the person in that tax year. If and when the amount becomes quantifiable during a later tax year, it is deemed to have accrued to the person from the disposal in that year. For example a taxpayer agrees to sell shares in a company to the purchaser for a price of R1 million in tax year one. The parties agree that the purchaser will pay an additional amount determined as a percentage of the net profits of the company in tax year two. The taxpayer would need to account for CGT on the amount of R1 million in tax year one, and the 'earn-out' amount (if any) in tax year two.
- A similar special rule applies when a person sells equity shares and more than 25% of the price is payable in subsequent tax years.

But what happens where (as in the *New Adventure* case):

- a taxpayer sold an asset for a price which accrues unconditionally on disposal, but which is payable in instalments over two or more tax years;

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The taxpayer would have paid CGT on the full sale price in the year of disposal but may not be able to recover the loss unless and until the taxpayer realises other capital gains.

- the sale agreement is cancelled in a later tax year due to, say, the default of the purchaser; and
- the purchaser must return the asset to the taxpayer?

In that case, the taxpayer must account for CGT on the full proceeds in the year of disposal of the asset. In the tax year in which the agreement is cancelled, to the extent that the taxpayer suffers a loss in that the full price is less than the value of the property, the taxpayer will suffer a CGT loss. (The purchaser must account for CGT on the value of the property transferred back to the taxpayer.)

Notably, however, the taxpayer will only be able to off-set that capital loss against other capital losses in the same or future years. In other words, the taxpayer would have paid CGT on the full sale price in the year of disposal but may not be able to recover the loss unless and until the taxpayer realises other capital gains.

What is apparent from the above is that a taxpayer must obtain professional tax advice and plan carefully before concluding an agreement for the sale of an asset where the price is paid in instalments over more than one tax year.

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CAPITAL V REVENUE: THE TAXPAYER PREVAILS

The SCA had to decide whether the share sale of the taxpayer constituted revenue or was capital in nature?

The SCA also had to decide whether an indemnity settlement paid by the taxpayer after it had sold the shares, formed part of the base cost of the shares for purposes of capital gains tax (CGT)?

The question of whether an amount constitutes capital or revenue in a specific instance, is an issue that our courts have grappled with on many occasions.

In *Commissioner for the South African Revenue Service v Capstone 556 (Pty) Ltd* (20844/2014) [2016] ZASCA 2 (9 February 2016), the Supreme Court of Appeal (SCA) had to deal with this very issue. The SCA had to decide two questions:

- whether the share sale of the taxpayer, Capstone, of approximately 17.5 million shares in JD Group Ltd (JDG), through which it made a profit of R400 million, constituted revenue or was capital in nature; and
- whether an indemnity settlement paid by the taxpayer after it had sold the shares, formed part of the base cost of the shares for purposes of capital gains tax (CGT).

The matter was an appeal from the full bench of the High Court, Western Cape Division (*Capstone 556 (Pty) Ltd v Commissioner for the South African Revenue Service 2014* (6) SA 195 (WCC); 77 SATC 1), on which we reported in our Tax Alert of August 2014.

Facts

When Profurn, a JSE listed company in the retail furniture industry, had run into serious financial difficulties by the end of 2001, it prompted two of its largest creditors, FirstRand and Steinhoff, to propose a financial rescue plan. Profurn's imminent liquidation would threaten the stability of South Africa's retail furniture industry. FirstRand ascertained that Profurn needed to reduce its debt by approximately R300 million and required a capital injection of approximately R600 million to survive. Subsequently, discussions took place between Lategan, Daun, Jooste and Sussman who agreed to carry out the rescue operation through the conclusion of a number of financing transactions which included the creation of a special purpose vehicle, the taxpayer. Daun, a wealthy German businessman and director of Steinhoff, was appointed as one of the taxpayer's directors. A memorandum of understanding (MOU) signed by Daun on 26 June 2002, reflected what the parties had agreed on and the agreements that would be concluded to effect the rescue operation. The parties also agreed that this was the effective date on which the taxpayer acquired the risks and rewards attached to the JDG shares. All parties agreed that the rescue operation would be very risky and would probably require a period of three to five years.

The transactions envisaged in the MOU had to be amended to the following: FirstRand acquired a 78.8% shareholding in Profurn. JDG and Profurn then merged and FirstRand acquired approximately 42 million JDG shares. After Daun invited Jooste to take part in the transaction, the taxpayer was restructured and it purchased approximately 17.5 million shares. The taxpayer financed this purchase through a loan received from its holding company, BVI, which also led to the possible payment of an 'equity kicker' to BVI. The possible payment of the 'equity kicker'

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The SCA had to decide whether the proceeds from the share sale was income of a revenue or capital nature, and whether the 'equity kicker' and indemnity settlement formed part of the base cost of the JDG share acquisition.

arose as the taxpayer's loan from BVI was funded by a loan that BVI received from Gensec and which required BVI to pay the equity kicker in addition to the loan. The equity kicker represented a portion of the growth in the value of the JDG shares, calculated by means of a formula. The taxpayer had actually paid the equity kicker even though it was not party to the loan agreement between BVI and Gensec. The taxpayer also incurred a contingent liability in acquiring the shares, in the form of an indemnity to FirstRand in the amount of R62.5 million.

On 29 April 2004, the taxpayer sold its JDG shares and realised a profit of R400 million. The taxpayer's liability in respect of the equity kicker amounted to R45,123,050. The contingent liability of R62.5 million was subsequently settled after another party who had acquired JDG shares, including a concomitant contingent liability to FirstRand, Daun et Cie, agreed to pay the taxpayer's full contingent liability in return for the taxpayer paying it R55 million (indemnity settlement). The taxpayer incurred the liability to pay the R55 million in its 2005 year of assessment.

Issues to decide

The SCA had to decide whether the proceeds from the share sale was income of a revenue or capital nature, and whether the 'equity kicker' and indemnity settlement formed part of the base cost of the JDG share acquisition, in terms of paragraph 20 of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act).

The parties agreed that the High Court was correct in finding that the equity kicker constituted borrowing costs and that a third thereof could be added to the base cost of the shares, in terms of an exception to paragraph 20(2) of the Eighth Schedule.

Was the income of a capital or revenue nature?

In essence, s1 of the Act defines 'gross income' as the total amount received by or accrued to a person, excluding receipts or accruals of a capital nature. In interpreting this definition, the SCA referred to a number of previous decisions on this issue and stated that the applicable principles in the current matter were as follows:

- One must look at the intention of the taxpayer. Where the gain is made in the operation of business in carrying out a scheme of profit making, the profit will be revenue in nature. This would be ascertained by considering the purpose for which the taxpayer entered into the transaction. A company's intention at a given time is determined by looking at the intention of the persons who were in effective control of the company at that time.
- One must look at the nature of the taxpayer's business activities.
- The period for which the asset is held and the period for which it was anticipated to be held at the time of acquisition are relevant.
- When dealing with an investment, the

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Based on Daun's evidence, which was corroborated by a number of other witnesses, the SCA held that the proceeds of the JDG shares were capital in nature.

nature of the risk undertaken has a bearing on whether the transaction is aimed at building up the value of the taxpayer's capital or directed at generating revenue and profit.

- In many commercial situations there may be no clear intention at the outset and it may then be accepted that the taxpayer's future intentions were indeterminate.

The SCA stated that the transaction must be considered in its entirety from a commercial perspective and not be broken into component parts or subjected to narrow legalistic scrutiny, when applying these principles.

In applying these principles to the facts, the SCA held that the purpose of the transaction should thus be determined as at 26 June 2002 when the MOU was concluded. The High Court also held that this was the case. On the question of who was in control of the taxpayer, the SCA agreed with the High Court and held that Daun was the 'brain' and 'mind' of the taxpayer and was in de facto control of the JDG shares from their effective acquisition to their disposal, as the decision when to sell was solely his. Daun, who the SCA found to be a credible witness, acquired the JDG shares as he believed that the rescue operation could be successful. The resale of the shares at a profit was one of several possibilities he initially considered. Daun's investment was very risky as it was made in the hope that Sussman's managerial skills would make the rescue successful by averting Profurn's imminent liquidation. Daun committed himself to the investment without knowing how long his commitment would need to last.

The SCA rejected SARS's argument that Daun's intention became one of profit making when he decided to sell some of the shares to Steinhoff as part of a book-building exercise Steinhoff had undertaken. Daun testified that he only decided to sell after discussing it with Sussman and after his wife had convinced him that he was overexposed in South Africa. Steinhoff's offer to sell pursuant to the book building exercise, was thus merely fortuitous. The SCA also rejected SARS's argument that the short-term nature of the loan from BVI and the nature of the equity kicker indicated an intention to fund the loan repayments by selling the shares. This was because the loan agreement was entered into on 5 December 2003, long after the MOU and in any event, the equity kicker was payable irrespective of whether the shares were sold or not. Based on Daun's evidence, which was corroborated by a number of other witnesses, the SCA held that the proceeds of the JDG shares were capital in nature.

Did the indemnity settlement form part of base cost?

This issue was heard by way of a cross-appeal brought by the taxpayer. The High Court had found that the indemnity settlement did not form part of the base cost of the shares as it was entirely separate from the acquisition of the JDG

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Whether an amount constitutes capital or revenue will always be a question of fact and that courts will not follow a one-size-fits all approach.

shares. With regard to the indemnity settlement, the SCA referred to paragraph 20(1)(a) of the Eighth Schedule of the Act, which states that the base cost includes "expenditure actually incurred in respect of the costs of acquisition" of an asset. The words 'expenditure actually incurred' refers to an unconditional legal obligation to pay and the words 'in respect of' connote a causal relationship. As the unconditional legal obligation to pay R55 million to Daun et Cie in terms of the indemnity settlement replaced the contingent obligation to FirstRand, the causal link between the acquisition of the shares and the indemnity settlement remained intact.

Costs

The SCA held that SARS had to pay all the taxpayer's costs in opposing the appeal and the costs incurred by the taxpayer in the cross-appeal, including the costs of two counsel.

Comment

This case confirms the principle that to determine whether an amount constitutes capital or revenue will always be a question of fact and that courts will not follow a one-size-fits all approach. In light of the increase in the CGT rate to 80%, which applies as of 1 March 2016, as opposed to 50% at the time the shares were sold, the case raises an interesting practical issue, especially for companies who decide to embark on litigation of this nature in future. Based on the facts in this case, had the shares been disposed of after 1 March 2016, the taxpayer would have paid tax on the sale at an effective rate of 22.4%. On an amount of R400 million, this would trigger a tax liability of R89,600,000. Had the amount been classified as income in terms of s1, the taxpayer would have been liable to pay tax at the rate of 28%, which would amount to R112 million and amounts to a difference of R22.4 million. The SCA's finding that the obligation to pay the indemnity settlement formed part of base cost, would have reduced the taxpayer's tax liability by a further amount of R12,320,000. On the same facts, the successful litigation would have reduced the taxpayer's tax liability by approximately R34,720,000 and would most likely have been worth the taxpayer's while, from a business and financial perspective. However, considering the high cost of and risks attached to litigation, companies would be well advised to do the math and count the possible costs of litigation, before they decide to challenge SARS's assessment on whether an amount constitutes capital or revenue.

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