DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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DISPOSAL OF SHARES BY A SPECIAL PURPOSE VEHICLE

Judgment was handed down in the case of *A (Pty) Ltd v Commissioner for the South African Revenue Service (case number 13003, as yet unreported)* on 13 June 2013.

The case involved the timeworn question of whether the receipts or accruals in respect of the disposal of a particular asset constitute gross income, or whether it is excluded as being capital in nature.

The facts of the case are somewhat convoluted but essentially entailed the following. M was a listed company in the furniture business. M was struggling and by 2001 it had run up a debt with ABC bank of nearly R900 million. As part of a rescue plan, and for ABC bank to reduce its exposure, various transactions were entered into. During June 2002, R600 million of the debt was converted into equity by means of a rights issue. As a result, ABC held nearly 78% of the shares in M.

FG, another company in the furniture business, was introduced, along with O (executive chairman of FG), Y (an intermediary), and Z (a German businessman). FG agreed to take over M in exchange for issuing FG shares to ABC. ABC received the FG shares in April 2003. ABC then sold nearly all of these FG shares, in equal parts, to A (a special purpose vehicle, being the appellant taxpayer), and a German company referred to as O et Cie (being one of Z's companies). A acquired its FG shares on 5 December 2003.

A funded the acquisition of the FG shares through the issue of preference shares to ABC. A also borrowed money from D through KL. A was a wholly-owned subsidiary of KL and KL was a wholly-owned subsidiary of D. By April 2004, shortly after A acquired the FG shares, A sold the shares to the E Group.

In respect of A's 2005 year of assessment, A accounted for the proceeds on the disposal of the FG shares to the E Group as being capital nature, declared a capital gain, and paid tax accordingly.

However, the South African Revenue Service (SARS) assessed A to the effect that the proceeds on the sale constituted gross income.

Capital or revenue?

The key concern for SARS was that A had disposed of the FG shares so soon after having acquired them. In fact, the evidence revealed that Y had entered into discussions with the E Group in November 2003 in respect of a transaction potentially involving the FG shares. This was before A had even acquired the FG shares. These discussions eventually culminated in A actually selling the FG shares to the E Group by April 2004.

The court's enquiry took the direction of attempting to establish the intention of A at the time of acquisition as well as at the time of disposal of the FG shares. It had to be shown that A intended the investment in the FG shares to be 'an investment for some significant duration'. This, of course, raised the question as to who was the controlling mind behind A.

The court concluded that, on the evidence, Y appeared to be the 'brain of the company'. A was the vehicle through which Y would hold his half of the FG shares, while Z held his half through O et Cie. This despite the fact that Y was not a director of A at the relevant time.

The evidence showed that there was always the intention to realise the shares for a significant profit. It was only ever a question of when. Even though various possibilities lay open at the time of acquisition, a profit-making intention was the dominant purpose within the mind(s) of those controlling A.

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This could be deduced from, *inter alia*, the fact that the funding that A had obtained was only for a period of three years. In addition, it had been envisaged that the amounts borrowed would be repaid from the proceeds of a sale of the FG shares.

Even if Z was the mind behind A, as was contended, and there was some intention to hold a long-term investment, the same conclusion must be reached, as the evidence did not show that the dominant intention behind the acquisition was to hold a long-term investment.

When discussions started with the E Group, both Z and Y realised that they could take advantage by selling the FG shares. This fitted within the range of possibilities that had been left open at the time of acquisition.

What was clear for the court was that shortly after acquiring the FG shares, the sale of the FG shares was initiated by Y and 'explored' by Z. On the facts, a mixed intention had converted into a 'clear purpose of selling to 'cash' in on the profit'. Accordingly, the court held that the proceeds on the disposal by A of the FG shares had to be included in A's gross income.

The court's decision was primarily based on an analysis of the facts. However, the court did make several interesting remarks in respect of the notion that an asset must have been acquired 'for keeps', and only sold under special circumstances, to qualify as a capital asset. This is so specifically in the context of shares.

The court remarked that the retention of shares should be re-examined in the light of modern market conditions. Many companies listed on exchanges a decade ago, the shares of which formed part of many share investment portfolios, are no longer there today. Holding shares 'for keeps' no longer makes investment sense. Due to elements such as quick advances in technological innovation, companies can no longer be expected to be 'successful for overly lengthy periods'. The idea of holding shares 'for keeps' comes from 'an old, static economic order that no longer exists'.

Deductibility of 'equity kicker'

Since the court found that the proceeds arising from the disposal of the FG shares had to be included in A's gross income, the further question arose of whether a certain amount referred to as an 'equity kicker' was deductible under s11(a) of the Income Tax Act, No 58 of 1962 (Act).

As mentioned above, A had been funded by means of a loan from D via KL. The loan had been structured in such a way that D would lend the money to KL and KL would on-lend the money to A. The agreement between KL and D provided that, over and above KL's obligation to repay the capital amount plus interest to D, KL also had to pay an 'equity kicker' on the maturity date (or whenever the loan is settled). This was an amount representing a portion of the growth in the value of the FG shares. It was calculated by means of a formula taking into account the difference between the market value of the shares on the maturity date (or settlement date) and a benchmark value.

However, A was not party to that agreement between KL and D and on the face of it had no unconditional liability to pay the 'equity kicker' to KL. SARS therefore argued that A could not claim the 'equity kicker' as a deduction.

Surprisingly, the court held that the 'equity kicker' was deductible by A. It was held that, in substance, the amount was incurred by A. KL was merely a conduit and A in fact incurred the obligation as it had to, ultimately, pay the funding costs. The court therefore did not limit itself to the agreement between KL and D, but looked at the substance of the transaction.

Deductibility of indemnity payment

A further amount that A wanted to deduct under s11(a) of the Act was an amount paid in respect of an indemnity it had provided. When ABC acquired the M shares and exchanged it for FG shares, ABC gave an indemnity to FG Group in respect of any contingent liabilities of M (identified by auditors) in the amount of R150 million. ABC was in turn indemnified for any such liability by A and O et Cie. In July 2004, O et Cie indemnified ABC also for A's portion of any liability under the indemnity.

Subsequently (in 2006) A entered into a written agreement with O et Cie in terms of which A assigned its obligations under the indemnity to O et Cie for an amount of R55 million payable to O et Cie. This amount was payable to O et Cie irrespective of whether any actual liability arose under the indemnity.

SARS argued that no amount had actually been expended by A in respect of the indemnity during the 2005 year of assessment. However, the court concluded that, on the evidence, the amount of R55 million had been actually incurred in July 2004, and thus fell within the 2005 year of assessment.

It appears that the court, here too, took a substantive approach and accepted that Z and Y had already come to the understanding in 2004 that the R55 million would be payable to O et Cie, although only in the future.

Interest

SARS had levied interest on A in terms of s89quat of the Act. A argued that the interest should be remitted in terms of s89quat(3), as it read at the time, because A had reasonable grounds for accounting for the proceeds on the sale of the FG shares as being capital in nature. It was submitted that A had acted in good faith in declaring a capital gain as opposed to gross income. The court agreed and ordered that the interest be remitted.

Heinrich Louw

TAX CHANGES FOR TRUSTS STILL UNDER CONSIDERATION

Proposed changes to tax legislation regarding trusts will not take place immediately, National Treasury has said.

In the Budget Tax Alert of 28 February 2013 and the Tax Alert of 31 May 2013, we detailed National Treasury's proposals for amendments to the current trust tax regime. At present, the conduit principle operating in trust tax law, allows for income that accrues in a trust to be taxed in the hands of the beneficiary. The proposed amendments aim to eradicate income splitting opportunities afforded through this principle, but should have no effect on special trusts.

Those present at a National Treasury briefing on trust tax law held in May 2013, were surprised at the lack of understanding of the operation of trusts and the apparent lack of consideration given to the serious consequences of imposing certain of National Treasury's proposals.

On 28 June 2013, the South African Institute of Tax Practitioners published a technical note confirming that National Treasury has not yet finalised any tax changes to the tax trust regime and that any amendments would first be discussed and issued for comment. Accordingly, a discussion document will be published for comment before any major legislative amendments are made. The Draft Taxation Laws Amendment Bill, 2013 was released for comment on 4 July 2013 and we confirm, in accordance with the technical note, that no amendments to trust tax law have been made.

Currently, it appears that Treasury's lack of understanding regarding the role of local trusts and offshore foundations has resulted in a more considered approach to the proposed legislative amendments and demonstrates great uncertainty regarding the future of this trust tax regime. Those waiting with baited breath for clarity regarding the taxation of trusts will have to wait a little bit longer.

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