DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

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IN THIS ISSUE

SALE OF SHARES BY SPECIAL PURPOSE VEHICLE

Judgment was handed down by a full bench of the High Court, Western Cape Division, in the matter of *Capstone 556 (Pty) Ltd v Commissioner for the South African Revenue Service*, on 26 August 2014. The matter was on appeal from the Tax Court (ITC 1867 75 SATC 273), on which we reported in our Tax Alert of 5 July 2013.

Facts

Profurn was a listed company and by 2001 it had run up a bank debt of nearly R900 million.

R600 million of the debt was subsequently converted into equity, after which the bank held approximately 78% of the shares in Profurn.

JDG, another company in the same industry, was introduced, along with Jooste (an intermediary), and Daun (a German businessman).

JDG agreed to take over Profurn in exchange for issuing JDG shares to the bank.

The bank received the JDG shares in April 2003, and then sold nearly all of these JDG shares, in equal parts, to the taxpayer, and a German company Daun et Cie (being one of Daun's companies).

The taxpayer acquired its JDG shares on 5 December 2003, and funded the acquisition of the JDG shares through the issue of preference shares to the bank and borrowing money from shareholders.

By April 2004, 5 months after the taxpayer acquired the JDG shares, it sold the shares to a purchaser.

Capital or revenue?

In respect of the taxpayer's 2005 year of assessment, the taxpayer accounted for the proceeds on the disposal of the JDG shares as being capital nature. However, the South African Revenue Service (SARS) assessed the taxpayer on the basis that the proceeds on the sale constituted gross income.

The Tax Court agreed with SARS, reasoning that Jooste was the 'controlling mind' behind the taxpayer, and on the objective facts Jooste's intention was clearly to make profit at the time of the sale, even if there was previously a mixed intention.

The High Court took the approach that, despite the objective facts pointing to the taxpayer having sold the JDG shares shortly after acquiring them, and by making use of short-term finance, *"the taxpayer's explanation of the events, including his or her intention in respect of the transaction in question, is … relevant and must be tested in the light of all the other circumstances…it would be an over-simplification to focus too closely on the bare facts…in drawing an inference as to the intention of the taxpayer"*.

The court found that the purpose of the entire scheme was a rescue operation, and not a profit-making scheme. On the broader evidence, such rescue operation would take between 3 and 5 years, and the parties involved could not be said to have a short-

continued

term intention. The taxpayer's intention was to make a 'strategic investment' in the relevant industry and to hold the shares until the rescue was successful.

Also, the taxpayer did not have to prove that it bought the shares as a long-term investment, but only that it did not buy the shares as trading stock as part of a profit-making scheme.

As for the intention of the taxpayer at the time of selling the shares, the court found that it was really Daun who controlled the decision to sell, and not Jooste as shareholder of the taxpayer. Jooste, and thus the taxpayer, were obliged to go along with Daun's decision as the main partner in the consortium. Thus there was no actual decision by the taxpayer other than to follow Daun.

Additionally, the court noted the following factors regarding the taxpayer, being a special purpose vehicle, that convinced it that the shares were acquired and held as capital assets:

- as a special purpose vehicle, the taxpayer was contractually precluded from doing anything other than acquiring and holding the shares – it could not trade with the shares;
- the taxpayer's financial statements reflected the shares as 'non-current' assets; and
- no trade was conducted by the taxpayer, and the taxpayer did not hold any board meetings.

The taxpayer's appeal, on this point, was accordingly upheld.

Equity kicker

In the Tax Court, the taxpayer sought to claim a deduction for payment of a so-called 'equity kicker' in circumstances where the proceeds on disposal of the JDG shares were found to constitute gross income. However, on the finding of the High Court that the proceeds did not, the question was whether the equity kicker could be included in the base cost of the JDG shares.

The taxpayer was partially funded by a loan from its shareholder BVI, which was in turn funded by a loan from its shareholder Gensec.

BVI and Gensec agreed that in addition to BVI having to pay back its loan to Gensec, it also had to pay an 'equity kicker', being an amount representing a portion of the growth in the value of the JDG shares, calculated by means of a formula. The taxpayer was not formally party to that agreement, and on the face of it had no unconditional liability to pay the 'equity kicker' to anyone. However, the taxpayer actually paid the equity kicker.

The Tax Court found that the equity kicker was deductible by the taxpayer because in substance, the amount was incurred by it. The High Court agreed that the amount was actually incurred by the taxpayer, also for capital gains tax purposes. However, the High Court found that the equity kicker constituted 'borrowing costs', which is generally excluded from being added to an asset's base cost. However, an exception exists where the asset is a listed share, such as the JDG shares were, allowing for a third of certain borrowing costs to be taken into account for purposes of determining the base cost of the shares.

The High Court therefore allowed one third of the equity kicker to be included in the base cost of the JDG shares.

Indemnity payments

In the Tax Court, the taxpayer also sought to deduct an amount paid to Daun et Cie in respect of an indemnity that Daun et Cie had provided to the bank. The amount was payable to Daun et Cie irrespective of whether any actual liability arose under the indemnity. SARS argued that no amount had actually been expended by the taxpayer during the 2005 year of assessment, but the Tax Court concluded that, on the evidence, the amount had actually been incurred in July 2004, and thus fell within the 2005 year of assessment.

The High Court noted that the decision by the taxpayer to pay Daun et Cie effectively converted a contingent liability, in respect of the acquisition of the shares, into an unconditional liability, only much later. The High Court found that, if anything, the amount paid constituted a cost of disposal, but not a cost of acquisition, and could therefore not be included in the base cost of the shares.

Costs

The High Court provisionally ordered SARS to pay 80% of the taxpayer's cost of appeal.

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continued

ELECTRONIC COMMUNICATION WITH SARS

The South African Revenue Service (SARS) recently released the new rules for dispute resolution prescribed under section 103 of the Tax Administration Act No 28 of 2011 (TAA). Among the many new features, it is interesting to note the provisions relating to the delivery of documents by a taxpayer to SARS, and specifically with reference to the delivery of documents by electronic means.

The rules define the term 'deliver' as follows:

'deliver' means to issue, give, send or serve a document to the address specified for this purpose under these rules, in the following manner: …

> *(c) by the taxpayer or appellant, by:*
>
> *(iii) sending it to SARS, the clerk or the registrar by electronic means to an e-mail address or telefax number; …*

The previous dispute resolution rules also provided for the delivery of documents to SARS by electronic means, but contained an important proviso. The definition of 'deliver' in the previous rules read as follows:

'deliver' means:

> *(d) transmitting the relevant document to the relevant person by electronic means; …*

Provided that in the case of paragraphs (c) and (d), the original, signed document must be handed to that person or sent by registered post to that person within ten days of it being so telefaxed or transmitted by electronic means.

SARS also recently released the new rules for electronic communication prescribed under section 255(1) of the TAA.

Rule 3(2) of the electronic communication rules provides as follows in respect of the delivery and receipt of electronic communications;

> *(2) Delivery of an:*
>
> *(a) electronic communication, excluding an electronic filing transaction, is regarded to occur when the complete communication:*
>
> *(i) enters the information system of SARS, the electronic communicator or the intermediary of the communicator; and*
>
> *(ii) is capable of being retrieved and processed by SARS or the communicator.*

In practice, when communicating with SARS by e-mail, the following circumstances are known to arise:

- an automated response is received, potentially generated by SARS, to the effect that 'the message could not be delivered';
- an automated response is received, generated by SARS, to the effect that 'the attachments to the message are too large';
- an automated response is received, generated by SARS, to the effect that the 'message has not been delivered, but will be delivered to the recipient at a later time'; or
- no response is received whatsoever, even if a 'read receipt' was requested.

The question is, how would the 'communicator' know whether the message or document has technically been 'delivered'.

The requirements in terms of the electronic communication rules are that the communication must have entered SARS's information system, and the communication must be capable of retrieval and processing by SARS.

Where an automated response is generated, the inference can be made that the communication has entered SARS's information system, but it would not be possible to know whether SARS is technically capable of retrieving the communication. Similarly, where no response is received at all, the 'communicator' would not know whether the requirements for delivery have been met or not.

The issue is really that, without there being some definite indication from SARS that a message or document has been received, the communicator would not know whether 'delivery' has taken place.

In this regard, rule 3 of the electronic communication rules provides as follows:

> *(1) Where an electronic communicator and a SARS official have not agreed that an acknowledgment of receipt for a communication be given in a particular form or by a particular method, an acknowledgement may be given:*

continued

(a) through a communication from a SARS official or the communicator pertaining to that communication, whether automated or otherwise; or

(b) by conduct that indicates that the communication has been received.

Rule 3(1) uses the words "an acknowledgement may be given", but does not say whether such "acknowledgement" necessarily means that the requirements for delivery in rule 3(2) will have been complied with. For example, would an automated response stating that the message has been received but will be delivered to the recipient at a later time, constitute an 'acknowledgment', and if it does, does it mean that the communication has entered SARS's information system and is technically capable of retrieval and processing by SARS?

The rule does not deal with what exactly constitutes an 'acknowledgement', and what the situation is where a communicator does not know whether a response constitutes an 'acknowledgment'.

The question that arises is, where a communicator does not know whether 'delivery' has technically taken place, whether there is a duty on that communicator to somehow elicit a response from SARS, or attempt to deliver the relevant message or document by some other means.

Rule 3(3) of the electronic communication rules provides as follows:

(3) Except for an electronic filing transaction, if an acknowledgement of receipt for the electronic communication in accordance with subrule (1) is not received, the communication must be regarded as not delivered.

The answer appears to be clear: where a communicator does not know whether SARS has received the communication or not because no 'acknowledgement' has been received, the communication is regarded as not delivered.

Where the communicator is as a result forced to attempt delivery by some other means, the communicator will effectively have been deprived of the right to deliver the message or document electronically.

One should however keep in mind that, at least in principle, rule 3 of the electronic communication rules applies equally to communications made by SARS to a taxpayer.

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