



SCA JUDGMENTS: CAPSTONE & KLUH

LEGAL BRIEF
APRIL 2016

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 Klüh is a farmer and cannot be applied to determine whether Klüh 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 Klüh, that would not make Klüh a farmer, given that Klüh did not have the right to the yield of the plantation nor the use of the land or the plantation and Klüh 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 Klüh, was Steinhoff.

Legal notice: Nothing in this publication should be construed as legal advice from any lawyer or this firm. Readers are advised to consult professional legal advisors for guidance on legislation which may affect their businesses.

© 2016 Werksmans Incorporated trading as Werksmans Attorneys. All rights reserved.

ABOUT THE AUTHORS



DOELIE
LESSING

Title: Director
Office: Stellenbosch
Direct line: +27 (0)21 809 6147
Email: dlessing@werksmans.com

Doelie Lessing is a specialist in corporate tax matters with specific emphasis on the tax issues associated with mergers and reorganisations of corporate entities; private equity deal structuring and black economic empowerment transactions. Her expertise extends to tax planning for international corporates, executives and wealthy families, tax structuring for local and international investment funds, Africa-specific investments and employee incentive plans. She has also undertaken tax-related litigation, alternative dispute resolution and settlements for a variety of clients.

Doelie is named amongst the world's leading private client lawyers in *Who's Who Legal: Private Client 2014* and *Who's Who Legal 2015 – Compendium Edition*. She is also named as a highly-regarded practitioner in the *International Who's Who of Corporate Tax Lawyers (2013)*, where the publication states she is known for "delivering high-end work in a timely manner".

She is also ranked as a leading lawyer in Tax by *Chambers Global (2013 & 2014)*, where the publication quotes sources noting that, "she is very good technically and always up to date with the newest legislation" and "incredibly responsive, personable and pleasant to deal with".

Doelie is further recognised in the *International Tax Review's World Tax 2011* and is named as a leading practitioner in the *3rd and 4th Editions of Euromoney's Expert Guide to the World's Leading Women in Business Law*.

Doelie is also a member of the International Tax Planning Association. She is the co-founder and past chairman of the Society of Trust and Estate Practitioners (STEP), Cape Town and acts as external examiner for the Tax Masters course offered by the University of Cape Town. Doelie is also the co-author of the *South Africa chapter of the Practical Law Private Client Multi-jurisdictional Guide, 2014 edition*.

She holds a BCom (Stellenbosch), an LLB (Stellenbosch) and an M Com (Tax) (with distinction) (Stellenbosch).



YVONNE
STEYN

Title: Senior Associate
Office: Cape Town
Direct line: +27 (0) 21 405 5221
Email: ysteyn@werksmans.com

Yvonne Steyn joined Werksmans Attorneys as a candidate attorney at the beginning of 2011 and in 2013 became an associate in the commercial law department of the firm. Her areas of speciality include general commercial law with an emphasis on company law. She also advises on insolvency and business restructuring.

In addition to the above, Yvonne has also been involved in tax related matters and also forms part of the tax department of the firm.

Yvonne Steyn graduated with a B.Com (Law) from Stellenbosch University and an LLB from the University of Stellenbosch.

> Keep us close

The Corporate & Commercial Law Firm
www.werksmans.com
A member of the LEX Africa Alliance

ABOUT WERKSMANS ATTORNEYS

Established in the early 1900s, Werksmans Attorneys is a leading South African corporate and commercial law firm, serving multinationals, listed companies, financial institutions, entrepreneurs and government.

Operating in Gauteng and the Western Cape, the firm is connected to an extensive African legal alliance through LEX Africa.

LEX Africa was established in 1993 as the first and largest African legal alliance and offers huge potential for Werksmans' clients seeking to do business on the continent by providing a gateway to Africa.

With a formidable track record in mergers and acquisitions, banking and finance, and commercial litigation and dispute resolution, Werksmans is distinguished by the people, clients and work that it attracts and retains.

Werksmans' more than 200 lawyers are a powerful team of independent-minded individuals who share a common service ethos. The firm's success is built on a solid foundation of insightful and innovative deal structuring and legal advice, a keen ability to understand business and economic imperatives and a strong focus on achieving the best legal outcome for clients.

