Reportable

IN THE HIGH COURT OF SOUTH AFRICA
(WESTERN CAPE DIVISION, CAPE TOWN)

Case No A49/14

In the matter between:

CAPSTONE 556 (PTY) LIMITED Appellant

and

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

Court: GRIESEL, YEKISO & BAARTMAN JJ

Heard: 1 August 2014

Delivered: 26 August 2014

JUDGMENT

GRIESEL J:

[1] This is an appeal and a cross-appeal against a judgment and order of the tax court (Davis J presiding).[1] It arises from an additional assessment in respect of the appellant's 2005 year of assessment in terms of which an amount of R200 633 728 was included in the appellant's

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[1] Income Tax Case No 1867, 75 SATC 273.

taxable income (over and above the amount assessed as a capital gain in the original assessment for that financial year). This arose from the disposal by the appellant of certain shares in JD Group Limited ('JDG') in the 2005 year of assessment, the proceeds of which were taxed by the commissioner as being of a revenue nature. In addition, separate amounts of R45 123 050 in respect of an 'equity kicker' and R55 million in respect of an indemnity obligation were disallowed by the commissioner as deductions from gross income. Interest in the amount of R50 188 561,99 was also imposed by the commissioner in terms of s 89*quat*(2) of the Income Tax Act 58 of 1962 ('the Act').

[2] The appellant objected to the assessment of the proceeds of the sale as revenue and also to the disallowance of the expenses in respect of the equity kicker and indemnity. These objections were dismissed by the commissioner.

[3] On appeal to the tax court, the appellant was unsuccessful in relation to the main issue, namely whether the amount in issue was rightly included as part of its income ('the first issue'). However, the tax court held in the appellant's favour in relation to the second and third issues, being the deductions in respect of the equity kicker and the indemnity respectively. The tax court also remitted the interest imposed by the commissioner. The present appeal is directed at the court's findings with regard to the first issue, whereas the cross-appeal is directed at the court's findings with regard to the second and third issues.

[4] The relevant factual background appears from the reported judgment of the tax court.[2] I accordingly do not propose to repeat the tax court's full and elaborate exposition of the factual scenario for purposes hereof, save to the extent necessary to explain my reasoning.

General approach on appeal

[5] Before considering the issues arising on appeal, it is necessary to refer briefly to the approach that should guide this court in that process. In the heads of argument filed on behalf of the commissioner herein, it was submitted that the finding of the tax court that the proceeds of the disposal of the JDG shares by the appellant were a receipt or accrual of a revenue nature was one of fact, not law. In the result, so it was submitted, where there is no material misdirection on fact by the trial court, the assumption is that its conclusion is correct. The appeal court will only reverse it where it is convinced that it is wrong. In such a case, if the appeal court is merely left in doubt as to the correctness of the conclusion, then it will uphold it.[3]

[6] As counsel for the appellant rightly pointed out, however, in *CIR v Pick 'n Pay Employee Share Purchase Trust*,[4] the Appellate Division reaffirmed that the question whether receipts are capital or income is a matter of inference from the facts 'and therefore ultimately a question of law'. (However, counsel for the commissioner pointed out, on the other

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[2] ITC 1867, 75 SATC 273 in paras 5-51.
[3] Counsel cited *S v Naidoo* [2002] 4 All SA 710 (SCA) para 26; *Mkhize v S* [2014] ZASCA 52 para 14 in support of these submissions.
[4] 1992 (4) SA 39 (A) at 56G-H (majority judgment per Smalberger JA) and at 51H-J (minority judgment per Nicholas AJA). See also *Revenue* 22 *Lawsa* (2ed) para 49 n 7 and the authorities cited therein.

hand, that the question as to the intention of the taxpayer, although also a matter of inference from the facts, is regarded as a question of fact.[5])

[7] While it is true that the *onus* of establishing the facts from which the desired inference should be drawn is on the taxpayer,[6] this factor is not a material consideration where, as in this instance, the primary facts are either common cause or not in dispute.[7] In the absence of adverse credibility findings against any of the witnesses, this court is accordingly at large to consider the issues afresh.

Capital or revenue

[8] Turning to consider this perennial problem in tax cases,[8] it has been pointed out that '[t]here is no simple and universally valid litmus test, the decision whether particular income falls on the one side of the ill-defined borderline between capital and revenue or on the other being "a matter of degree depending on the circumstances of the case"'.[9] This has given rise to 'unpredictability of the outcome of assessments'[10] and has spawned a substantial body of jurisprudence.

[9] In *ITC 1185*,[11] Miller J observed:

'The test to be applied when it is necessary to determine whether profit made on the sale of property by a taxpayer represents revenue or a receipt of a capital nature has been formulated in many ways but there is no essential difference to be found

[5] *Lawsa op cit* para 51 n 3 and the authorities cited therein.
[6] *Pick 'n Pay supra* at 52A.
[7] *Ibid,* at 56G-H.
[8] See eg the opening remarks of Miller J in ITC 1185; (1972) 35 SATC 122 (N) at 122-3.
[9] *CIR v Guardian Assurance Co South Africa Ltd* 1991 (3) SA 1 (A) at 19D-F per Kriegler AJA.
[10] *Lawsa op cit* para 49.
[11] *Supra, loc cit.*

between any one formulation and another and in so far as the general approach to the problem is concerned. The fundamental inquiry is whether, in buying and selling the property and thus earning the profit which is the subject of the inquiry, the taxpayer was *engaged in carrying on a trade or business or profit-making scheme*. If that is what he was doing, the profits are income and taxable in his hands. If however, he held the property as an investment of capital the realisation of the asset would simply be a conversion of the capital asset to cash, which he would receive and hold as capital, not as revenue.' (Emphasis added)

[10] Meyerowitz and Spiro on *Income Tax* para 299 referred to the 'rather clumsy phrase', 'operation of business in carrying out a scheme of profit-making' (partially italicised in the above extract) which, in plain language, means 'that receipts or accruals bear the imprint of revenue if they are not fortuitous, but designedly sought for and worked for'. This formulation was quoted with approval in the majority judgment in the *Pick 'n Pay* case *supra*.[12]

[11] A variety of tests are employed in order to determine whether or not a particular receipt is one of a revenue or capital nature. They are laid down as guidelines only – there being no single infallible test of universal application; 'no simple and universally valid litmus test', as Kriegler AJA put it. One of the most widely used tests applied by our courts over the years – described by *Silke on South African Income Tax*[13] as the 'golden rule' – is the test of 'intention': with what intention did the taxpayer acquire and hold the asset? However, such intention is not conclusive, nor should the *ipse dixit* of the taxpayer as to his or her intention be accepted without critical scrutiny, since it may be coloured

[12] At 57F.
[13] AP de Koker and RC Williams *Silke on South African Income Tax* (SI 51, March 2014) para 3.2.

by self-interest,[14] or it may prove to be unreliable or constitute pure reconstruction. Instead, such evidence should be weighed with great care against the objective facts surrounding the transaction.[15]

[12] When considering the intention of a taxpayer, it is important to bear in mind, as Smalberger JA pointed out in *Pick 'n Pay supra*, that '[i]n a tax case one is not concerned with what possibilities, apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself. One is solely concerned with his object, his aim, his actual purpose.'[16] Put differently, the concept of *dolus eventualis* as applied in criminal law has no place in the context of tax law. Consequently, it is important not to confuse contemplation with intention in the above sense.

[13] Another test frequently applied by the courts in this context is to distinguish between 'fixed capital', on the one hand, and 'floating capital', on the other. The distinction was explained by Innes CJ in *CIR v George Forest Timber Co Ltd*,[17] as follows:

'Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it remains intact.'

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[14] ITC 1185 *supra* at 121.

[15] *Malan v KBI* 1983 (3) SA 1 (A) at 18G. These principles were recently reaffirmed by the Supreme Court of Appeal in *SARS v Pretoria East Motors (Pty) Ltd* [2014] ZASCA 91 para 8.

[16] At 58E-G

[17] 1924 AD 516 at 524. See also *Solaglass Finance Co (Pty) Ltd v CIR* 1991 (2) SA 257 (A) at 269J-270J and the cases referred to therein; *Lawsa op cit* para 49.

[14] These tests, though easy to state, are not always easy to apply in practice, as the plethora of cases in our law reports and widely divergent opinions expressed therein amply illustrate. Ultimately, each case has to be decided on the basis of its own facts.

Discussion

[15] In his grounds of assessment, the commissioner contended that at the time the JDG shares were acquired by the appellant, it did not intend to hold them as capital assets and/or for purposes of earning dividends, but intended to dispose of them in the short term for profit; ie 'in relation to the JDG shares it carried on business in pursuance of a scheme of profit-making', as it was put in the grounds of assessment. The commissioner based this contention, *inter alia*, on the objective facts that the JDG shares were held for less than five months before being disposed of; that the purchase of the shares was financed from external sources, and not from the appellant's available funds; and that the appellant could not benefit from the dividends generated by the JDG shares, such dividends being earmarked for paying preference dividends and/or repaying the short-term shareholder loan.

[16] The objective facts relied on by the commissioner are among the considerations often invoked to support an inference that the shares were acquired in pursuance of a scheme of profit-making and that the proceeds of the sale are accordingly of a revenue nature. However, even if the objective facts suggest that the amount in question is *prima facie* of a revenue nature, the taxpayer may be able to provide an explanation to rebut such inference. The taxpayer's explanation of the events, including

his or her intention in respect of the transaction in question, is therefore relevant and must be tested in the light of all the other circumstances.[18]

[17] In this instance, it is clear to me that it would be an over-simplification to focus too closely on the bare facts outlined above in drawing an inference as to the intention of the taxpayer. The true factual matrix as it emerges from the voluminous evidence before us is far more complex and nuanced. It is essential, therefore, to consider the objective facts relied on by the commissioner in the broader context of the evidence as a whole.

Intention of the taxpayer

[18] There was some debate before us regarding the intention of the taxpayer in this case, more particularly whether such intention is to be determined with reference to the state of mind of Mr Daun or Mr Jooste. The tax court found that Mr Jooste should, for purposes of this enquiry, be regarded as the 'brain' of the company.[19] Counsel for the appellant took issue with this finding and argued that Mr Daun was for all relevant purposes the 'brain'. They also referred to the undisputed evidence that Mr Daun was the 'captain of the ship', as he repeatedly described himself in the course of his evidence. Mr Jooste was merely a 'passenger'.

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[18] *Lawsa op cit* para 50.
[19] Judgment paras 67 and 78.

[19] In the view that I take of the matter, it does not really matter whether one regards the one or the other as the 'brain', as it makes no difference to the eventual outcome for reasons that will appear in due course.

[20] Dealing briefly with the objective factors on which the commissioner relied, it is true that the shares were finally acquired by the appellant only on 5 December 2003 and they were sold less than five months later. If an investor in the street had acquired JDG shares on the same day and disposed of them five months later at a substantial profit, there could be little argument if the commissioner were to tax the resultant profit as revenue. However, as appears from the judgment of the tax court,[20] this is not what happened in the present case. The effective date of the transaction as a whole dates back to 21 June 2002. It is accordingly at that date that one must look when considering the period for which the asset was held.

[21] Moreover, the purpose behind the acquisition of the shares has been fully explained on behalf of the taxpayer, based on facts which are *sui generis*. This appears, *inter alia*, from an affidavit prepared for submission to the Competition Commission in order to obtain the necessary approval for JDG to take over management of Profurn. It sketches in some detail the origin and relevant background to the transaction as well as Mr Daun's motivation for entering into the deal:

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[20] Judgment para 56. See also paras 7, 8 and 28.

‘4. I am indirectly still the holder of approximately 13% of the total issued share capital of Profurn and having had intimate knowledge of the company and being a major contributor towards its success, I am saddened as to what has transpired and the fact that the company could collapse as a result of its debt burden, lack of management and other negative factors.

5. I have been approached by FirstRand Bank Limited, a major creditor and shareholder of Profurn, to mount a rescue operation (in the sum of R600 million) and I am prepared to do so conditionally upon same being structured through JD Group Limited which, in my opinion, is the only competent professional manager in the retail furniture industry in South Africa which can turn around the businesses of Profurn and in the absence of which same will in my opinion result in a massive corporate failure.’

He thereupon sketched the two possible scenarios that may arise regarding Profurn, depending on whether the *de facto* situation is retained, or whether the ‘rescue mission’ is successful. He concluded as follows:

‘7. I emphasise that I will not be prepared to mount any rescue operation and invest the substantial amount afore-referred to unless the JD Group Limited is placed in immediate management control thereby being able to address all the negative aspects or the business. It is in my opinion not possible to deal with such issues in three to four months’ time as based upon the present trading losses being sustained by Profurn, it will not survive such period and even if it did, the nature of the business three to four months down the line would not evidence any interest for me.’

[22] This is a crucial piece of evidence, which was not challenged in cross-examination nor was it contradicted by any other evidence. The reasons why a court is ordinarily wary of accepting the *ipse dixit* of a

taxpayer as to his or her intention[21] are absent in this instance, as the affidavit was deposed to by Mr Daun on 12 June 2002, ie some nine days *prior* to the effective date of acquisition of the asset. The contents of affidavit make it clear that the whole purpose behind the scheme was a 'rescue operation', not a profit-making scheme.

[23] That this was indeed the dominant purpose behind Mr Daun's decision to acquire the JDG shares is borne out by the fact that this decision was made at a time of great economic uncertainty; was attended by considerable risk; and that a period in excess of three years was anticipated by all concerned as being the minimum time that would be required before the transaction could be 'bedded down' – if indeed it was 'bedded down' at all – for which period the appellant and Daun et Cie were committed to remain as shareholders. Moreover, the success of the venture was by no means assured and depended on a number of uncertain factors:[22]

- Dr Lategan testified that 'these were absolute desperate times' when the transaction was concluded.

- Mr Jooste confirmed this when he testified that 'in 2001 the [furniture] industry was really in deep trouble'.

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[21] Para [11] above.

[22] Compare the remarks of Smalberger JA in a similar context in *Pick 'n Pay supra* at 58H-I, where he stated:

> 'A different conclusion might have been justified if the making of profits was inevitable. But this was not the case. The prospect of profits was highly problematical. They depended upon the degree of success achieved by the scheme.'

- In the words of Mr Muller, 'Profurn was nearly bankrupt and it was debatable whether JD would make it, you know, to turn around quickly and successfully'.

- To illustrate the risk of failure, Dr Lategan pointed to the fact that after Mr Daun had committed himself to the deal in terms of the MOU, the share price of Profurn deteriorated by a further 50c, from the agreed acquisition price of R2,80 to R2,30 per share.

- At that stage, Profurn faced imminent liquidation. This threatened to destabilise the entire retail furniture industry in South Africa, in which both Mr Daun and Mr Jooste were major players. Moreover, Profurn also owed between R70–90 million to Steinhoff, of which Mr Jooste was the chief executive and Mr Daun was a director. Thus, from both their perspectives the rescue of Profurn via a merger with JDG was seen as essential in order to protect Steinhoff from economic harm and at the same time to restore stability to the industry.

[24] The objective evidence thus shows overwhelmingly that the transaction involved a large-scale rescue operation in the South African furniture industry, one that was anticipated to require both capital and management expertise; that it would take between three and five years to be successfully accomplished (if at all); and there was no short-term intention on the part of anyone who participated in the arrangements concerning the JDG shares. This is further borne out, *inter alia*, by the facts – (a) that the acquisition of the JDG shares was accompanied by the assumption of a five-year indemnity to the extent of R125 million (R62.5 million, in the case of the appellant), which five-year period was later

extended until 23 April 2010; and (b) that Mr Jooste attempted to raise finance for the JDG transaction for a 3 to 5 year period.

[25] In summary, the appellant's intention when it first decided to acquire the JDG shares was to make a strategic investment in a leading company in the furniture industry and to hold those shares for however long it took to turn around the Profurn ship, which was anticipated to take in excess of three years.

[26] In the light of this evidence, the tax court held, correctly in my view, that '[t]he objective evidence, read as a whole, suggests that the investment in the JDG shares was to last for a period of at least 3 years, arguably slightly longer, depending upon the success of the venture.'[23]

[27] Somewhat surprisingly, therefore, the tax court later concluded:

'The evidence concerning the intention on acquisition is thus not definitively in appellant's favour; it does no more than show that there was always an intention to realise the shares for a significant profit. The question was not if but when a sale would occur. Hence, a profit making intention was always a dominant purpose within the mind of those who controlled appellant; . . .'[24]

and

'. . . the evidence does not provide an answer, on the probabilities, that this was to be a long term investment. There may have been a purpose to so hold, but there is no clear proof of it being the dominant purpose. . . . When both the purpose at the time of acquisition and sale are considered, it cannot be concluded, on the probabilities,

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[23] Judgment para 68.
[24] Judgment para 77.

that a long-term investment was realised to best advantage. To the contrary, the mixed intention had converted into a clear purpose of selling to "cash in" on the profit.'[25]

[28] I respectfully disagree with the reasoning contained in these extracts. First, these findings are contrary to the weight of the evidence and the court's own earlier finding referred to above to the effect that 'the investment in the JDG shares was to last for a period of at least 3 years, arguably slightly longer'. Secondly, it was not incumbent upon the appellant to prove that the intention on acquisition of the shares was 'definitively' in its favour; a balance of probability is sufficient. Thirdly, it was likewise not incumbent upon the appellant to prove that that it bought the JDG shares as a 'long-term investment'; all that it was required to prove was that it did not buy the JDG shares as trading stock in pursuance of a scheme of profit-making.

[29] As for the decision to sell, the tax court placed considerable reliance on this fact in finding that the earlier 'mixed' intention had converted into a clear purpose of selling to 'cash in' on the profit. For the reasons I have stated above, I read the evidence somewhat differently and differ from the assessment as to an earlier 'mixed' intention on the part of the appellant. As for 'cashing in' on a profit, this is neither here nor there: any investor who sells a capital asset at a profit after holding it for some length of time also 'cashes in' on its profit. In any event, the alleged 'intention to realise the shares for a significant profit' was no more than a fond hope that the transaction would turn out to be successful. It does not convert the transaction into a profit-making

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[25] Judgment para 78.

scheme. As mentioned earlier, it is not what the taxpayer *contemplated* that is relevant, but 'his object, his aim, his actual purpose'.[26]

[30] In so far as the tax court sought to justify its conclusion with reference to 'the duration of the Gensec loans [which] only adds to the picture of a mixed intention', the duration of the loans has been fully explained by the appellant. As rightly pointed out by the tax court, Mr Jooste had initially attempted to raise finance for the transaction for a maximum of a 3 to 5 year period.[27] This was going to be granted by Gensec until its holding company, Sanlam, decided to scale down its (Gensec's) operations and Mr Muller (with some trepidation) had to break this news to Mr Jooste. The point is that it was not the appellant's decision to settle on a relatively short-term loan with Gensec; it had no control over it whatsoever.

Decision to sell

[31] The intention at the time when the asset was disposed of may be relevant for different reasons. In *Lawsa,* the position is summarised as follows:

'The taxpayer's intention at the time when the asset was disposed of is relevant in determining the capital or revenue nature of the proceeds of the disposal. If the taxpayer's intention at that time was merely to realise a capital asset, this supports a conclusion that the proceeds of the disposal are capital; but if the taxpayer's intention at the time of disposal was to treat the asset as trading stock, this suggests that the proceeds of the disposal are income, and the intention with which the asset was acquired and held will be irrelevant. The possibility of a change of intention by the

[26] *Pick 'n Pay supra*.
[27] Judgment para 70.

taxpayer, between acquisition and disposal of the asset, must be considered. A different intention at these two points implies that there has been a change of intention in the interim.'[28]

[32] The tax court referred to the fact that '[w]ithin a very short period however, the sale of the JD shares was on the agenda, initiated by Mr Jooste and explored further by Mr Daun'. From this fact it drew the inference that the appellant's perceived 'mixed intention had converted into a clear purpose of selling to "cash in" on the profit'. However, this inference is based on a shaky foundation, as the decision to sell must again be seen in proper context. As mentioned earlier, the shares were effectively acquired during June 2002, not December 2003. Moreover, the circumstances that prevailed at the time when the decision to sell was made were materially different from those prevailing during the middle of 2002, when the obligation was incurred. Since the effective date, much had changed: 'miraculously the world economy changed in about 2003/2004', in the words of Dr Lategan. The management takeover of Profurn by JDG's Mr Sussman and the 'unique turnaround strategy' employed turned out to be an unqualified success, which contributed to the Profurn 'ship' being 'turned around' in a much shorter period than anticipated. Of course, all of this was reflected in a substantial increase in the price of JDG shares between the effective date in 2002 and the eventual date of sale in 2004.

[33] On the negative side, there was the fact that during the latter part of December 2003 and the first months of 2004, the South African Rand weakened significantly, losing value at an alarming rate against major

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[28] *Lawsa op cit* para 51.

currencies, with foreign investors, including Mr Daun, becoming increasingly nervous about the outlook for the South African economy and its ability to generate investment returns in terms of foreign currency risk. He explained that he reassessed his investment portfolio, which he regarded as having become disproportionately exposed to the South African Rand at that time. His large exposure to the South African currency, together with structural economic-risk factors, resulted in Mr Daun becoming inclined to realise certain of his interests in South Africa.

[34] More or less at the same time, Mr Jooste – quite fortuitously – came to hear, through his association with Citibank in the context of a completely unrelated transaction, that it would be theoretically possible to dispose of a substantial parcel of shares of a listed company by means of a process of 'book building'. This process was subsequently explained to, and found favour with, Mr Daun. He accordingly approached Mr David Sussman of JDGroup, to whom he had given a commitment when the transaction was conceived that he would stay the course and would remain invested until the Profurn ship had been turned around, or 'bedded down'. To his surprise, Mr Sussman released him from his commitment without demur. Finally, his wife (and financial confidante) also urged him to sell. All of these factors contributed to Mr Daun's decision, late in March 2004, to sell the whole parcel of JDG shares.

[35] This was confirmed in the evidence of Mr Daun, where he replied in the affirmative to the following question during cross-examination:

‘Let me understand this: your inclination to sell JD Group shares came only because of the approach from Citigroup?’ and Mr Daun replied ‘Yes’.

Later during cross-examination, the following exchange took place:

‘Simply put, Mr Daun, it’s not that you owned these shares and then had a change of heart and decided to sell them: you owned these shares, an opportunity presented itself to you, and you took that opportunity. --- Yes, I must repeat what I told yesterday about meeting with my wife, and I was always unsecure, do it or not do it. You know when in life and you make decisions, you think what is the *pro*, what is the *contra*, was I missing future opportunities. So the original plan was not to sell. Therefore it was a change of my original intention was this book building on the table. And then the last kick might have come from my wife, that she said why you not taking this? It’s an opportunity on the table, cash on the table – take it. And then I decided on this, ja, and I accepted that.’

[36] He also explained that the decision to sell was ‘an opportunistic decision’ which could not have been contemplated when the shares were acquired in 2002.

[37] In *ITC 1185, supra*,[29] Miller J held:

‘The fact that a property is sold for a substantial profit very soon after it has been acquired is, in most cases, an important one in considering whether an inference adverse to the taxpayer should be drawn, but it loses a great deal of its importance when there has been a *nova causa interveniens*.

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[29] 35 SATC 122 at 128.

[38] Counsel for the appellant relied on the evidence quoted above in support of a submission that the approach from Citigroup was solely responsible for Mr Daun's inclination to sell the JDG shares, and that this represented a *nova causa interveniens* as contemplated by Miller J. In my view, this argument is sound.

[39] In the final analysis, the decision to sell was taken by Mr Daun for reasons that have been explained. The appellant, as a separate legal entity, had no say in the matter: it was a junior partner in a consortium controlled by Mr Daun. It was a material term of the underlying agreement that Mr Daun would control the decision when to sell the parcel shares as a whole; not only his 50% thereof. As a fact, therefore, the appellant had no choice in the matter. In the circumstances, the intention of the appellant at the time of the sale is irrelevant in determining the question whether the asset was of a capital or revenue nature. Its only intention at that time was to honour its commitment to its consortium partner.

[40] Apart from the considerations referred to above, there are further objective factors that point in the direction of the shares being acquired and held as a capital asset:

- The sole purpose of the appellant was to acquire and hold the JDG shares, and that – as an SPV – the appellant engaged in no activity whatsoever other than what was required by the acquisition and holding of the shares. Indeed, the appellant was contractually precluded from doing anything else. This tends to strengthen the inference of the shares being held as fixed, as opposed to floating, capital.

- This was also the way the asset was reflected in the appellant's financial statements for the financial year ending February 2004, namely as 'non-current assets'. Thus, the appellant clearly did not regard the relevant asset as 'trading stock', or 'stock-in-trade', or 'floating capital'.

- In any event, as pointed out by Smalberger JA in *Pick 'n Pay supra*: 'Where no trade is conducted there cannot be floating capital.'[30] In this case, it is clear that the appellant conducted no trade; it did not even hold board meetings.

[41] On the evidence as a whole, the inference is accordingly more probable, to my mind, that the JDG shares were acquired and held by the appellant as a capital asset. I am accordingly satisfied that the taxpayer has discharged the onus of proving on a balance of probabilities that the JDG shares constituted capital and they were acquired with a capital intention.

Change of intention?

[42] There was some debate before us on the question whether the eventual decision to sell the shares should be seen as a change of intention on the part of the taxpayer. The significance of such a change in intention lies in para 12(2)(*c*) of Schedule 8 to the Act, which provides that there would have been a deemed disposal of the JDG shares on the date of the change of intention, and the difference between the cost of the shares and their value on the date of the change of intention would be subject to capital gains tax. The difference between the market value on

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[30] At 60E.

such date and the eventual proceeds would then be subject to income tax because they were not of a capital nature.

[43] On the facts of the present case, it would make very little difference to the appellant's overall tax liability, given our finding as to the capital nature of the asset in question. Nonetheless, I am satisfied on the evidence as a whole that the decision to sell was simply one to dispose of a capital asset; not to convert a capital asset into trading stock. The distinction is a subtle but important one. It was recognised in *John Bell and Co* (*Pty*) *Ltd* v *SIR*,[31] where Wessels JA held:

'. . . the mere change of intention to dispose of an asset hitherto held as capital does not *per se* subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and so render its proceeds of gross income. For example, the taxpayer must already be trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and in either case, the asset in question is taken into or used as his stock-in-trade.'

[44] In the result, the profit realised from disposal thereof can in my view only be described as 'fortuitous', in the sense as explained by Smalberger JA, with the result that it constituted receipt of a capital nature within the definition of 'gross income' in s 1 of the Act.

[45] It follows that the appeal should succeed.

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[31] 1976 (4) SA 415 (A) at 429C-D.

Deductibility of equity kicker and indemnity obligation

[46] Turning now to the deductibility of the expenses claimed in respect of the equity kicker and the indemnity obligation, these issues, as mentioned earlier, were decided in favour of the appellant by the tax court, which findings gave rise to the cross-appeal herein. Having found that the proceeds of the sale were of a revenue nature, the tax court held that both items qualified for deduction from the appellant's taxable income in terms of s 11(a), read with s 23(g), of the Act as being 'expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature'.

[47] In the light of our finding that the tax court erred in finding that the proceeds of the sale were of a revenue nature, it follows that the cross-appeal has become academic. This court nevertheless now has to consider whether the items in question formed part of the 'base cost' of the JDG shares for capital gains tax purposes as being 'expenditure actually incurred in respect of the cost of acquisition or creation of that asset', as contemplated by para 20(1)(a) of schedule 8 to the Act. The commissioner resisted a finding to that effect, contending that the amounts in question should be included in the appellant's capital gain.

Equity kicker

[48] The background to the liability to pay the equity kicker is dealt with in paras 32 and 80–90 of the judgment of the tax court. In a nutshell, the liability arose from the loan agreement for R150 million between the appellant's holding company, BVI, and Gensec, in terms of which Gensec would, in addition to interest on the loan, be entitled to a share of the profit (if any) yielded by the investment.

[49] The commissioner's opposition to this claim is based on the contention that the sum paid by the appellant to Gensec in relation to the equity kicker was paid on behalf of BVI and in settlement of its (BVI's) obligation to Gensec. Such liability was not delegated or transferred to the appellant, with the result that payment was made by the appellant in the absence of any unconditional legal obligation requiring it to do so, and no deductible expenditure was incurred by the appellant, so it was argued.

[50] The tax court rejected this contention and found, instead, that the obligation to pay the equity kicker was, 'in substance', incurred by Capstone, which was required to discharge the obligation;[32] and that it was Capstone 'which "really" incurred the obligation and which is thus entitled to the deduction as opposed to BVI, because it "actually", as employed in the context, incurred the liability'.[33]

[51] In this court, counsel for the commissioner assailed these findings and pointed, *inter alia*, to the absence of any written confirm-ation of the alleged arrangement between the appellant and BVI. They also placed strong reliance on the fact that the financial statements of neither company reflect such an arrangement.

[52] These arguments are by no means without merit, but I am un-persuaded that the tax court erred in its finding that it was the appellant who actually incurred the expense. In my view, the approach adopted by the commissioner is overly formalistic and fails to have regard to the

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[32] Judgment para 89.
[33] Judgment para 90.

basic commercial reality of what actually took place. I am accordingly satisfied that the appellant is indeed the party that actually incurred the expense.

[53] However, this is not the end of the enquiry, as the commissioner contended in the alternative that the equity kicker forms part of the 'borrowing costs' of the transaction. In this regard, reference is made to para 20(2) of schedule 8, which provides that –

'[t]he expenditure incurred by a person in respect of an asset does not include any of the following amounts—

(a) borrowing costs, including any interest as contemplated in s 24J or raising fees'.

[54] The concept, 'borrowing costs'[34] is not defined in schedule 8 or elsewhere in the Act. It is not necessary for this court to attempt to lay down an exhaustive definition of the concept, but simply to attribute meaning thereto in order to answer the question whether the equity kicker, as applied in this case to the loan agreement between BVI and Gensec, falls within its ambit. In this process, the court must employ the technique prescribed by Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality*.[35] As stated therein, '[t]he inevitable point of departure is the language of the provision itself, read in context and having regard to the purpose of the provision and the background to the preparation and production of the document'. Moreover, '[t]he process is objective not subjective'.[36]

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[34] Afrikaans: *leenkoste*.
[35] [2012] ZASCA 13; 2012 (4) SA 593 (SCA) para 18.
[36] *Loc cit* (footnote omitted).

[55] The context in which the words appear is in a schedule to a fiscal statute, dealing specifically with capital gains tax. The words are used in a section excluding certain expenditure for purposes of calculating the base cost of an asset. In seeking to achieve that purpose, the legislator has deliberately, it seems, utilised a concept of very wide import, namely 'borrowing costs'. It has gone further and expanded that wide meaning by incorporating by reference the equally wide definition of 'interest' in s 24J(1) of the Act, which includes (as far as is relevant for present purposes):

'(a) gross amount of interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;

(b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and

(c) …

irrespective of whether such amount is –

(i) calculated with reference to a fixed rate of interest or a variable rate of interest; or

(ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.'

[56] As I read these provisions of para 20(2)(a), their purpose is to exclude from deductible expenditure the overall costs expended by a taxpayer in acquiring an asset with borrowed money.

[57] Applying that interpretation to the facts in this case, Gensec's Mr Muller described the concept of an equity-backed finance transaction as one in which the lender could get a higher return. Gensec's higher return on its investment was justified, according to him, because of the greater risk it undertook. Gensec described the equity kicker as an 'IRR' (Internal rate of return). The IRR calculations by Gensec on the loans show that it regarded the equity kicker as part of its return on the investment, ie a cost of finance or borrowing cost. Muller in cross-examination conceded that the equity kicker made Gensec a 'healthy return' on its investment. In summary, it is clear that the equity kicker obligation arose under the loan agreement in question and formed part of the *quid pro quo* for the loan. It was (in the same way as interest) a type of consideration for the loan of money; or, put differently, part of the cost of borrowing.

[58] I accordingly conclude that the equity kicker clearly constitutes a 'borrowing cost' for purposes of para 20(2)(*a*) of schedule 8. This would ordinarily result in all such borrowing costs being excluded from the base cost calculation. However, para 20(2) itself creates an exception to this rule in relation to 'borrowing costs and expenditure contemplated in subparagraph (1)(g)': this sub-paragraph makes provision, *inter alia*, for expenditure directly related to the cost of an asset which constitutes 'a share listed on a recognised exchange'. The transaction under consideration falls, of course, squarely within that exception in relation to the listed JDG shares in question. It follows that one-third of the interest forms part of the base cost which may be deducted.

[59] In the final result, an amount of R30 082 033 (two-thirds of the amount of R45 123 050) falls to be included in the capital gain on the basis that it does not constitute part of the base cost of the shares by virtue of the provisions of para 20(2)(a), read with para 20(1)(g) of the schedulre.

Indemnity

[60] As for the claim in respect of the indemnity obligation, the facts appear from paras 29, 33 and 91–94 of the judgment. Based on those facts, the tax court concluded as follows:

> 'This evidence serves to indicate that, as at July 2004, the appellant had assumed an unconditional liability towards Daun et Cie in the amount of R55 million. This amount was then recorded as a loan in the appellant's books of account ending 28 February 2005. . . . The evidence revealed that the appellant's liability to Daun et Cie in respect of this indemnity was subsequently settled by way of a set off. However that does not mean that this Court is not entitled to conclude that R55 million was expenditure actually incurred during the 2005 year of assessment, because in that year of assessment an unconditional liability to pay that amount had been created.'[37]

[61] Assuming, without deciding, that the tax court's reasoning quoted above is sound and that the appellant had assumed an unconditional liability towards Daun et Cie during the relevant tax year, this leaves the more fundamental question unanswered, namely whether the liability assumed towards Daun et Cie can be regarded as expenditure incurred in respect of the 'cost of acquisition' of the shares. The fact of the matter is that the appellant's original indemnity obligation to

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[37] Judgment para 95.

FirstRand was contingent in nature. By the time of the sale of the shares, the appellant had not incurred any obligation in terms of the indemnity and it was uncertain whether any such obligation would ever be incurred. The original indemnity liability thus remained contingent as at the date of the sale of the shares and no liability attached to the appellant in respect of the indemnity to FirstRand, given its contingent nature. In the result no amount associated with it could have formed part of the base cost of acquiring the shares.

[62] This contingent liability to FirstRand, which may never have materialised, was voluntarily converted into an unconditional liability to Daun et Cie *after* the sale of the shares. The subsequent 'indemnity settlement obligation' undertaken by the appellant in favour of Daun in the sum of R55 million was therefore something completely new and served a different purpose. It was incurred as a direct consequence of the sale of the JDG shares, and its purpose was to clear up unresolved issues in the appellant after the sale of the shares. I accordingly agree with the commissioner's contention that the indemnity settlement amount thus incurred by the appellant in favour of Daun *et* Cie constitutes a *novus actus interveniens*, entirely separate from the acquisition of the JDG shares. The cost may therefore more properly be regarded as a cost of *disposal*, not a cost of *acquisition*.

[63] It follows that the amount of R55 million falls to be included as part of the appellant's capital gain in disposing of the shares.

Costs

[64] The above result means that the appellant was successful on appeal in relation to the main issue, which would ordinarily entitle it to its costs of appeal. Although the cross-appeal has become academic, the commissioner's alternative contentions with regard to the equity kicker and the indemnity obligation were, substantially, upheld in this judgment. The commissioner thus succeeded in achieving partial success, which cannot be regarded as negligible in the light of the substantial amounts involved. I would accordingly regard it as fair to make some adjustment to the costs recoverable by the appellant. On a fairly robust assessment of the varying degrees of success and the relative costs involved, I regard it as fair to hold the respondent liable for 80% of the appellant's costs of the appeal.

[65] In the light of the fact that the issue of costs and the basis that I have proposed has not been canvassed before us during argument, this part of the order will be provisional. The parties will be granted leave, if so advised, to address written submissions to this court, within five (5) court days from the date of this judgment, to show cause why the proposed order regarding costs should not become final. In the absence of any submissions, the provisional order will become final.

Order

[66] For the reasons set out above, the following order is issued:

(a) The appeal is upheld and the additional income tax assessment in respect of the appellant for the 2005 tax year is set aside and referred back to the Commissioner for reassessment in the light of this judgment.

(b) The respondent is ordered to pay 80% of the appellant's costs on appeal, including the costs of two counsel.

(c) Paragraph (b) of this order is provisional. The parties are granted leave, if so advised, to address written submissions to this court, within FIVE (5) court days from the date of this judgment, to show cause why the proposed order regarding costs should not become final, failing which, the provisional order will become final.

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B M GRIESEL
Judge of the High Court

YEKISO J: I agree.

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N J YEKISO
Judge of the High Court

BAARTMAN J: I agree.

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E D BAARTMAN
Judge of the High Court