THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

MEDIA SUMMARY OF JUDGMENT DELIVERED IN THE SUPREME COURT OF APPEAL

FROM The Registrar, Supreme Court of Appeal

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Please note that the media summary is for the benefit of the media and does not form part of the judgment.

CSARS v Capstone 556 (Pty) Ltd (20844/2015) [2016] ZASCA 2 (9 February 2016)

MEDIA STATEMENT

Today, the Supreme Court of Appeal (SCA) dismissed the appeal of the Commissioner for the South African Revenue Service (SARS), and upheld the cross-appeal of Capstone 556 (Pty) Ltd (Capstone), against an order of the Western Cape Division of the High Court, Cape Town. In the result, the SCA (i) confirmed that the profit of almost R400 million made by Capstone from the sale of approximately 17 million shares in a company, JD Group Ltd (JDG), was of a capital nature and not of a revenue nature, even though Capstone had paid for and obtained transfer of the shares less than a year before; and (ii) held that the amount of R55 million in respect of a tax liability flowing from the original acquisition transaction formed part of the base cost of the shares.

The issues before the SCA where (i) whether the profit from the sale of the shares was of a revenue or capital nature; and (ii) whether a contingent liability incurred by Capstone as part of the share purchase transaction, which was later converted into an unconditional liability to a third party, formed part of the base cost of the shares.

The shares that formed the subject of the dispute were acquired by Capstone as a result of a corporate restructuring of a JSE-listed furniture business, Profurn Limited (Profurn), which was in severe financial difficulty. The turnaround strategy that was adopted involved the merger of Profurn with another more financially sound furniture business, JD Group Limited (JDG), in return for JDG shares. The shares would initially be issued to First Rand Bank Ltd (FirstRand), who would then on-sell them in various quantities to, amongst others, Capstone. The shares were eventually paid for and transferred by FirstRand to Capstone in December 2003, and were sold less than a year later, in April 2004, for a profit of almost R400 million.

With regard to the first issue, SARS argued that this profit must be taxed as being of a revenue nature, while Capstone argued that it was of a capital nature. The SCA reaffirmed that the applicable test for determining whether a profit must be treated as revenue is whether it is a gain made by operation of a business in carrying out a scheme of profit-making. If so, it is of a revenue nature. If not, it is of a capital nature. And where a profit is the result of the sale of an asset, the intention with which the taxpayer had acquired and held the asset is of great importance and may be decisive. The court held that this was the case here.

Although the shares in question were sold less than a year after Capstone acquired ownership over them, which would ordinarily suggest a short-term transaction, the SCA held that in substance, risk and reward was acquired by Capstone at a much earlier date, in June 2002. This is the date on which a binding memorandum of understanding was signed by the various parties laying out the turnaround strategy, and fixing the price at which Capstone was to acquire the shares. This is the relevant date to assess the intention with which the acquisition was made. And at that date, it was clear that Capstone and its controllers expected the turnaround to take between three and five years, and they viewed the enterprise as an investment to rescue the business of Profurn. Capstone's controllers did contemplate the potential sale of the shares at some point in the future, but this was merely one of many options, after a significant period, and not the dominant purpose behind the acquisition. Accordingly, the nature of the profit fell to be treated as capital.

With regards to the second issue, part of the acquisition price for the shares that Capstone agreed to pay to FirstRand was an indemnity in respect of certain tax liabilities incurred by Profurn. Capstone subsequently wanted to finalise the entire transaction and so wished to replace its contingent liability to FirstRand with a quantified and unconditional liability. Accordingly, in the 2005 year of assessment, it was agreed between Capstone and another company involved in the restructuring transaction, Daun et Cie, that Capstone would pay Daun et Cie R55 million if Daun et Cie took over Capstone's contingent liability to FirstRand. The SCA held that it was clear that the initial contingent liability was part of the base cost. The SCA held that it was also clear that the obligation to pay R55 million was undertaken in substitution of the contingent obligation to FirstRand, and accordingly that the liability to FirstRand was 'converted' into liability to Daun et Cie. Overturning the ruling of the court a quo, the SCA held that there was no break in the chain of causation, and the acquisition of the shares remained the *causa causans* of the indemnity settlement. It therefore formed part of the base cost of the acquisition of the shares.

Accordingly, the SCA dismissed SARS' appeal, and upheld Capstone's cross-appeal.

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