REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT, JOHANNESBURG

CASE NO: 12644

(1) REPORTABLE: YES
(2) OF INTEREST TO OTHER JUDGES:NO
(3) REVISED.

13 February 2012 ....
DATE SIGNATURE

In the matter between:

A (PTY) LIMITED Applicant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

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J U D G M E N T

COPPIN, J:

[1] This is an appeal in terms of the Income Tax Act, 1962 ("*the Act*") against the respondent's dismissal of an objection raised by the appellant to the respondent's assessment for the year 2003 in which the respondent reduced and disallowed a capital loss claimed by the appellant in respect of

the redemption of redeemable preference shares ("*preference shares*"), which it held in B Ltd, by B Ltd, on the basis that the loss was a "*clogged loss*" contemplated in paragraph 39(1) of the Eighth Schedule of the Act.

[2] There were essentially two main issues between the parties that were argued before us. The order in which I mention them is not in the sequence in which they were argued.[1] The first issue, which is purely one of law, relates to the interpretation of paragraph 39(1) of the Eighth Schedule of the Act ("paragraph 39(1)") and, more particularly, whether that paragraph applied to the redemption of the preference shares and accordingly rendered the appellant's capital loss, as a result of the redemption of the preference shares, a "*clogged loss*"[2] because of the connection between the appellant and B Ltd.[3] The second issue relates to the quantum of the appellant's capital loss and, more particularly, to the meaning of the word, "*recovery*" in paragraph 20(3) of the Eighth Schedule of the Act ("paragraph 20(3)") (which is a legal issue) and whether the appellant actually recovered part of the cost of purchasing the preference shares from E Bank when B Ltd redeemed them (which is a factual issue).

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[1] The appellant and the respondent presented the issues in a different sequence in argument but nothing other than convenience was the reason.

[2] A "*clogged loss*" means a loss which must be disregarded in the determination of the disposer's aggregate capital gain (or aggregate capital loss). The loss is ring-fenced and is deductible only from the capital gain(s) arising from the disposal(s) of assets to a "connected person" – Silke on *South African Income Tax* Vol. 3.24.160.

[3] An organogram produced before us showed the appellant's link to B Ltd Limited.That it was so linked was common cause. It is part of the D Group.

[3] Insofar as this judgment pertains to issues of law, they have been decided only by me as President of this Court. The factual issues have been decided jointly with my assessors.[4]

[4] The parties submitted written statements of facts agreed between them, which the court received respectively as Exhibits "A" and "B". In terms of Exhibit "A" the parties agreed to the following facts:

"*1.1 On 31 August 2001, B Ltd (formerly B Ltd Retail Limited) passed special resolutions approving an increase in its authorised share capital to include 2933 333 333 fixed rate compulsory convertible cumulative preference shares of 1,10 cents each and introducing a new Article 34 into its Articles of Association ('Article 34' and the 'B Ltd Articles of Association', respectively) a copy of these resolutions is in the trial bundle at 1-14. These resolutions were registered with the Registrar of Companies on the 25th of September 2001.*

1.2 In October 2001, 833 333 175 redeemable preference shares were allotted and issued by B Ltd in accordance with Article 34. Of these preference shares, 830 757 065 shares ('the preference shares') were issued to a number of banks making up a so-called E Bank at a price of 18 cents per share (par value of .01 cents per share plus premium of 17.99 cents per share).

1.3 Although the date of allotment and issue of the preference shares was October 2001, as between B Ltd and the holders of the preference shares, the date of allotment and issue of such shares was treated as being 30 June 2001.

1.4 Articles 34.2 and 34.3 dealt with a dividend in respect of the preference shares.

1.5 Article 34.5 dealt with the redemption of the preference shares.

1.6 On 3 November 2003 the written agreement in the trial bundle at 41 ff was concluded by D Group and the E Bank ('the purchase agreement') inter alia for the acquisition of the preference shares.

1.7 The transaction gave effect to part of the D Group's intention to obtain the preference shares and 100% of the ordinary shares of B Ltd. The acquisition of the ordinary shares was also given effect to pursuant to the purchase agreement.

1.8 In terms of clause 1.2.40 of the purchase agreement, the 'preference shares purchase price' was defined as 'a purchase price equal to 33 cents … less

[4] In terms of section 83(4C) of the Income Tax Act, 1962, issues of law must be decided by the President of the Tax Court alone.

the amount of the December 2003 dividend in respect thereof …'. As a result, the purchase price of the preference shares was an amount of R274 149 831 less the 'December 2003 dividend'.

1.9 *The 'December 2003 dividend', as referred to in clause 1.2.40 of the purchase agreement was an amount of R3 738 406. This was the dividend which accrued to the holders of the preference shares in terms of Article 34.2, read with Article 34.3, in December 2003.*

1.10 *Pursuant to the purchase agreement, the appellant paid an amount of R274 149 831 to E Bank on 25 February 2004. Having received the 'December 2003 dividend' of R3 738 406, E Bank repaid that amount to the appellant.*

1.11 *The appellant contends that the 'implementation date' defined in clause 1.2.19 of the purchase agreement was on or about 5 February 2004. The respondent contends that the 'implementation date' was on 9 February 2004. However, if the appellant provides the respondent with documentation in relation to the 'implementation date', the parties are willing to agree a date.*

1.12 *In March 2004, B Ltd (then under the control of D Group) redeemed the preference shares in accordance with Article 34, pursuant to a resolution dated 12 March 2004 (included in the trial bundle at 161) for a total redemption price of R234 893 886 ('the redemption price'). D Group had 100% control of B Ltd and the appellant.*

1.13 *The parties agree that at the time of the redemption of the preference shares, there was no certificate which could be surrendered because the preference shares were dematerialised. The cancellation of the preference shares was registered through STRATE (the licensed central securities depository for the electronic settlement of financial instruments in South Africa).*

1.14 *B Ltd was obliged to cancel the preference shares on redemption.*

1.15 *Documentation relating to the cancellation of the redeemed preference shares was requested by the respondent but the appellant was unable to obtain any such documentation.*

1.16 *The parties agree that upon redemption of the redeemable preference shares, the par value of the redeemable preference shares, in the sum of R83 075 (being 01 cents per share i.e. one-tenth of a cent, multiplied by the number of shares redeemed), was transferred from current profits to the capital redemption reserve fund of B Ltd.*

1.17 *The parties agree that whether the redeemable preference shares were redeemed in terms of section 98 of the Companies Act, 61 of 1973 (as amended) ('the Companies Act') or cancelled in terms of section 85(8) of the Companies Act pursuant to an acquisition by a company of its shares in terms of section 85 of the Companies Act:*

1.17.1 *the accounting treatment would be the same*

1.17.2 *at the level of the books of account (save for the transfer of an amount equal to the aggregate of the par value of the redeemable preference shares to the capital redemption reserve fund of such company, which applies solemnly in the case of redemption) the accounting entries in the books and records of such a company would precisely be the same, viz:*

1.17.2.1 *reduction of issued share capital;*

1.17.2.2 reduction of share premium; and

1.17.2.3 debit to reserves or current profits to the extent that payment exceeds the sum of 1.17.2.1 and 1.17.2.2.

In its financial statements, B Ltd applied South African statement of generally accepted accounting practice AC125 which only affects how the amounts are classified on the balance sheet for financial statement purposes (see trial bundle at 201), which does not affect 1.17.2.1, 1.17.2.2 and 1.17.2.3 above).

1.17.3 The financial effect on B Ltd would be identical."

In agreeing to the contents of paragraph 1.17, appellant does not admit that the contents of that paragraph are relevant to the issues in this appeal.

1.18 Although the redemption occurred on 12 March 2004, for the purposes of calculating the redemption price the parties treated the date of redemption as 10 March 2004.

1.19 The redemption price was paid by B Ltd to appellant on 12 March 2004.

1.20 The redemption price was calculated on behalf of B Ltd in the manner reflected in the document in the trial bundle at 304 and in an amount of R234 893 886 was paid by B Ltd as the redemption price.

1.21 The total redemption price was made up as follows:

Issue price: Value plus original	*Par R149 536 272*	*R0.18 x 830 757065*
Dividend in terms of Article 34.2 read with 34.3	*R1 433 909*	*R0.001 72603 (rounded) x 830757065*
Redemption premium in terms of Article 34.5	*R83 923 705*	*R0.10102 (rounded) x 830757065*
TOTAL	*R234 893 886*	*R0.28275 (rounded) x 830757065*

1.22 The difference between the redemption price paid by B Ltd of R234 893 886 and/or regional issue price of the preference shares of R149 536 272 is R85 357 614. This amount of R85 357 614 fell within the definition of 'dividend' in section 1 of the Income Tax Act. This amount of R85 357 614 is made up of the dividend of R1 433 909 and the redemption premium of R83 923 705 referred to in paragraph 1.2.1 above.

1.23 The expenditure incurred in acquiring the preference shares before any 'recovery' in terms of the Income Tax Act or other reduction was R270 411 425.

1.24 The appellant does not accept that there was any recovery or reduction of the expenditure of R270 411 425, incurred by the appellant in respect of the preference shares, either in terms of any of the provisions of the Income Tax Act or at all. However, if it is held, as contended by the respondent, that the redemption premium and the dividend, referred to in paragraph 1.2.1 above, were recoveries or a reduction of the cost of the preference shares in terms of the Income Tax Act, then:

1.24.1 If the recovery or reduction is calculated as having taken place on 5 February 2004 the amount of the recovery or reduction was R80 316 569;

1.24.2 If the recovery or reduction is calculated as having taken place on 9 February 2004 the amount of the recovery or reduction was R80 892 688.

1.25 The CM19 and CM15 forms in the trial bundle at 164, 167 and 127-9 were lodged with the Registrar of Companies on the dates reflected in such forms. Upon the redemption of the preference shares, they reverted to the authorised share capital.

1.26 At the time of the redemption of the preference shares appellant and B Ltd were members of the same group of companies and were connected persons (both as defined in section 1 of the Income Tax Act)."

[5] With reference to paragraph 1.24.2 of Exhibit "A" the parties agreed on the date of the 9th of February 2004.

[6] In terms of Exhibit "B" the parties agreed as follows:

*"1. There was a process of negotiation which lead up to the conclusion of an agreement between **the D Group** and **E Bank** which is shown in the documents.*

*2. Once the opportunity presented itself, D Group undertook a limited investment assessment based on publically available information ie annual financial statements, the consequence of which D Group believed that the value of the investment in B Ltd on a "**DCF (discounted cashflow) valuation basis**" was approximately **40c** per share **(See document at Trial Bundle 39)**.*

*3. The term **"DCF valuation basis"** means on a "fully diluted basis". This means, as if all of the convertible shares in B Ltd had been converted on a one for one basis (ie as if the ordinary shareholders in B Ltd had been diluted by such conversions). In this regard, B Ltd had <u>convertible debentures</u> and <u>convertible preference shares</u> (which included the shares in issue in this matter). The <u>convertible debentures</u> are referred to at note 10 of the 2003 B Ltd's financial statements (**Trial Bundle 86.1**). The <u>convertible preference shares</u> are referred to at note 11 of the 2003 B Ltd's financial statements (**Trial Bundle 86.2**).*

4. *At the relevant time, the <u>debentures</u> had already converted into ordinary shares but the <u>preference shares</u> were only convertible in 2004. D Group valued B Ltd as if both the debentures* ***and the preference shares*** *had been converted. Therefore the reference in the document at* ***Trial bundle 39*** *to* ***2 869 344 "fully diluted shares in issue"*** *is to the aggregate of the existing ordinary shares in B Ltd (including those into which the debentures had already been converted) and the ordinary shares which would exist upon conversion of the B Ltd preference shares. There is no number listed next to the references to* ***"preference shares****" and* ***"debenture****" in that document because this document is based on the assumption that those shares have converted into ordinary shares.*

5. *The effect of the "fully diluted" valuation method which D Group used was that no distinction was drawn for valuation purposes between a B Ltd <u>ordinary share</u> and a B Ltd <u>preference share</u>.*

6. *The second page of the document* ***(Trial Bundle 40)*** *shows the discounted cash flow projection.*

7. *After internal discussions in and around* ***September 2003****, an initial proposal was made to the E Bank in which it was proposed by D Group that it would acquire 100% of the B Ltd ordinary shares and preference shares for a consideration of* ***30c*** *per share.*

8. *The document at* ***Trial Bundle 33*** *contains the above proposal and it was the very first proposal which D Group made to the E Bank. It was prepared by someone in D Group's acquisitions team. The offer was made to acquire "100% of the fully diluted ordinary shares of B Ltd Limited" and, therefore, the offer of "R0.30 per B Ltd ordinary share" in the document means that D Group was offering 30c per ordinary share and per preference share.*

9. *In all discussions and negotiations with the E Bank, both ordinary and preferenceial shares were considered on an equal basis.*

10. *With regard to the price negotiations, the E Bank response was that the original D Group proposal per the document at* ***Trial Bundle 33*** *was below their anticipated price.*

11. *D Group increased its offer to* ***31.5c*** *per share but the E Bank response was that this was still below their anticipated price of* ***33c*** *per share.*

12. *This is evidenced in a letter from F Bank (which was acting for the E Bank) to G Finance* ***(see the document at Trial Bundle 24)****. G Finance were representing D Group.*

13. *The date on the document at* ***Trial Bundle 24*** *is incorrect – it was written in about* ***October 2003****.*

i. THE AGREEMENT (Trial Bundle 41-85)

14. *A meeting took place on or about* ***24 October 2003*** *between Ms Y and Ms Z representing the E Bank and D Group representatives.*

15. *At that meeting a price of* ***33c*** *per share, based on the fully diluted ordinary shares of B Ltd, was agreed. Other principles relating to the deal were agreed, the result of which culminated in the conclusion of the agreement with the E Bank signed on 5 November 2003 (****"the Agreement****").*

16. *Prior to the signing of the Agreement, a bundle was prepared for the purposes of obtaining the approval of the acquisition by the D Group board of directors at their*

> *meeting on **31 October 2003**. **(Trial Bundle 26-32)** This document refers to an "offer price of 33 cents per share on a fully diluted basis".*
>
> *At its meeting, the D Group board approved the acquisition at **33 cents** per share*
>
> ***(Refer Extract from the Minutes of Special Meeting - Trial Bundle 34)**".*

[7] We were informed from the Bar that despite the aforesaid agreements, the evidence of one witness would be led by the appellant regarding the conclusion of the sale of shares agreement between, *inter alia*, the appellant (or its holding company) and the E Bank which previously held the shares. Accordingly, the appellant called Mr X, presently Financial Director of D Group, who testified briefly about his involvement in the conclusion of the sale of shares agreement and related matters. He testified, *inter alia*, that he was not involved in the signing of the sale agreement but was involved in the negotiations; that by entering into the sale agreement D Group intended to take over B Ltd and vest 100% of the control of B Ltd in D Group; that a due diligence was undertaken and D Group was satisfied that B Ltd was a profitable business; that they (i.e. on behalf of D Group) were aware that shares held by the E Bank were redeemable and that a redemption premium was payable to the shareholder upon redemption of the preference shares, by B Ltd; that they were also aware that unless the preference shares were redeemed by a certain date they were to be converted to ordinary shares. According to this witness, in his view (based on the 2003 financials), B Ltd was basically insolvent; he was aware that it had resources but did not know exactly what they were. The witness conceded that the benefits referred to in clause 7.1.2 of the sale agreement referred, *inter alia*, to the right to receive dividends and the right to receive, upon redemption, the redemption premium.

The witness conceded that the dividend that was due in December 2003 had (i.e. in terms of the sale agreement) been deducted from the price. The witness also conceded that the redemption of the shares occurred within about one month from the implementation date of the sale agreement. I shall deal with the other aspects of his evidence insofar as it might have been relied upon by the parties in their submissions on the issues. No other witnesses were called and no other oral evidence was led. The parties closed their respective cases and their respective counsel made submissions on the issues.

[8] I shall now proceed to deal with a consideration of the issues and the submissions made in that regard.

THE APPLICABILITY OF PARAGRAPH 39(1)

[9] If paragraph 39(1) is applicable then the capital loss of the appellant constitutes a "*clogged loss*". It would be applicable if the redemption of the shares is "a disposal to any person" as meant and contemplated in that paragraph since it was common cause that B Ltd, at the time of the redemption, was "a connected person" as meant and contemplated in that paragraph.

[10] Paragraph 39(1), insofar as is relevant, provides:

> "*39.* ***Capital losses determined in respect of disposals to certain connected persons****. – (1) A person must, when determining the aggregate capital gain or aggregate capital loss of that person,*

> *disregard any capital loss determined in respect of the disposal of an asset to any person –*
>
> *(a) who was a connected person in relation to that person immediately before that disposal; or*
>
> *(b) which is immediately after the disposal –*
>
> *(i) a member of the same group of companies as that person …*
>
> *(ii) …*"

[11] The term "*disposal*" is defined in paragraph 11(1) of the Eighth Schedule of the Act (insofar as is relevant for purposes of this case) as follows:

> "*11. **Disposals** – (1) Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes –*
>
> *(a) the sale, donation, expropriation, conversion, grant, cession, exchange, or any other alienation or transfer of ownership of an asset;*
>
> *(b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;*
>
> *(c) the scrapping, loss, or destruction of an asset;*
>
> *(d) …*
>
> *(e) …*
>
> *(f) …*
>
> *(g) …*"

[12] The respondent, who seeks the confirmation of its assessment and the dismissal of the appellant's objection, expressed the view that paragraph

39(1) is applicable and that the redemption of the preference shares was a disposal. The appellant, on the other hand, submits that paragraph 39(1) is not applicable because the redemption of the shares was not a disposal by the appellant to any other person. The appellant places emphasis on the preposition "*to*" which is used in addition to the term "*disposal*" in paragraph 39(1) and submits, in essence, that the kinds of disposal that are contemplated in paragraph 39(1) are those where the asset, or the rights in the asset, are transferred from the disposer to any other person. The contention is that even though, in terms of paragraph 11(1), the term "*disposal*" includes "*redemption*" the language of paragraph 39(1), in particular the phrase in that paragraph "*the disposal … to*", delineates and confines the kind of disposal to those envisaged in paragraph 11(a) such as sales, etc., where there is a transfer of the asset, or the rights in the asset, from the disposer to any other person.

[13] The appellant submits that in the case of the redemption of shares there is no transfer of the shares (or the bundle of rights represented by the shares) from the holder of the shares to the redeeming company. On redemption, so the argument went, the shares (or rights represented by the shares) were extinguished and ceased to exist. The respondent's counter-argument was, in essence, that the redemption was a kind of "*buy back*", and was a disposal to the redeeming company (in this case B Ltd) as contemplated in paragraph 39(1) and that the appellant's loss was, accordingly, a "*clogged loss*".

[14] These submissions brought into focus the meaning of paragraph 39(1) and in particular whether the term "*disposal*" in that paragraph had to be given a constrained meaning in the light of its context in that paragraph and, in particular, because it is used in that paragraph in conjunction with the preposition "*to*".

[15] As was submitted by both parties, in interpreting *fiscal* or tax legislation one commences with a literal interpretation because such legislation ought to be certain. In *Van Heerden and Another v Joubert NO and Others*[5] the court explained what is meant by the golden rule of statutory interpretation in terms of which words in a statute had to be given their ordinary literal meaning within their context in the statute. In terms of this rule the ordinary grammatical meaning of the words must be adhered to if the language of the statute is unambiguous and its meaning is clear. The court may only depart from the ordinary meaning if it leads to an absurdity so glaring that it could never have been contemplated by the Legislature. In *Cape Brandy Syndicate v England Revenue Commissioners*[6] the rule which applied in interpreting *fiscal* legislation was stated as follows:

> "*.....one has to look at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.*"[7]

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[5] 1994 (4) SA 793 (A) at 795.

[6] [1921] 1 KB 64 at 71. This approach has been accepted by our courts, see eg.*Commissioner for Inland Revenue v Simpson* 1949 (4) SA 678 (A) 695.

[7] The same principle was referred to in *CIR v George Forest Timber Co Ltd* 1924 AD 516 at 531-2.

[16] It is also a fundamental principle that when interpreting legislation literally every word used by the Legislature must be taken into account[8]. However it must also be borne in mind that in interpreting anti-avoidance provisions, such as paragraph 39(1)[9], a wider interpretation is required so as to suppress the mischief at which the provision is aimed at and to advance the remedy.[10] It is very important to bear in mind in this regard that interpreting "*widely*" does not mean that the meaning of the provision being interpreted must be stretched beyond what its language permits.

[17] The mischief at which paragraph 39(1) is aimed is clearly to prevent a taxpayer from avoiding or reducing its tax liability by creating a capital loss through the disposal of an asset to a person (including a company) that it is connected to. To allow such losses, i.e., as a result of disposals to connected persons to be deducted generally, would provide fertile ground for the creation of fictitious losses. Tax liability would be reduced while the asset, or the benefit thereof, would still be retained by the disposer, albeit through the connected person.

[18] The wording of paragraph 39(1) accordingly clearly covers all transactions such as sales, or the transfer of assets (including shares), from the disposer to a connected person or company. The difficulty arises where there is no transfer of the asset (or the rights therein) from the disposer to the connected person.

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[8] *CIR v Southern Life Insurance* 1986 (4) SA 730 (A): *Nkomo v Attorney- General, Zimbabwe* 1994 (3) SA 34 (Z) 42.

[9] The parties were in agreement that paragraph 39(1) was an anti-avoidance provision. See also Silke on *South African Income Tax* Vol 3.

[10] *Commissioner of Taxes v Fereira*, 38 SATC 66, 1976 (2) SA 653 (RAD).

[19] According to the canons of construction referred to above the preposition "*to*" in paragraph 39(1) cannot be ignored unless its inclusion would result in an absurdity so glaring that it could never have been contemplated by the Legislature. The preposition "*to*" according to the Concise Oxford Dictionary, means "*1. in the direction of … (3) so as to reach*". On adopting a literal interpretation of paragraph 39(1) the disposal of the asset must thus be "in the direction of", or "so as to reach" the connected person. This implies a disposal of a kind in which the asset (or the rights represented therein, in the case of shares) must be transferred to the connected person.

[20] A great deal of argument was directed at the true nature of the act of redemption. Although the respondent did not submit that the preposition was mere surplusage, the respondent, in essence, submitted that there was no difference between the redemption of shares and a share "*buy- back*". The respondent referred to authorities and academic writing in support of his argument.[11] The respondent, in another context, also referred to a *dictum* in *AA Mutual Association v Century Insurance Co Ltd*[12] where Nicholas AJA referred to an earlier position where it was considered that the public interest required that shares should not be redeemable – the general rule then being

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[11] *Inter alia* Blackman "*Commentary on the Companies Act*" Vol 1 (Juta Revision 6) paragraph 209 pages 5-43; *Lord Provos Magistrate and Council of City Edinburg v British Linen Bank* 1913 AC 133 at 14-1 (where it was stated that the redemption of the redeemable annuities connoted an optional repurchase of the annuities); *R Handevel (Pty) Ltd* 1983 (8) ACLR 44 (where reference was made to the *Lord Provos* case and it was held that the redemption of stock was a repurchase, albeit not optional); Gower and Davies *Principles of Modern Company Law* (7th edition) at page 250 (where the authors opine that subject to one difference, which is stated, the "*redemption*" and "*purchase*" of shares are transactions which are "*broadly speaking, treated alike*").

[12] 1986 (4) SA 93 (AD) at 101.

that a company could not issue redeemable shares, "*because redemption would amount to an illegal purchase by the company of its own shares*".

[21] The respondent submitted that the redemption was the same as a "buy- back" (or repurchase) by a company of its own shares for the following reasons. In each case the asset (the corporeal right) is extinguished; in each case the issue share capital of the company in which the shares are held, is reduced; the share premium is reduced; on redemption of the preference shares they revert to authorised share capital and can be re-issued; the company pays for the shares and payment is a bilateral act; the sale or redemption takes place pursuant to an agreement (in the case of preference shares the agreement is reached in advance and embodied in the articles of association that makes no difference to the principle); in the case of both there is a contract that regulates the relationship. The respondent submitted further that accordingly there was either an alienation, or transfer of ownership, of an asset which resulted in its extinction as contemplated in paragraph 11(a) of the Act and this constituted a disposal to a person. The respondent also submitted that the disposal contemplated in paragraph 11(b) is also a disposal to a person. With reference to that paragraph it was submitted that listed there are all concepts which connote waiver and that the right which is abandoned, or waived, or an asset which is forfeited, does not occur "*in vacuo*", there is a disposal to another party or person.

[22] The appellant's counter-submissions on this point are briefly the following. Upon redemption of a share the rights of the relevant shareholder

simply cease to exist. Reference is made to what Viscount Simmonds stated in *IRC v Universal Grinding Wheel Co Ltd*[13], namely:

> "*Where a redemption has been affected, the shares redeemed disappear for every purpose.*"

No transfer of rights to the redeeming company occurs. A company cannot hold its own shares and upon redemption of the redeemable shares, those shares cannot be disposed of "*to*" the company. The redemption of shares is not a "buy- back" or a repurchase by the company of its own shares. Relying on a passage in *Blackman*[14] it was submitted that in a "buy-back" a company does not buy back the rights in those shares, but the rights of the shareholder ceases to exist. There is similarly no disposal of rights in the redeeming company upon the redemption of shares. It is a misnomer to call a redemption of shares a repurchase of shares. In the case of a redemption there is no alienation or transfer of the shares, or the rights embodied therein, but those rights are extinguished. It was further submitted that the relevant question to ask when dealing with the application of paragraph 39(1) is not whether an act is a bilateral act, but whether the asset is transferred by the disposer to a connected person.

[23] I do not think that it is necessary for me to decide the difference between a redemption of shares and a "*buy- back*" or "*repurchase*" of shares, but it is important to determine what occurs upon redemption. Whether the act of redemption automatically results in the extinction of the shares, or

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[13] [1955] 2 All ER 29 at 32-3 (HL).

[14] Vol 1 5/43.

whether it merely results in a transfer to the redeemer, who has to perform a further act of extinguishing them? It was common cause that upon redemption the asset (in this case, the preference shares, or the bundle of rights they represent) are extinguished. In the present case and despite the provisions of the Articles of Association which I shall also shortly discuss, it is common cause that no share certificates were handed over by the appellant upon redemption and that the shares were "*dematerialised*". They ceased to exist.

[24] The argument of the respondent seemingly suggests that upon redemption the assets (or the rights in the assets) are transferred (or pass) to the redeemer who then extinguishes them when they are in its possession.

[25] In terms of Article 34.6.2 of B Ltd's articles of association:

> "*At the time of redemption, the registered holders of the preference share shall be bound to surrender to the company the certificate relating thereto in order that the same may be cancelled …*"

As I stated above, even though the Articles envisaged that the share certificates be handed over at the time of redemption for cancellation, in the present case there was no handing over of certificates and the shares were dematerialised. In any event the handing over of certificates, as envisaged in the Articles, is not for the purpose of transferring the rights evidenced thereby to the company, but to enable the company to cancel the share certificates.

[26] The wording of paragraph 39(1) is clear. The respondent has not submitted that the proposition, "*to*", was mere surplusage, nor did the respondent make out a case for the deletion of that word from the paragraph.[15] Furthermore, it has not been shown that the ordinary literal meaning of the paragraph (inclusive of the preposition "*to*") leads to an absurdity, or that it would permit the mischief which the Legislature intended to prevent by means of that paragraph. While the redemption of shares constitutes a "*disposal*" as defined in paragraph 11, it is not a "*disposal to any other person*" as envisaged in paragraph 39(1). The redemption of shares results in the extinction and not in a transfer of the rights embodied in the shares to the company redeeming them, or to any other person.

In the circumstances paragraph 39(1), in my view, does not apply to the redemption of shares in the present case and the loss incurred is accordingly not a "*clogged loss*" as envisaged in that paragraph.

THE SECOND ISSUE: THE TRUE LOSS OF THE APPELLANT

[27] The capital gain is the excess of the proceeds of an asset upon its disposal or, in the case of a deemed disposal, the market-value over its base cost. If the base cost exceeds the proceeds, a capital loss arises.[16]

[28] The ultimate question for determination here is what the extent of the appellant's capital loss is. According to the appellant it is R120 875 153[17], but

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[15] Compare *Bhyat v Commissioner for Immigration* 1932 (AD) 125 at 129 and *List v Junger* 1979 (3) SA 106 (AD) at 123D.

[16] *Silke* at 24-12.

according to the respondent it is less, namely R35 517 539.[18] The difference arises because the respondent contends that in determining the base cost of the preference shares (which were redeemed) the purchase price of those shares, namely R270 411 425-00, must be reduced by an amount of R85 357 614 (being the sum of the preference dividend payable in terms of B Ltd's Articles 34.2 and 34.3, namely, R1 433 909 and the redemption premium payable in terms of B Ltd's Article 34.5, namely R83 723 705) on the basis that the preference dividend and the redemption premium constituted a "recovery" in terms of paragraph 20(3) of the Eighth Schedule.

[29] The relevant provisions are paragraphs 20(1)(a) and 20(3) of the Eighth Schedule of the Act. The relevant portions of those paragraphs are the following;

> Paragraph 20(1)
> *"…. The base cost of an asset acquired by a person is the sum of-*
> *(a) the expenditure actually incurred in respect of the cost of Acquisition…. of that asset"*
>
> Paragraph 20(3)
> "*The expenditure contemplated in subparagraph (1)(a) to (g), Incurred by a person in respect of an asset must be reduced by Any amount which-*
> *(a)…….*
> *(b) has for any reason been….recovered or become recoverable From or has been paid by any other person…."*

[30] The appellant disputes that the dividend and the redemption premium constitute a recovery as contemplated in paragraph 20(3). The appellant

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[17] Which is arrived at as follows: Proceeds of disposal redemption price R234 893 886 less dividends (R85 357 614) = R149 536 272; base cost: cost of acquisition (para 20(1)(a)) R270 411 425 less R149 536 272 = R120 875 153.

[18] Which is arrived at as follows: R234 893 886 less R85 357 614 = R149 536 272 less R185 053 811 (arrived at as follows: R270 411 425 (purchase price of shares) less R85 337 614 = R185 053 811) = (R35 517 539).

submits that on a proper (literal) construction of paragraph 20 it is clear that in order to have *recovered* an amount, the appellant must have got back into its possession the expenditure (or part of the expenditure) incurred in respect of the acquisition of the preference shares. According to the appellant, to treat the dividend and/or premium as a *recovery* of the purchase price of the preference shares as contemplated in paragraph 20(3) would produce absurd results. The appellant equated such a situation with one where rental received in respect of a property which is disposed of is treated as a recovery of the purchase price of the property or part of such price. To illustrate, if the taxpayer bought a property for R1 m and had received rental of R1,5 m, the property would have a negative base cost.

[31] The appellant submits that it never got back any portion of the purchase price which it had paid to the E Bank for those shares. The redemption premium was received because of the redemption of the shares and was not a repayment or part-repayment of the purchase price of the shares from the E Bank. The transaction in respect of which it received the premium was different and separate from the purchase transaction. According to the appellant, the Legislature could not have intended the receipt of money from a different transaction to be a recovery by the purchaser of the cost of acquisition.

[32] The appellant furthermore submitted that in interpreting the relevant provision one should do so contextually, bearing in mind the object and purpose of the Legislature in imposing capital gains tax. Capital gains tax is

levied on (a) gain(s) made by a taxpayer upon the disposal of a capital asset. The intention of the Legislature, so the argument went, is that the gain is the difference between the cost of the asset and the proceeds of the asset upon disposal, but excluding any amount which is included in the gross income of the taxpayer.[19] According to the appellant, this is to ensure that an amount taken into account in determining the income tax of the taxpayer is also not taken into account in determining the taxpayer's liability for capital gains tax. Furthermore, it was intended that the fruits of an asset (such as the rental, etc.) form part of the gross income derived by the taxpayer from the asset and it was not the intention of the Legislature to treat such fruits as a recovery of the cost of the asset. A dividend would be included in the gross income. If the dividend earned from shares was treated as a recovery in terms of paragraph 20(3), then one would have an absurd situation where the dividends would be deducted from the purchase price of the shares and also taken as a reduction of the proceeds (on disposal) by the amount of the dividends – resulting in a "*double counting*" of the dividends in the calculation of the capital gain or capital loss from the disposal of the shares. The appellant, by means of a table, illustrated that this is precisely what the respondent has done in its amended grounds of assessment.

[33] The appellant submitted that the fact that paragraph 20(3) specifically refers to an amount which has been "*recovered*" and not to a "*benefit*" resulting from the acquisition of the asset, shows that the Legislature never

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[19] With reference to paragraph 35(3)(a) of the Eighth Schedule of the Act.

intended to treat benefits resulting from the acquisition of an asset as a *recovery* contemplated in that paragraph.

[34] The respondent's argument in justification of its assessment of the loss as per its amended grounds of assessment may be summarised as follows. The cost price of the preference shares ought to be reduced because the appellant "*reduced the price or recovered or has been paid the anticipated benefits*" on redemption of the preference shares by B Ltd. The appellant bore the burden of proving that an amount is not subject to deduction in terms of section 82 of the Act. The legal and factual position in relation to the benefit attaching to the preference shares and which were for the account of the appellant are indistinguishable from the position relating to the December 2003 dividend, which was deducted from the purchase price of R274 149 831. In each case the appellant's entitlement to the payments arose from an express contractual provision in the purchase agreement and not from an extraneous and unrelated event.

[35] The respondent submitted that it was important to take into account that the purchase agreement for the shares was entered into on the 5th of November 2003; that the B Ltd preference dividend was payable, in arrears, on or about the 30th of June and 31st of December every year; at the time of the conclusion of the purchase agreement the preference dividend for 31 December 2003 was not due and payable, but the parties agreed that this would be deducted from the purchase price; the purchase price (in terms of the agreement) was only paid on the 25th of February 2004, but the parties

had already agreed that that amount (i.e. the December dividend) which was not due and payable at the time of the conclusion of the agreement, would be deducted from the purchase price; the evidence (i.e. given by Mr X) established that the benefits referred to in clause 7.1.2 of the purchase agreement were limited to dividends which would accumulate from 1 January 2004 as well as the premium which accumulated on the nominal redemption value of the preference shares and it was those benefits which the appellant wished to acquire in terms of the purchase agreement; that it was no co-incidence that the preference shares were redeemed within a short period after the implementation date; the directors (i.e. of B Ltd) only passed a resolution on the 12th of March 2004, but there is a very close connection between that date and the implementation date (i.e. even if one accepts for the purpose of argument that the implementation date was the 5th of February 2004) and that this is confirmed by the language used in the letter of the 8th of November 2004.[20]

[36] The respondent further submitted that the meaning given to the word, "*recover*", in *CSAR v Pinestone Properties CC*[21] be applied to the facts of the present case namely, as defined in the Oxford English Dictionary – "*to get … back again into one's hands or possession, to regain possession of (something lost or taken away)*". According to the respondent, if that meaning is applied, there can be no doubt that it was always contemplated that the benefits attaching to the preference shares would be utilised by the appellant to reduce or recover part of the purchase price which it had paid to acquire

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20 See Dossier page 217/218 and Mr X's evidence.

21 2002 (1) SA 202 (N) at 208.

those shares. Furthermore it was submitted that the amounts recovered and paid to the appellant are recoveries in terms of paragraph 20(3) of the Eighth Schedule.

[37] On behalf of the respondent it was further submitted that B Ltd paid the appellant pursuant to the agreement whereby the appellant acquired the preference shares from the E Bank and that there was "*an almost inseparable link between the act of acquisition and the rights which would attach to the preference shares so acquired ... The ultimate payment of the dividend and premium were not unforeseen and unrelated events.*".

[38] The same principles apply in the interpretation of paragraph 20(3) as discussed when dealing with the first issue. The provision should also be interpreted contextually, bearing in mind the object and purpose of the Legislature in imposing capital gains tax and the aim and object of the paragraph being considered. There is merit in the contention that the fruit derived from an asset will, generally, not constitute a recovery envisaged in paragraph 20 (3). On a proper construction of that paragraph, in order for the amount to be a recovery the taxpayer must have got back the cost (or part) expended in acquiring the asset. The fruits of the asset, such as rent, in the case of the asset being a rental property, or dividends earned in respect of shares, are generally, not amounts that have been recovered as contemplated in paragraph 20, but constitute income earned from the

particular asset[22]. To treat the fruits of an asset as a recovery for the purpose of calculating the capital gain or loss could produce absurd and inequitable results, such as double-counting. On the other hand, a repayment to the taxpayer of part of the purchase price of an asset clearly constitutes a recovery envisaged in that paragraph. Whether a particular amount is a recovery, or merely fruit of the asset, is a matter of fact to be determined in every case[23].

[39] The appellant was aware at the time of acquiring the preference shares from E Bank of the benefits attached to the shares. Mr X conceded that the benefits in the sale agreement referred to the dividends and the redemption premium that where linked to the preference shares. The appellant must have been aware of the redemption price that was payable upon redemption as well as the other conditions applying to the redemption of those shares and as contained in paragraph 34.5 of B Ltd's Articles. In terms of paragraph 34.8 of B Ltd's Articles the redemption of the preference shares had to take place no later than the first day following the third anniversary of the date of allotment and issue of the preference shares, failing which they were to be converted into ordinary shares[24]. It is common cause that the

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[22] According to **the South African Revenue Service – Comprehensive Guide to the Capital Gains Tax** (Issue 3) p144 – a dividend received shortly after the acquisition of a share, the price of which includes the value of the dividend, is not regarded as a recovery of cost under par. 20 (3) (b). The reasons given are that there is no guarantee that the share price will not drop after a dividend has been declared. Secondly, because the major part of the value of a share usually comprises the right to receive dividends, that does not seem to be a justification for treating such a dividend as a recovery of cost. (However, a pre-acquisition dividend is treated differently).

[23] *CSAR v Pinestone Properties CC* 2002 (1) SA 202 (N) at 205, where the court on appeal quotes from the court a quo's judgment.

[24] Article 34.8 of B Ltd's Articles of Association provides that any preference share not redeemed on the first day following the third anniversary of the date of allotment and issue of the preference share, will, without further notice to the holder thereof, be converted by the

preference shares were allotted and issued in October 2001[25], but that the date of allotment and issue was treated as been the 30th of June 2001. The third anniversary would have been in June or October 2004. The date of acquisition of the preference shares by the appellant from the E Bank was in November 2003. At that time the issue of redemption must have been considered by the appellant (and D Group). It would have been crucial. It would have also been considered that by acquiring the preference shares as well as the ordinary shares the D Group would obtain control of B Ltd and, in effect, *inter alia*, be able to decide on the timing of the redemption of the preference shares, if it was decided that they are to be redeemed.

[40] On the probabilities, B Ltd could not have been in a poor financial position at the time the appellant acquired the preference shares from the E Bank. It could not have recovered in such a short space of time to have been able to redeem the shares at the beginning of March 2004. One of the conditions for redemption of the preference shares was that B Ltd had to retain a certain stated viable financial level after redemption (Article 34.5.2). Another consideration is that at the time of acquisition the amount that was to be received upon redemption was easily determinable or calculable. Paragraph 34.5 of B Ltd's Articles state the components of the redemption price. An assessment would have been made of the different options open to the appellant and the D Group to achieve the maximum benefit, including obtaining ultimate control of B Ltd.

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company into ordinary shares in the share capital of B Ltd. Upon such conversion the premium was clearly no longer payable.

[25] The exact day has not been stated in exhibit "A".

[41] Notwithstanding all of those facts and probabilities, the question remains whether the dividend portion and redemption premium portion of the redemption price could be regarded as recoveries envisaged in paragraph 20(3). The part of the payment that comprises the nominal value, but in respect of which there is no issue in these proceedings, could be regarded as a recovery because it was, in effect, a repayment of the share price paid at the time of issue and allotment of the preference shares. The dividend portion is a fruit of the preference shares and cannot be regarded as a recovery as envisaged in paragraph 20(3). Similarly, the redemption premium is also a fruit of the asset (i.e of the preference shares which were redeemable). The fact that these benefits might have been taken into account in determining the price which the appellant paid for the preference shares does not convert them into the recoveries envisaged in paragraph 20(3).

[42] One must also take into account that B Ltd was not obliged to redeem the preference shares and the redemption could only occur once certain conditions stipulated in Article 34.5 of B Ltd's Articles were met. Furthermore, the redemption was a different transaction to the sale or acquisition of the preference shares. The parties to each of these transactions were not the same. Furthermore, the dividend portion and the redemption premium portion could only have been paid out of profits or reserves of B Ltd, whereas the share premium portion of the nominal price, which constituted the bulk of the issue and therefore nominal price (17.99 cents) could have been paid out of the share premium account which B Ltd would have been obliged to maintain

in terms of s76(3)(c) of the Companies Act[26]. In addition, even though the "benefits" may have been taken into account in arriving at the price of the preference shares, which the appellant paid to the E Bank, the appellant paid for the shares and did not pay the E Bank for the cost of the dividends to be earned, or for the redemption premium that would be paid by B Ltd if the shares were redeemed. Accordingly, when B Ltd paid the dividends and redemption premium to the appellant it did not intend to be repaying, or reimbursing, the appellant for an expenditure that the appellant incurred in that regard in acquiring the preference shares, nor did it do so.

[43] Accordingly, in calculating the capital loss of the appellant, the respondent erred in treating the dividend portion and the redemption premium portion of the redemption payment made to the appellant by B Ltd, as recoveries[27] of the cost of acquiring the preference shares.

[44] To sum up, paragraph 39(1) does not apply to the redemption of the preference shares and the appellant's loss is not a "clogged" loss that may only be deducted as envisaged in that paragraph. Regarding the second, main issue, in calculating the appellant's capital loss the dividends and redemption premium paid to the appellant in respect of the redemption of the preference shares are not to be treated as recoveries as contemplated in paragraph 20(3).

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[26] Act 61 of 1973

[27] i.e. as envisaged in paragraph 20(3) of the Eighth Schedule of the Income Tax Act.

[45] Neither party has asked for costs to be awarded against the other. There are also no circumstances warranting that a particular party be ordered to pay the costs of the other. Accordingly no costs order is made.

[46] In the result:

a. The appeal is upheld;

b. The matter is referred back to the Commissioner for reassessment on the basis that paragraph 39(1) is not applicable to the redemption of the preference shares by B Ltd and in calculating the capital loss of the appellant the dividend and redemption premium amounts are not amounts that were "recovered" as contemplated in paragraph 20(3).

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COPPIN J
PRESIDENT

I agree:

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MISS J L KILANI
ACCOUNTING MEMBER

I agree:

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MR P RANCHHOD
COMMERCIAL MEMBER

COUNSEL FOR THE APPELLANT P A SOLOMON SC
J T BOLTAR

INSTRUCTED BY	WERKSMANS ATTORNEYS
COUNSEL FOR THE RESPONDENT	D FINE SC G MOETI
INSTRUCTED BY	THE STATE ATTORNEY