IN THE TAX COURT OF SOUTH AFRICA

HELD AT CAPE TOWN

CASE NO: 13003

In the matter between:

A (PTY) LTD	Appellant
And	
THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICES	Respondent

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JUDGMENT: 13 June 2013

DAVIS J

Introduction

[1] This appeal primarily concerns the question of whether proceeds of the disposal by the appellant of certain shares in the FG (Pty) Ltd ('FG') in the 2005 year of assessment were of a capital or revenue nature. If, as the appellant alleges, the proceeds stand to be classified as of a capital nature, the further question arises as to whether the expenditure of R 45 123 050 actually incurred and paid by the appellant KL (Pty) Ltd ('KL') and by KL to D Limited ('D Ltd') as a so called "equity kicker" in respect of loans from D Ltd to KL and from KL to the appellant are to be excluded from the capital gain made by the appellant on the sale of the FG shares.

[2] If the proceeds are of a capital nature, then the further question arises as to whether an expenditure of R 55 million, which the appellant contends was actually incurred by it in the 2005 year of assessment, in respect of an indemnity obligation arising as a concomitant of the purchase of the FG shares, ought to be excluded from the capital gain made by the appellant on the sale of the FG shares, in that this amount formed part of the base cost thereof.

[3] By contrast, if the gain is classified as of a revenue nature, the question arises to whether the expenditures of R 45 123 050 and R 55 million constitute deduction from the revenue gain.

[4] Finally the question of interest levied by the respondent in terms of the additional assessment of 1 May 2010 for the appellant's 2005 year of assessment needs to be considered.

The factual background

[5] In order to determine these various questions, it is necessary to sketch the chronology in the dispute between the parties. By 2000, M Ltd, a listed company in the retail furniture industry, had encountered serious financial difficulties. At the end of 2001, it owed in excess of R 900 million to a certain bank ('ABC'), which was also financially exposed to other companies in the furniture industry. In consequence therefore, ABC was seriously exposed to extremely significant financial risks. ABC therefore sought a rescue plan for M Ltd in order to reduce its financial exposure. According to the evidence of Dr X, a senior executive of

ABC, Mr Y was used as an intermediary to initiate an approach to a prominent German entrepreneur Mr Z who had previously invested in the South African furniture industry, with the view to Mr Z investing fresh capital into M Ltd. Mr Z expressed interest therein but only if the management of M Ltd was taken over by Mr O of the FG Group, whom he regarded as having the necessary skills 'to turn the M Ltd ship around'. According to Mr Z, both capital and management were required to affect a rescue of M Ltd, which, in turn, would have prevented ABC from incurring a massive financial loss.

[6] At that stage ABC considered that a sustainable level of debt for M Ltd was approximately R 300 million as opposed to R 900 million which M Ltd owed it. A solution was devised in a form of a rights issue by M Ltd which resulted in R 600 million of the debt owed to ABC being converted to equity, followed by a merger whereby M Ltd shares were exchanged for FG shares. An agreement for the sale of FG shares was concluded in which a consortium led by Mr O ultimately acquired 5/6th thereof with the remainder being retained by ABC.

[7] In the result, the O consortium acquired some R 35 million FG shares for R 500 million. Pursuant to this proposal, a series of agreements and amended agreements were entered into, commencing with a memorandum of understanding ('MOU') signed by Mr Z in Rastede, Germany on 26 June 2002. It was accepted by all the relevant parties that this MOU gave rise to a binding commitment and that the risk and rewards in the contemplated transaction

passed to Mr Z on behalf of a consortium which included himself and the appellant with effect from 21 June 2002, being the effective date of the MOU.

[8] It appears that, when the arrangements were implemented, the price of the shares ultimately acquired by the appellant and by Mr O was fixed as of that implementation date (21 June 2002), and interest was paid by the purchaser with effect from that date.

[9] The ultimate structure which was adopted was that one half of the FG shares were acquired by Mr Z's German company - O et Cie and the other half was acquired by the appellant. Further delays took place, owing to the need to obtain Competition Commission and Reserve Bank approvals. In summary, the appellant finally acquired its shares on 5 December 2003, pursuant to negotiations which commenced in late 2002 and culminated in the MOU in June 2002 and the agreements and amended agreements which followed thereafter.

[10] Turning to the nature of appellant, the evidence indicated that the financial interest in the appellant was that of companies controlled by or introduced by Mr Y, although Mr Y was not a director of the appellant at the times material to this appeal. The directors of the appellant were Mr Z and the manager of his South African interests, Mr DD, as well as Dr X who represented the interests of the ABC (to which the FG shares acquired by appellant had been pledged) and Mr

NN, who represented the interests of D Ltd, which had advanced funding to the appellant through the latter's 100% holding company, KL.

[11] It was also common cause that the appellant and its 100% holding company, KL, were special purpose vehicles, the sole purpose of appellant being to acquire and hold the FG shares. No other business was transacted, no physical director's meetings were held and the appellant's only other obligations were those associated with the funding obtained to acquire the FG shares and the normal statutory obligations such as filing tax returns and the preparations of financial statements. The appellant was funded to the extent of R 100 million by virtue of the issue of three year and one day preference shares issued to ABC. ABC required the appellant to be a ring fenced SPV ('Special Purpose Vehicle') which concluded no activity other than the holding of the FG shares which were pledged as security to the bank for the redemption of the preference shares. The appellant was also funded by a shareholders loan of R 150 million, this funding having been advanced by D Ltd to appellant's sole shareholder KL, which, as already noted, was also a SPV. KL then advanced the funding obtained from D Ltd to the appellant on the same terms and conditions applicable to the funding from D Ltd to KL. It was a condition of the funding advanced by D Ltd that it would be used to enable the appellant to acquire the FG shares and D Ltd obtained a reversionary right in respect of the FG shares pledged to ABC as a partial security for the repayments of the funding advanced by it to KL and in turn by KL to the appellant.

[12] The acquisition of the FG shares carried with it two additional liabilities. In the first place, a liability, initially contingent, arose from the fact that appellant was obliged to assume its share of an indemnity obligation which flowed from the acquisition of the M Ltd shares by ABC which granted an indemnity of R 150 million to FG Group in respect of certain M Ltd liabilities identified in the course of a due diligence exercise performed by its auditors, R 125 million of which, in turn, was indemnified by the consortium in favour of ABC, (R 62.5 by O et Cie and R 62.5 by the appellant respectively) after the sale of the FG shares. During the same 2005 year of assessment, appellant assumed an unconditional liability of R 55 million in favour of Mr O in respect of appellant's share of the indemnity and O et Cie assumed full liability under the indemnity to ABC, which enabled the latter to release the funds arising on the sale of the FG shares by the appellant rather than retaining funds sufficient to cover the amount of the appellant's previous shares of the indemnity. The second liability which arose was to pay the 'equity kicker' to D Ltd by way of KL, which amount represented D Ltd's share of the gain arising through the sale of the FG shares by the appellant.

[13] The appellant provided a tax indemnity to ABC pursuant to the acquisition of the FG shares, in respect of potential liabilities that might arise for FG as a result of the acquisition of the M Ltd business. The liability of appellant in terms of this indemnity was limited R 55 million. In summary, appellant and O et Cie concluded an agreement, in terms of which the appellant committed to pay its proportionate obligation arising from the tax indemnity to O et Cie and committed to pay its proportionate contribution of R 55 million on the basis that, if the

appellant was required to pay less than R 55 million under the tax indemnity, it would, in any event, have to pay the difference to O et Cie.

[14] During the latter part of December 2003 and the first month of 2004, the Rand depreciated significantly. According to his evidence, Mr Z reassessed his investment portfolio, which he regarded as having been disproportionately exposed to the South African Rand. His large exposure to the South African currency together with structural economic factors which, in his view, increased the risk of investments, resulted in Mr Z, seeking to realise certain of his South African investments.

[15] In November 2003, evidence, which is common cause, revealed that Mr J of the E Group had discussed a book building exercise with Mr Y at a coffee shop in San Francisco. Some months later in March 2004, the E Group made a presentation concerning the process of a book building exercise, the aim of which was to dispose of the entire investment in the FG Group in a transaction to institutional investors without the risk of creating what was referred to as an overhang. Shortly thereafter, Mr Z met Mr J in Johannesburg on or about 25 March 2004. A meeting took place between Mr Z and Mr O, at which Mr O raised no objection to the proposed sale. In terms of the agreement between the appellant and E Group, completion of the sale and purchase of 14 141 182 of the FG shares by E Group was to take place on 21 April 2004 and the payment was also made on that date by E Group to the appellant.

[16] On 30 April 2004, D Ltd and KL concluded a further agreement to settle the loan agreement. At this time, appellant had sold the FG shares acquired in terms of the agreement and the parties therefore agreed to calculate the 'equity kicker', which was payable to D Ltd on the basis of the proceeds actually realised by the appellant upon its disposal of the FG shares. On 12 July 2004 Mr Z resigned as a director of appellant, with effect from 30 April 2004 together with Mr DD, Dr X and Mr NN. Mr Y was appointed to the board of appellant on 12 July 2004. On 13 July 2004 an agreement between O et Cie and ABC was concluded in terms of which O et Cie assumed liability for the full indemnity agreed to by appellant and ABC on 1 December 2003.

[17] According to Mr Y, when the discussion about the indemnity took place, Mr O agreed to assume the full liability for the indemnity. As Mr Y told the Court:

> "…what I would refer to as a ridiculous request from ABC to want to have 62½ million cash now tied up on deposit for five years for a potential indemnity, the discussion with Mr Z was to say, let's finalise this. I sign to ABC and let you people work out how much the tax can or cannot be, and let's settle on an amount, because I want to finish it, I want it finished in my books and we finished it in your books.
>
> I did not have that discussion on the amount and the data and the detail because Mr T in our offices did that with Mr Z, and the final conclusion was that Mr Y would stand in for the whole indemnity like he signed for ABC, but we at A (Pty)

> Ltd will pay up to an amount of R 55 million, and that was out liability, and that's payable irrespective of what the claim was."

[18] Appellant declared and paid tax upon the disposal of the FG shares on the basis that the taxable capital gain had been realised in terms of s 26 A of the Income Tax Act 58 of 1962 ('the Act') read together with the Eight Schedule thereto. On 28 February 2005, a provisional tax payment of R66 million was made.

[19] So much for the essential chronology. I turn now to deal with the first of the main issues, namely the question of whether the disposal of the FG shares by appellant stands to be classified as or a revenue of capital nature.

Capital or revenue

[20] The key evidence with regard the determination of the classification of the proceeds was given by Mr Z and Mr Y. There is also some further background evidence which is relevant and which in turn fleshes out the details provided in the chronology.

[21] Mr O, the executive chairman of the FG Group, testified about events leading up to the conclusion of an interim arrangement which was signed on 20 June 2002 between ABC, the FG Group and M Ltd. Mr O testified that he had

been approached by Dr X of ABC Group to take over the M Ltd Group which was in 'dire straits'. Mr O told the Court:

> "The condition that I put before them would be that if we did such a deal they would have to be behind us in this deal, they would have to stand behind us as far as funding was concerned and also as a shareholder because given my previous experience… these deals take a long time to put to bed and that was absolutely of paramount importance."

[22] According to Mr O, at a meeting attended by Dr X and Mr S also of ABC, the potential involvement of Mr Z was drawn to Mr O's attention. Mr O testified that he would have been "more than happy" to have Mr Z as a substantial shareholder as "what was of paramount importance was to have a shareholder that was behind through these difficult times".

[23] He testified further that, in January 2003, Ms U, an attorney advising the FG Group, drafted a transaction document, the main theme of which was a scheme of arrangement which would have facilitated the takeover of M Ltd by the FG Group. Of additional relevance was Mr O's testimony that, at a point when the turnaround transaction had met with considerable success in April 2004, Mr Z met him together with Mr Y. In Mr O's words,

> "He was apologetic – but almost in a tongue in cheek way said to me Mr O given what has transpired and I know that we have had this commitments staying the course with you, but given what you have achieved how do you feel about us

> disposing of O et Cie or myself disposing of my stake. In the course of that time we were cock-a-hoop and I had absolutely no objections whatsoever."

[24] The importance of this testimony became more apparent when the relationship between the various parties was set out in the evidence of Mr S and Dr X, executives of ABC. Some of their testimony is to be found in the chronology set out above but there is a need to drill down somewhat further. According to their evidence, since ABC was overexposed to the furniture retail sector in general and particularly after 1999 when M Ltd's business had declined and it became evermore reliant on bank overdraft facilities to finance its business, such that by 2001 it had exceeded its banking facilities, ABC decided to engage, through Mr Y, with Mr Z to participate in a rescue operation to salvage the failing business of M Ltd. To recapitulate, pursuant thereto, a rights issue took place on 11 June 2002 in which ABC acquired 214 181 308 shares (approximately 78% of the total share capital of M Ltd) resulting in a conversion of debt of R 599. 7 million to equity. During April 2002 a consortium led by Mr Z agreed to acquire part of the M Ltd stake which had been acquired by ABC with the intention that affectively that department would be taken up by an entity or entities controlled by Mr Z.

[25] Mr Z placed a condition on his acquisition of M Ltd shares, namely that the FG Group under the leadership of Mr O must conclude an interim management agreement with M Ltd and take over the management of the company. According to their evidence, a further condition demanded by Mr Z was that ABC

must agree to provide funding for the proposed transaction by way of preference shares that would be redeemable after three years and one day. It was this proposal which ultimately led to the FG Group acquiring the business of M Ltd from ABC in exchange for the issue of FG shares pursuant to a 311 scheme of arrangement and FG Group taking over the management of the M Ltd business.

[26] In May 2003, the appellant, ABC, O et Cie, which was the German investment company of Mr Z, and KL concluded a written sale and subscription agreement in terms of which ABC agreed to sell to the appellant shares that were held by it in the FG Group.

[27] This agreement represented the culmination of the detailed negotiations between the parties which had commenced during 2002 and ended in the agreement in May 2003.

[28] Of particular relevance was O et Cie and ABC's conclusion of a memorandum of understanding on 26 June 2002, setting out the basis for the disposal by ABC of M Ltd shares to FG Group, in exchange for FG shares and the subsequent but conditional disposal of the FG shares to an entity or entities controlled by Mr Z, as a representative of a so called consortium. The acquisition was subject to various conditions as well as regulatory approvals, including approvals from the competition authority.

[29] Though a due diligence exercise which had been performed by the FG Group with the assistance of M and M, a firm of chartered accountants, certain undisclosed contingent liabilities were discovered. ABC, as the seller, agreed to indemnify the buyer, the FG Group, against these contingent liabilities, the total value of the indemnity being R 150 million. In January 2003 ABC contacted Mr Z concerning this indemnity. Thereafter Mr Z agreed to assume 5/6th of the indemnity, that is in the amount of R 125 million. In April 2003 ABC received the FG shares and then attempted to establish what would be the most efficient structure to implement the various terms of the memorandum of understanding into which they had entered.

[30] ABC proposed the creation of a South African SPV (which turned out to be the appellant) as the acquirer of FG shares, in the amount of R 500 million. The appellant had initially been funded by way of a shareholders loan of R 300 million to be provided in cash by Mr Z together with the preference share finance, to which reference had been made, of R 200 million to be provided by ABC. Subsequently, it transpired that Mr Z wished to hold his FG shares directly in O et Cie and the latter's investment would not be made through an SPV. As a result, appellant agreed that it would acquire one half of the 35 282 964 FG shares and the other half would be acquired by O et Cie.

[31] In May 2003 Mr Z, in a gesture of good faith signed the agreements represented by ABC on the understanding that the structure could be amended to accord with his ultimate intention. Eventually, on 1 December 2003 an addendum was concluded in terms of which appellant would acquire one half of the FG shares and O et Cie would acquire the other half in both cases from ABC. The date of implementation was 5 December 2003. It was now envisaged that the appellant would issue preference shares to be subscribed for by ABC for R 100 million. This amount, together with cash of R 150 million, would be used to pay for the FG shares. In July 2002, a funding agreement had been concluded between D Ltd and KL for an amount of R 95.7 million, which agreements provided that the funding period be for three years from the advance date. This enabled the consortium to confirm its ability to fulfil its contractual obligations towards ABC. D Ltd also provided a proposal to fund an additional capital requirement of R 54.3 million. By December 2003, in the light of these initial commitments, D Ltd agreed to fund the full R 150 million to KL to enable the latter to advance this amount to the appellant for the purposes of acquiring the FG shares.

[32] Accordingly, a new loan agreement was concluded by D Ltd and KL on 5 December 2003. Pursuant to this loan agreement, D Ltd was entitled to be paid a portion of the increase in the market value of the FG shares which had been purchased by appellant in terms of the agreement, a right which became known in this case as ‘an equity kicker’. Pursuant to this funding, KL advanced to the appellant the shareholders loan of R 150 million, interest free, unless otherwise

agreed. It was agreed by KL and the appellant that interest would be charged. Appellant and KL also agreed that appellant would be liable to KL for an amount equal to the 'equity kicker' for which KL was liable for D Ltd on similar terms.

[33] Appellant provided a tax indemnity to ABC pursuant to the acquisition of FG shares in respect of potential liabilities that might arise for FG Group as result of the acquisition of the M Ltd business. The liability of appellant in terms of this indemnity was limited to R 71 875 000. Appellant and O et Cie then concluded an agreement in terms of which appellant committed to pay its proportionate contribution of R 55 million on the basis that the appellant was required to pay less than R 55 million under the tax indemnity. It would, in any event, pay the difference to O et Cie.

[34] In the light of this evidence it is now possible to assess the important evidence given by Mr Z and Mr Y.

[35] Mr Z testified that during the negotiations with ABC, which led up to the agreement in which Mr Z was to head the consortium, he discussed the proposals with Mr Y and,

> "Because of our long standing friendship, I think it might be around that time that I asked he was involved me since that time, it was ten years ago we meet first time. I said are perhaps interested to come on my boat in this whole possible potential investment."

He testified further that when Mr Y showed interest he told Mr Y that he had to "bring money on the table".

[36] Mr Z also confirmed that, in his discussions with Mr O, the latter had been insistent that Mr Z become a co-shareholder for a long time "cause these problem in M Ltd Group are difficult to solve and we need to change the culture, and this takes time". He insisted that the basis of the relationship between himself and Mr Y, who was to be the only other member of the consortium, was that "I was the captain of the ship and he was a passenger". Given the extent of his commitment to this investment, he insisted that he required the freedom to decide how to deal with the investment and he did not want to be blocked by any other party, once he had made the decision, including Mr Y. Mr Z made this point on numerous occasions; for example when he spoke of the structure of appellant:

> "… there was another thing which was for me very important to be director in this company A (Pty) Ltd, together with my manager South Africa, Mr DD, that was to protect our position in the shares because in the end I was not economically ownership, but legally the shares were in my boat, and with my partner we agreed that in the end I had to take the shots about it, and to becoming director, let's assume somebody would come in A (Pty) Ltd to sell the only and huge investment A (Pty) Ltd had in this thing, I had to be asked with my co-director, Mr DD, so call it when Mr NN wants to sell the shares or other directors I could block that, and this was a third point, okay I got this bank, that's right, I got the O story, that's right, but I've got my interests to remain captain and controlling this block of shares."

[37] The next significant piece of evidence given by Mr Z concerned a discussion which he had with Mr Y concerning a 'book building' exercise. This took place in January or February 2004 at the furniture fair in Germany in which Mr Y informed him that he had been approached by E Bank to become involved with a book building exercise which could result in a sale of the FG shares. Shortly thereafter Mr Z came to South Africa and had a meeting with Mr J of E Bank in which Mr J explained the nature of a book building exercise. It was during this discussion that Mr J explained how Mr Z, who consistently described himself as "the captain of the ship controlling 35 million shares", could dispose of such a large some of shares, being 20% of the FG Group and still maximise his investment.

[38] He testified further that once he had understood the nature of the book building exercise, and hence the potential sale of the complete block of FG shares, he spoke with Mr O to confirm that Mr O would approve of a potential sale. To his surprise Mr O did so agree, a point which Mr O confirmed in his own testimony referred to above.

[39] Mr Z then testified that he had spoken to Mr Y about the book building exercise and informed him that he would discuss the issue with his family in Germany and thereafter consider it. His wife was concerned that he had "all your eggs in the South African basket" and therefore it would be prudent to divest of some of his South African assets, when an opportunity arose as was now the case with the book building exercise. Mr Z then described the basis of the

structure in terms of which the shares were sold, which accorded with the description thereof given by Mr J.

[40] He continued to insist throughout his cross examination that it was his decision to sell based on an overexposure to South Africa and that as 'the captain of the boat', Mr Y and hence appellant had no say in the decision, other than to follow Mr Z and dispose of the latter's shares in the same transaction.

[41] Mr Z was asked the following under cross examination:

> "You put a lot of money in it (the transaction) and you gave a commitment to Mr O that you would keep the money in a transaction until the transaction was bedded down. And then you were free and you intended to be free to take that money out by disposing of the shares in one way or another over time or in a book building exercise, it doesn't matter and reinvest them in other areas of your portfolio."

To this Mr Z replied:

> "Here at one stage you might dispose of it, have the freedom and here it was the same thing with Mr O; he freed me but this was – I could have stayed for another five years or ten years or I should have stayed on looking back, but any how… I got freedom from Mr O and then yes I was free and then I discussed with my wife as I told the story…"

[42] When confronted with the argument that:

> "Your original intention was to hold these shares until such time as a transaction had bedded down, although you may not have excluded other options as well is that right?"

Mr Z said;

> "I had the full theoretically possible options when I have – I told you before, when I have of the South African 'company' more than 20% of the shares and in case it develops in a certain direction I got a good base as a strong shareholder to control, to get control of this business. I could buy further shares on the market, you know this option created for me as well as huge traction. It was nothing in stone so it could have been – it could have been, I'm looking back I should have done it, it could have been that I bought more shares, more shares and get control solely of the operation including M Ltd."

[43] The next critical witness was Mr Y, the chief executive officer of TSD International Limited, and, who at present, is a director of appellant. Mr Y explained that, as the chief executive officer of TSD, his role in the consortium had to be secret. It would have been extremely damaging to the company if the market knew that he had invested in the FG Group in that:

> "'From a commercial point of view because my dear friend Mr. H, if he heard that I invested in Mr O and not in his company knowing him he would have probably pulled all the orders from TSD the same day and similarly with a lot of the retailers and that is how life works in business. So for me as a business man and of course from a privacy point of view I try to live my life out of the lime light."

[44] Although he "shared it with the compliance officer of TSD, to declare it in terms of what we should do I checked it with our in house lawyers if they have a problem with it they told me no", he was concerned to remain anonymous. In addition, he informed the Court that Mr Z had full control and 'he made it a thousand times in my life clear to me'. He then continued.

> "Remember I'm in my boat and you are just going for the ride and therefore it was for me a silent investment with him from an integrity point of view, I shared that with Mr NN cause he was going to be the man putting in the money but I wanted it not to be known to anyone else."

[45] Mr Y was examined and cross examined carefully about the source of funding which was available to appellant in order to participate in the venture with Mr O. He testified that, in his negotiations with Mr NN of D Ltd, he had preferred to have obtained finance which could have run for five years, although Mr NN clearly regarded 3 years as the maximum period for such a loan. Under cross examination Mr Y was asked about his approach to selling. As an example of his evidence, he was asked the following:

> "I'm sure that if Mr Z came to you and said, I want to sell these shares and therefore you must sell them as well and you sat down with him and said listen I'll give you 3 good reasons why that's a bad idea. Here's the three good reasons. And he listened to you and he said I agree with you we shouldn't be selling, you could have done that if you felt strongly enough about it, is that correct?"

To which Mr Y replied:

> "Mr Y always asked my opinion in our business affairs that is absolutely correct. The only twinkle in that statement is that he didn't many times take my advice cause he was the senior partner and Mr Y is a very confident man."

[46] Under cross examination, the contents of correspondence generated on behalf of appellant's attorney on 23 March 2010 to respondent, was put to Mr Y. In particular, he was asked about the following:

> "During March 2004 Mr O approached E Bank to procure a purchase for his interest to FG Group, E Bank indicated that they would only be interested if it could get a large block FG Group shares to place. The reason for this being that the placement of a large block of shares was more attractive and easier to facilitate because of increased liquidity and the underlying share and could attract the larger placement base without creating any potential significant movement in such share price. It was the agreement between the consortium members from the outset that if Mr O as the primary consortium member would wish to realise his investment, the other members would be obliged to realise sufficient funding to facilitate Mr O's exit or to participate in any proposed transaction."

Mr Y however testified that there was never any suggestion of anybody "buying out" Mr O's investment. Although Mr Y considered that the share price was going to continue to increase, given the success of the venture, he did not insist that appellant keep all its shares but requested from Mr O that appellant retain a small proportion to which request Mr O agreed. According to Mr Y;

> "I honour Mr Y in my deal that is his call. To be fair with you of course it's normal to have tried to say to him Mr Y I think it's not the time to sell I think we should stay in longer … we've got a deal so I'm not going to start – that didn't happen, so I didn't even have to speculate about it, Mr Y says I'm selling. The only part that I said to him was can I keep then what I can afford."

[47] Turning to the meeting between Mr Y and Mr J in November 2003. at which a book building exercise was discussed, Mr Y testified that he did not discuss the sale of FG shares with Mr J, but rather raised the question of whether or not secondary shares could be sold by way of a book building exercise. In this connection Mr Y testified:

> "I asked a theoretical question to say that, can you use a currently, public listed company shares in the same way as we had now done, this primary book build for TSD – that was really the question that I – how I can recall what I asked him."

Later when pressed about the contents of this meeting, he testified:

> "I can't possibly remember my exact words on that date, I said I can remember that I wanted and that I was interested to ask Mr J, can you sell shares in a company that is already listed secondary to a book build market. Whether FG then came up already at that stage in the discussion… I can't remember or whether it was mentioned later. I have now said that a few times. I mean I can't say that it happened in the coffee shop or not."

In further clarification, he said:

> "I was in the process of a brand new way of raising capital for TSD and all I wanted to know from Mr J was can you also use this method to sell shares in a company that already exists."

However, Mr Y conceded that he could not deny that FG shares had come up for discussion during this meeting.

[48] In the light of this evidence, it is necessary to turn to the evidence of Mr J, who was the chairperson of the banking division of E Group in South Africa. He explained the nature of a book building exercise which had been referred to in the testimony of other witnesses as essentially where a parcel of shares exists which is of so large a quantity that a structured process of sale must take place. The purpose of a book building exercise is to ensure that his block can be sold

> "As quickly as possible to avoid the market believing that there is an overhang in the shares, so clearing the book of shares as quickly as possible to – via the sale to the institutional market, only to the institutional market and in this particular case which is the – is common nowadays, it was to a global audience of institutional investors."

[49] Mr J confirmed, that in late 2003, E Group had engaged in an equity raising exercise by way of a book build for TSD in which Mr Y was involved. Pursuant thereto, on a visit to the United States of America, the two met for coffee in San Francisco where Mr Y asked Mr J whether the transaction in which

they were engaged for TSD, that is a book building exercise, could be replicated for a parcel of existing shares being secondary shares. Mr J testified that:

> "Mr Y gave me the name of the company and I then said, yes well that should be doable. And that was the end of the conversation. I then asked him, you know as a banker getting a sniff of an opportunity, you know what one – whereto from here and he said no decision had been made, it wasn't his decision in any case to sell the shares and that was the end of the conversation."

[50] In February 2004, Mr Y approached Mr J suggesting that he may wish to submit a proposal in relation for a book building exercise during which conversation he explained that the transaction involved Mr Z.

[51] In this connection a letter, responding to a request from respondent for further information, written by Ms SS, a compliance officer for E Group, is instructive:

> "No further discussion between Mr Y GML took place until February 2004 when Mr Y again raised the possibility of the sale of his shares with GML. He asked GML to present a proposal to him as to how such a sale should be structured, the execution considerations, timing issues and the fee proposals. GML submitted this proposal … to Mr Y during March 2004. There were also a few follow up meetings with Mr Y and Mr Y Mr O on this matter during March 2004. It was during March 2004 that Mr Y and Mr O decided to proceed with FG Group shares held by A (Pty) Ltd and O et Cie and mandated GML to manage the sale on their behalf."

Appellant's Case

[52] Mr Kuschke, who appeared together with Mr Emslie on behalf of the appellant, submitted that, if the intention of the appellant had to be determined with reference to that of Mr Y, who unlike Mr Z had a clear economic interest in appellant, then at no material time did Mr Y contemplate or intend the sale of the FG shares, but his wishes were subordinated to and overridden by those of Mr Z. The evidence suggested that Mr Y was opposed to the decision of Mr Z to sell the FG shares but accepted the decision was not his to make. In the view of Mr Kuschke, for all purposes concerning the sale of the acquisition of the sale of these shares, Mr Z was the controlling director and mind of the company. Mr Z said on numerous occasions during his evidence that he was the 'captain of the ship' and he had sole power to make the key decisions.

[53] Mr Kuschke submitted further that the controlling mind of the appellant had to be determined with reference to the intention of Mr Z. Together with a fellow director, Mr DD, who it was common cause fell under Mr Z's authority and control, Mr Z was the controlling director of the appellant as far as the acquisition and disposal of the shares were concerned. In this connection Mr Kuschke referred to the evidence of Mr Y in which he said that Mr Z was:

> "In charge of the whole investment and being the senior partner and being in total control of A (Pty) Ltd like Mr Y wanted it his bearing on the decision making of A (Pty) Ltd at the end of the day caused the sale of the shares as it caused the investment in the beginning because he invited us into the boat with him."

In Mr Kuschke's view, this evidence was supported by Mr Z who testified that there was a 'clear understanding that I was the captain of the ship and he was a passenger.

[54] In this connection, Mr Kuschke submitted that the evidence of Mr J, when the latter testified about the 2003 meeting in a San Francisco coffee shop confirmed that the 'decision to sell was not Mr Y's to make and thus, supported this version of events.

[55] Further support for this version was to be found in the evidence of Mr Z who stated:

> "I wanted to keep this block of shares together and this was the original understanding with Mr Y … I negotiated the deal and for me it was important to keep these shares together because when I started the whole business I didn't know where to go and I could have gotten the majority of the company buying further shares and want to make sure that these would not run away therefore we agreed as well that I could buy these shares."

[56] To the argument that the shares were acquired in December 2003 and disposed of on or after 29 April 2004, Mr Kuschke submitted that this short time period was an insufficient basis to conclude that the investment was short term or speculative. He submitted that all the parties to the various agreements concurred, notwithstanding the written terms, that the 'risks and reward date' was

the effective date under the memorandum of understanding, which had been signed by Mr Z in Rastede, Germany 26 June 2002. It was on this date that a binding commitment had arisen and the risk and reward in the contemplated transaction had passed on to the consortium with effect from 21 June 2002. Furthermore, the parties conducted themselves on this basis. Interest was charged from June 2002 as confirmed in the evidence of both Dr X and Mr S. The effective purchase price for the FG shares was fixed by reference to the June 2002 price as opposed to December 2003 price. The South African Reserve Bank wanted to be satisfied that the acquisition price was attributable to the risk date on which the market price was agreed and, in the event the Reserve Bank was so satisfied, a point confirmed in a letter to the South African Reserve Bank of 1 September 2003 generated by ABC.

[57] In support of the argument that the intention with regard to the acquisition with the FG shares could not be classified as a short term holding, Mr Kuschke referred to the evidence of Mr O who had said:

> "The possibility of us taking over this group which was in dire straits, and the condition that I put before them (ABC) would be that if we did such a deal they would have to be behind us in this deal and they have to stand behind us as far as funding was concerned and also as a shareholder because given my previous experience … these deals take a long time to put to bed."

In this connection, he insisted that, if Mr Z was to be a shareholder "I had no objection to Mr Z participating in this deal provided that he was shareholder that would stand the test of time and allow us to bed this down." In this connection, Mr O testified further, "Mr Z was familiar with the furniture industry and he gave us an absolute commitment that his was not about making a quick buck." Mr S confirmed this view, when he testified, "my own personal view would have been that this turn around would take a long time. More than three years."

[58] Mr Z, under cross examination, reflected a similar attitude:

> "S-D: And he [Mr O] said you gave him an absolute commitment that you were not in it for a quick buck. – Yes
>
> S-D: Okay. – That was the truth, that was reality.
>
> S-D: Alright. Now … - I must say this against you question now, you are thinking different. But this was the reality, you know.
>
> S-D: No, no. I'm not thinking different, Mr Z. … I'm not suggesting that you were in it for a quick buck…"

[59] Accordingly, Mr Kuschke contended that the overwhelming inference to be drawn from an examination of this evidence was that the appellant had made a strategic long term investment in the FG Group, that there was no discussion between Messrs Mr O and Mr Y as to whether and when they would exit the investment, whereas there had been earnest discussions about what would occur if Mr O was unable to turn around the M Ltd business. In the words of Mr NN "M Ltd was nearly bankrupt and it was debatable whether FG would make it you know to turn around quickly and successfully."

[60] Dr X also testified along similar lines:

> "…I don't think the three year preference share, the three year convertible loan would actually – would be a strong indication of the period for which we

> envisaged this to happen. …these were absolute desperate times at the time, when we did the FG transaction following the M Ltd transaction we were already under the water, we obtained the rights at R 2.80, we converted the FG, the M Ltd shares at R 2.30, we were on the down thread, the economy was in a desperate situation, and I want to use this opportunity to tell you that miraculously the world economy changed in about 2003/2004 and that led up to what eventually arose for the financial crises."

[61] To the argument that the R 54 million loan by D Ltd was only granted for a period of 7 months, and which loan was utilised by the appellant for the purposes of the investment supported respondent's contention of a short term investment, Mr Y testified:

> "I had various discussions with various financial institutions about my affairs and how to restructure it and the FG shares at the end did not need to refinanced because the sale happened, but I refinanced the whole other lot. Investec took over the whole lot and I was discussing the refinance of the TSD shares the FG shares and everything with two or three bankers at that stage."

Mr Kuschke also pointed to a question put by Mr Sholto-Douglas on behalf of respondent:

> "Let me make this clear Mr Y, I am not quibbling but at that stage because of the value of the underlying shares refinancing wouldn't have difficult."

An inference was also sought to be drawn from the evidence of Dr X who testified:

> "Knowing that the transaction will take some time we entered into a three year transaction. We may redeem it early but we may also ask for the preference shares to be rolled over … and continue for a longer period of time."

[62] Turning to Mr Z's decision to sell, Mr Kuschke submitted that there had not been a change of intention, whereby the shares initially held as capital assets had now changed character to stock in trade. For this submission, he relied on a *dictum* of Wessels JA in **John Bell and Co (Pty) Ltd v SIR** 1976 (4) SA 415 (A) 429:

> "[t]he mere change of intention to dispose of an asset hitherto held as capital does not per se subject the result at profit to tax. Something more is required in order to metamorphose the character of the asset and so render its proceeds of gross income."

In Mr Kuschke's view, there was no reliable evidence which had been produced to justify the conclusion of so significant a change of intention.

[63] Turning to the evidence of Mr J, Mr Kuschke submitted that showing an interest in how to sell a large block of shares in a listed company, which had a low volume of daily trades on the JSE and which exercise would provide an idea of the value of those share, did not justify a conclusion that there was an intention to sell, particularly when the decision to sell did not reside with that of the enquirer. The enquiry to Mr J was couched in hypothetical terms, at a time when Mr Y had experienced for the first time an analogous capital raising exercise

whereby new shares were made available to the investing public on an international basis. To an extent that there was any doubt, Mr Z's evidence was conclusive when he said:

> "So the original plan was not to sell. Therefore it was a change of my original intention was the book building on the table. And then the last kick might have come from my wife when 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 … and I accepted that."

It was therefore the approach from E Group that triggered Mr Z's decision to sell the shares. In the view of the appellant, this represented a *nova causa interveniens* as envisaged by Miller J in **ITC 1185**: 35 SATC 122 at 128:

> "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*. The industrial development announced was undoubtedly such a *nova causa*. It was of such a nature as to make it very readily understandable that even persons who had owned property for investment for some time might be tempted to sell in the light of the highly enhanced values which attached to the properties after the announcement… I therefore do not consider that in this case the expedition with which the property was sold after the announcement in any way detracts from what I said concerning the main dominant purpose of its acquisition."

[64] In Mr Z's words, the decision to sell was quite 'an opportunistic decision' which could not have been contemplated when the shares were acquired in 2002.

Evaluation

[65] As Mr Sholto-Douglas, who appeared together with Mr Janisch and Mr Cassim on behalf of the respondent noted, in **ITC 1185** at 123 Miller J also said:

> "It is the function of the court to determine on an objective review of all the relevant facts and circumstances what the motive, purpose and the intention of the taxpayer were. Not the least important of the facts will be the course of conduct of the taxpayer in relation to the transactions in issue, the nature of his business and occupation and the frequency or otherwise of his past involvement or participation in similar transactions."

In other words, whatever a taxpayer may tell the Court has to be analysed through the prism of the objective facts presented to the Court. When the evidence of the relevant persons testifying on behalf of the taxpayer are analysed through the prism of objective facts, then the intention of the taxpayer, both at the time of acquiring assets and at the time of the sale may well be of decisive importance. In this connection as Smallberger JA, in **CIR v Pick n Pay Employee Share Purchase Trust** 1992 (4) SA 39 (A) at 58, said:

> "Contemplation is not be confused with the intention in the above sense. In a tax case one is not concerned with what possibilities apart from his actual purpose, the taxpayer foresaw and with which he reconciled himself with. One is solely concerned with his object, his aim his actual purpose…"

[66] In this case the question arises as to how ascertain the intention of the appellant. When the evidence of Messrs Mr Y, Mr O and Dr X, who was also a director of appellant, are analysed, there was, not much in the way of material difference pertaining to the intention with which the shares were acquired. Initially, it was envisaged that appellant, a special purpose vehicle, would hold the full block of FG shares. By May 2003, when Dr X took the draft sale agreement to Mr Z in Rastede, the latter decided that he would hold his portion directly in O et Cie. Appellant therefore became the vehicle whereby Mr Y would hold his half of the shares. Mr Z, together with Messrs DD and Dr X (later NN) constituted the board of appellant. As Mr Z testified, he and Schouten had acted as directors to protect his interest in controlling the FG shares as one block.

[67] A true picture of appellant appears to be that Mr Y was, for all purposes the organiser of appellant, responsible for the financing of appellant, and hence the brain of the company. Mr Z confirmed that this submission was correct, save for Mr Z's role to ensure that the shares would be sold as one block. In this connection, the evidence suggests that Mr O's decision would prevail and bind appellant in regard to the sale of the shares.

[68] The objective evidence, read as a whole, suggests that the investment in the FG shares was to last for a period of at least 3 years, arguably slightly longer, depending upon the success of the venture. While Mr Z did seek to paint a gloss

on the appellant's case by suggesting that there was a possibility that he might acquire more FG shares in the future and perhaps even take control of the company, this appeared to be a decision which he would have only taken as a means of salvaging something from an investment if it failed or had gone poorly.

[69] A constant theme running through Mr Z's evidence was that he wanted to have the freedom to deal with his 'investment' as he saw fit. There was no significant restrictions which were imposed upon Mr O and Mr Y insofar as the FG shares were concerned, save that they would remain invested until the M Ltd transaction had 'been bedded down'.

[70] Two further factors are not insignificant in the overall assessment. Whatever Mr Y's evidence with regard to has long term intentions, he had attempted to raise money for the FG transaction for a maximum of a 3 to 5 year period.

[71] Furthermore, the nature of the equity kicker, to which reference has already been made in the introduction as part of the financing package, supported the argument that there was an intention to fund the loan repayments by way of a sale of the shares, because the equity kicker was clearly calculated to constitute a portion of the gain realised by the borrower on the assets acquired with the loan. The loan agreement made it clear that the envisaged source of funds to pay the equity kicker would be the proceeds of the FG shares the cash from which had to come to KL through a declaration of a dividend by appellant.

Even if there was a refinancing, the equity kicker would have become immediately repayable.

[72] In my view, the evidence of Mr J cannot be easily discounted. It is common cause that at the meeting in San Francisco in November 2003, less than a month before the ultimate acquisition of the shares, Mr Y initiated a discussion with Mr J as to whether shares could be sold by way of a book building exercise, albeit that various versions of this meeting were presented and the witnesses were careful not to confirm that the only transaction on the agenda was that of FG shares. It appears that Mr Y disclosed the name of the FG Group, the size of the stake he had in mind as well as Mr O’s involvement. Not long thereafter, further discussions took place; that is in February 2004. Mr Z testified further that, not only had he heard about this concept from Mr Y at the Frankfurt Furniture Fair in January 2004, but that Mr Y had informed Mr Z that “E Group was keen to make a book building”. Although there was some denial about who had taken the initiative, the letter which had been generated by the E Group to respondent clearly indicated that Mr Y had raised the question of the applicability of a book building exercise.

[73] I accept that the question of retaining shares needs to be re-examined in the light of modern market conditions. For example, in **BARNATO Holdings Ltd v SIR** 1978 (2) SA 440 (A) at 453 the court said:

> "That would tend to indicate *prima facie* that those shares were not acquired for better or worse or relatively speaking 'for keeps' i.e. only to be disposed of if some unusual, unexpected or special circumstance or warranting or inducing the disposal, super vide which is a usual badge of a fixed capital investment."

[74] The approach of 'for keeps' was again adopted by the Appellate Division (as it then was) in **CIR v Nussbaum** 1996 (4) SA 1156 (A). Significantly, if one examines the New York Stock Exchange in the year 2000, companies such as Compaq, EF Hutton, Paine Webber, MCI World Com, Eastern Airline, Enron, Woolworth's (the US company not the South African unrelated organisation) Panam, The Pullman Company, Arthur Andersen, General Foods Corporation, TWA were all part of many balanced share portfolios. By 2013, all have now disappeared. It cannot be expected that holding shares 'for keeps' would thus have made investment sense nor, given the rapid rise of technological innovation, is it likely that companies will be successful for overly lengthy periods. The idea of 'shares for keeps' is thus reflective of an old, static economic order that no longer exists.

[75] That having been said, the question which arises in this case and which remains the key test is what was the intention of the taxpayer both at the point of acquisition and at the sale. That the appellant does not have to show that shares are 'held for keeps' does not relieve it of the burden of proving it was intended to be an investment for some significant duration. Further, in the present case, these shares were not part of an investment share portfolio which

may need more rapid responses to protect the overall investment but a once off transaction.

[76] In my view the evidence suggests that Mr Z was not a reluctant seller. He and appellant through Mr Y realised that they could take advantage of a transaction which had turned significantly in their favour. The possibilities of a sale had always been in their mind from the commencement of the transaction as is evidenced by the nature of the financing, the equivocal approach by Mr Z to his exact intention, the discussions between Mr J and Mr Y about the book building exercise and the expedition in the actual sale of the shares As Mr Z said:

> "For me it was important to control the 20% block shares because this was important for all options which I didn't know which would be realised when I started this investment, because I didn't know what happened later."

[77] The evidence does not discount the possibility of an early realisation. It cannot be concluded on the strength of the available evidence that the probabilities are in favour of the shares being initially acquired as a capital asset. It is significant that in correspondence with the Reserve Bank in October 2003, it was stated that appellant's intention was to hold the shares for a long term, yet not more than a month later, consideration was already been given to the disposal of the shares which ultimately took place in April 2004. The evidence concerning the intention of 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; from Mr Z's own evidence, it was clear that he was keeping his options open as to when to sell, possibly hold for longer than initially intended, acquire more shares or attempt to obtain a controlling interest in the FG Group. A variety of possibilities lay open at the time of acquisition.

[78] Much was made of the evidence of Mr Z to contend that he was the controlling mind of appellant; that is he was the captain of the boat. Further, it was contended that Mr Y strove to hold appellant's FG shares as was evident in appellant's retention of a parcel thereof. Whatever the answer thereto, appellant bears the onus. In this case, the enquiry needs to focus on who was the 'mind of the company'. As Centlivres CJ said in **CIR v Richmond Estates LTD** 1956 (1) SA 602 (A) at 606:

> "A company is an artificial person with no body to kick and no soul to damn and the only way of ascertaining its intention is to find out what its directors acting as such intended. Their formal acts in the form of resolutions constitute evidence as to the intentions of the company of which they are directors but where a company has only one director, who is also the managing director and the sole beneficial owner of all its shares. I can see no reason in principle why it should be incompetent for him to give evidence as to what was the intention of the company at any given time. In such a case it is, perhaps, not going too far to say that his mind is also the mind of the company."

In this case, Mr Y was clearly 'the mind' of appellant. Whoever were the directors, it was in substance 'his' company. Assuming in appellant's favour that in respect of this investment, Mr Z was the controlling mind, to the extent that this concept applied specifically to the FG shares, 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. If appellant is treated separately from Mr Z, the duration of the D Ltd loans only adds to the picture of a mixed intention. Within a very short period however, the sale of the FG shares was on the agenda, initiated by Mr Y and explored further by Mr Z. When both the purpose at the time of acquisition and sale are considered, it cannot be concluded, on the probabilities, 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.

[79] In the light of this finding, I turn now to deal with the question of the deductibility of the equity kicker and the indemnity settlement.

Deductibility of equity kicker and indemnity settlement amount

<u>The equity kicker</u>

[80] In terms of the revised sale of subscription agreement which was concluded between the appellant, ABC, O et Cie and KL on 1 December 2003, appellant would acquire 17 641 842 shares in the FG Group from ABC, the agreement being effective as of 5 December 2003. The purchase price for the shares to be so acquired was R 250 million to be settled as to R 150 million in cash and as to R 100 million by setting off a portion by way of the subscription

price of 1010 preference shares in appellant to be subscribed for by ABC at a subscription price of R 101 million. All the remaining terms and conditions of the original sale of agreement, save as provided for in the addendum, continued to be of full force and effect, including the term that KL as a sole shareholder of appellant would make a shareholders loan to appellant in the amount of R 150 million.

[81] On 5 December 2003 KL entered into a loan agreement with D Ltd in terms of which the latter loaned R 150 million to KL. The sole purpose of the loan was recorded as been to enable KL to make a shareholders loan to appellant so that appellant could acquire the FG shares in terms of the sale and subscription agreement. The balance, still owing including capitalised interests thereon, was repayable to D Ltd on the maturity date of 31 May 2004. Over and above the capital and interest, KL was obliged to pay to D Ltd on settlement of the loan obligation, a further amount representing the equity kicker, calculated on the basis of an agreed formula with reference to the difference between the market value of a portion of the FG shares on the maturity date or pre-payment date and an agreed benchmark amount in relation to the outstanding principle asset from the maturity date. If, on the maturity date, the indemnity obligations of appellant to ABC had not materialised or had not been paid in full, KL was entitled to deduct amounts calculated on the basis of an agreed formula in respect of the equity kicker and to retain these amounts. This was then referred to as ‘the retained kicker’.

[82] On 5 December 2003, ABC delivered to appellant an unconditional irrevocable undertaking to transfer 17 641 842 shares in FG to First National Nominees (Pty) as nominee for appellant. Appellant discharged the purchase price by paying the cash amount of R 150 million funded by the proceeds of KL shareholder loan to which reference has already been made and by then setting off R 100 million of the subscription price paid by ABC for the preference shares. On 29 April 2004, as has already been described, appellant sold 14 141 842 FG shares to E Group and 3.5 million FG shares to its ultimate holding company, Mayfair Speculators (Pty) Ltd.

[83] On 30 April 2004 D Ltd and KL concluded a further agreement which related to the repayment to the former of the loan amount of R 15 million and the payment of the equity kicker, given that appellant sold the FG shares. In terms of this agreement, the total equity kicker payable by KL to D Ltd was R 45 123 050 and KL was entitled to retain R 6 452 252 as the retained kicker. Accordingly KL's obligation in relation to the equity kicker was in the amount of R 38 670 798.

[84] In terms of s 11 (a) of the Income Tax Act 58 of 1962 ('the Act') appellant may deduct expenditure and losses actually incurred in the production of income, provided that such expenditure and losses are not of a capital nature. This provision is qualified by s 23 (g) of the Act which provides that no deduction shall be made in respect of any monies to the extent to which such monies were not laid out or expended for the purposes of trade.

[85] Respondent contends that the obligation in relation to the equity kicker arose out of the loan agreement between D Ltd and KL. Pursuant to this loan agreement, KL became contractually bound to make payment to D Ltd of the equity kicker. Appellant was not a party to this loan agreement and it acquired no obligations in terms thereof. To the extent that appellant made payment of the amount representing the equity kicker, this payment was paid on behalf of KL and settlement of the latter's obligations to D Ltd. These payments were made in the absence of any unconditional legal obligation by appellant requiring it to do so, with the result that the expenditure does not stand to have been incurred by appellant.

[86] In support of this argument, respondent relied upon the 2004 financial statements of KL, where the shareholders loan advanced to appellant is reflected as a long term liability, and in the 2005 financial statements, where, pursuant to the sale of the FG shares and settlement of the shareholders loan, the shareholders loan was extinguished. When examined on this, Mr Y said:

> "My understanding was that A (Pty) Ltd who is the owner of this asset can be the only party that can pay interest or capital or equity kickers as at the end of the day, nobody else, because KL had no assets."

[87] Mr Kuschke submitted that the unchallenged evidence of Mr Y was the following:

> “Whatever the relationship was between D Ltd and KL that exact relationship was mirrored down to A (Pty) Ltd because… the only way they [D Ltd] could get interest, their loan back and the equity kicker was that KL enforced exactly all the same liabilities onto A (Pty) Ltd… They might have netted it off, I mean it will have no effect on KL’s financials because KL is purely a conduit as an SPV… So they might have netted it off against each other because the liability would have been as base cost in A (Pty) Ltd. Will come in and it goes out so it’s quite normal for accountants to then put it off against each other.”

[88] Accordingly, Mr Kuschke submitted that the expenditure actually incurred by appellant, in the form of its liability to pay the equity kicker, was viewed from the position of appellant as a real cost in the acquiring of the FG shares. Once a profit had been generated by way of the sale of the shares, the equity kicker would be payable. The liability was therefore incurred and appellant was required to discharge that liability.

[89] In my view, if, as has been found, the gain from the disposal of the FG shares stands to be classified as a revenue gain in the hands of appellant, the obligation, pursuant to the equity kicker, was, in substance, incurred by appellant which was required to discharge that obligation. As Mr Y testified, KL was nothing more than a SPV, a conduit which was required in the discharge of the equity kicker.

[90] The equity kicker was expenditure incurred in order to implement the transaction which was of a revenue nature and this obligation fell ultimately to be discharged by appellant. I am fortified in this view by the meaning given to the phrase 'actually incurred' in **CIR v Golden Dumps (Pty) Ltd** 1993 (4) SA 110 (A) at 117 where Nicholas AJA employed the ordinary dictionary meaning for 'actually' as, 'in act or fact', in reality.' In substance, it was appellant which 'really' incurred the obligation and which is thus entitled to the deduction as opposed to KL, because it 'actually', as employed in this context, incurred the liability.

<u>The indemnity settlement</u>

[91] In terms of the original sale of subscription agreement of 14 May 2003 appellant indemnified ABC against 5/6 of any claim for damages arising out of or in connection with any demand or claim made against ABC in respect of the ABC indemnity up to the maximum of R 125 million. Pursuant to the addendum to the sale of subscription agreement of 1 December 2003, the extent of the indemnity was then reduced to a maximum of R 71 875 000.00. On 8 July 2004, after the sale by appellant of the FG shares, O et Cie addressed a letter to ABC in respect of the indemnity, irrevocably and unconditionally guaranteeing to pay ABC the indemnified amount, in the event that appellant failed to make payment or to fulfil any of its other obligations in terms of the indemnity. On 9 August 2006 appellant entered into a written agreement with O et Cie in terms of which it assigned to O et Cie its obligations arising from the tax indemnity in favour of ABC. In terms of this agreement, appellant assigned its obligations in respect of the ABC indemnity to O et Cie and committed to pay its proportionate contribution up to an amount of R 55 million provided that appellant repay any remaining

portion; that is any payment under the tax indemnity less than R 55 million to O et Cie in accepting the assignment of all appellant's obligations arising under the indemnity.

[92] This amount of R 55 million "will be settled to Mr O by A (Pty) Ltd within 90 days of receiving confirmation of final payment and settlement under the tax indemnity to FG Group Ltd or the final expiry of obligations under the tax indemnity, which ever date occurs later". Provided that appellant complied with its contribution obligations, O et Cie indemnified and 'held appellant harmless against any and all obligations arising from the latter's obligation under the tax indemnity in favour of ABC with effect from 9 August 2006'.

[93] Respondent contends that the amount of R 55 million representing the payment for the indemnity settlement is not deductible in terms s 11 (a) and 23 (g) of the Act as no expenditure in respect of the indemnity was in fact incurred by appellant in the 2005 year of assessment. By contrast, appellant contends that the liability of R 55 million towards O et Cie was an unconditional legal liability, which constituted expenditure actually incurred by the end of the 2005 year of assessment. In this connection, Mr Kuschke relied on **Edgars Stores Ltd v CIR** 1988 (3) SA 876 (A) at 889:

> "Thus it is clear that only the expenditure… in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11 (a) from income returned for that year. The obligation may be unconditional *ab initio* although initially conditional, may

become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditures deductible in that year."

[94] This view is supported by the evidence of Mr Y, who explained how Mr Z and he had solved the problem in respect of the indemnity which had been required by ABC:

> "Mr Z immediately said, I will sign for them like I gave my word in the beginning as surety for the whole lot, on condition that I and you come to terms with how we're going to settle this, because I want finality. It's now finished. I'm out of the A (Pty) Ltd boat, you've now come into the boat, it's finished, and you must sort out A (Pty) Ltd's affairs further, but now we must come to finality. And this was again the partnership between me and Mr Z where he stepped in, gave them the indemnity to let that go away, and made it a discussion between me and him, how to resolve it further…
>
> …the discussion with Mr Z was to say, let's finalise this. I sign to ABC and let your people work out how much the tax can or cannot be, and let's settle on an amount, because I want to finish it. I want it finished in my books and we finished it in your books… and the final conclusion was that Mr Z would stand in for the whole indemnity like he signed for ABC, but we at A (Pty) Ltd will pay up to an amount of R 55 million, and that was our liability, and that's payable irrespective of what the claim was. And that was the deal we've done. I've seen the figures. Piet came to me, he showed me the proceeds, the expenses, what is the profits to be distributed, and he says that the deal Mr Z is prepared to do, so let's do it. And that must have been in July just prior to Mr Z, or while he had to sign the indemnity to ABC because he wanted finality on it."

[95] This evidence serves to indicate that, as at July 2004, the appellant had assumed an unconditional liability towards O et Cie in the amount of R 55 million. This amount was then recorded as a loan in the appellant's books of account ending 28 February 2005. Under cross examination, Mr Y said the following in reply to the question that the payment date was in the future, "It's in the future yes. The liability paid was agreed in July 2004 and when we repay it will be in the future." The evidence revealed that the appellant's liability to O 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 R 55 million was expenditure <u>actually</u> incurred during the 2005 year of assessment, because in that year of assessment an unconditional liability to pay that amount had been created.

G Co.

[96] In the calculation of appellant's profit and concomitant expenditure, an amount of R 4 980 250 was reflected as the 'G Co. portion of the profit'. According to Mr Y, he considered that Mr T, who had joined TSD in January 2002, had done 'all the leg work' in relation to appellant's role in the disputed transaction. As a result, Mr Y decided to pay Mr T's company, G Co., the amount of R 4 980 250 as recognition for T's contribution to the ultimate profit. As he said:

> "Mr T has done a great job running around doing all this work for me… I have no time, I've done this deal in principle. You run with this deal and at the end all the

> costs, all the things associated you will get a portion of it. I can't remember exactly the size..."

[97] To the extent that G Co. was entitled to its share of the gain arising from the sale of the FG shares, it would appear that Mr Y had promised the amount to Mr T. There is however no evidence that, had Mr Y reneged on his promise, there would have been a legal liability against appellant which could have been enforced by Mr T. Accordingly, this amount cannot stand to be considered to be expenditure actually incurred by the appellant in the production of income .

Interest

[98] Appellant contends that it had reasonable grounds as contemplated in s 89 *quat* (3) for the correctness of disclosures made by its tax returns and accordingly, the court should remit the interest so levied. In the light of the fact that the respondent's discretion of s 89 *quat* (3) is subject to objection and appeal, Mr Kuschke submitted that this Court was entitled to substitute its own decision for that of the appellant. He submitted that it was clear from all the evidence, given by very senior business men with considerable experience, that the appellant had acted in good faith in declaring a capital gain in 2005 tax return. In my view, there is nothing to gainsay this particular submission, particularly in that the amounts were so disclosed and appellant duly discharged its obligation pursuant to this disclosure, by paying its CGT liability.

Conclusion

[99] In the result, the 2005 assessment against the appellant is set aside and revised as follows:

1. The proceeds of the disposal by appellant of 17 641 842 shares in FG Group Limited amounting to R 498 434 500 constitutes a receipt or an accrual of a revenue nature.

2. The following amounts are allowed as deductions from appellant's taxable income:

   2.1 R 45 123 050 paid by appellant in respect of 'the equity kicker' arrangements; and

   2.2 R 55 000 000 paid by appellant in respect of the indemnification agreement;

3. Interest on the tax which has been found to be payable by appellant in terms of s 89 *quat* (2) shall be remitted.

DAVIS J