



**IN THE TAX COURT OF SOUTH AFRICA
(CAPE TOWN)**

CASE NO: 12466

In the matter between:

ABC (PTY) LTD

Appellant

And

**THE COMMISSIONER FOR THE SOUTH AFRICAN
REVENUE SERVICE**

Respondent

JUDGMENT DELIVERED ON 12 MARCH 2014

YEKISO, J

[1] The appellant, ABC (Pty) Ltd (“ABC”), is a limited liability company incorporated in terms of the company laws of the Republic of South Africa, having its registered offices in the province of Gauteng.

[2] The respondent is the Commissioner of the South African Revenue Services (“the Commissioner”), it being a duly appointed official to administer the Income Tax Act, 58 of 1962 (“the Income Tax Act”). It derives its mandate to administer the Income Tax Act from the provisions of section 2 of the Income Tax Act.

[3] The crux issue for determination in this appeal is whether ABC realised a capital gain when it disposed of 4,37% of the shares it held in D Entity (Pty) Ltd (“D Entity”) during the 2002 and 2003 years of assessments. ABC elected to use the market value of the shares as its base cost. ABC contends that it incurred a capital loss in respect of disposal of the relevant shares in D Entity. It contends that the aggregate base cost of the shares it disposed of was in an amount of R8,086,162-00 and that this amount was greater than the proceeds realised out of disposal of such shares. In this regard ABC contends that the aggregate market value of D Entity, as at the valuation date, was in an amount of R198,768,000-00 and that the aggregate base cost of the shares it disposed constitutes 4,37% of the total aggregate base cost of shares in D Entity.

[4] The valuation of the shares was obtained from EF (Pty) Ltd (“EF Entity”) which was mandated to prepare a valuation of shares of all companies in the X Group, which includes D Entity, in order to determine the base cost of the various interests of the group as at 1 October 2001 for capital gains tax purposes. In terms of this valuation, the market value of all the shares in D Entity, as at 1 October 2001, was value at approximately R198m. The Commissioner adjusted this valuation, in terms of paragraph 29(7)(b) of the 8th Schedule to the Income Tax Act to nil.

THE ASSESSMENT

[5] On 10 April 2007 the Commissioner raised additional assessments in respect of ABC' 2002 and 2003 tax years ("the additional assessment"). In terms of this additional assessment, the sum of R2m was recognised as proceeds arising from the sale of 2.37% shareholding in D Entity in the 2002 tax year. In the 2003 tax year, the sum of R2,2m was recognised as sales proceeds arising from the disposal of 2% of ABC' shareholding in D Entity.

[6] In the additional assessments, raised in terms of paragraph 29(7) of the 8th Schedule, the Commissioner adjusted the value at which the relevant shares in D Entity had been valued by ABC from R8,686,162-00 to nil. The Commissioner consequently assessed ABC for a capital gain of R2m in its 2002 year of assessment and for a capital gain of R2,2m in its 2003 year of assessment in respect of its disposal of the relevant shares during the aforementioned years of assessment.

[7] On 5 July 2007, ABC objected to the additional assessment raised by the Commissioner in respect of the 2002 and 2003 years of assessment. The objection was based thereon that the Commissioner's rejection of the valuation furnished by ABC as at 1 October 2001 was misguided and flawed in material respects.

[8] On 7 August 2007 the Commissioner disallowed ABC' objection. On 4 September 2007 ABC lodged this appeal against the disallowance of its objections.

MATERIAL FACTS / COMMON CAUSE FACTS

[9] The facts set out in the paragraphs which follow are either common cause or not seriously disputed by either of the parties.

[10] ABC, as an entity, was incorporated on 14 June 1996, its main objective or business in its Memorandum of Incorporation being described as “investments in all aspects by the principal”.

[11] Prior to the 2002 and 2003 years of assessment, ABC acquired 23,73% shareholding in D Entity. The main business or object of D Entity, as described in its Memorandum of Incorporation, is the developing, owning, operating and conducting the business of casinos, hotels and related leisure ancillary activities.

[12] D Entity was awarded a casino licence on 21 October 2000 by the Kwazulu Natal Gambling Board. The casino licence so awarded is an exclusive licence for exclusive use for a period of 15 years. It confers immunity to D Entity from competition within a defined area, the area within which the licence had to operate being defined in the licence itself.

[13] Once D Entity was awarded the casino licence a dispute arose between it and members of a religious group referred to as G Group. The dispute between D Entity and the X Group related only to the site which was targeted for the erection of the casino and not to the awarding of the casino licence itself.

[14] As a result of delays occasioned by this dispute, D Entity had had to acquire an alternative site at which it had intended to operate a temporary casino. Once the

alternative site was acquired, D Entity had to apply for a temporary licence to operate a temporary casino at the acquired alternative site. The temporary licence was officially granted to D Entity on 4 October 2001.

[15] The legal proceedings instituted by the X Group did not succeed. It would appear that the proceedings never even got to the merits of the disputes involved. The High Court, so it would appear, dismissed an application for an extension of a period within which the X Group had to institute those legal proceedings. That decision was subsequently upheld by the Supreme Court of Appeal.

[16] The value of the shares held by ABC in D Entity was determined by obtaining a valuation of the total share value of D Entity as at 1 October 2001. ABC's shares in D Entity constituted 23,73% of the total value of shares. The evaluation was based on a mandate given to EF Entity to prepare a valuation of the associated companies within the X Group of companies which included D Entity. The evaluation was for purposes of determining the base cost of the various interests within the group as at 1 October 2001 for capital gains tax purposes. The valuation was obtained from EF Entity on 25 August 2004.

[17] The valuation method used in the determination of the base cost of the associated companies within the X Group was the discount cash flow methodology. This method entails that the business is valued on its future forecast free cash flow discounted back to the present values through the application of a discount factor which represents the required return sought by an investor.

[18] The valuation so obtained dealt with such aspects as source of information; business overview; the casino market; the strategic position of D Entity in the market; financial performance; discussion of the valuation methodology; selected valuation methodology; discounted cash flow valuation; and valuation.

[19] The total shareholding in D Entity, as at 1 October 2001, was valued at R198,768,000-00. Based on the discount cash flow methodology, ABC' 4,37% shareholding in D Entity which it disposed of during the tax years 2002 and 2003, was valued at R8,686,162.00 as at 1 October 2001. ABC sold 2,37% of its shares during the 2002 year of assessment for R2m and a further 2% during the tax year 2003 for R2,2m.

[20] In terms of paragraph 26 of the 8th Schedule to the Income Tax Act, the taxpayer may adopt any of the three methods to determine the base cost of an asset, these being the market value of the asset as at 1 October 2001; the time apportioning basis (the base cost being determinable once the proceeds are known); and 20% of the proceeds. The taxpayer has an option as regards which of the three methods of valuation to use for purposes of determining the valuation date value of its asset.

[21] In terms of paragraph 26(3) of the 8th Schedule, the base cost of the shares is limited to the proceeds of sale of such shares. Based on this approach, ABC contends that it incurred a capital loss in respect of the shares it disposed of. It (ABC) did not claim a capital loss arising from the disposal of 4,37% of its shares in D Entity.

[22] Based on the evidence of Mr Y, who was the general manager of ABC at the time the shares were disposed of, ABC disposed of 2,37% of its D Entity' shares to one

Mr K, whilst the other 2% shares disposed of in 2003 were sold to L Investments for R2,2m.

THE CAPITAL GAINS TAX REGIME

[23] The Capital Gains Tax was introduced on 1 October 2001. It was introduced to the Income Tax Act by way of two legislative changes, these being the insertion of section 26A and the introduction of the 8th Schedule to the Income Tax Act. Capital Gains Tax is payable on any capital gain made on the disposal of assets which were in the seller's possession on, or were acquired after 1 October 2001. A capital gain or loss is determined by calculating the difference between the proceeds and the base cost of the disposed asset.

[24] A person's capital gain in respect of a particular asset is equal to the proceeds from the disposal of the asset less its base cost. Thus, the starting point for determining the amount of capital gain arising out of disposal of an asset is to establish its base cost.

[25] The relevant provisions for purposes of determining the issues in dispute in these proceedings are those contained in paragraph 25(1); paragraph 26(1); paragraph 26(3); paragraph 29(1)(c) and paragraph 31 of the 8th Schedule.

[26] Paragraph 25 of the 8th Schedule under the heading "Determination of base cost of pre-valuation date assets" reads as follows:

"(1) The base cost of a pre-valuation date asset (other than an identical asset in respect of which paragraph 32(3A) has been applied), is the sum of the valuation date

value of that asset, as determined in terms of paragraphs 26,27 or 28 and the expenditure allowable in terms of paragraph 20 incurred on or after the evaluation date in respect of that asset.”

[27] Each relevant share that ABC disposed of in D Entity was a pre-evaluation date asset. Pre-evaluation date asset is defined in paragraph 1 of the 8th Schedule as an asset acquired prior to valuation date by a person and which has not been disposed of by that person before the valuation date.

[28] In relation to pre-evaluation date assets, paragraph 26(1) of the 8th Schedule gives the taxpayer an election to value the asset as at 1 October 2001 in order to determine its base cost in any one of the following options, these being: its market value as contemplated in paragraph 29; 20% of the proceeds from the disposal of that asset, after deducting the expenditure permitted under paragraph 20, incurred after 1 October 2001; and the time apportionment base cost of the asset, as determined in terms of paragraph 30 of the 8th Schedule.

[29] ABC elected to use the market value of the shares held in D Entity as at 1 October 2001 to determine the base cost of the shares it disposed of. It is for this purpose that a valuation was obtained from EF Entity in respect of all the shares in D Entity. The valuation so obtained (the EF Valuation) was prepared by Mr Z of EF Entity Services (Pty) Ltd and is intended to indicate a valuation of each entity within the X Group, including D Entity, for capital gains tax purposes. It is dated 25 August 2004. In terms of the EF Valuation, the value of D Entity was determined in an amount of R198,768.000-00.

[30] In terms of paragraph 29(1)(c) of the 8th Schedule the market value on the valuation date of the shares disposed by ABC had to be a market value determined in terms of paragraph 31 of the 8th Schedule. In terms of paragraph 31(1)(g) such market value ought to have been the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market on the valuation date (the valuation date being 1 October 2001).

[31] Paragraph 26(3) of the 8th Schedule limits the base cost of a taxpayer in cases where the market value option has been elected but the proceeds from the disposal of that asset is less than the base cost. Paragraph 26(3) of the 8th Schedule provides as follows:

“(3) Where a person has adopted the market value as the valuation date value of an asset, as contemplated in sub-paragraph (1)(a), and the proceeds from the disposal of that asset do not exceed that market value, that person must substitute as the valuation date of that asset, those proceeds less the expenditure allowable in terms of paragraph 20 incurred on or after the valuation date in respect of that asset. “

[32] It is within the parameters of the legislative matrix set out in the preceding paragraphs that a determination has to be made if the Commissioner was correct in disallowing ABC' objection; if ABC has established the market value, as at 1 October 2001, of the shares it disposed of; and whether the valuation of the asset disposed of is reasonable.

BURDEN OF PROOF

[33] In terms of section 102(1) of the Tax Administration Act, 28 of 2011, the burden of proving a market value of an asset in terms of paragraph 29 of the 8th Schedule is borne by the taxpayer, it being ABC in the instance of this matter. The section provides that a taxpayer bears the burden of proving that the valuation of an asset disposed of is correct or whether a decision that is subject to objection and appeal under a tax act is incorrect. Thus, in the instance of this matter, ABC must discharge the onus of proving on the balance of probabilities that the value placed upon D Entity as at 1 October 2001, as per the EF Valuation, is a reasonable market value.

THE EVIDENCE

[34] In an attempt to prove the reasonableness of the market value placed on the shares it disposed of, ABC relied on the evidence of Mr H, Mr Y, Mr I as well as two expert witnesses in the persons of Mr Z and Mr J. The evidence of Mr J was intended to show, in the circumstances of this matter, that a net asset value methodology in determining the value of shareholding in D Entity, as contended by the Commissioner, is not appropriate and that the appropriate method in the determination of the required value is the discounted cash flow valuation method. The values relied upon by ABC in an attempt to prove the market value of the shares it disposed of was based on a discount cash flow valuation method. The Commissioner, without conceding that the net asset evaluation method is not the appropriate method in the circumstances of this matter, nonetheless, is prepared to assume for purposes of argument that the discount cash flow valuation method is the correct method to have been used in order to determine the market value of the relevant shares. Based on this approach, the evidence of Mr J is thus rendered irrelevant in the determination of the question as to

whether the valuation as presented in the valuation report is based on the correct valuation method.

[35] Consequently, the question that then remains to be determined is whether ABC has established, through the evidence of Mr Z, together with the other witnesses of fact called to testify, that the value placed on D Entity in the EF Valuation may be considered reasonable due regard had to the provisions of paragraph 29 of the 8th Schedule. A determination of this issue will be based on the evidence tendered at the hearing of this appeal as a whole to the extent such evidence is relevant for the determination of the reasonableness or otherwise of the valuation as presented in the valuation report. In as far as the evidence of Mr Z is concerned, a proper approach in the evaluation of his evidence, as an expert witness, has to be adopted. As regards the proper approach to be adopted in the evaluation of the evidence of an expert witness, I was referred to several authorities. I refer to some of those authorities in the paragraphs which follow.

[36] In *Menday v Protea Assurance Company Limited* 1976 (1) SA 565 (E) at 569B–E the court made the following observation:

“It is not the mere opinion of the witness which is decisive but his ability to satisfy the Court that, because of his special skill, training or experience, the reasons for the opinion which he expresses are acceptable.”

[37] And in *Holtzhausen v Roodt* 1997 (4) SA 766 (W) at 772B-773B the court made the following observation with regards to the approach to be adopted in the assessment of the evidence of an expert witness:

“Fourth, the facts upon which the expert opinion is based must be proved by admissible evidence. These facts are either within the personal knowledge of the expert or on the basis of facts proved by others. If the expert has observed them, then the expert must testify as to their existence. The duty of the expert is to furnish the judge with the necessary scientific criteria for testing the accuracy of the expert’s conclusions so as to enable the judge or jury to form their own independent judgment by the application of these criteria to the facts proved in evidence.”

[38] In *Coopers SA (Pty) Ltd v Deutsche Gesellschaft Für Schädlingskämpfung MBH* 1976 (3) SA 352 (A) at 771F-H the court made the following observation:

“As I see it, an expert’s opinion represents his reasoned conclusion based on certain facts on data, which are either common cause, or established by his own evidence or that of some other competent witness. Except possibly where it is not controverted, an expert’s bald statement of his opinion is not of any real assistance. Proper evaluation of the opinion can only be undertaken if the process of reasoning which led to the conclusion, including the premises from which the reasoning proceeds, are disclosed by the expert.”

[39] In DT Zeffert *et al The South African Law of Evidence, 1st Edition 2003* at 303-5 it is pointed out that:

“[a]n expert witness may be asked to state his or her opinion either as an inference from facts within his or her personal knowledge, or upon the basis of facts proved by others.”

and that generally

... the witness' opinion is valueless unless there is proof of the assumed facts upon which it is based. It is therefore essential that the court should be told of the premises which the witness has assumed, and if one or more of these is finally rejected, the opinion too must be discarded.”

“In many cases, if an expert's opinion is to carry weight it is essential for him or her to state his or her reasons. As we have seen, the court should not ordinarily accept a bald statement of opinion on the very point which it has to decide.”

“...it is submitted that, in some circumstances, it is conceivable that a failure to give, or to be able to give, reasons may so take away from the evidence as to leave it without any weight.”

“But, usually, the determination, as we shall see, depends on the examination of the opinions and the analysis of the reasoning behind them.”

[40] Based on the authorities cited above, it then becomes necessary to consider and to determine whether the facts relied upon by Mr Z as the basis or premises for his conclusions are proved; whether he has given reasons for the opinions which he expressed; and, if so, whether those reasons justify his conclusions.

[41] But, in order to assess and to evaluate the evidence of Mr Z in a proper context, a reference will have to be made to the evidence of some of the witnesses of fact, in particular, the evidence of Mr H and Mr I tendered at the hearing of this appeal.

[42] Before dealing with the evidence of Mr H and Mr I, it is necessary to deal with the reasons given by the Commissioner for raising an additional assessment in respect of ABC' 2002 and 2003 years of assessment. In its letter of assessment dated 10 April 2007 the Commissioner states "Kindly be advised that we have reviewed the information supplied and evaluated the various representations made, and are of the view that it is not regarded as appropriate to value the company using the discount cash flow method as the casino had not commenced business at 1 October 2001. D Entity should therefore be valued using the "net asset value" method of evaluation at 1 October 2001. Note that the facts taken into account when valuing D Entity are detailed in our above letter of findings."

[43] The letter proceeds "In our opinion the value of the licence at 1 October 2001 should be limited to the costs incurred to date (approximately 19 million). This is stated in light of the abovementioned factors, and taking into account the fact that the market for the sale of casino licences was limited. D Entity would therefore be valued at nil at 1 October 2001 (the company had a nil net asset value at that date)."

[44] Mr T, a Chartered Accountant and a Principal Auditor in the office of the Commissioner, lists in his letter of findings several material facts the Commissioner took into account in adjusting the valuation of D Entity. Mr T lists these factors as being that the casino licence was its only asset of note; that the licence could not be varied or sold without the permission of the KwaZulu Natal Gambling Board; that there had only been four other applicants of the casino licence in the Richards Bay area; that D Entity was unable to utilise the said licence as at 1 October 2001 as it was involved in a protracted court action with the X Group; that the High Court had not ruled on the G Group application as at 1 October 2001; that there was uncertainty that its application for a

temporary licence in Empangeni would be approved; that D Entity did not have guaranteed bank funding as at 1 October 2001; and the estimate of revenues, which would be generated by the casino, was made in 2000 and not adjusted downwards to take account of the contraction of the economy after the attacks of 11 September 2001.

[45] In his evidence Mr T gave two main reasons for the adjustment, these being that the discount valuation method could not be used in the determination of D Entity's shares; and that the forecasts used by Mr Z for the purpose of valuation were not reliable. The letter of findings concludes that D Entity would therefore be valued at nil as at 1 October 2001, in other words that D Entity had a nil asset value as at 1 October 2001. It is worth noting that the Commissioner did not list the unreliability of the projections and assumptions made in the EF Entity Valuation as one of the factors it took into account in raising the additional assessment.

THE EVIDENCE OF MR H

[46] Mr H is a holder of a Bachelor of Commerce degree obtained from the University of the Witwatersrand. As at the time he tendered evidence at the hearing of this appeal he had been employed by S Global and holds the position of the Executive Director. The nature of S Global's business is to develop, own and operate hotels, casinos and resorts. He became involved in the casino industry in 1995 when he was employed by the X Group as the Executive Director. Similarly, the nature of business of the X Group is to own, operate casinos, hotels and resorts. In the years 1995/1996 the X Group acquired five casinos from the S Group which at the time was intent on reducing the number of licences it held in the homeland areas to make itself attractive to be awarded casino licences and to operate casinos in the new dispensation in

geographic areas other than the former homelands. The X Group was one of the shareholders in D Entity.

[47] In D Entity Mr H held the position of the director responsible for most of the work that required to be done in order for D Entity to achieve success to obtain the casino licence. The application by D Entity for a casino licence was a sixth such application that he was involved in. D Entity was awarded a casino licence on 21 October 2000 by the KwaZulu Natal Gambling Board. The licence so acquired was an exclusive licence for exclusive use for a period of 15 years. It conferred immunity to D Entity from competition within a defined area, the area within which the licence had to operate being defined in the licence itself. He testified that he is not aware of any casino that had been closed down because of economic reasons.

[48] A casino licence, so Mr H asserted in his evidence, guarantees the holder thereof a significant return in future. He testified that on this basis alone, the Commissioner's contention that the value of D Entity's shares is nil, should be rejected. The casino licence that was awarded to D Entity on 21 August 2000 was an incredibly valuable asset. He stated that the perceived risks indicated by the Commissioner pertaining to the litigation that D Entity had with the Richards Bay X Group did not cause the licence to lose its value. The casino licence itself was never threatened by the dispute with the Richards Bay X Group. The dispute itself pertained to the site where the casino was to be erected and not to the licence itself.

[49] It was put to Mr H in cross-examination that due to the fact that a temporary licence was not awarded to D Entity on 1 October 2001, that the effect thereof meant

that no value could be attached to the licence itself as D Entity could not utilise the casino licence as at 1 October 2001. Mr H disagreed with this statement and re-iterated that as at 1 October 2001, D Entity had a casino licence and that the value of D Entity, as at 1 October 2001, lies in that licence. The temporary licence that was to be issued to D Entity was not a separate licence but merely a change in respect of the site where the casino licence would be operated.

[50] By the time the temporary licence was formally granted on 4 October 2001, D Entity had made great progress in developing the temporary site which enabled them to start operating the casino on 28 May 2002. Mr H testified that in D Entity' mind, as at 1 October 2001, there was no doubt that a temporary licence would be granted based on an interaction between management and the members of the KwaZulu Natal Gambling Board and specifically its monitoring committee.

THE EVIDENCE OF MR I

[51] Mr I is a holder of a Bachelor of Commerce Honours degree obtained from the University of Cape Town. He also holds a Certificate in Theory of Accountancy similarly obtained from the University of Cape Town. He is a qualified Chartered Accountant.

[52] At the time D Entity had applied for a casino licence Mr I was a Chief Executive Officer of the X Company which managed the operation of D Entity. He testified that the relationship between D Entity and the KwaZulu Natal Gambling Board changed significantly after the permanent casino licence was awarded to D Entity on 21 August 2000. After the permanent casino licence was awarded D Entity and the KwaZulu Natal Gambling Board worked closely together to ensure that D Entity would start operations

as soon as possible. He testified that the KwaZulu Natal Gambling Board was eager that the operations should start as soon as possible since that would generate income in the form of levies and taxes to the KwaZulu Natal Provincial Government.

[53] At the time D Entity had applied for a temporary licence to relocate its operations to a temporary site, he (Mr I) had been in constant communication with the chairperson of the KwaZulu Natal Gambling Board and it was conveyed to him that the KwaZulu Natal Gambling Board would support the application for the issuing of a temporary licence to D Entity to operate on a temporary site at Empangeni. As at 1 October 2001 there was no doubt in his mind that the temporary licence would be awarded. Although the temporary licence was awarded on 4 October 2001, D Entity, as far back as 2 August 2001, had already purchased a site at Empangeni at which the temporary casino would be operated. By the time the temporary casino licence was awarded on 4 October 2001, D Entity had already started with other preparations to conduct the business of a casino at the Empangeni site. He testified, finally, that D Entity would never have embarked on such preparations if they did not believe that a temporary licence would be granted.

[54] Within the context of the background as set out in the evidence of Mr H and Mr I, I shall now proceed to evaluate the evidence of ABC' expert in the person of Mr Z.

THE EVIDENCE OF Mr Z

[55] Mr Z testified that he is a Chartered Accountant and holds a Bachelor of Commerce Honours degree obtained from the University of South Africa. Amongst

other things, and through licences issued by the Johannesburg Stock Exchange (“JSE”), he acts as sponsor and designated advisor to matters pertaining to the JSE and listed companies in particular. He explained in his evidence the process involved in compiling the EF Valuation including interaction with management, in particular, Mr H and Mr I who was at that stage the Chief Executive Officer of the entire associated companies in the X Group. His evidence is based on the EF Valuation he compiled for the associated companies within the X Group. In compiling the EF Valuation Mr Z used a discount cash flow (“DCF”) method amongst a variety of valuation methods that may be deemed appropriate in the assessment of the market value of an entity. According to him the discount cash flow methodology values the business of an entity on its future forecast free cash flows, discounted back to present value terms through the application of a discount factor which represents the required return sought by an investor. This discount factor is also reflective of the risk inherent in the business.

[56] Two essential elements emerge in the methodology utilised in the evaluation of the market value of the entire shareholding in D Entity, these being, a determination of the “future forecast free cash flows”; and a determination of the appropriate “discount factor”.

[57] It is submitted on behalf of the Commissioner that the valuation compiled by Mr Z falls woefully short in relation to both of the elements described above in that, in the first instance, the “future forecast free cash flows” were not established by any admissible evidence; and that Mr Z did not, on any acceptable basis, establish that an appropriate “discount factor” was applied by him.

[58] In addition to what has been stated in the preceding paragraph, it is further submitted on behalf of the Commissioner that Mr Z, having determined the value of D Entity, in valuing the relevant D Entity' shares, failed to apply a discount based on the fact that these were minority shares.

MINORITY SHAREHOLDING

[59] ABC, as at 1 October 2001, held 23,7% shares in D Entity. This factor is well taken into account in the valuation. Mr Z testified that the information on the basis of which the valuation was compiled was based, amongst others, on minority shareholding. According to him, there was no need for an adjustment on the basis that ABC was a minority shareholder. If anything, so Mr Z testified, the fact that ABC held a substantial number of shares, almost a quarter of the issued share capital in D Entity, would have warranted a premium on the value. On the other hand, Mr H testified that ABC and the X Group, which held 26,27% in D Entity, are the only shareholders that were actively involved and actively participated in the management of D Entity. Although M Investments (Pty) Ltd ("M Investments"), a Black Economic Empowerment ("BEE") partner, held 40,75% shares in D Entity, M Investments was a special purpose vehicle. M Investments represented a large number of BEE shareholders, who amongst themselves, held an aggregate of between 0,25% to 2% of the shares.

[60] Mr H, furthermore, testified that although M Investments was represented during management meetings, the business acumen of ABC and the X Group was the driving force in taking management decisions. Finally, Mr H testified that ABC and the X Group were the sponsoring shareholders to comply with the required 50/50 debt/equity ratio required by financial institutions. It therefore follows, in my view, that

the criticism of the valuation, based on the fact that ABC was a minority shareholder in D Entity, does not render the valuation as compiled by Mr Z as being unreasonable.

FUTURE FORECAST CASH FLOWS NOT ESTABLISHED

[61] The cash flows upon which Mr Z based his discount cash flow calculations are those reflected in the valuation spreadsheet annexed as annexure “A” to the EF Valuation. It is submitted on behalf of the Commissioner that the valuation spreadsheet in annexure “A” to the EF Valuation is fundamentally flawed in a number of respects, these being the validity or reliability of the projected “revenue”; the validity or reliability of the projected “tax”; the validity or reliability of the projected “capital expenditure”; the validity or reliability of the projected “working capital movement”; the validity or reliability of the “terminal value”; and the utilisation of an incorrect date.

[62] Before dealing with the issues raised in the preceding paragraph it is worth noting that the reliability or reasonableness of the valuation we are called upon to determine is the valuation as at 1 October 2001 based on information known at that date and not on any information known between 1 October 2001 and August 2004, the date the valuation was done. It is on the basis of the information as at 1 October 2001 that we are called upon to determine whether the valuation as presented can be considered to be a reasonable market value.

[63] The Commissioner assessed ABC on the sale of shares in the D Entity in April 2007 using a nil base cost value on the shares sold in 2002 and 2003. This value had not been arrived at by looking at the reasonableness or not of the figures submitted by ABC but rather at the method used to arrive at a value. The discount cash flow market

value method was rejected by the Commissioner who considered that the net asset value should have been used as opposed to the discount cash flow method. During all the communication that took place between ABC and the Commissioner in the years that followed leading up to the hearing of this appeal, ABC was not asked to submit any figures to back up the reasonableness of the figures used in the valuation submitted. There was a period of nine years between the date the valuation was prepared and the date ABC' objection was disallowed culminating in the hearing of this appeal.

[64] The initial presentations of the valuation by ABC highlighted the revenue projections as having been provided by management. It was in the course of these proceedings that it became apparent that the revenue projections had been prepared for management by A & B. Those revenue projections were presented to the KwaZulu Natal Gambling Board on 10 July 2001 in support of the temporary casino licence, in other words, a mere two months prior to the valuation date of 1 October 2001. These were intended to substantiate an application for a temporary licence which would have enabled D Entity to operate a temporary casino at Empangeni. These were the figures that were presented to Mr Z by management. They had been compiled independently by a highly professional firm with the added knowledge that they had been audited to some extent by G Accounts on behalf of the Gambling Board. In addition, the figures were not prepared for a capital gains valuation but rather in support of a temporary licence application. In my view, figures prepared by a third party and subjected to public scrutiny would be more reliable than if prepared by management solely for capital gains valuation purposes. In my view, the figures relied upon in substantiating future revenue projections constitute the best possible evidence of the forecast that could be made on

1 October 2001 in order to determine the value of the casino licence since these were done a mere two months before 1 October 2001.

[65] For the Commissioner to now complain that the valuation should be rejected on the basis that the figures used to prepare revenue projections had been prepared by A & B when the Commissioner rejected the valuation because the Commissioner considered that the net asset value method should have been used is, in my view, shifting the goal posts. Accordingly, I hold the view that the projected income figures as at 1 October 2001 are not only reliable but reasonable.

VALIDITY OR RELIABILITY OF PROJECTED TAX

[66] The Commissioner contends that the valuation did not consider the reasonableness of the tax deduction. However, no evidence was tendered at the hearing of this appeal as to what rate should have been used and we were, therefore, not given an idea of the materiality of the criticism. In fact, the attitude expressed on behalf of the Commissioner is that the witnesses who were called to testify for the Commissioner had no mandate to do an evaluation. It would therefore appear that the only mandate that the witnesses for the Commissioner were mandated to do was merely to level criticism at the reasonableness or otherwise of the projected tax deduction. Mr Z, on the other hand, testified that the figure for the projected tax deduction was obtained from the X Management who had been in the casino industry for a considerable period of time. Mr Z testified that he used a tax rate of 30% which was the ruling corporate statutory rate at the time. In the light of the fact that it is a statutory rate that was used and that the X Management had vast experience in the casino industry, I am of the view that Mr Z was justified in accepting the information

provided by management as reasonable despite the criticism levelled at the perceived shortcoming in the evidence of Mr Z raised in the Commissioner's submissions.

CAPITAL EXPENDITURE

[67] Professor P, an expert called to testify for the Commissioner, criticizes Mr Z's valuation on the basis that the valuation spreadsheet includes a deduction for capital expenditure which appears significantly too low. He cites in his criticism capital expenditure for the years 2003 and 2006 reflected at only R5,000-00 and the capital expenditure for the year 2004 which is reflected as being nil.

[68] What Prof P appears to have failed to point out is that for the year 2005 there is provision for capital expenditure in an amount of R181m. The total capital expenditure provided for in the valuation spreadsheet approximates an amount of R200m. In the Commissioner's letter of findings it is stated that the estimated costs occasioned by a delay in commencing operations increased from R160m to R180m. Thus, the estimated capital expenditure in the approximate amount of R200m reflected in the valuation spreadsheet appears to be in excess with a figure of approximately R20m due regard had to the Commissioner's estimate in the approximate amount of R180m in this expenditure item.

OTHER BASIS OF CRITICISM

[69] There are other basis of criticism relating to the determination of the future forecast cash flows as reflected in the valuation report. These relate to the validity or reliability of projected working capital; validity or reliability of the terminal value; and utilisation of an incorrect date.

[70] In as far as the validity or reliability of projected working capital is concerned, it would appear that the main elements which affect working capital in an entity are the movements in stocks, debtors and creditors other than cash. Other than bar and food stocks, a casino or a hotel operation carries no other stocks. There are no debtors with patrons or customers paying cash for the required services. The insertion in the forecast of a positive working capital in the valuation report is therefore, in my view, understandable. In view thereof, there is, in my view, no basis for an adjustment with regards to the projected working capital.

[71] In as far as the validity or reliability of the terminal value is concerned, in my opinion, the witnesses for ABC explained very clearly that whilst licences to operate a casino were granted for a limited period of 15 years, it is seldom that licences would not be renewed at the end of that period. Exclusivity to a particular area may be lost but the licence to continue will more than likely to be granted. I can therefore understand and appreciate the reasonableness of including cash flows into “perpetuity” as opposed to limiting cash flows to the duration of the operation of a licence.

[72] In as far as the utilisation of an incorrect date is concerned, ABC conceded that an incorrect date for the cash flow was used, this being 1 March 2002 instead of 1 October 2001. This could have the effect of reducing the total value by an amount of approximately R20m.

[73] Finally, in as far as the future forecast cash flows is concerned, I consider the basis for using the A & B figures to be reasonable and the best option to choose for the date of 1 October 2001.

THE DISCOUNT RATE

[74] It is common cause that the Commissioner raised the additional assessment on the basis that a discount cash flow method was used as opposed to the net asset value method. That ABC used the discount cash flow method in the determination of its value appears to be common cause. It further appears to be common cause between the expert witnesses that in order to apply the discount cash flow method it is necessary to determine an appropriate discount rate to be applied to the protected cash flows. This is confirmed in the valuation wherein the following is stated under the heading “Valuation Methodologies”:

“Discount cash flow (“DCF”) methodology – values the business on its future forecast free cash flows, discounted back to present value terms through the application of a discount factor which represents the required return sought by an investor. This discount factor is also reflective of the risk inherent in the business.”

[75] Mr Z accepted in his evidence that in determining a discount rate it is necessary to make adjustments taking into account the relevant risks. Hence, in the valuation, a discount rate of 20,86% has been applied. A discount rate is arrived at in a manner set out in paragraph 11.2.3 of the valuation, under the heading “Weighted average cost of capital”

[76] The discount rate as applied by Mr Z is the subject of criticism by Prof P. Prof P states that the discount rate used in the EF Entity valuation was too low and that instead of a discount rate of 20,86% as used by EF Entity, an appropriate discount value should have been used due regard had to all those factors mentioned in paragraph 7.28 of Prof P's report. However, it appears that all those factors on the basis of which Prof P contends that the discount rate should have been in the region of approximately 40%, are not based on facts which he himself independently established but are, rather, based on information which was conveyed to him.

[77] The other factors which constitute the basis of Prof P's opinion, that is, those contained in paragraph 7.28.4 and 7.28.6 of his report, appear to have been conceded by Prof P in the course of his testimony, so that one cannot, therefore, on the basis of all the factors set out in paragraph 7 of his report, conclude that the value as compiled by Mr Z is unreasonable. On the other hand, the discount rate used by Mr Z has been explained, in my view, in much detail. As regards the risk premium, Prof P stated that the 40% rate referred to in his report is just an illustrative figure and conceded that no value could be placed thereon as he did not try to make any valuation and did not have any instructions to make an evaluation. He accordingly, could not justify his view that an appropriate discount rate should have been in the region of 40%.

[78] It was conceded on behalf of the Commissioner during the course of trial that the valuation methodology chosen by SARS when rejecting the valuation put forward by ABC was incorrect and therefore the discount cash flow method was agreed as the most appropriate method in the circumstances of this matter. ABC have set out fully in the table at page 136 of the report the basis on which Mr Z arrived at the weighted

average cost of capital which is the discount rate in reducing the total of the future cash flows, as forecast, to a present day value. The weighted average cost of capital basis and the elements comprising it for arriving at an appropriate discount, are used extensively throughout the world and were not disputed by the Commissioner. That said, I can see no basis for the view that the weighted average cost of capital of 20,86%, as applied by Mr Z, is unreasonable.

[79] As will be noted in the table at p136 of the report, there are two specific portions making up the weighted average cost of capital, these being, cost of debt and cost of equity, with a split of 10% and 90% of the total weighted average cost of capital in this particular valuation. There appears to be no dispute about the split nor was there any dispute about the cost of debt portion valued at 0, 95%. The cost of equity has three elements namely the risk free rate, the specific risk rate and the risk premium. There appears to be no dispute about the risk free rate of 10, 55%. The specific risk element is further broken down into two sections namely the Beta factor and market risk premium. The Beta factor, as set out on P 135 of the report, is a relative measure of a quoted share`s volatility compared to the share market as a whole which has Beta equal to 1. The factor is supposed to indicate the market`s perceived risk of the nature of the specific industry which in this case is the running of a casino. A Beta of 1, 16 was used which was the average of the Beta factors existing at that time for Sun International and Gold Reef Casinos. This factor is not, in my view, inappropriate. The market risk premium is the additional risk that is attached to an investment in a company as opposed to a fixed return investment such as government bonds. The market range of the premium existing in October 2001 was between 6 – 8%. A premium at the higher end of 7, 5% was not contended by the Commissioner to be too low. The risk premium

is added to the total of the risk free rate and the specific risk rate and is expressed as a % on this total. It is risk considered to be the additional risk of investment in a specific company based on a number of factors including start up, management and locality. A premium risk of 15% was added in this calculation in order to arrive at the total discount factor of 20, 89%.

[80] It was contended on behalf of the Commissioner that the risk premium of 15% was too low and little justification given for using this amount, but no attempt was made to put forward what might be considered to be a “reasonable” premium from the Commissioner’s point of view. Professor P, in the course of his evidence, suggested that an overall weighted average cost of capital of 40% should have been used. However, to arrive at a 40% weighted average cost of capital figure one would have to use a risk premium in excess of 100% in order to arrive at this figure. With the greatest of respects, Professor P’s view in this regard does not appear to carry weight and I cannot, based on the view expressed, conclude that the discount rate arrived at in the manner set out in the table at p136 of the report is unreasonable.

[81] As regards the criticism relating to the application of the same discount rate to all of the entities in the X Group, it is so that the other casinos in the group such as M and V, are established casinos. But the fact of the matter is that the risk inherent in casinos such as M and V is, amongst others, the distance from any major city and/or large industrial or tourist area. On the other hand, D Entity is strategically placed between the only two casinos along the eastern side of Southern Africa. D Entity is situate close to the growing port of Richards Bay, the industrial hub of Zululand and Empangeni and a large population in the vicinity. Moreover, the X Group, which was

tasked with the management of D Entity, had vast experience in running casinos and, therefore, would have known that they had a prospective winner in their hands. ABC' arguments about the "swings and roundabouts" of each operation in arriving at the same risk premium for the group should be understood in this context.

[82] I have furthermore considered all the other factors referred to in the Commissioner's submission relating to the appropriateness of the discount factor applied, those relating to unresolved litigation and failure to take into account the risks regarding construction. In my view, it cannot be seriously contended that the perceived failure to take the aforementioned factors into account should seriously affect the reasonableness or otherwise of the value as compiled by Mr Z and the application of the concomitant discount rate. I accordingly determine that the EF Valuation Report, as compiled by Mr Z, is not only reliable, but, in the circumstances of this matter, also reasonable.

[83] As pointed out in paragraph [45] of this judgment Mr T, who testified for the Commissioner, stated in his evidence that the two main reasons for raising an additional assessment was based on the fact that the discount cash flow method of valuation applied was not an appropriate method of valuation in the determination of D Entity' shares and that the forecasts used by Mr Z for the purpose of valuation are not reliable. I have already made a finding in the preceding paragraph that the EF Valuation report, as compiled by Mr Z, is not only reliable but also reasonable in the circumstances of this matter. It therefore follows that the Commissioner's reasons for the adjustment of the assessment, as testified by Mr T, cannot be sustained. In as far as the method used in the determination of the value of shares in D Entity I have already referred to a

concession by Prof P elsewhere in this judgment, so that the reason for the adjustment of the assessment, on the basis that discount cash flow methodology applied in the determination of the value of the shares is not an appropriate method, can similarly not be sustained.

[84] In paragraphs [36] to [39] of this judgment I referred to several authorities relied upon by the Commissioner in contending that the valuation as compiled by Mr Z is not reliable. I have carefully considered all those authorities relied upon by the Commissioner in contending that the EF Valuation, as compiled by Mr Z, is not reliable. The valuation is being criticised on the basis that certain portions of the valuation are based on hearsay evidence and that Mr Z, as an expert witness, on occasions, did not give reasons for his opinions.

[85] Mr Z did testify in these proceedings. He was extensively cross-examined on basis of all the elements set out in his valuation. In my view, in those instances where he was called upon to give reasons for his opinion, he was able to and did indeed give reasons for his opinion. It was only on being asked whether he remembered where he had got the forecast figures he used to arrive at the total cash flows that he seemed not to have a clear recollection as to where he had got the forecast figures from. Mr Z ascribed this to effluxion of time in between the time he compiled the valuation and the time he testified in these proceedings. The fact that he no longer had contemporaneous documents he may have used in the course of compiling his report, did not assist either. But that to me is not reason enough to just simply reject the discount rate used in the determination of the relevant values due regard had to Mr Z's experience in respect of valuation of casinos.

[86] As for the information and the data on the basis of which Mr Z compiled his report, such data and information was furnished to Mr Z by management. In other words, he compiled his report based on information furnished to him by management. The question, in my view, which has to be answered is, whether it was reasonable of Mr Z to compile a report on the basis of information which was in possession of management, furnished to him by management for purposes of compiling the required report. As I have mentioned in paragraph [64] of this judgment, the figures that were given to Mr Z for purposes of compiling his report, were not prepared for a capital gains valuation, but rather in support of a temporary licence application. Those were figures prepared by a third party and subjected to public scrutiny and thus, in my view, more reliable than if prepared by management solely for capital gains valuation purposes.

[87] Not all the views expressed in this judgment have found unanimity amongst ourselves. Whilst the views expressed in this judgment find unanimity between the tax member in the person of Brian Hilliard and I, the business member, in the person of Sam Montsi, has reservations to some of the elements set out in the EF Valuation Report. These relate to the discount rate used to arrive at the present value of D Entity' cash flows was that of the whole group, which included established casinos.

[88] Mr Montsi is of the view that failure to take into consideration factors peculiar to D Entity or, to convincingly explain the rational for not doing so is, in his view, a material factor that ought to have been taken into account. With regards to the terminal value, Mr Montsi is of the view that any investor presented with the opportunity to invest in D Entity as at 1 October 2001 should have argued, with merit, that the terminal value

should be excluded or should be significantly discounted to take into account the uncertainties arising from loss of monopoly and the absence of a guarantee that a casino licence would indeed be extended after the period of 15 years shall have elapsed.

[89] In conclusion, ABC obtained a valuation of the market value of shares in D Entity as at 1 October 2001. That valuation was done by an expert in the field and the method used, the assumptions made, the information used and the calculations done are set in great detail in the valuation. The valuation methodology used by Mr Z is the discount cash flow methodology, which was initially rejected by the Commissioner. It was only during the course of trial that it was conceded that the discount cash flow methodology applied is the appropriate methodology in the circumstances of this matter, as opposed to the net asset value methodology. It therefore follows, in my view, that the additional assessment in respect of the 2002 and 2003 tax years of assessment ought to be set aside.

[90] In the result, the following order is made:

[90.1.] The additional assessments in respect of the 2002 and 2003 tax years of assessments are hereby set aside.

[90.2.] The Commissioner is ordered to pay the costs on a scale as between party and party.