IN THE TAX COURT OF SOUTH AFRICA

HELD AT MEGAWATT PARK, SUNNINGHILL

(1)	**REPORTABLE:** ***NO***
(2)	OF INTEREST TO OTHER JUDGES: ***NO***
(3)	REVISED: ***Yes***

Date: ***17th September 2019*** Signature: ____________

CASE NUMBERS: 13798; 13931 & 14294

DATE: 17th September 2019

Before: The Hon Mr Justice Adams (President)
Dr M F Van Wyk (Accountant Member)
Mr T L V Makhakhe (Commercial Member)

Date of Hearing: 26, 27 and 30 August and 6 September 2019
Date of Judgment: 17th September 2019

In the matter between:

TAXPAYER Appellant

and

THE COMMISSIONER FOR
THE SOUTH AFRICAN REVENUE SERVICES Respondent

Summary: Tax Court – capital gains tax and capital losses – employee share incentive scheme and trust – meaning of 'asset' and 'right' as defined in the Eight Schedule to the Income Tax Act

ORDER

(1) The understatement penalty imposed by the respondent in respect of the 2013 year of assessment in the amount of R2 275 206 be and is hereby waved and / or remitted.

(2) Save to the extent reflected in para (1) above, the appeals by the appellant against the additional assessments for the tax years 2007 to 2013 are dismissed.

(3) Save to the extent reflected in para (1) above, the additional assessments raised by the respondent in respect of the appellant's 2007 to 2013 years of assessment are confirmed.

(4) There shall be no order as to cost, including in relation to the interlocutory application heard by Meyer J in which he handed down an order on the 11th of July 2018 in terms of which the cost of that interlocutory application was reserved.

JUDGMENT

Adams J (Accountant Member *et* Commercial Member concurring):

[1]. We have before us two appeals by […] ('the taxpayer') against the assessment in terms of the provisions of the Tax Administration Act, Act 28 of 2011 ('the TAA') by the respondent ('the Commissioner') in respect of the taxpayer's tax years of assessment 2007, 2008, 2009, 2010, 2011, 2012 and 2013. In terms of the assessments for these years the Commissioner had disallowed capital losses which allegedly arose in […] ('the Trust'), which is the taxpayer's employee share incentive scheme trust.

[2]. To the extent that this appeal involves matters of law, this judgment and the order is my own. To the extent that issues of fact were considered and

decided, the learned accountant member and commercial member concur with the findings of this court.

[3]. The issue in these appeals relates to the consequences in regard to capital gains tax in the context of an employee share incentive scheme with a trust as the vehicle used in the implementation of the scheme. In the trust losses were incurred, for the account of the taxpayer, arising in essence from the disposal to employees of shares in the capital of the taxpayer. Simply put, the question is whether the capital losses reflected in the books of account of the Trust are in fact capital losses as defined in the Income Tax Act, Act 58 of 1962 ('the Act') and, if so, whether those losses can and should be attributed to the taxpayer. Put another way, the question is whether these capital losses incurred by the Trust are losses which translate into capital losses by the taxpayer for purposes of Capital Gains Tax ('GCT')?

[4]. It was alleged by the taxpayer that during the 2007 to 2013 tax years it suffered substantial capital losses as envisaged in the Eighth Schedule of the Act and the Commissioner was requested to take these losses into account in the assessment of the taxpayer's liability for tax in respect of those years. SARS was not prepared to do this. What the Commissioner did do was to assess the taxpayer for income tax for the aforesaid years and in the process disallowed these capital losses claimed by the taxpayer as follows: 2007 – R234 161 613; 2008 –R90 992 505; 2009 – R84 602 796; 2010 – R97 124 960; 2011 – R146 983 885; 2012 – R121 614 885; and 2013 – R122 008 055.

[5]. The taxpayer lodged objections to all of the additional assessments, which objections the Commissioner disallowed, and it is against the disallowance of the taxpayer's claims to capital losses and the subsequent disallowance of the objections which the taxpayer appeals.

[6]. It may be apposite at this point to briefly refer to the most relevant legislative provisions to place in context the issues which require adjudication.

[7]. At the relevant time, section 26A of the Act provided as follows:

'26A Inclusion of taxable capital gain in taxable income – There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of

that person for that year of assessment, as determined in terms of the Eighth Schedule'.

[8]. Paragraph 2 of the Eight Schedule to the Act ('the Eight Schedule') provided *inter alia* that the Eighth Schedule applied to the disposal on or after the valuation date of any asset of a resident. The Eighth Schedule therefore applied to assets owned and disposed of by the taxpayer, who is a resident, and paragraph 1 defined *'asset'* as including:

'(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property';

[9]. Paragraph 11 provides as follows:

'11. Disposals – Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset,

[10]. Paragraph 4 defines a capital loss as follows:

'4. Capital loss – A person's capital loss for a year of assessment in respect of the disposal of an asset—

(a) during that year, is equal to the amount by which the base cost of that asset exceeds the proceeds received or accrued in respect of that disposal.'

[11]. As regards the capital losses claimed by the taxpayer for the 2007 to 2012 tax years, the taxpayer had originally alleged that the capital losses arose in the following circumstances. The trust had disposed of shares in its name in the capital of the taxpayer ('the trust shares') to the employees of the taxpayer at a sum less than the base cost of the shares. These shares were owned by the Trust and not by the taxpayer and did not vest, at the relevant time, in the taxpayer. These shares were held by the Trust and were not 'assets' of the taxpayer as defined in paragraph 4 of the Eighth Schedule and consequently did not constitute a disposal by the taxpayer.

[12]. The aforegoing facts are common cause between the parties. The taxpayer therefore accepts that it cannot claim capital losses in calculating its taxable capital gain on this basis as these losses arose in the Trust.

[13]. Equally true is the fact that the taxpayer, for purposes of CGT, is not a vested beneficiary of the Trust in relation to the trust shares. The taxpayer cannot claim capital losses sustained in the Trust as such losses are not associated with the taxpayer *qua* beneficiary with vested rights in the assets of the trust. The taxpayer is not a beneficiary of the shares in the Trust. It is only a vested beneficiary, with a vested interest in the shares of the trust, which the taxpayer was not, who are required to account for any capital losses arising from the disposal of the shares. The taxpayer did not acquire a vested right to the assets in the Trust at its inception.

[14]. Therefore, applying paragraph 4 of the Eighth Schedule, the taxpayer may not set off the relevant capital losses against the capital gains that it derived for each year of assessment and any losses made on the disposal of the shares owned by the Trust may not be treated as losses made by the taxpayer.

[15]. This means that the taxpayer is not entitled to claim a capital loss on the basis of the difference between the 'base price' of the shares and the price at which they were sold to the employees. The taxpayer accepts this and this appears to be common cause between the parties. However, it is the taxpayer's case that it is nevertheless entitled to claim these capital losses for these years, being from the 2007 to 2012 fiscal years, as well as for the 2013 tax year, and they say so for the following reasons.

[16]. The taxpayer is entitled to claim capital losses for capital gains tax ('CGT') purposes in circumstances where the Trust granted share options to selected employees of the taxpayer. The Trust was established in order to enable the taxpayer to provide financial assistance to employees of the taxpayer for the acquisition of shares in the taxpayer. This was done and the employee share incentive scheme was structured in the way it was in light of the provisions of section 38 of the Companies Act, which prohibited the giving of financial assistance by a company for the acquisition of its own shares, but which permitted the use of a trust as a means of providing financial assistance

for employees to acquire shares. The Trust was also established in order to satisfy the listing requirements of the Johannesburg Stock Exchange.

[17]. It was always understood by all concerned that the Trust would make losses as a result of the granting of share options to selected employees, which losses would be made good by the taxpayer. After all, so it was contended on behalf of the taxpayer, it was the taxpayer who wished to make shares available to its employees as a performance incentive and not the trust, hence the arrangement that the taxpayer would bear any losses resulting from the implementation of the scheme. The taxpayer determined the identity of the employees it wished to incentivise by offering them share options. Thereafter the instruction would be issued by the taxpayer to the trustees of the Trust to offer share options to the relevant employees, which the trustees of the Trust were then obligated to do by virtue of the terms of the Trust Deed. As a result of the instruction received, the trustees would offer share options to the specified employees, entitling them to acquire a specific number of […] shares at a specified price ('the strike price').

[18]. When the Trust acquired shares in order to be able to deliver shares to employees who exercised their options, the shares were registered in the name of the Trust but were paid for by the taxpayer. The shares were paid for by the taxpayer on behalf of the Trust, which compensated the taxpayer by crediting a loan account in its name for the cost of the shares. When employees exercised their options and paid the strike prices to the Trust (not less than two years after the share options had been granted), these amounts were received by the taxpayer in part settlement of its loan account – and in this way the loan account created by the Trust in favour of the taxpayer when it (the taxpayer) paid for the shares acquired by the Trust was reduced by the strike prices paid by the employees.

[19]. Employees of the taxpayer who accepted the options granted to them only exercised their options and paid the strike price if the prevailing market value of the shares was higher than the strike price. This is so because it would have made no sense to exercise an option and pay a strike price that was more

than the market value of the shares, when the shares could be obtained for their market value by buying them on the Johannesburg Stock Exchange. This meant that in reality the Trust typically made losses, being the difference between the market value of the shares (acquired and therefore owned by the trust) and the price (being the 'strike price') at which the employees bought the shares when they exercised their options. I interpose here to note that in this process of the Trust acquiring the shares in the taxpayer and then on-selling it to the individual employees there was, more often than not, a 'commercial loss' in that the shares would be sold at a price less than what the employees purchased them. The corollary is a profit in the hands of the employee, who acquired shares at a price less than the value on the open market. This fact is confirmed by the income tax levied on the profit made by the employees when they, in turn, resell the shares soon after acquiring same.

[20]. The taxpayer was able to track these losses and same was recorded in the books of account of both the taxpayer and the Trust on an annual basis. There can be no doubt that there were losses represented by the amounts claimed as capital losses by the taxpayer for the 2007 to 2013 tax years. The question is this: are these losses 'capital losses' in the hands of the taxpayer?

[21]. The trustees of the Trust and the directors of the taxpayer interpreted the relevant provisions of the trust deed to mean that the appellant was responsible to make good the losses resulting from the difference between the proceeds received in respect of the sale of the shares by the employees and the market value of the shares sold. This is also what happened in practice.

[22]. As I indicated above, for CGT purposes the word 'asset' is defined in para 1 of the Eighth Schedule as including a right or interest of whatever nature to or in property.

[23]. It is therefore the case of the taxpayer that when it instructed the trustees of the Trust to offer share options at a particular strike price to selected employees of the taxpayer, the trustees were obligated in terms of the provisions of the Trust Deed to issue such options. Consequently, so it was submitted on behalf of the taxpayer, it acquired a right to require the Trust to

offer the share options to the selected employees. It therefore had the right, so the taxpayer contends, to instruct the trustees to grant the share options and, on the exercise of those options by the offerees, to acquire shares and deliver them to the offerees. Secondly, it acquired the right in terms of the Trust Deed to require the trustees to grant the call options to specific offerees at specified strike prices once it had exercised its first right. This latter right, so the taxpayer contends, was an 'asset' for CGT purposes, being incorporeal property 'of whatever nature', as contemplated in the definition of the Eighth Schedule.

[24]. This second right was important to the taxpayer because it was the mechanism and a tool whereby it caused share options to be offered to its selected employees at the determined strike prices. The benefit to the taxpayer, and therefore the value in this right, was that this, namely the placement of shares in the hands of its group employees by means of the share options, was in the interests of the taxpayer because it was an incentive to the employees to work hard in order to boost the taxpayer's share price, which would in turn benefit the selected employees, and it also served to retain the services of such employees in the interests of the taxpayer.

[25]. This was the rationale behind the taxpayer making good the losses suffered by the Trust on the disposal of shares to the employees (via the exercise of the share options). In a very real sense, so the argument went on behalf of the taxpayer, the losses of the Trust made good by the taxpayer were the cost to the appellant of acquiring the right to require the Trust to place share options in the hands of specified employees at specific strike prices, for the ultimate benefit of the taxpayer itself. The link between the losses borne by the taxpayer and its right to require the Trust to make the share options available to the employees selected was both clear and close.

[26]. This in a nutshell is the case on behalf of the taxpayer.

Background and Facts

[27]. The taxpayer is the holding company in the […] group of companies and it wholly owns the subsidiaries in the group. During 2000 it was resolved that the taxpayer would adopt and implement a share incentive scheme for its key

management personnel, which scheme would be conducted through a trust. The purpose of the Trust was to incentivise and retain employees of the taxpayer and the other companies in the group.

[28]. The trust deed listed the duties of the trustees *inter alia* as follows:

'The trustees, in addition to any other duty imposed by this deed, whether express or implied, shall –

8.1 … grant options to offerees as directed in terms of clause 13, …'.

[29]. Clause 13 of the trust deed states *inter alia* as follows:

'13.1.1 The directors may, in terms hereof grant authority to the trustees to make offers and grant options not only in respect of new shares to be allotted by the company but also in respect of shares which are acquired by the trust from whatsoever source.'

[30]. The Trust was obliged to grant specific quantities of share options to specific employees at specified strike prices when instructed to do so by the directors of the appellant. This was the evidence of Mr Franklin, a trustee of the Trust, who confirmed under cross-examination that on receipt of an instruction from the directors of the appellant, it was the duty of the trustees to grant those options. This fact is therefore not in dispute. My reading of the Deed of Trust in any event confirms this.

[31]. The amounts advanced to the Trust to enable it (the trust) to buy the shares which it would ultimately offer to the employees were reflected in a loan account in the books of the taxpayer. This loan account was reduced by the amounts paid by the employees in respect of their payment of the purchase price of the shares when they exercised their option. The taxpayer was required to make good the losses of the Trust, which consisted of balances left in this loan account which resulted from the shares being sold to the employees at less than their market value at any given point in time and, more importantly, for less than the prices at which the Trust acquired the shares. This the taxpayer did by crediting that loan account in its books. This was done by debiting an expense and crediting the loan account, whereafter the debit and the credit in the loan account were set off against each other, giving rise to payment of the Trust's losses by the taxpayer and the partial repayment by the Trust of the taxpayer's loan to it. In this way, the taxpayer had recognised an expense,

credited the loan account, and made payment by setting off or writing off, as the Commissioner prefers to put it, the credit against the debit in the loan account.

[32]. The 'asset' of the taxpayer for CGT purposes, so Mr Emslie, Counsel for the taxpayer, submitted, was the right, once an instruction had been issued to the trustees, to have share options made available by the Trust to specific employees at specified strike prices. The cost of this asset, so it was submitted on behalf of the taxpayer, was the amount of the losses made good by the appellant. These losses were made good by crediting the loan account to which reference has already been made. The base cost of the 'asset', namely the right to have share options made available to selected employees at determined strike prices, was the amount of the loss incurred by the Trust that was made good by the taxpayer. The taxpayer's obligation to make good these losses was a *sine qua non* of its instruction to the Trust to offer share options to the group's employees.

[33]. The taxpayer's asset, being the right referred to above, was 'disposed of' for CGT purposes, so the taxpayer contended, when the Trust offered the share options to the selected employees at the determined strike prices. The asset, namely this right, was extinguished by performance by the Trust of its obligation to offer the share options to the selected employees. This 'extinction' of the asset by virtue of the requisite performance having been made by the Trust constituted a 'disposal' by the taxpayer of its asset. This means, so the taxpayer argued, that the right of the taxpayer had been disposed of as contemplated in in terms of paragraph 11 (1) of the Eighth Schedule, which provides that 'a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset'.

[34]. Thus the taxpayer had an asset, namely the right referred to above, that was 'disposed of' by extinction. The base cost of this asset was an amount equal to the amount of the loss incurred by the Trust as a result of it having to grant the options in question, which loss was required to be made good by the appellant. There were no 'proceeds' on disposal of the asset, and therefore, so the argument is concluded on behalf of the taxpayer, it made a capital loss for

CGT purposes, being the proceeds of the disposal of the asset concerned, i e nil, less the base cost thereof, being the amount of the losses made good by the appellant.

[35]. My understanding of the appellant's case in sum is that it acquired the right to incentivise its employees with the assistance of the trust. This right, which the appellant argues is an 'asset' as defined in the Eighth Schedule, came to them at a cost, being the difference between the share price on the open market and the purchase price paid by the employees when they exercise their share options. This right which the appellant has is for its exclusive benefit in that it facilitates in ensuring commitment and loyalty from key members of its personnel. This right is extinguished completely when the employees in question 'cash in' at a profit the shares offered to them a few years earlier. The appellant then loses an asset without receiving anything in return, hence, so the appellant contends, a capital loss.

[36]. This, it was submitted, is precisely what was claimed by the taxpayer in respect of each of the years of assessment in dispute.

[37]. The value to the appellant of this right lies therein that they have committed and loyal employees, who are incentivised by the knowledge that they (the employees) have the right to purchase shares in the company at a discounted price. That right is acquired at a cost, being the difference between the acquisition consideration and the 'strike price' at which the shares are disposed of.

[38]. The scheme was structured and implemented as follows. The taxpayer established the Trust, which is a discretionary trust. The beneficiaries of the trust were specified in the Deed of Trust to be the individual employees who participated in the employee share incentive scheme and the taxpayer, but the latter only in relation to the profits earned on the resale of the shares. From time to time the trust would acquire shares in the taxpayer, which were paid for by the taxpayer, which ensured that at any given point in time the trust owned enough shares in the group of companies to enable it (the trust) to implement the share incentive scheme. In the books of accounts of the trust the shares

were reflected as assets owned by the trust and the purchase price for these shares, financed by the taxpayer, was reflected as a loan by the taxpayer to the trust.

[39]. The taxpayer, once it had identified those employees whom it wished to incentivise by their participation in the scheme, would then instruct the trust to allocate shares (owned by the trust) to those employees identified and to offer options to purchase those shares in terms of the Deed of Trust. For example, on the 23rd of May 2006 ('the share option date') shares totalling 1 855 184, owned by the trust in the companies in the group, in terms of 'employee share trust offer no 93' were identified by the taxpayer for allocation to a list of nominated employees in the group. The identified employees were thereupon offered options to purchase these shares at the 'strike price', which in essence was the prevailing share price as and at the share option date.

[40]. The way the scheme operated in practice is best illustrated by way of the following concrete example. On the 23rd of May 2007 ('the option date'), shares totalling 2 438 152, owned or to be acquired by the trust in the taxpayer, were allocated, in terms of 'employee share offer no 99', to a list of nominated employees in the group, one such employee being Mr S G, who joined one of the subsidiaries as a financial manager on the 9th of October 2000. He had been identified by the taxpayer as a person who would participate in the employee share incentive scheme. On or about the 20th of June 2007, Mr S G was granted an option to purchase 6 885 fully paid ordinary shares at R94.2537 per share. The value of the shares and the consideration payable by Mr S G in terms of the option was an amount of R648 936.72. On the 3rd of September 2007 Mr S G accepted the option. On the 24th of May 2011, Mr S G exercised his option, as he was entitled to do pursuant to the option agreement, read with the Deed of Trust, in respect of 1 721 of the 6 885 shares which formed the subject of offer no 99, which by then had 'vested' in him. He bought these shares at R94.2537 per share (as per the option agreement of the 3rd of September 2007), paid for them and then immediately on-sold the shares at a profit of R75 417.34, inclusive of tax payable by the employee, for a total purchase price of R237 627.96.

[41]. In this example it is the case of the taxpayer that this loss to it, being the value of the shares (R237 627.96) less the consideration received for these shares (R162 210.62) = R75 417.23, ultimately results in a loss by the taxpayer, reflected as a loss in the trust, which is born by the taxpayer. What in fact happens, according to my reading of the accounts presented during the trial, is that, in this example the net amount ‘written off’ by the taxpayer is an amount of R75 417.23. This 75 417.23 would be included in the capital loss of R121 614 885 claimed by the taxpayer in respect of the 2012 tax year of assessment.

[42]. It was a term of the option agreement, incorporating by reference the deed of trust, that the incentive scheme shares would only be released to an employee as follows: 25% after two years from the option date; 50% after three years; 75% after four years; and 100% after five years. In other words all of the shares offered to employees would only vest in the employee after the expiration of a period five years. Those employees who left the taxpayer during these periods in fact forfeited their options.

[43]. The employee share scheme and the trust were intended as an incentive to employees to promote the continued growth of the taxpayer by giving them an opportunity to acquire shares in the taxpayer. The trust was therefore formed and appointed to provide a valuable incentive to the eligible employees in the form of a direct interest in the taxpayer and its subsidiaries by implementing the employee share incentive scheme in accordance with the Deed of Trust and the rules of the trust.

[44]. In order to enable the trust to fulfil the purpose set out above it was required to implement the scheme as set out hereinbefore. The benefit to the employees was that they made a profit in the purchase and sale of the shares pursuant to the provisions of the option agreements. Even if they exercised their options and opted not to on-sell the shares, the benefit to the employees lay therein that they would have acquired shares at discounted prices, which meant that they became owners of the shares worth more than the consideration they would have paid for the shares.

[45]. The trustees were obliged to implement the share scheme to incentivise the employees in accordance with the import and intent of the employee share scheme as more fully set out in the Deed of Trust and its rules. In furtherance of the aforesaid objective, the taxpayer and Trustees had agreed that any losses suffered by the trust in the implementation of the scheme would be borne by the taxpayer.

[46]. Any dividends paid in respect of the trust scheme shares would accrue for the benefit of the taxpayer as would any increase in the value of the shares whilst owned by the trust and before being allocated to the employees. The result of the scheme was that the taxpayer's employees became entitled to the incremental value of the shares owned by the trust from the option date to the date on which an employee exercised his option and acquired the shares.

[47]. At any given point in time there would be some shares owned by the trust, which had been financed by the taxpayer. The amount by which these shares had been financed was reflected as a loan repayable to the taxpayer by the trust. In the books of the taxpayer this amount of the advance in respect of the purchase price for the shares was reflected as a loan payable by the trust to the taxpayer.

[48]. As I indicated above, in our example the taxpayer, in calculating his taxable income for the 2012 tax year of assessment, claimed as a capital loss the amount of R75 417, being the differenceof the value of the shares when the option was granted to the employee during 2006 and the value of the shares when the employee bought and acquired them during 2011.

[49]. These deductions claimed were disallowed by SARS. The taxpayer accepts that the disallowance of these claims was correct insofar as the disallowance was based on the grounds initially advanced by the taxpayer, that being a loss suffered in the trust in respect of shares which vested in the taxpayer. However, the appeal against the disallowance is now based, as I indicated above, on the value of a right, being an asset as defined in the Eighth Schedule to the Act, which the taxpayer enjoyed against the trust and in terms of which right the taxpayer 'owned' commitment and loyalty from its key

personnel. That right is extinguished when the shares are disposed of to and acquired by the employees

The evidence on the central issue

[50]. The taxpayer called three witnesses, namely one of the trustees of the trust, Mr David Franklin, the share trust administrator, Ms Sean Farquhar, and the taxpayer’s chief executive officer at the relevant time, Mr Guy Hayward. SARS called no witnesses on this issue.

[51]. I do not intend dealing in detail with the evidence of the witnesses. In my view it suffices to say that the *viva voce* evidence led confirmed the aforegoing background and facts in the material respects. The employee share incentive scheme and the underlying rationale were confirmed by the witnesses, who emphasised the fact that in terms of the agreement between the trust and the taxpayer any and / or all losses suffered by the trust as a result of the implementation of the scheme were to be borne by the taxpayer. The scheme was funded by the taxpayer who loaned to the trust the amounts required to acquire for the trust the shares in the capital of the taxpayer for purposes of the implementation of the scheme. The net balance of the loan at any given point in time would never have been required to be repaid by the trust to the taxpayer. The accounting practice was that the net credit balances standing to this loan account at the end of a tax year would simply be written off in the books of account of the taxpayer as a ‘capital loss’, styled a ‘share trust loss’, which on a yearly basis reduced the accumulated profits by the amount of this loss.

[52]. Some of the witnesses were constraint to concede that the ‘loan’ repayable by the trust was a simulation as it would never have been repaid by the trust. This arrangement is also not recorded anywhere in the Deed of Trust

[53]. I interpose here to note that the letter of the case pleaded by the taxpayer was not supported by the evidence. The witnesses were not able to explain, for example, what the asset owned by the taxpayer was which was the subject of the capital loss claimed. I suppose that this is understandable as the case pleaded is at a very technical and legal level. In any event, when asked about what ‘asset’ was being contemplated by the taxpayer as attracting the

'capital loss', these lay witnesses were, in my view, called upon to express a legal opinion, which they understandably were unable to do.

[54]. The evidence also clearly demonstrated that an integral part of achieving the purpose of the share scheme was ensuring that, as far as reasonably possible, the employees enjoy the benefit of the growth in value of the shares with interest free funding and without having to carry the attendant risk of a decrease in share value. It is common practice for trusts to be used as a mechanism for group funding of these schemes, and for the efficient management and administration thereof.

[55]. The design of the scheme was such that there was no risk to the employees. Until such time as the employee decided to exercise his option, he was under no obligation to purchase the shares.

[56]. The evidence was also that the employee share scheme worked and the employees benefitted directly from the increase in the value of the share price over the period from the option date to the date on which the employee exercised his option to purchase the shares. This is demonstrated in the example above. The employee was taxed on this increase in the value of the shares, which was regarded by SARS as income in the hands of the employee. It was the evidence on behalf of the taxpayer that the scheme enabled the taxpayer to retain dedicated employees, with an incentive to maintain their allegiance to their employer, and from which they ultimately benefited from the increase in value of the share price of the taxpayer.

[57]. It is conceivable that the incentive the scheme created contributed significantly to a desire on the part of the employees to remain employed by the taxpayer. They ultimately benefited materially from the scheme. The incentive provided by the scheme probably changed the mind-set of the participants in their decision-making. Their decisions would probably have been made with the bigger vision in mind.

[58]. The evidence of the taxpayer's witnesses, notably Mr Hayward, was that any loss incurred by the trust in the implementation of the employee share scheme would be borne by the tax payer. It was the objective of the taxpayer to

fund and to finance the scheme and under no circumstances was the trust to be burdened with any losses arising from acquisition of the shares by the trust and the disposal thereof to the employees. Although the payments made by the taxpayer in settlement of the purchase price of the trust shares were reflected as a loan by the taxpayer to the trust, there was an arrangement that the loan or any outstanding balance would never be repaid by the trust at any point during the cycles in the process of the scheme.

Capital Gains Tax ('CGT') – The Law and its application *in casu*

[59]. In the light of this background and facts, I now turn to consider the appellant's contention that on the facts described above its 2007 to 2013 tax assessments ought to have been revised and reduced.

[60]. 'Capital gains tax' was introduced into this country with effect from the 1st of October 2001 by way of the Eighth Schedule to the Act. Reduced to the essentials and with a little simplification in order to assist the narrative, the essential factor to which regard is had is the difference between the amount at which a person acquires a capital asset and the amount of the proceeds received on its subsequent disposal. Should such proceeds exceed the amount at which it was acquired, there is a capital gain. Conversely, should the proceeds from the subsequent disposal of the asset be less, there will be a capital loss. The aggregate of capital gains and capital losses are then taken into account to calculate a net capital gain (this being the difference between the aggregate capital gain of a year and the aggregate capital loss of the previous year) and a percentage then applied to the net capital gain to calculate the taxable capital gain for the year of assessment. In terms of s 26A of the Act, that taxable capital gain then falls to be included in the taxable income of the person concerned.

[61]. In terms of para 4 of the Eighth Schedule, a person's capital loss for a year of assessment is equal to the amount by which the base cost of that asset exceeds the proceeds received or accrued in respect of that disposal.

[62]. The learned authors of *Silke: On South African Income Tax* comment as follows on the provisions of this scheme:

'Although one refers colloquially to the terms "capital gains tax" or the "capital gains tax provisions", in truth, it is not a separate tax. Taxable capital gains do not constitute "gross income" or "income", but are added directly to a taxpayer's other taxable income and subjected to normal (income) tax. This result is achieved by the charging provision, s 26A, which includes in a person's taxable income for any year of assessment a percentage of his taxable capital gains, as determined in accordance with the provisions of the Eighth Schedule. The effective consequence is that the taxable capital gains are aggregated with other taxable income and taxed according to the normal (income) tax rates.'

[63]. The essential starting point of the scheme is the so called 'base cost' of an asset. Although paragraph 20 of the Eighth Schedule provides in considerable detail for the determination of base cost in particular circumstances, it is in simple terms set out in paragraph 20(1)(a) as being 'the expenditure actually incurred in respect of the cost of acquisition or creation of that asset'.

[64]. Paragraph 35 provides that the proceeds from the disposal of an asset by a person are equal to the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal.

[65]. *In casu* the crisp issue for adjudication relates to the concept of a 'right' as envisaged by the definition of an 'asset' in para 1 of the Eighth Schedule. As I indicated above, the taxpayer's case is based exclusively on a right it claims it acquired and which right it subsequently disposed of at a capital loss. This right, so the taxpayer contends, is constituted by the fact that when it instructed the trustees of the Trust to offer share options at a particular strike price to selected employees of the taxpayer, the trustees were obligated in terms of the provisions of the Trust Deed to issue such options. It therefore had the **right** to require the Trust to offer the share options to the selected employees at specified strike prices. The value of this right, so the taxpayer contends, equates to the value of the shares at the time when the employee exercised his option less the share price when the share was acquired by the taxpayer. The benefit to the taxpayer which arises from this right, and therefore the essence

and the being of the right, lies therein that the taxpayer had acquired a dedicated and committed employee, who was bound to add value to the business of the taxpayer over a number of years of between two to five years, which are the period during which the shares would vest pursuant to the option agreement.

[66]. The question is whether this right is an asset. This requires an investigation into the meaning of 'right' generally and specifically in the context of paragraph 1 (definitions) of the Eighth Schedule to the Act, which provides as follows:

'"asset" includes-

(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property.'

[67]. The appellant had abandoned the arguments originally raised in its objection to the 2007 to 2012 assessments because paragraph 80(2) of the Eighth Schedule only applies to capital gains arising in the Trust. This is not in dispute. Paragraph 80(2) was not applicable because there was no capital gain in the Trust. But there was also no capital loss in the Trust. Any losses in the trust were made good by the appellant resulting in no taxable capital loss in the Trust. The appellant's original grounds of objection to the assessments and arguments in that regard therefore could not be sustained.

[68]. The question is whether the new grounds raised by the appellant in its Rule 32 statement of the grounds of appeal and its arguments in that regard are sustainable.

[69]. It was contended by the appellant that it had the right to issue instructions to the Trust to offer to its employees share options. When the appellant exercised this right and issued instructions to the trustees to offer specific quantities of share options to specific offerees at a specified strike prices, the trustees had a duty to do so and – as a matter of law the appellant had a corresponding right to require the trustees to carry out the instructions given.

[70]. This right, so the appellants submitted, was its right to require the trustees to perform their obligations by offering the specific quantities of share options to the specific offerees at the specified strike prices, once the detailed instructions had been given to the trustees. It was a *jus in personam ad faciendum*, being a right to claim performance or an act.

[71]. This right, according to the appellant, was an asset for CGT purposes.

[72]. The appellant furthermore contended that once the trustees offered or granted the nominated quantity of share options to the specified offerees at the specified strike price, the trustees' legal duty or obligation was discharged because performance had taken place. Consequently at that point, the appellant's right was extinguished or discharged or had expired, as contemplated in paragraph 11(1)(b). Accordingly, this gave rise to a "disposal" of the 'asset' for CGT purposes.

[73]. The appellant alleges that the expenditure incurred by it in making good the Trust's losses was the cost to the appellant of the asset in the form of the right to require the trustees to offer the share options to the offerees. The employees would exercise those options at a time which would give rise to a loss, which would ultimately be for the account of the company. The specific instruction by the appellant to the trustees was the *causa causans* of the expenditure, so the appellant argues, incurred in making good the Trust's losses. That expense, according to the appellant, is incurred in respect of the acquisition of that asset as per section 24M(2)(b) of the Act when it is quantified. It follows from the above, according to the appellant, that the expenditure actually incurred by the appellant when it made good the Trust's losses (once these had been quantified) was the base cost of the asset – the right – that was 'disposed of' – as contemplated in paragraph 11(1) – when the trustees performed their legal duty or obligation by offering the specified share options to the specified offerees at the specified strike price.

[74]. In conclusion it was argued on behalf of the appellant that its case is simple and logical. When the trustees gave an instruction to the trustees to offer certain quantities of share options to certain employees at specified strike

prices, a legal obligation arose. Once the obligation existed, there was – as a matter of law – a corresponding right (i e an ‘asset’ for CGT purposes) in the hands of the appellant. When the trustees offered the share options to the offerees, the legal obligation was discharged by performance, the appellant’s right was extinguished, and a CGT ‘disposal’ took place. The base cost of this asset was the appellant’s expenditure actually incurred in making good the Trust’s losses arising when the employees exercised their share options. This was a voluntary expenditure actually incurred, not a write-off, so the appellant contended. In the premises, so the appellant submitted, it was entitled to claim the capital losses which it did claim for the 2007 to 2013 years of assessment.

[75]. Mr Fine, on the other hand, submitted that it is unclear what the nature of the appellant’s right is. It appears to arise from the appellant’s instruction to the Trust. However, so he contends, no rights can arise merely from an instruction by the appellant to the Trust. I disagree with this submission. All things considered, I am of the view that the appellant indeed had a right as alleged by it. The trust deed regulated the legal relationship between *inter alia* the appellant and the trustees and, in terms of this legal arrangement the taxpayer had a right as against the trustees to require them to offer share options to its employees and, in the event of the options being accepted and exercised to ensure that the shares are acquired and sold to the employees. The taxpayer’s duties were to fund the scheme.

[76]. The respondent submits that, in any event, if the appellant does have such a right, it is not a right or interest to or in property, as contemplated by the definition (b) of ‘asset’ in paragraph 1. Furthermore, insofar as definition (a) of asset in paragraph 1 is concerned, the right claimed is not corporeal property, an intellectual property right or a contractual right. When dealing with capital gains and capital losses, so the argument on behalf of the respondent is developed further, the legislature had in mind gains and losses made or incurred on the disposal and acquisition of assets. That emerges clearly from a proper and sensible reading of the Eighth Schedule read in its context and the Act as a whole.

[77]. The Commissioner furthermore contends that it is farfetched to suggest that this right to require the trustees of the Trust to make offers to the employees and to deliver the shares, is a right which is an ‘asset’ as contemplated by the Eight Schedule. That interpretation of the word ‘asset’ also, so the Commissioner submitted, does not accord with a common sense meaning to be attributed to the word. This is so because this right will never be reflected as an asset in the appellant’s financial statements.

[78]. As I indicated above, I disagree with the submission on behalf of the Commissioner that the appellant did not have the right as claimed by it on the basis that the Deed of Trust did not expressly grant them such a right. I do however agree that the right contended for is illusory, which is relevant to the question whether this right is in fact an ‘asset’ within the contemplation of the Eight Schedule for purposes of CGT.

[79]. In interpreting the word or phrase ‘asset’ in this context, regard must be had to the aim, scope and purpose of the Eighth Schedule. An interpretation which yields a sensible and business-like result must prevail rather than an absurd and uncommercial result.

[80]. In my view and having regard to the wording of subparagraph (b), any right referred to in the context of capital gains tax is a right in or to property, whether movable or immovable, corporeal or incorporeal. By definition this means that any personal rights cannot be susceptible to capital gains tax as it cannot possibly be termed an ‘asset’.

[81]. It is trite that the law of property (things) defines what a thing is and which rights a person can enjoy in relation thereto, for example ownership or a usufruct. A real right is a right in or to a thing or property. The most absolute real right is that of ownership, which entitles the holder of the right to dispose of a thing. He may, for instance, sell it and transfer ownership to someone else. On the other hand, a limited real right in another's property entitles the holder of the right to enjoy and use it, but not to dispose of it. Examples thereof are the following: Servitudes, real security right, for example a pledge in respect of movable property or a mortgage bond over another's immovable property.

[82]. Rights that can be disposed of consist of personal rights *(jus in personam)*, and real rights *(jus in rem)*. The question is which one of these two forms of rights, if any, are ‘assets’ for CGT purposes. A personal right is a right in or against a particular person or group of persons. The parties to a contract have rights against each other. Personal rights are of two types, namely: *a jus in personam ad rem acquirandam*, being a right to claim delivery of a thing, and a *jus in personam ad faciendum*, being a right to claim performance or an act. A personal right imposes a personal duty upon the grantor in favour of the grantee to perform.

[83]. A proprietary or real right is often defined as a legally protectable interest which a person has in or to property against other persons, for example ownership, servitude on land or immaterial (intellectual) property rights. As I indicated above, proprietary rights are to be distinguished from personal rights, which are a person’s claim against another to performance on the strength of an obligation which stems from a contract.

[84]. With these basics in place I now turn my attention to the case of the appellant and the question whether the right which it alleges is an ‘asset’ as defined in the Eighth Schedule. The question is whether the right which is the subject of the losses entitles the appellant to claim capital losses.

[85]. The first aspect is identifying the asset in or to which the appellant has an interest. The evidence on behalf of the taxpayer did not assist in that regard. My understanding of the case of the taxpayer is that the right specified above itself constitutes the asset. I accept that a right, whether personal or real, is an asset if regard is had to our common law principles. However, in my judgment a personal right is not an asset as defined in the Eighth Schedule. It is based on contract and is not in any way attached to or related to property. For this reason alone, the appeal should fail.

[86]. As clearly appears from their terms, the provisions relating to the definition of a right in paragraph 1 of the Eighth Schedule are not of application to the right alleged by the taxpayer. This is a personal right unrelated to any

proprietary rights vesting in the taxpayer. In my judgment, it has not been established by the taxpayer that it has suffered a capital loss.

[87]. Even if I am wrong in the above regard, the appeal should still, in my view, fail. I say so for the following reasons.

[88]. The Eighth Schedule contains substantive provisions relating to the determination of capital losses. That means that, in order to qualify for a capital loss, the taxpayer is required to bring itself within the substantive provisions of the Eighth Schedule. The appellant is therefore required to prove that it disposed of its asset, owned by it, which resulted in a capital loss in the year of assessment. I am not persuaded that the appellant had discharged the onus resting on it to prove these requirements.

[89]. The loss, in my view, the appellant had failed to prove arose as a result of the disposal of an asset by the appellant. I find myself in agreement with the submissions on behalf of the respondent that the appellant, in presenting its appeal resorted to sophistry. The right which the appellant relies on in support of its claim for a capital loss strains the definition of 'asset' as contemplated by the Eight Schedule.

[90]. Furthermore, the appellant claims that its asset, the right, is disposed of or extinguished when the Trust performs its obligations and delivers the shares to the offerees on the options being exercised. How this process amounts to a disposal or extinction of the asset is not altogether clear. However one views this matter, I do not believe that the appellant has proven the extinction of the right. No evidence was led in this regard. Insofar as the appellant contends that the right is extinguished by the granting of the option, no loss is suffered by the Trust as a result of such extinction. There is no expenditure, on the basis alleged by the appellant.

[91]. The appellant cannot positively state when expenditure was actually incurred in respect of the cost of acquisition or creation of that asset for the purposes of determining the base cost. I suppose the point about this matter and the appellant's case is that, as regards the requirement that the appellant should prove the 'base cost' and the cost at which it disposed of the asset, more

questions than answers are raised. When exactly was the right, being the asset, acquired or created? What was the price at which the asset was acquired? For how much was the right disposed of and when exactly did such disposition occur? Very importantly, the appellant alleges that the right assured it of a degree of commitment and loyalty from its employees. Therein lays the value of this asset, so the appellant contends. However, the right is disposed of and no proceeds are received on such disposal. The question is however whether the appellant, on its own version, did not receive a consideration, being a dedicated work force, when it disposed of its right. What is the amount to be attached to that consideration?

[92]. The respondent submitted that the grant of the option could not possibly result in actual expenditure because, even if this constitutes the acquisition or creation of a right, there is simply no unconditional legal obligation in respect of any amount concerned. The expression expenditure 'actually incurred' simply means that there must be an unconditional legal obligation in respect of the amount concerned as opposed to the requirement that the obligation is actually discharged. Once the obligation has been incurred, the expenditure becomes deductible. I agree with these submissions.

[93]. *In casu* when the right was acquired no unconditional obligation in respect of an amount existed because there was no obligation which had come into existence and was enforceable at that stage. Instead, at best, the obligation was conditional and remains so until at least further steps are taken i.e. acceptance of the option and even that did not bring into existence an unconditional obligation. There would only be an obligation if and when the options were exercised by the employees, the shares were delivered and payment effected which is less than the costs of acquisition of the shares. The obligation was conditional and therefore there was no expenditure incurred. Therefore, when the right was either acquired or created, the obligations were conditional and no expenditure was incurred.

[94]. Also, the appellant claims that the base cost of the asset is the expenditure incurred by the appellant which is equal to the loss made by the

Trust on the delivery of the shares when it acquired the right. As I indicated above, the case of the appellant relating to the 'base cost' of the right and the 'proceeds received or accrued in respect of the disposal' of the right is as clear as mud.

[95]. For all these reasons, I am not persuaded that, even if the right claimed by the appellant is an 'asset', same is not an 'asset' for purposes of capital losses. I am also not convinced that the appellant had established the 'base cost' of this asset or that the asset was in fact disposed of and that the proceeds received in respect of such disposal was nil.

Understatement Penalties

[96]. The respondent imposed understatement penalties in respect of the 2013 year of assessment in the amount of R2 275 206. The penalty was imposed for a 'substantial understatement' at a rate of 10%. Understatement penalties are imposed in terms of section 222 of the TAA.

[97]. During closing arguments, I was advised from the bar that the parties are in agreement that this penalty should be remitted. There is therefore no need for me to deal with this aspect of the disputes between the parties.

[98]. The substantial understatement penalty therefore stands to be waived by the respondent or remitted as, by agreement between the parties, it should never have been imposed in the first place.

Conclusion

[99]. In summary, the losses in the books of account of the appellant arising from the employee share incentive scheme did not entitle the appellant to have its tax liability for the 2007 to 2013 years reduced on the basis that these losses constitute capital losses. They do not relate to any assets disposed of at a loss by the taxpayer, neither do they relate to a right in or to property owned by the taxpayer or anyone else.

[100]. The appeals must therefore fail.

[101]. For all of these reasons I have concluded, and the other members of the court agree, that there is no merit in the appellant's argument, and that the appeals must be dismissed. In the result the appeals will be dismissed and the additional assessments confirmed. It will therefore be so ordered.

Order

Accordingly, I make the following order:-

(1) The understatement penalties imposed by the respondent in respect of the 2013 year of assessment in the amount of R2 275 206 be and is hereby waved and / or remitted.

(2) Save to the extent reflected in para (1) above, the appeals by the appellant against the additional assessments for the tax years 2007 to 2013 are dismissed.

(3) Save to the extent reflected in para (1) above, the additional assessments raised by the respondent in respect of the appellant's 2007 to 2013 years of assessment are confirmed.

(4) There shall be no order as to cost, including in relation to the interlocutory application heard by Meyer J in which he handed down an order on the 11th of July 2018 in terms of which the cost of that interlocutory application was reserved.

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L R ADAMS

President of the Tax Court

Johannesburg

We agree

Dr M F VAN WYK

Accounting Member of the Tax Court

Johannesburg

Mr T V L MAKHAKHE

Commercial Member of the Tax Court

Johannesburg

HEARD ON:	26, 27, 30 August and 6 September 2019
JUDGMENT DATE:	17 September 2019
FOR THE APPELLANT	Advocate T S Emslie SC
INSTRUCTED BY:	Webber Wentzel
FOR THE RESPONDENT:	Adv Dennis Fine SC, together with Advocate Fiona Southwood
INSTRUCTED BY:	Mathopo Moshimane Mulangaphuma Incorporated t/a DM5