

Conversion of shares

The tax implications

Mini dissertation by

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Abstract

The current economic downturn has had far reaching consequences. In the South African context various Black Economic Empowerment transactions have been put in jeopardy as a result of declining turnover and profits. Preference shares held in many target companies are as a result being converted into ordinary shares to relieve pressure on the target companies by removing the obligation to pay preference dividends.

This paper considers the capital gains tax consequences of such conversions.

It is argued that the necessary elements needed to trigger a capital gains tax liability is are not present in such transactions.

Based on the theory that an asset consists of a bundle of rights, it could be argued that on the conversion of a share, a disposal of certain rights take place as certain of the rights in that bundle is given up. However, considering the definition of the term 'asset' in the Eighth Schedule to the Income Tax Act, is it argued that no disposal takes place on the conversion of a share of a specific class into a different class.

It is further argued that even if it is held that a disposal does take place on the conversion of the shares, no proceeds accrue or is received from the disposal.

As a result, the necessary triggers for a capital gains tax liability are not present and the conversion of the shares does not have any adverse capital gains tax liability consequences.

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CHAPTER 1 – INTRODUCTION

1 Background

One of the striking consequences of the introduction of capital gains tax into the South African tax system is the extent to which certain transactions previously entered into without a second thought prior to its introduction, could now have far-reaching capital gains tax consequences for a taxpayer.

It was common for a testator in his will who had advanced loans to relatives during his lifetime, to provide that, on death, any balance of the debt would be forgiven. Such a writing-off would now trigger a capital gain in the hands of the relative by virtue of paragraph 12(5) of the Eighth Schedule to the Income Tax Act.¹

Another example of the influence of the introduction of the capital gains tax legislation relates to the conversion of one type of share to another, typically, but not exclusively, a preference share to an ordinary share. Specifically in the realm of Black Economic Empowerment transactions, the capital gains tax consequences resulting from such conversions could, and have had a significant impact.

This paper discusses the arguments that lead to the introduction of a capital gains tax regime in South Africa, the principles underlying the system and

¹ No. 58 of 1962.

gives and overview of the legislation. It goes on to discuss the legal nature of a share in so far as it relates to capital gains tax. It is argued that the conversion of a share into a different type of share does not satisfy the requirements for the triggering of a capital gains tax liability and as such no liability arises.

2 Research methodology

The research methodology used was the historic method. A review of the literature was undertaken to determine the historical reasons for the introduction of a capital gains tax system in South Africa, the legal framework of convertible shares and the capital gains tax consequences on the conversion of such shares. A case study was used to illustrate the tax consequences of such a conversion.

3 Abbreviations

The abbreviations used in this paper are summarised in Table 1 below.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
BEE	Black Economic Empowerment
SARS	South African Revenue Service
SPV	Special purpose vehicle
STC	Secondary tax on companies
the Act	Income Tax Act No. 58 of 1962
the Companies Act	Companies Act No. 61 of 1973
the Eighth Schedule	The Eighth Schedule to the Income

	Tax Act No. 58 of 1962
the Guide	The South African Revenue Service's Comprehensive Guide to Capital Gains Tax

4 Structure of dissertation

4.1 Chapter 1: Introduction

Chapter 1 gives an introduction to the background of the study. The research methodology is described and the abbreviations used in the study are defined.

4.2 Chapter 2: The basis of the South African tax system

Chapter 2 gives an overview of the principles of efficiency, equity and simplicity underlying most tax systems, and the trade-offs between these principles in relation to capital gains tax. It further briefly examines the reasons for the introduction of capital gains tax into the South African tax system.

4.3 Chapter 3: Capital Gains Tax in South Africa – An overview

Chapter 3 discusses the interrelationship between capital gains tax and income tax. The effective date for the commencement of capital gains tax is discussed as well as the residence basis of South Africa's capital gains tax regime. An overview is given of the principles in the determination of residence as well as of the logical steps in understanding the legislation relating to capital gains tax in South Africa.

4.4 Chapter 4: The legal nature of shares and the rights attaching to various classes of shares

In Chapter 4 an overview is given of shares in general, and the nature of a share is discussed with reference to the Companies Act and case law. The chapter concludes with a discussion of the various classes of shares, the rights attaching to the various classes and the possibility of converting a particular class of share into a different class.

4.5 Chapter 5: The implications on the conversion of shares

Chapter 5 is a discussion of the capital gains tax consequences of the conversion of preferences shares to ordinary shares. The key terms are discussed in detail and applied to the case study under consideration. A conclusion is reached regarding whether a capital gains tax liability arises from the conversion of shares.

4.6 Chapter 6: Conclusion

In Chapter 6 the conclusion is reached that no capital gains tax consequences result from the conversion of a share from one class to another.

CHAPTER 2 – ARGUMENTS FOR AND AGAINST THE INTRODUCTION OF CAPITAL GAINS TAX IN RELATION TO THE KEY PRINCIPLES UNDERLYING A GOOD TAX SYSTEM

Background to South Africa's capital gains tax legislation

5 Introduction

Few issues in tax policy are as divisive as capital gains tax. Some argue that taxes on capital gains – the increase in value of assets such as shares or businesses – are counterproductive and unfair. They contend that such taxes stifle entrepreneurship and are often levied on phantom income that presents nothing more than the effect of inflation. Some claim a reduction in tax on capital gains would spur so many additional sales of assets that they would increase national tax revenue.²

Others view capital gains as 'unearned income' and tax preferences for capital gains as undeserved windfalls for the rich. They argue that the taxation of capital gains must be examined in the context of the taxation of capital income generally, by which measure capital gains are highly favoured.³

6 Understanding the principles

The key to understanding capital gains tax policy and legislation lies in the principles of any tax system:

² Leonard E Burman. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (1999) at 2.

³ Burman (note 2) at 3.

- Efficiency
- Equity
- Simplicity

In practice, efficiency in the realm of government finance amounts to interfering as little as possible with well-functioning markets, while designing taxes or subsidies to move consumption and production toward efficient levels in markets that fail to meet the conditions for efficiency. Because the conditions for efficiency are often more difficult to identify in imperfect markets, the logical response is to strive for neutrality – that is, to tax different forms of income in the same way – unless there is convincing evidence of a market failure that can be addressed through the tax system.⁴

Tax equity requires that people be taxed according to their ability to pay. This principle rests on two assumptions. The first is that people with equal ability to pay should pay the same tax. Economists call this notion ‘horizontal equity’. The second is that people with greater ability to pay should pay more tax. This is called ‘vertical equity’. Some would also add that those with greater ability should pay a larger share of their incomes than those with lesser ability. This belief underlies the progressivity of marginal rates in the income tax system.⁵

⁴ Burman (note 2) at 4.

⁵ Burman (note 2) at 5.

The cost to a government in administering a tax, and to individuals and businesses in complying with it, are a loss to society. Under a simple tax system, few of society's resources have to be allocated to the unproductive activity of tax compliance, and more available to produce valuable goods and services. If it is difficult to enforce a tax, aggressive or dishonest taxpayers may receive more tax benefit than others. This clearly violates horizontal equity.⁶

More than most other aspects of tax policy, decisions pertaining to capital gains tax involve certain trade-offs among the different principles.⁷

It is against the backdrop of the basic principles underlying any tax system and the trade-offs necessary, that the introduction of a capital gains tax in South Africa should be understood.

7 Introduction of capital gains tax in South Africa

The debate regarding the taxation of capital gains became topical in South Africa after the Finance Minister announced in his Budget review in parliament on 23 February 2000 that a capital gains tax would be introduced in South Africa with effect from 1 April 2001. This date was later extended to 1 October 2001 in the 2001 budget review.⁸

The minister stated that the absence hitherto, of a capital gains tax had encouraged taxpayers 'to convert income that would ordinarily be taxable into

⁶ Burman (note 2 at 6.

⁷ Burman (note 2) at 10.

⁸ South African Revenue Service *Comprehensive Guide to Capital Gains Tax* (2007) at 1.

tax-free capital gains', and that capital gains tax would make the tax system more equitable in that realised capital gains are equivalent to income and can be used in the same way; capital gains tax thus formed an essential backstop to personal and corporate income tax.⁹

Another reason advanced for the introduction of capital gains tax was to bring South Africa's tax system more into line with international benchmarks. The United States of America introduced capital gains tax in 1913, the United Kingdom in 1965, Canada in 1971 and Australia in 1985.¹⁰ Many African countries¹¹ have also adopted capital gains tax, though often in a more limited form.

The design of the Eighth Schedule to the Act had been influenced by the capital gains tax legislation of a number of countries; most notably Australia and the United Kingdom, and to a lesser extent, Canada and the United States of America.¹²

8 Reasons for the introduction of capital gains tax

Various reasons were advanced for the introduction of capital gains tax into the South African tax system.¹³ Some of these arguments were founded in international experience, whilst others were based on South Africa's unique position.

⁹ SARS (note 8) at 3.

¹⁰ SARS (note 8) at 1.

¹¹ Botswana, Egypt, Nigeria and Zimbabwe.

¹² SARS (note 8) at 1.

¹³ Rick Krever *A Capital Gains Tax for SA*. Available from: <http://www.ftomasek.com/RickKreverDraft.html> [Accessed on 8 August 2009].

The various arguments advanced are briefly discussed below.

8.1 *International benchmarking*

As stated above,¹⁴ many of South Africa's main trading partners had introduced a capital gains tax years ago. Even some of the other African countries had capital gains tax regimes, albeit rudimentary.¹⁵

8.2 *Horizontal equity*

As stated above,¹⁶ horizontal equity demands that persons in similar economic circumstance should bear a similar tax burden. Thus, the same tax burden should be borne irrespective of whether the income is received in the form of wages or capital gain. In this context, the previous exclusion of capital gains from the income tax base fundamentally undermined the horizontal equity of the tax system.¹⁷

8.3 *Vertical equity*

Vertical equity connotes that taxpayers with a greater ability to pay taxes should bear a greater burden of taxation.¹⁸ Furthermore, international experience indicated that the biggest share of capital gains tax revenues could be attributed to the wealthiest of individuals.¹⁹

¹⁴ Paragraph 7 *supra*.

¹⁵ Paragraph 7 *supra*.

¹⁶ Paragraph 6 *supra*.

¹⁷ Burman (note 2) at 15.

¹⁸ Paragraph 6 *supra*.

¹⁹ SARS (note 8) at 1.

Thus, including capital gains in taxable income contributed to the progressivity of the income tax system, while enabling government to pursue other tax policy objectives, premised on the widening of the tax base, and reducing standard tax rates.²⁰

It was argued that given the skewed distribution of wealth in South Africa, the introduction of capital gains tax would markedly improve the vertical equity of the income tax system in South Africa.²¹

8.4 *The shift from income to capital*

When capital gains were not taxed, taxpayers had an incentive to re-characterise income as capital. There were many ways in which this could be done, some more complex than others.

Taxpayers were also encouraged to shift from income bearing investments, to those that produce capital gains. This eroded the tax base and resulted in an artificial allocation of resources.²²

Many of the techniques for converting income to capital relied on deception or non-disclosure for their success. Although the effective tax rate differential between ordinary income and capital gains means that these

²⁰ SARS (note 8) at 2.

²¹ Krever (note 13).

²² SARS (note 8) at 2.

techniques remain attractive, the enhanced disclosure brought about by the capital gains tax system, make them more difficult.²³

8.5 *Economic efficiency*

The application of scarce resources to tax planning and tax avoidance is clearly a deadweight loss to society.²⁴

The efficiency case for introducing a capital gains tax was particularly strong if one considered the impact on the allocation of investment funds. If capital gains went untaxed, individuals were encouraged by the tax system to invest their savings in assets that provided returns in the form of capital gains, rather than income producing assets. Scarce investment funds were misallocated when tax factors were given undue weight over risk-return considerations in the allocation of investment capital. It was argued that capital gains tax would narrow the gap in the tax treatment of different assets, reducing these distortions in individual portfolio decisions.²⁵

8.6 *The broadening of the tax base*

A further argument advanced for the introduction of capital gains tax was that its introduction would enable the tax base to be broadened, thus facilitating lower overall tax rates. If more taxpayers were brought into the net, it was argued, the burden would be more evenly distributed.²⁶

²³ Krever (note 13).

²⁴ Paragraph 6 *supra*.

²⁵ Krever (note 13).

²⁶ SARS (note 8) at 3.

8.7 *Summary of the rationale for taxing capital gains*

In summary, the rationale for taxing capital gains is to be found primarily in the improved equity that such a tax introduced into the tax system. Without a capital gains tax, so it was argued, the potential for avoidance was immense. A capital gains tax protects the integrity of the income tax base by preventing leakage through dressing up, or converting income to capital.²⁷

In addition, the introduction of a capital gains tax could lead to greater neutrality and efficiency in the tax system, though potentially at the cost of reduced simplicity. It seems that South Africa have accepted that trade-off in its quest for the optimal tax structure. According to Stiglitz,²⁸ trade-offs are inevitable in any branch of economics. The price of greater equity may well be greater economic inefficiency or complexity:

'The optimal tax structure is the one that maximises social welfare, in which the choice between equity and efficiency [and simplicity] best reflects society's attitude toward these competing goals'.²⁹

While some of the stated objectives relating to the introduction of capital gains tax in South Africa might have been met, some still remain a challenge.

²⁷ Burman (note 2) at 8.

²⁸ JE Stiglitz Economics of the Public Sector 2ed (1988).

²⁹ Stiglitz (note 28) at 478-479.

CHAPTER 3 – CAPITAL GAINS TAX IN SOUTH AFRICA: AN OVERVIEW

The structure and internal logic of the capital gains tax legislation

9 The interrelationship between income tax and capital gains tax

Prior to the introduction of capital gains tax, gains of a capital nature were not subject to tax under the Act except where the receipt or accrual in question (though in reality of a capital nature) fell within one of the subparagraphs³⁰ of the statutory definition of 'gross income'.³¹

After the introduction of capital gains tax on 1 October 2001,³² any amount received or accrued from the disposal of an asset that falls within the definition of 'gross income' (thus any amount which is taken into account under the income tax regime) continues to be taxed under the income tax system and is not subject to capital gains tax.³³

The legislative provisions which impose what is colloquially termed 'capital gains tax', are contained in the Eighth Schedule read together with section 26A of the Act, which links the general provisions of the Act to the Eighth Schedule. The term 'capital gains tax' is not defined in either the Act or the Eighth Schedule.

³⁰ For example, para (d) which covers compensation for loss of office.

³¹ Section 1 of the Act.

³² Paragraph 7 *supra*.

³³ Eighth Schedule, para 35(3)(a).

The term 'capital gains tax' is, strictly speaking, a misnomer, as section 26A read with the Eighth Schedule, imposes a tax on all gains (except those specifically excluded) which arise from the disposal of any asset, and does not posit any inquiry whether the gain is 'of a capital nature'. So-called capital gains tax is in reality a 'catch-all tax' which sweeps up the gains from the disposal of all assets, other than those already subject to income tax, other gains specifically excluded in the legislation, and those gains which fall outside the ambit of the terms, 'disposal' and 'asset'.³⁴

Although capital gains tax is imposed in terms of the Act, and although a person's 'taxable capital gains' are included in 'taxable income',³⁵ it is useful to continue to distinguish between amounts which are 'income' (revenue) and amounts which are 'capital'. In terms of this distinction, 'income' means the amounts falling within the definition of 'gross income'³⁶ (which as defined, specifically exclude amounts of a capital nature) and which are dealt with under the general provisions of the Act and the schedules thereto other than the Eighth Schedule, while 'capital gains' are those gains which are identified and quantified in terms of the Eighth Schedule and are included in taxable income in terms of section 26A of the Act.

Conversely, 'revenue expenditure' is a term which can still usefully connote expenditure which is deductible in terms of section 11(a) (which

³⁴ RC Williams *Capital Gains Tax: A Practitioner's Manual* 2ed (2005) at 2.

³⁵ Section 26A of the Act.

³⁶ Note 31 *supra*.

expressly prohibits the deduction of expenditure of a capital nature); whilst certain expenditure of a capital nature qualify for inclusion in the 'base cost' of an asset for capital gains tax purposes.³⁷

Capital gains tax thus forms an integral part of the income tax system, with capital gains being added to a person's 'taxable income' and taxed, subject to certain relief, at the taxpayer's marginal rate of tax.

10 Effective date for the commencement of capital gains tax

The capital gains tax legislation applies to the 'disposal' of any 'asset' of a 'resident' where the disposal occurs on or after 1 October 2001 – the so-called valuation date.³⁸

Where an asset was disposed of before 1 October 2001, a taxpayer would have been taxed in the usual way on receipts and accruals of 'income', but will not be taxed on 'capital gains' except where the receipt or accrual in question fell within one of the subparagraphs of the definition of 'gross income'³⁹ and consequently was subject to income tax.

On 1 October 2001, this changed, and gains of a capital nature, arising from the disposal of an asset, that would previously have escaped tax under the Act, are now subject to capital gains tax in the manner provided for in the Eighth Schedule, unless the gains are specifically excluded. Where a taxpayer had

³⁷ Eighth Schedule, para 20(1).

³⁸ Eighth Schedule, para 2.

³⁹ Note 31 *supra*.

acquired the asset prior to 1 October 2001 and had not disposed of it before then, only the gain which accrued after that date is potentially taxable.⁴⁰

11 The residence basis of capital gains tax

In colloquial terms it may be said that South Africa's capital gains tax system applies to the world-wide assets of 'residents' of South Africa.⁴¹

Non-residents incur a liability for capital gains tax only in respect of certain limited categories of property held by them. In the language of the Act,⁴² the Eighth Schedule applies to-

- a) *any 'asset' (as defined)⁴³ of a 'resident' (as defined);⁴⁴*
- b) *the following assets of a person who is not a resident, namely-*
 - i. *immovable property situated in the Republic held by that person or any interest⁴⁵ or right of whatever nature of that person to or in immovable property situated in the Republic; or*
 - ii. *any asset which is attributable to a permanent establishment of that person in the Republic.*

Capital gains tax was introduced in the context of, and in harmony with, the (virtually simultaneous) change of South Africa's tax system.⁴⁶ Thus, liability for capital gains tax will (subject to certain relief for international double taxation)

⁴⁰ Williams (note 34) at 5.

⁴¹ Williams (note 34) at 5.

⁴² Eighth Schedule, para 2.

⁴³ Eighth Schedule, para 1.

⁴⁴ Eighth Schedule, para 1.

⁴⁵ 'Interest' in immovable property situated in South Africa as including 'equity shares' in a company (or similar rights in similar entities), or a vested interest in the assets of a trust if at least 80% of the value of the shares, rights or vested interest is attributable (directly or indirectly) to immovable property in South Africa, and in the case of a company or other entity, the non-resident holds (directly or indirectly) at least 20% of the equity share capital, or ownership or right to ownership of that other entity.

⁴⁶ In 2001 the system for South African residents changed from a source basis to a residence basis.

be incurred by persons who are 'residents'⁴⁷ of South Africa in respect of gains made on the disposal of their world-wide assets. Non-residents will incur liability for capital gains tax only in respect of the particular categories of assets falling under (b)(i) and (ii), above.⁴⁸ Non-residents will not be liable for capital gains tax on other assets which they own in South Africa (such as non-property shares). This is in line with international practice and consistent with South Africa's double tax agreement with foreign countries.⁴⁹

12 Determination of residence of a person

South Africa applies two tests – the ordinarily resident test and the physical presence test – in order to determine whether or not an individual is resident of South Africa. A 'resident' is defined as a natural person who is either ordinarily resident, or resident by virtue of the physical presence test.⁵⁰ However, there is no statutory definition of 'ordinarily resident' and it has been left to the South Africa courts to interpret the term.^{51 52}

12.1 Ordinarily resident test

This test is to determine whether an individual is ordinarily resident in South Africa.

The courts have interpreted the term 'ordinarily resident' to mean:

⁴⁷ Eighth Schedule, para 1.

⁴⁸ Note 42 *supra*.

⁴⁹ Burman (note 2) at 15.

⁵⁰ The definition of 'resident' in s 1 of the Act.

⁵¹ *Cohen v CIR* 13 SATC 362.

⁵² *CIR v Kuttel* 54 SATC 298.

*'...the country to which he would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and would be described more aptly than other countries as his real home.'*⁵³

12.2 Physical presence test

This test applies to an individual who is not considered ordinarily resident in South Africa. In terms of this test, an individual who is physically present in South Africa for a period(s) exceeding –

- 91 days in aggregate during the year of assessment under consideration;
- 91 days in aggregate during each of the five years preceding the year of assessment under consideration; and
- 915 days in aggregate during the above preceding five years of assessment,

will be regarded as resident in South Africa from the beginning of the sixth year of assessment.⁵⁴

However, any individual that is deemed to be exclusively a resident of another country with which South Africa has entered into a double tax agreement is excluded from the definition of resident.

13 A logical approach to the Eighth Schedule

It is suggested that the subtleties of the capital gains tax legislation contained in the Eighth Schedule is easier understood if a logical approach is adopted. The legislation could be broken down in a number of steps.

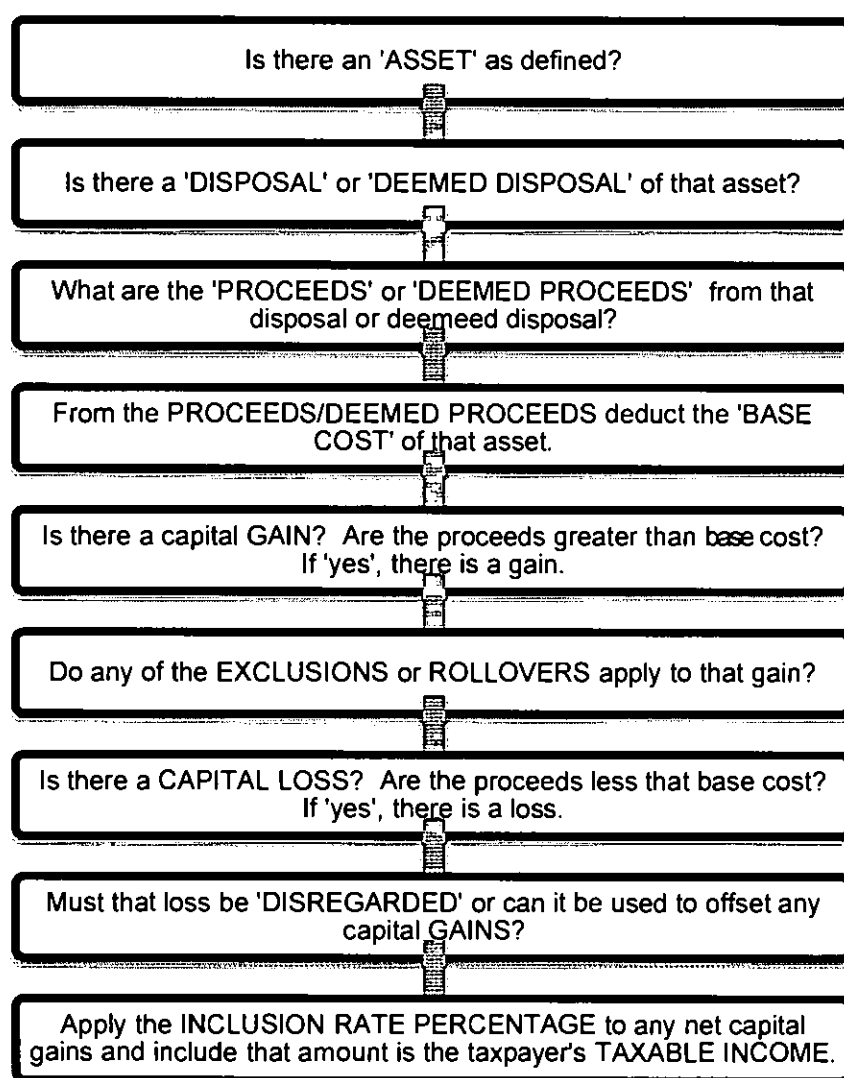
⁵³ *Cohen v CIR* (note 51) at 174.

⁵⁴ Note 50 *supra*.

The understanding of the approach to the Eighth Schedule is dependent on a number of important definitions and terms.

The steps outlined below will be used as a basis for the discussion regarding the capital gains tax implications of the conversion of shares in Chapter 5.

13.1 The logical steps in understanding the capital gains tax legislation



CHAPTER 4 - THE LEGAL NATURE OF SHARES AND THE RIGHTS ATTACHING TO VARIOUS CLASSES OF SHARES

A legal overview

In order to determine and understand the possible capital gains tax consequences on the conversion of shares from one class to another, it is necessary to understand the legal nature of a share.

14 Shares in general

A 'share' means a share in the share capital of a company. A share in a company is a proprietary interest in the company, not its assets.⁵⁵ A share is made up of various rights.⁵⁶ Shares are objects of property which are bought, sold, mortgaged, bequeathed, and even bequeathed by way of a usufruct.⁵⁷ It is incorporeal moveable property transferable in the manner provided for by the Companies Act⁵⁸ and the articles of the company.⁵⁹

Shares may be created with or without par value.⁶⁰ Capital consisting of par value shares may be converted into stated capital consisting of no-par value shares and *vice versa*.⁶¹

⁵⁵ JT Pretorius et al *Hahlo's South African Company Law through the cases: A source book* 6ed (1999) at 148.

⁵⁶ *Borland's Trustees v Steel Brothers & Co Ltd* [1901] 1 Ch 279 at 288.

⁵⁷ *Cooper v Boyes* NO 1994 (4) SA 521 (C) at 535.

⁵⁸ No 61 of 1973.

⁵⁹ Companies Act, s 91.

⁶⁰ Companies Act, s 74.

⁶¹ Companies Act, s 75(1)(f) and (g).

15 Nature of shares

The nature of shares have been discussed and considered in a number of cases by our courts.

In *Standard Bank of SA Ltd v Ocean Commodities Inc*⁶² Corbett JA held:

*'A share in a company consists of a bundle, or conglomerate, personal rights entitling the holder thereof to a certain interest in the company, its assets and dividends.'*⁶³

In the more recent case of *Cooper v Boyes NO*⁶⁴ the court held that it was clear that there was no simple definition of a share. The various definitions previously considered, simply emphasised a complex of characteristics which are peculiar to shares. The essence of it was that a share represents an interest in a company, which interest consists of various personal rights which may be as an incorporeal entity to be negotiated or otherwise disposed of.

These personal rights were succinctly described as

*'...those fixed in the company's articles of association and in the normal course of events afford the shareholder, qua shareholder, the right to dividends when declared, the return of capital on the winding-up of the company (or authorised reduction of capital); and the right to attend and vote at meetings of shareholders. These rights are limited save where statute decrees otherwise, for example as provided in section 228(a) and (b) of the Companies Act, or where the company acts ultra vires its articles.'*⁶⁵

In his capacity as a party to the legal relationship between the shareholder and the company, there accrues to the shareholder-

⁶² 1983 (1) SA 276 (A).

⁶³ *Standard Bank of SA Ltd v Ocean Commodities Inc* (note 62) at 288.

⁶⁴ *Cooper v Boyes NO* (note 57).

⁶⁵ *Letseng Diamonds Ltd v JCI Ltd; Trinity Management (Pty) Ltd v Investec Bank* 2007 (5) SA 564 (W) at para 17.

- a) *rights*, mainly the right to dividends when they have been declared and the right to participate in a distribution on liquidation; and
- b) *duties*, mainly to honour the provisions of the articles.

On the strength of membership of the company, certain powers and rights such as the right to vote at meetings and to receive notices, also originate.⁶⁶

As to the legal nature of shares, it was held in *Short v Treasury Commissioner*⁶⁷ that:

'Shareholders are not, in the eye of the law, part owners of the undertaking. The undertaking is something different from the totality of the shareholdings.'

It is clear that there is no simple definition of a share and the concept of a share serves different functions.

16 Classes of shares

Except where the constitution of a company otherwise provides, all shares of the same nominal value, rank equally.⁶⁸ The shares in a company may be divided into different classes, normally either by the memorandum or articles.⁶⁹ The division between different classes of shares is primarily based on the nature of the rights afforded by them in regards to dividends and participation in a distribution on liquidation.

⁶⁶ Companies Act, s 75(1)(i).

⁶⁷ [1948] 1 KB 116 (CA) at 122.

⁶⁸ *Campbell v Rolfe* [1933] AC 91 (HL) at 98.

⁶⁹ Companies Act, s 52.

In broad terms, the three main classes of shares may be described as:

- ordinary shares;
- preference shares; and
- deferred shares.

A company, if so authorised by its articles, may by special resolution, convert any of its shares, whether issued or not, into shares of another class.⁷⁰

The broad characteristics of the various classes of shares will be briefly discussed below.

16.1 Ordinary shares

If all a company's shares are issued without differentiation, they will be ordinary shares.⁷¹ A person holding ordinary shares in a company is regarded as a 'normal' shareholder. Such a shareholder is entitled to a dividend, if and when declared, to a share in 'surplus assets' (if any), when the company is wound up, and to attend and vote at general meetings of the company.⁷²

16.2 Deferred shares

Deferred shares (which may be deferred as regards dividends, capital or both) also called vendors', promoters' or 'management' shares, as the case may be, receive no dividends until the holders of preference shares have received their

⁷⁰ Section 75(1)(i).

⁷¹ PM Meskin *Henochoberg on the Companies Act* 5ed (1994) Available from: [http://zadtt200/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://zadtt200/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed on 22 August 2009].

⁷² HS Cilliers et al *Corporate Law* 2ed (1992) at 219.

preferential dividend and holders of ordinary shares have received a specified minimum dividend.⁷³

16.3 Preference shares

Preference shares will usually be entitled to have dividends paid, at a predetermined rate, in priority to any dividends on the ordinary shares. Similar to dividends generally,⁷⁴ a preference dividend may be paid out subject to solvency and liquidity criteria, and if such dividend has been declared in the manner provided by the articles.

The right to a preference dividend may be cumulative (in which case arrears of preference dividends not declared in an earlier period must be paid, as well as that for the current period, before any dividend is paid to the ordinary shareholders) or non-cumulative (when only the current period's preference dividend is payable). In doubt, preference shares are cumulative.⁷⁵

Since the Companies Act provides that a company may, if so authorised by its articles⁷⁶ by special resolution convert any of its shares into shares of a different class, a company may convert both its ordinary and preference shares into different classes of shares.⁷⁷

⁷³ Cilliers (note 72) at 226.

⁷⁴ Companies Act, s 90.

⁷⁵ The presumption that preference shares are cumulative was upheld in the unreported case *Du Plessis v Utopia Vakansie-Oorde Bpk* No 0537/73 TPD; no appeal was made against the finding of the court *a quo* on the question of cumulativeness.

⁷⁶ Companies Act, s 62.

⁷⁷ Companies Act, s 75(1)(i) read with s 99.

Convertible preference shares are preference shares which are issued under conditions which confer on the shareholder a right to convert, usually after a given date, all or part of those preference shares into other, generally ordinary, shares of the company. Usually the price at which preference shares can be converted into ordinary shares is fixed by the conditions of issue.⁷⁸

The nature of the rights of preference shares depends substantially on the construction of the terms of issue of the shares as contained in the memorandum or articles, as read with any relevant separate document, e.g. a resolution of members.

*'The rights inter se of preference and ordinary shareholders must depend on the terms of the instrument which contain the contract that they have made with the company and with each other.'*⁷⁹

17 Are the rights attached to a share separate from the share itself?

As stated above, the rights of shareholders of each class of share are, as a general rule, embodied in the memorandum and articles of association of a company.⁸⁰

The nature of a share in the context of the conversion of a share was considered in the Australian case of *Re Alex Russell, deceased*⁸¹ where the court considered the question whether the right to convert could be separated out from preference shares. On this point the court said:

⁷⁸ Cilliers (note 72) at 224.

⁷⁹ Per Galgut AJA in *Donaldson Investments (Pty) Ltd v Anglo-Transvaal Colliers Ltd* 1983 (3) SA 96 (AD) at 113.

⁸⁰ Companies Act, s 91.

⁸¹ [1968] VR 285.

'It follows that while it is correct to speak of the testator's preference shares as consisting of a bundle or congeries of rights, it is not correct to speak of a shareholder owning each of those rights as a separate piece of property, or as a separate chose in action... It is not permissible, therefore to separate out the various rights appertaining to the holder of preference shares and to treat some of those rights as "actual estate" and others as "notional estate".'

Consequently, while shares comprise of a bundle of rights, those rights are not separate from the shares, capable of being held separately.⁸² Thus, while it is possible to sell (cede) individual rights attaching to shares such as the right to receive a dividend, it does not alter the fact that a share comprises of a bundle of rights and that those rights are not held separately from the share.⁸³

The exact nature of the rights attaching to preference shares and more specifically convertible preference shares, have from a capital gains tax perspective, a profound impact on the treatment of such conversion for tax purposes. This will be discussed in detail in Chapter 5.

⁸² Pretorius (note 55) at 167.

⁸³ *Lawrie v Beaton* 1938 TPD 260.

CHAPTER 5 – CAPITAL GAINS TAX IMPLICATIONS OF THE CONVERSION OF SHARES

General

18 Introduction

The current economic downturn has had far-reaching consequences. The global recession has resulted in a decline in international trade, rising unemployment and falling demand for consumer goods.⁸⁴ Consumer spending has declined significantly as household income has decreased as a result of more stringent lending requirements by financial institutions, unemployment and rising commodity prices (specifically food and oil).⁸⁵

The decline in business turnover and profit margins resulting from the slowdown in the economy might also have other implications for companies. If those companies have preference shares as part of their capital structure, they might not be able to honour obligations in relation to those preference shares.⁸⁶

In the South African context, this phenomenon might be of specific significance in relation to BEE transactions.⁸⁷

⁸⁴ Lawrence Summers 'The big freeze' (5 June 2009) *The Financial Times*. Available at <http://www.ft.com/bigfreeze> [Accessed on 22 August 2009].

⁸⁵ Ben Steverman and David Bogoslaw 'The Financial Crisis Blame Game' (18 October 2008) *Business Week*. Available at

http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm [Accessed on 22 August 2009].

⁸⁶ Peter Dachs 'Conversion of shares – the tax implications' (2009) March *Taxpayer* 42.

⁸⁷ Ernest Mazansky 'Share Conversions – CGT Consequences' (2003) 17 *Tax Planning* 133.

The most significant obstacle in most BEE transactions is acquiring funding for the transactions.⁸⁸ The ability of the new owners to service the financing arrangements in these transactions depends principally on the profitability of the entities in which they are investors.⁸⁹

Financial institutions have in the past suffered significant losses through these types of transactions in instances where the companies invested in, failed after the conclusion of a BEE transaction. This has lead to financial institutions being cautious to fund these types of transactions.⁹⁰

To address this problem, different structures were developed which gave financial institutions (financing the majority of the transactions) an increased sense of security and to encourage the continuance of funding of these types of transactions.⁹¹ One of the most prevalent structures was to create a SPV (usually a private company) to facilitate the transaction. The BEE partner would take up shares in the SPV. A financial institution would then advance funds either to the SPV itself, or to the BEE partner. These funds would then be utilised by the SPV to acquire shares in the ultimate target company of the transaction. These shares were usually preference shares. The dividends paid

⁸⁸ Ernst & Young 'Mergers & Acquisitions: A Review of Activity for the Year 2004'. Available at <http://www.tradersafrica.com/articles.asp?articleid=%7B3DFC8CEE-02B2-4593-BBCF-5F75FAA0C9C2%7D>. [Accessed on 22 August 2009].

⁸⁹ PWC Reporter 'Economic crisis – BEE transactions under threat?' Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page259?oid=39668&sn=Detail> [Accessed on 22 August 2009].

⁹⁰ Vuyo Jack 'Human Resources face important BEE challenges' 5 July 2009 '*Business Report*'. Available at <http://www.busrep.co.za/index.php?fArticleId=5066484>. [Accessed on 23 August 2009].

⁹¹ Jack (note 90).

to the SPV would then be used to settle the liability arising from the funding advanced by the financial institution.

The preference shares are often compulsorily convertible into ordinary shares subject to certain criteria being met.⁹²

The economic downturn has lead to many of the target companies in BEE transactions experiencing a decline in earnings.⁹³ This has lead to certain of these companies not being able to honour their obligations undertaken in relation to the preference shares issued by them, and thereby threatening the BEE transaction as a whole as the SPV is unable to honour its obligations in relation to the repayment of the loan used to acquire the shares initially. In order to ease the pressure on such companies, consideration is now given to converting those preference shares held to ordinary shares, thereby removing the entitlement to preference dividends.⁹⁴ In addition, terms of repayment of the initial loans are renegotiated with financial institutions.

With the most of these types of transactions having a high monetary value,⁹⁵ the potential tax consequences for taxpayers may be significant.

⁹² Mazansky (note 87) at 134.

⁹³ Khehla Shubane and Colin Reddy 'BEE deals 2007: Empowerment and its critics' Available at http://transformationaudit.org.za/research-database/civil-society/advocay-organisations/bee_2007_final.pdf/preview_popup/file [Accessed on 23 August 2009].

⁹⁴ Jack (note 90) *supra*.

⁹⁵ Mike Holden 'BEE levels the employment playing field' (29 August 2008) *Mining Weekly* Available at <http://www.miningweekly.com/print-version/bee-levels-the-employment-playing-field-2008-08-29> [Accessed on 23 August 2009]. The average value for BEE transactions in the resources sector in 2007 was approximately R832-million. 153 transactions were concluded in the mining industry, valued at R96-billion, in 2007.

The capital gains tax consequences of the conversion of shares will be considered by way of a case study.

19 A case study: the facts

As part of a BEE transaction, an interest was acquired in a target company ('TargetCo') by SPV (Pty) Ltd (the SPV). The issued ordinary shares in SPV were held by NewCo (Pty) Ltd ('NewCo'). The shares in NewCo are held by previously disadvantaged individuals.

The interest in TargetCo was acquired by the SPV by subscribing for convertible preference shares. The acquisition of the convertible preference shares were financed through a loan advanced by a commercial bank.

The preference shares are convertible during a specified period into ordinary shares on a one for one basis.

The rights attaching to the preference shares include the following:

- The preference shares will carry voting rights *pari passu* with the ordinary TargetCo shares;
- Dividends will be paid semi-annually in arrears on certain dates; and
- Any special capital reductions authorised by TargetCo on the ordinary shares will result in a corresponding reduction of the preference capital.

All the parties are South African tax residents.

19.1 Description of the transaction

The SPV now intends converting all the convertible preference shares into ordinary shares, as the period within which the preference shares may be converted has commenced.

The capital gains tax consequences of this transaction will be evaluated below.

20 Triggering of a capital gains tax liability

For the Eighth Schedule to find application, and thus a liability for capital gains tax to be triggered in relation to a resident, various requirements need to be satisfied. If any requirement is not met, no liability for capital gains tax arises.

The requirements will be discussed below.

21 Is there a disposal or a deemed disposal of an asset?

The term 'disposal' is a defined term in the Eighth Schedule. The definition contained in paragraph 11(1) insofar as it is relevant to the discussion, reads as follows:

'Disposal – (1)...any event, act, forbearance⁹⁶ or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes-

the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;'

⁹⁶ According to the *Shorter Oxford English Dictionary* 3ed (1999) 'forbearance' means 'abstinence from enforcing what is due, especially the payment of a debt'.

It is clear that virtually any conceivable transaction in terms of which an asset or an interest is transferred or abandoned, will result in a 'disposal' as defined for capital gains tax purposes. A 'disposal' includes both 'voluntary' acts (sale or donation) as well as involuntary acts (expropriation or loss).⁹⁷

As has been noted above⁹⁸, the event that triggers a 'capital gain' or 'capital loss' is the 'disposal' of an asset during the year of assessment. The 'proceeds' of such a disposal and the 'base cost' of the asset disposed are the two elements in the quantification of the capital gain or loss *vis-à-vis* the disposal of that asset.⁹⁹

The coupling of the concepts of 'asset' and 'disposal' is important in the interpretation of para 11(1).

The scope of the term 'disposal' as defined in paragraph 11(1) is narrowed by subparagraph (2) which provides that certain events – which may otherwise have fallen within subparagraph (1) – do not constitute a 'disposal'. Conversely, the scope of 'disposal' is significantly expanded by paragraphs 12(1) and (2) which provides for certain events – which do not fall within paragraph 11(1) – to be treated as disposals nonetheless.

⁹⁷ WD Geach *Capital Gains Tax in South Africa The Essential Guide* 1ed (2001) at 31.

⁹⁸ Paragraph 20 *supra*.

⁹⁹ Geach (note 97) at 32.

The preamble to paragraph 11, and in particular the use of the word 'includes' impacts on the interpretation of the term 'disposal'.¹⁰⁰ This aspect will be considered prior to the discussion of the application of paragraph 11 of the Eighth Schedule.

21.1 The meaning of the word 'includes'

Generally, where the word 'includes' is used, this would indicate an extension of the words that precede it.¹⁰¹

This is however not always the case. In *R v Debele*¹⁰² the court held that the legislature may have three alternative intentions when using the word 'including':

- As a general rule 'including' is not a term of exhaustive definition, but rather a term of extension.
- Secondly, it may be used in an exhaustive sense to enumerate the various items or actions intended to be understood as part of the term being defined.
- The third alternative contemplates a situation where a number of items that are not accurately described by a particular word or phrase, are grouped together under a single term that more or less applies to all the items which follow the word 'includes'. In this instance the list of items also represent an exhaustive list.

¹⁰⁰ Dachs (note 86) at 43.

¹⁰¹ Williams (note 34) at 177.

¹⁰² 1956 (4) SA 570 (A). This case dealt with the interpretation of the word 'including' in the context of the Criminal Procedure Act, No. 56 of 1955.

As regards the definition of 'disposal' in the Eighth Schedule, it seems clear that the events described in subparagraphs (a) to (g) of paragraph 11, were intended to exhaustively define what is meant by 'disposal'. This conclusion is reached on the basis that the various subparagraphs include events such as 'sale, donation, expropriation..., grant, cession, exchange or any other alienation or transfer of ownership of an asset', which clearly would be a disposal both as commonly understood as well as is defined in the introductory words to the definition of 'disposal'.¹⁰³ Therefore, the only reasonable conclusion one can reach is that subparagraphs (a) to (g) are intended to exhaustively define what is meant by a 'disposal'.¹⁰⁴

The first subparagraph of the definition of disposal that could be of relevance with regards to the case study is (a) which defines a disposal as including the 'sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset...'.

Of the events included in subparagraph (a) the only event that could be relevant for purposes of the case study is a 'conversion' as the preference shares are to be converted into ordinary shares. The question therefore arises as to what is meant by 'conversion' in the context of subparagraph (a).

¹⁰³ Mazansky (note 87) at 134.

¹⁰⁴ Williams (note 34) at 183.

21.2 'Disposal' in the context of the conversion of shares

As stated above, the term 'disposal' is widely defined.¹⁰⁵ It is clear that the conversion of an asset is deemed a disposal. And a disposal is a critical element in determining a capital gain, as has been discussed previously.¹⁰⁶ In fact, it is the trigger to the determination of capital gains tax.

In the SARS's Comprehensive Guide to Capital Gains Tax¹⁰⁷ it is stated that a 'conversion' involves a substantive change in the rights attaching to an asset.

The first question is whether it is every conversion that triggers a disposal for capital gains tax purposes. There must surely be certain conversions that could not give rise to a disposal.

For example, where a person has a fixed property which he decides to subdivide, there is patently a conversion of the property. However, it is clearly wrong to regard this as a disposal where the taxpayer has merely converted the original property into a number of smaller properties. The subdivision may well increase the value of the subdivided property as a result of the property being more marketable. However, it is absurd to regard the subdivision of the property as a disposal merely because the definition includes the word 'conversion', where that conversion does not result in the disposal of a portion

¹⁰⁵ Paragraph 21 *supra*.

¹⁰⁶ Paragraph 20 *supra*.

¹⁰⁷ The Guide was published in final form in December 2007.

or the entire asset. The taxpayer has not given up anything, nor has he received anything more than what he had prior to the subdivision (conversion).

It would seem from the construction of paragraph 11(1), that the conversion contemplated must result in the transfer of ownership of an asset.¹⁰⁸

This seems clear as paragraph 11(1)(a) refers to:

'the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset'. (Emphasis added.)

The use of the expression 'or any other alienation or transfer of ownership of an asset' seems to indicate that the conversion must also give rise to an alienation or transfer of ownership. And this is borne out by the other words in the provision. As discussed above,¹⁰⁹ these transactions would, in the normal course standing on their own, result in an alienation or transfer of ownership that would be expected from a sale, donation, expropriation, grant, cession or exchange.

This argument is further strengthened by the rule of interpretation known as the *ejusdem generis* rule. The application of this rule will be discussed below.

21.2.1 'Conversion' in relation to the other terms in paragraph 11(1)(a)

The rule of construction known as the *ejusdem generis* rule is sometimes expressed by the maxim *noscitur a sociis*, that is, the meaning of a word may

¹⁰⁸ Mazansky (note 87) at 133.

¹⁰⁹ Paragraph 21.1 *supra*.

be ascertained by reference to those associated with it. In other words, where two or more words which are susceptible of analogous meaning are coupled *noscitur a sociis*, they are understood to be used in their cognate sense. They take, as it were, their colour from each other, that is, the more general is restricted to a sense analogous to the less general.¹¹⁰

In *CIR v Lunnnon*¹¹¹ it was stated that *noscitur a sociis* is a maxim the operation of which is perhaps not now so wide as it used to be, but it is an important maxim and is of some assistance in a case like the present. In this case the question before the court was whether a voluntary amount received as a gratuity on termination of services constituted a benefit granted in respect of employment. Innes CJ referred to the Commissioner's main argument that the transaction was covered by the words 'any other benefit or advantage of any kind granted in respect of employment' contained in section 6 of the Income Tax Act No. 41 of 1917 as follows:¹¹²

'This general expression related to the particular words 'salaries, stipends, wages, allowances'. These were all granted 'in respect of employment' in the sense that they were paid in return for the employment. The immediately preceding words 'estimated annual value of any quarters or board or residence' undoubtedly referred to cases where such privileges formed part of the consideration paid for employment, and adopting the maxim noscitur a sociis, the 'other benefits or advantages of any kind' must be confined to such as the employee was entitled to demand. They could not include a gift which the employer was under no obligation to bestow.'

¹¹⁰ P St J Langan *Maxwell on Interpretation of Statutes* 12ed (1989) 289.

¹¹¹ 1924 AD 94.

¹¹² Note 111 *supra* at 99.

In *Ovenstone v Secretary for Inland Revenue*¹¹³ the court had to consider the phrase 'any donation, settlement or other disposition' and interpret the meaning of 'other disposition' within this phrase. By applying the principle of *noscitur a sociis* it was held that the words 'other disposition', despite their very broad meaning in everyday language, should be restricted to disposals of a gratuitous nature similar to a donation or settlement.

In applying this rule to paragraph 11(1)(a) it is submitted that the meaning of 'conversion' must be considered in relation to the other transactions listed in the subparagraph and as such any conversion should result in the alienation or transfer of ownership of an asset. To give effect to the words 'any other', the listed transactions, including 'conversion', have to result in an alienation or transfer of ownership.¹¹⁴

So why not also for a conversion? The answer can be found in the definition of 'asset' in the Eighth Schedule.

21.3 The definition of an asset for purposes of the Eighth Schedule

An 'asset' is defined in paragraph 1 of the Eighth Schedule as:

- (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;¹¹⁵ and*
- (b) *a right or interest of whatever nature to or in such property;*

¹¹³ 1980 (2) SA 721 (A).

¹¹⁴ Williams (note 101) *supra* 179.

¹¹⁵ Coins made mainly from gold or platinum fall within the definition of 'foreign equity instrument' in s 1 of the Act, and are taxed on disposal in terms of para 43(4) of the Eighth Schedule.

Currency is excluded from the definition of 'asset'.¹¹⁶ This means, for example, that if an asset is donated there is capital gains tax for the donor, but if cash is donated there is no capital gains tax, as cash does not constitute an asset.

Both subparagraphs of the definition of 'asset' quoted above, need to be analysed in order to fully understand the meaning of the term in the context of the Eighth Schedule.

The common denominator between the two subparagraphs is that of 'property', and this concept has previously been discussed by our courts.

In *Stander v Commissioner for Inland Revenue*¹¹⁷ Friedman JP in discussing the meaning of 'property' referred to *Commissioner for Inland Revenue v Estate Crewe and Another*¹¹⁸ where Watermeyer CJ held:

'One would expect that when the estate of a person is described as consisting of property, what is meant by property is all rights vested in him which have a pecuniary or economic value. Such rights can conveniently be referred to as proprietary rights and they include jura in rem, real rights, such as rights of ownership in both immovable and movable property, and also jura in personam such as debts and rights of action.'

21.4 What is an asset in this sphere?

The argument advanced is that an asset is not merely the asset itself, but any right or interest in the asset. This accord with the so-called 'bundle or rights'

¹¹⁶ Eighth Schedule, para 1.

¹¹⁷ 1997 (3) SA 617 (C).

¹¹⁸ 1943 AD 656 at 667.

theory holding that an asset is not a single monolithic entity, but is a bundle of different rights that can be dealt with separately.

If this theory is applied to a share which has been described as a bundle of rights,¹¹⁹ it is in principle possible to see that certain of the rights attaching to a share could be sold separately from other rights. A typical example would be the right to a dividend.

Consequently, when for example a cumulative redeemable preference share, that is preferent as to dividend and capital, but carrying a voting right only if a dividend is in arrears, is converted to an ordinary share, it could be seen that certain rights are disposed of:

- the right to a cumulative preferent dividend;
- the right to a preferent participation in capital; and
- the right to be redeemed.¹²⁰

That would thus most certainly be a disposal triggering capital gains tax. An alternative argument may however be advanced.

21.5 Alternative argument regarding the definition of 'asset'

The alternative argument turns on the definition of 'asset' and its application in the sphere of the conversion of shares.¹²¹

¹¹⁹ Paragraph 15 *supra*.

¹²⁰ Mazansky (note 87) at 134.

¹²¹ Mazansky (note 87) at 133.

If one considers the definition of 'asset', two distinct scenarios emerge.

21.5.1 Subparagraph (a)

The situation contemplated under subparagraph (a) refers to a situation where a person holds the 'whole' of the property – being the full ownership (dominium) of property, including all the rights attaching to that property. Thus, it refers to something more than merely a right to the property – it refers to ownership of the property itself.

21.5.2 Subparagraph (b)

On the other hand, subparagraph (b) would only find application where a person has a right or an interest to, or in property. That person does not have full ownership (dominium) of the property himself as understood under subparagraph (a).

It is submitted that once it has been established that subparagraph (a) finds application, it is not necessary to consider subparagraph (b) further, as the right or interest in, or to property that is referred to in subparagraph (b) would be encompassed by what is referred to in subparagraph (a), being the full ownership of the property.

Not following this approach would lead to absurdities, as it would conceivably lead to situations where a taxpayer might have multiple assets in respect of what is legally just one asset. This might lead to situations where

provisions of the capital gains tax legislation such as kink-tests¹²² or time-apportionment base cost calculations¹²³ would be applied to various sub-elements of an asset. This would lead to absurd results and is questionable whether this could have been what was intended by the legislature.

21.5.3 Application of the subparagraphs of the definition of 'asset'

The difference between the applications of the respective subparagraphs could be illustrated through an example.

Where a person has ownership of an asset (property) including all the rights and interests attaching to that asset, subparagraph (a) would find application - for instance, where a person owns a fixed property (it is registered in his name) including all the rights underlying that property, such as *inter alia* the right of use and the right to the fruits of the property. It would also be applicable where a person holds a share with all the underlying rights such as the right to dividends, the right to capital and a voting right.

Subparagraph (b) would find application in situations where a person does not have 'full ownership' of the property, but merely a right or an interest to, or in the property - for instance, where a person has a servitude over a property, he has a right or an interest to, or in the property without having ownership of the actual property. Similarly, in instances where a person has

¹²² The so-called 'kink-test' in para 26 of the Eighth Schedule is aimed at ensuring that a capital loss cannot be created using a valuation date market value which is larger than proceeds. The market value is in effect limited to the proceeds, resulting in neither a capital gain nor a capital loss.

¹²³ In terms of the time apportionment base cost method, a value of an asset as at 1 October 2001 is calculated. By adding the subsequent costs as permitted by para 20 of the Eighth Schedule, the base cost is determined.

the right to receive a dividend, he has a right or an interest to, or in the property (the share) but not ownership of the share.

21.5.4 Application to the case study

In the case study under consideration, based on the alternative argument,¹²⁴ the SPV has ownership of the shares – it is the registered shareholder of the convertible preference shares. Incidental to the actual ownership of the shares, it also has various other underlying rights such as the right to preference dividends, the right to capital, a voting right, and a right to convert the preference shares into ordinary shares.

The SPV has 'full ownership' of the shares, and not merely a right or an interest to, or in the shares. Thus, it is submitted that the correct interpretation of the definition of 'asset' applicable to this situation is that only subparagraph (a) needs to be considered.

With the conversion of the convertible preference shares, the SPV is not disposing of the asset – shares – as understood in subparagraph (a). Prior to the conversion, SPV has shares with certain incidental rights to the ownership thereof, and after the conversion it still has shares with certain incidental rights. No asset as understood in terms of subparagraph (b) is disposed of if the right to convert is exercised, as the subparagraph does not find application in this situation – SPV did not merely have a right or interest to, or in the shares but the full ownership of the shares. As a result SPV has

¹²⁴ Paragraph 21.5 *supra*.

the same asset prior to, and after the conversion – it is one and the same asset – and consequently there could be no disposal of the asset held by the SPV.

However, based on the argument that an asset consists of a number of rights and that on conversion a shareholder gives up certain of those rights,¹²⁵ the various rights disposed of would trigger capital gains tax.

It is submitted that the correct approach would be to apply the alternative argument, as this has a stronger base in the Act.

This should signal the end of the enquiry regarding the capital gains tax consequences on the conversion of shares.

However, even if this is not accepted and it is held that there is a disposal on the conversion of the shares, it still has to be determined whether there are any proceeds or deemed proceeds from the disposal.

22 What are the proceeds or deemed proceeds from the disposal or deemed disposal?

In terms of paragraph 3 of the Eighth Schedule, a capital gain is defined as:

*'equal to the amount by which the **proceeds** received or accrued in respect of that disposal exceed the base cost of the asset.'* [Emphasis added.]

¹²⁵ Paragraph 21.4 *supra*.

It is therefore necessary to determine the proceeds received from the disposal. Paragraph 35 of the Eighth Schedule provides that:

'the proceeds from the disposal of an asset by a person are equal to the amount received by or accrued to ... that person in respect of that disposal.'

The key elements are that an amount must be received by, or accrued to, a person for the disposal of the asset. These terms are familiar as they are also found in the definition of 'gross income'.¹²⁶ Established principles with regards to the interpretation of the terms 'amount', 'received' and 'accrued' should apply.¹²⁷

22.1 Meaning of the terms 'amount', 'received' and 'accrued'

The terms 'amount', 'received' and 'accrued' is not defined in the Act. For this reason, the courts have been called upon, on numerous occasions, to interpret their meaning.

In *CIR v People Stores (Walvis Bay) (Pty) Ltd*,¹²⁸ Hefer J accepted the following statement made by Watermeyer J in *Lategan v CIR*:¹²⁹

'In my opinion, the word "amount" must be given a wider meaning and must include not only money, but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value...'

In *CIR v Delfos*¹³⁰ the court held that the taxpayer should be assessed on all amounts having a monetary value. It went further, determining that if a

¹²⁶ Note 31 *supra*.

¹²⁷ Mazansky (note 87) at 134.

¹²⁸ 1990 (2) SA 353 (A).

¹²⁹ 2 SATC 16.

receipt or accrual is something which is not in money's worth or cannot be turned into money, it should not be regarded as income.

As stated above, the term 'property' includes any asset. Therefore, if the taxpayer receives something which is an asset, and this asset has a value, then there is an amount for purposes of the gross income definition. Similarly, if a taxpayer receives an asset which has a value, there would be an amount for purposes of paragraph 35 of the Eighth Schedule.

In *CIR v Butcher Bros (Pty) Ltd*¹³¹ support is found for the statement that the onus rests on the Commissioner to show that some 'amount' has been received or accrued, and if he is able to do so, that amount should be assessed.

In *Lace Propriety Mines Ltd v CIR*¹³² it was held that the value to be placed upon a non-cash receipt or accrual is the amount that could be obtained for it on the open market if sold under a reasonable method of sale.

In the recent judgment in *C: SARS v Brummeria Renaissance (Pty) Ltd & others*¹³³ the court held that whether a receipt or accrual in a form other than money has a money value is the primary question. Whether this receipt or accrual could be turned into money is only one way to determine whether it has a money value. The test was held to be objective rather than subjective.

¹³⁰ 1933 AD 242.

¹³¹ 1945 AD 301.

¹³² 1938 AD 267.

¹³³ 2007 (6) SA 601 (SCA).

Accordingly it follows that the Commissioner must value the amount and that this value must be the open market value of the award and any receipt or accrual that has a money value will be taxed.¹³⁴

The application of the terms discussed above, will be considered with regards to the conversion of shares.

22.2 What is received?

The question that arises is what is received in return for the conversion – the giving up of the preferent rights referred to in 21.4 above?

On a conversion it would appear that, having given up those rights, the shareholder acquires other rights, for example:

- the right to participate to an unlimited extent in profits;
- the right to participate to an unlimited extent in the capital; and
- the right to vote at all times and not only when the dividend is in arrears.¹³⁵

Thus, the shareholder, on conversion, is certainly given up some rights (that is some assets based on the alternative advanced above¹³⁶) and receiving other rights (that is assets) in return.

¹³⁴ Williams (note 34) at 212.

¹³⁵ Mazansky (note 87) at 134.

¹³⁶ Paragraph 21.5 *supra*.

But for there to be proceeds, those rights received in return constitute an 'amount'. As discussed above,¹³⁷ the term has been interpreted by South African courts to mean the value of every form of property, whether corporeal or incorporeal, having a money value. And if an amount is not capable of being turned into money, it cannot be considered to be an amount for the purposes of the definition of 'gross income'¹³⁸, and therefore also for the purposes of paragraph 35 of the Eighth Schedule.

In principle, therefore, it would be possible for these new rights to be received to constitute an 'amount'. Yet it would seem that in all, except for the most unusual situations, this conclusion is notional, but is it also highly impractical.¹³⁹

Remembering that for there to be an 'amount' the property has to have a money value and be capable of being turned into money. While it is notionally possible that

- a future right to dividends;
- the right to vote; and
- the future participation in capital

can be sold, other rights are unlikely to have a market. Notionally there might be a market for these rights, but from a practical point of view, this is highly unlikely, especially in the case of a private company.¹⁴⁰

¹³⁷ Paragraph 22.1 *supra*.

¹³⁸ Note 31 *supra*.

¹³⁹ Mazansky (note 87) at 134.

¹⁴⁰ Mazansky (note 87) at 135.

It follows that, except in a most unusual situation, that it would not be possible to turn those rights into money. And even if this submission is incorrect, it is still necessary to value that amount to determine the proceeds. And it would be most surprising if, on an objective basis, any possible value, especially for a private company, would be anything but nominal.

When the preference shares are electively convertible into ordinary shares subject to certain criteria being met,¹⁴¹ it would seem that a different conclusion may be reached. To clarify the distinction, a shareholder might have convertible redeemable preference shares, and at a point in time, he or the company has the option to require it

- to redeem the shares;
- to convert the shares into ordinary shares; or
- to simply continue to retain them in issue.

A conversion of this nature would thus require the independent action of the shareholder or the company, that is, the exercising of the option, so as to trigger the conversion.

But where the shares are compulsorily convertible, an independent objective trigger would be found, resulting in the automatic conversion from preference shares into ordinary shares without intervention. For example, the shares might convert after

¹⁴¹ This is a fairly common feature in BEE transactions.

- a certain period;
- the company has paid a certain amount of dividends;
- it has achieved a certain level of profits; or
- it has achieved a predetermined minimum growth rate.¹⁴²

It is submitted that a conversion of this nature cannot trigger capital gains tax even if the rights acquired, can otherwise on conversion, be construed as an 'amount'. The reason for this submission is that on conversion, the shareholder is not obtaining any new rights. Because conversion is automatic on the achievement of the relevant benchmark, those rights already existed in the preference shares when they were first issued. In other words, no new rights are being acquired on its conversion. All that is happening is that its existing rights, that hitherto lay dormant, have now come to reality. Those rights were inherent in the instrument and were part of what was acquired. In most instances they would be acquired with the expectation that those rights would indeed come into reality. They have not actually been acquired, that is, received or accrued.¹⁴³

23 Conclusion

It is submitted that on the conversion of shares from one class to another, no capital gains tax liability arise, as there is not disposal or proceeds.

¹⁴² Pretorius (note 55) at 167.

¹⁴³ Mazansky (note 87) at 135.

CHAPTER 6 – CONCLUSION

Based on the arguments above, it is submitted that, based on the premise that an asset comprises of a number of rights, a conversion of preference shares into ordinary shares results in the disposal of certain of the rights attaching to the preference shares (certain rights are given up), even though the conversion does not result in the alienation or transfer of ownership of that asset. Thus, there would be a disposal for purpose of determining whether any capital gains tax liability arises from the conversion.

However, there is an alternative argument that, based on the definition of 'asset', the conversion of preference shares into ordinary shares, there is no disposal as a shareholder holds the same asset after the conversion as was held prior to the conversion as would only consider subparagraph (a) of the definition of 'asset' in these circumstances.

If one accepts that there is a disposal for capital gains tax purposes, it has to be determined whether any proceeds have been received by or accrued from the disposal of the asset. It might be argued that there are no proceeds since the shareholder does not receive anything upon conversion of the shares held, and there is furthermore no disposal to a third party. The counter argument is that the receipt of the new class of shares or rights attaching to such shares constitutes proceeds despite the fact that no new shares are actually acquired.

If one accepts that the shareholder acquires new rights on conversion of the preference shares into ordinary shares that could constitute an 'amount'. However, because those rights cannot be turned into money – other than in a purely notional sense – they are not for the purposes of paragraph 35 of the Eighth Schedule, an 'amount', and hence there are no proceeds.

In the unlikely event that there is an amount, in many, if not most situations the value of this 'amount' is likely to be so small as to be insignificant.

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